MINUTES
of the
FIFTH MEETING
of the
INVESTMENTS OVERSIGHT COMMITTEE

November 30, 2009
State Capitol
Santa Fe

The fifth meeting of the Investments Oversight Committee for the 2009 interim was called to order by Representative John A. Heaton, chair, on Monday, November 30, 2009, at 9:10 a.m. at the State Capitol in Santa Fe.

Present
Rep. John A. Heaton, Chair
Rep. Donald E. Bratton
Sen. Timothy M. Keller
Rep. Larry A. Larrañaga
Sen. Carroll H. Leavell
Sen. Steven P. Neville
Sen. Henry Kiki Saavedra
Sen. John M. Sapien
Rep. Jim R. Trujillo
Rep. Luciano "Lucky" Varela

Absent
Sen. John Arthur Smith, Vice Chair
Sen. Tim Eichenberg

Advisory Members
Sen. Carlos R. Cisneros
Rep. Miguel P. Garcia
Sen. Mary Kay Papen
Sen. William H. Payne
Rep. Sheryl Williams Stapleton
Rep. Shirley A. Tyler

Rep. Andrew J. Barreras
Rep. Roberto "Bobby" J. Gonzales
Sen. Stuart Ingle
Rep. Patricia A. Lundstrom
Rep. Jane E. Powdrell-Culbert
Sen. John C. Ryan
Sen. Michael S. Sanchez
Rep. Richard D. Vigil
Sen. Peter Wirth

Other Legislator Present
Sen. Sue Wilson Beffort

Staff
Tom Pollard, Legislative Council Service (LCS)
Doris Faust, LCS
Claudia Armijo, LCS

Guests

The guest list is located in the meeting file.

Monday. November 30

Updates on Recent Investment Performance of the State Investment Council (SIC), Public Employees Retirement Association (PERA) and Educational Retirement Board (ERB)

Bob Jacksha, interim state investment officer, SIC, provided an overview of the SIC's 2009 third-quarter investment performance report, noting that, with the exception of real estate, every other asset category's performance was improved from the previous quarter. He said that the fact that real estate values are reported according to appraised property values explains the struggles in real estate assets.

Mr. Jacksha told the members that market values show the effect of unrealized losses, and they improved from $75 million from the last reporting. He added that over the last 12 months, combined funds dropped about $1.1 billion.

When asked to remind committee members of the peak values for the funds, Mr. Jacksha said he would have to look into that. He then told the members that, in his opinion, the report that the members are reviewing is confusing, and his office is contemplating an improved format for future reports. He stated that the report shows where the land grant permanent funds and Severance Tax Permanent Fund rank compared to other like funds. He noted that the land grant permanent funds' performance for various periods is "pretty good", and in any market where there are double-digit returns, it can be expected that the performance of the Severance Tax Permanent Fund will lag behind that of the land grant permanent funds.

Mr. Jacksha told the members that the SIC has work to do regarding the funds' percentile rankings. He also noted that the SIC is working on getting the reports up to date more quickly for reporting purposes.

There was a broad discussion about Dubai and its international investments. The discussion turned to the fact that world markets have become much more interrelated. It was noted that, in general, a typical pension fund now has about 15 percent in international investments.

Members asked Mr. Jacksha for insight into his "game plan" in his new role as interim state investment officer. He responded that the SIC is looking at asset allocation and determining if it needs to shift some assets. He further stated that the SIC needs to review the performance of the various fund managers. He noted that the most important thing in the long term is to meet the SIC's goal of an 8.5 percent return.

There began a discussion regarding performance-based fees and whether they are built into the management fees. Mr. Jacksha mentioned that there is a cost associated with changing managers, so the decision to make such a change is not one to take lightly. He added that some asset classes have performance-based fees built in, and others do not. According to Mr. Jacksha, hedge funds, private real estate and fixed-income funds are handled in-house, so there are no fees associated with these funds. Mr. Jacksha stated that his philosophy is that New Mexico needs the best managers possible. Consequently, the SIC will look at performance versus flat-fee and will determine what is in the best interest of the state.

Members asked Mr. Jacksha if he has made any major changes at the SIC since he took over his new position. He replied that since he started on October 27, 2009, he has implemented reviews that he expects will result in some changes and also implemented a fund manager review. Neither are completed yet. To clarify, he said that the review of managers will be in public securities and hedge funds. Mr. Jacksha mentioned that the SIC is spending a great deal of time on legal matters, and those matters are consuming a lot of resources.

There was a discussion about the SIC's investments in equities. Mr. Jacksha noted that the SIC may have too much money in equities. He said that the funds lost money in the major downturn, and he thinks that the SIC should look at other allocations with a reduced equity exposure. He noted that 80 percent to 85 percent of the SIC's risk is in equities.

Representative Heaton told Mr. Jacksha that the committee needs information about how the New Mexico private equities programs are performing. Mr. Jacksha responded that he will compile and share information on that subject with the members.

Julian Baca, deputy director, PERA, addressed the committee regarding the PERA's investment performance. He told the members that the fund rose 18 percent in a six-month period. Mr. Baca advised the members that the PERA's cash position was a bit high, but compared to its peers, 80 percent have higher cash allocations. He said the PERA's fees for 2009 were $13.8 million (15 basis points).

There was a general discussion about the state's obligation relating to the PERA Fund and the Educational Retirement Fund plans and members. Jan Goodwin, executive director, ERB, added that neither of the two retirement boards can act independently to change member benefits or contribution rates. Such acts would require statutory changes. Some committee members expressed concern about the state's ability to maintain the retirement funds due to the number of public employees and effect of the three percent multiplier on employees' retirement pensions.

Terry Slattery, executive director, PERA, told the members that the SIC has national and local ads out for the position of chief investment officer (CIO) and that, so far, the SIC has received 30 replies. He added that the reply date has been extended to early January due to the holidays. He said that the board chair and the investment committee chair will conduct the interviews, with hopes of a decision by March 2010.

Ms. Goodwin reported to the committee regarding the ERB's fund performance. She indicated that overall, the portfolio has been doing very well, and most of the managers have been performing well. There is one equity manager not doing well; that manager will be at the next meeting to discuss the poor performance with the board. Ms. Goodwin advised the members that Page 10 of the ERB report highlights its performance attribution.

Members inquired about the ERB's personnel, and Ms. Goodwin responded that the ERB was hiring an interim CIO in the hopes that Mr. Jacksha will return in the future. She added that she does not anticipate any major changes from the ERB's plan currently in place.

There was an extensive discussion regarding the ERB's issuance of a request for proposals (RFP) for a search firm to conduct an employment search to fill the interim CIO position. Some members questioned the decision to use an outside firm rather than having the ERB conduct the search, especially because the position is for an approximate nine-month period. It was noted that the committee would like the board to reevaluate the decision to hire the search firm.

The final discussion concerned the amount of distributions from the Educational Retirement Fund and the amount in the fund corpus. Ms. Goodwin told committee members that the Educational Retirement Fund is a mature pension fund with distributions greater than contributions. The fund distributes about $600 million gross annually and has less coming into the fund in the same period. She noted that the ERB first looks to investment earnings to make up the difference, and then if those earnings are not sufficient, the ERB taps into the fund corpus.

Dan White, financial economist, Legislative Finance Committee, presented a memorandum to the committee regarding the FY 2010 first-quarter report on investment performance. Mr. White advised the committee that the SIC is low on contract funds, so there may be cause for concern regarding the hiring of an outside search firm.

Mr. White reported on the status of the contract for the performance review. He told the members that the results of the review will not be available until early January. He noted that most of the delay was due to the immense number of documents reviewed and produced as a result of the federal subpoenas that have taken priority over the review.

Mr. White's memorandum included highlights pointing out that all state investment agencies produced positive returns during the first quarter of FY 2010. However, the Educational Retirement Fund was the only fund that outperformed quarterly, annual and five-year benchmarks. Also, the SIC- managed land grant and severance tax permanent funds continued to underperform in the first quarter of FY 2010, missing quarterly benchmarks by 170 and 180 basis points, respectively. It was noted that peer rankings, while improved for the ERB, remain extremely low for the SIC and the PERA, particularly in the one-year and five-year time periods.

Overview of Current Statutes Governing the Attorney General's Role in Investigation or Prosecution of Cases Related to State Investments and Discussion of Potential Alternatives for Additional Legislation

Al Lama, chief deputy attorney general, introduced Mary Helen Baker, director of special prosecutions, and Assistant Attorney General Patrick McNertney.

Mr. Lama noted the issues relating to the statute effective in January 2010, and he spoke regarding the State of New York's Martin Act. Mr. Lama discussed the act and how the New York attorney general has aggressively used its provisions. He said that the act also relates to actions being looked at in New Mexico. He mentioned that the Martin Act was enacted in the early 1920s and is a broad statute authorizing the attorney general with law enforcement powers. Mr. Lama noted that the definition of "security" in both New Mexico and New York is broad.

Mr. Lama next advised the members that, pursuant to the New Mexico Uniform Securities Act, there are a number of Martin Act components in the new statute effective in January 2010, with the major difference being that in the New Mexico securities statute, the authority is vested in the director of the Securities Division of the Regulation and Licensing Department (RLD), and the director can employ peace officers.

The New Mexico Uniform Securities Act has been expanded to include criminal prosecutions and requires the attorney general to commission a special assistant if requested by the securities director. Mr. McNertney, who joined the Securities Division in 2003, told the members that the New Mexico Uniform Securities Act is a potent tool in the arsenal against investment fraud, noting that it does not require the proof of specific intent to defraud. He said that the New Mexico Uniform Securities Act is a powerful weapon for prosecuting con artists and others with similar ill intentions.

Ms. Baker told the committee that prosecutions pursuant to the statute are expensive. She noted that cases in the Criminal Division of the Attorney General's Office (AGO) typically involve intricate financial transactions with many complicated layers that may seem valid, and typically there are numerous victims. She gave examples of cases prosecuted in New Mexico and highlighted the high costs and the long time frame involved in the prosecutions. Ms. Baker also said that the attorney general is willing to prosecute white collar crime, but it is expensive, and when a person is indicted it will take at least two attorneys, three investigators, two support staff members and an expert. Then a long trial and appeals process are also involved.

Mr. Lama mentioned to the committee that the one thing the AGO representatives hope to tell the legislature is that there is a need for resources for the agency that administers the provisions of the statute.

There was a general discussion regarding what the attorney general might be doing relating to the accusations that New Mexico is a "pay to play" state. The AGO representatives were unable to answer the members' questions in detail, but they assured members that the AGO is cooperating with the federal agencies involved. Mr. Lama noted that the attorney general is looking into any opportunities for a civil action, but he could not talk about an ongoing criminal investigative process.

The idea of a joint task force between the AGO and the Securities Division was discussed. It was noted that there is a need for the agencies to work together. There is expertise in both agencies, and a joint effort would be helpful. Also, the Securities Division is in charge of licensing and can ensure that securities are registered. Historically, the division has not had experienced prosecutors, nor has it had investigators who understand white collar crime, specifically a securities case.

Bruce Kohl, director, Securities Division, RLD, said it is key to remember that the attorney general can independently bring a prosecution and does not require a referral from the Securities Division. One of the obvious problems faced by the Securities Division is the potential conflict of interest of an executive agency investigating another executive agency.

There was a discussion regarding the statute of limitations. Mr. McNertney noted that the statute of limitations in securities cases is five years, and there is a criminal tolling statute giving prosecutors more time to prosecute. Additionally, he noted that there is not a statute of limitations under the securities law for civil actions.

Update on the Status of the Independent Fiduciary and Operational Review of the SIC, PERA and ERB Investment Programs and the Deliberation of the Retirement Systems Solvency Task Force.

Raul Burciaga, assistant director for drafting services, LCS, told the members of the committee that the evaluation committee first selected three finalists. The successful offer came from Ennis Knupp, a company out of Chicago. The contract was signed on September 4, 2009. It was initially approved for $300,000; however, bids came in from $300,000 to $800,000. The best and final bid came down to $413,000 for the same scope of work as set forth in the RFP, with an inclusion of $10,000 for travel.

According to Mr. Burciaga, the selection of Ennis Knupp was based on evaluation points as set out in the RFP as well as confirmation with the company's references related to the quality of its work.

Mr. Burciaga explained that Ennis Knupp representatives met with the investment agencies and asked for certain documents. A large volume of documents was provided over the following weeks by the agencies. However, there was a delay in getting some of the documents from some of the agencies. Some of this delay was due to the competing requests for documents from federal authorities.

Mr. Burciaga told the members that there have been some conversations with Ennis Knupp about potential constitutional or statutory recommendations as a result of its review. The final recommendations will not be available until the report is submitted. However, based on the conversations, there may be some recommendations relating to budget and staffing autonomy; custodial bank selection; hiring and termination of the State Investment Office (SIO) for the SIC; the role of the SIO on the SIC; open meetings and records requirements that may negatively affect the value of investments; the SIO standard of prudence; global equity approach and limits;

and the orientation and continuing education of board and council members. The dates for Ennis Knupp to present its findings have not yet been finalized.

The members inquired as to anything in the final report that might indicate what other states are doing. Mr. Burciaga replied that the scope of work in the contract calls for Ennis Knupp to look at best practices and also policy practice procedures relating to industry standards. The committee asked for a copy of Mr. Burciaga's report summary discussing the scope of work pursuant to the contract, and Mr. Burciaga agreed to provide the information.

Mr. Burciaga reported to the committee regarding the Retirement Systems Solvency Task Force (RSSTF). The RSSTF was created by Laws 2009, Chapter 288, Section 19, which was House Judiciary Committee Substitute for House Education Committee Substitute for House Bill 573, introduced by Representative Heaton. The RSSTF was charged with looking at the solvency of the retirement funds.

Mr. Burciaga reported that at the first meeting of the task force, staff from each of the three retirement systems presented a primer or overview of their respective retirement programs, where they stood financially and what changes had been made to shore up the respective funds.

At the second meeting of the task force, the Retiree Health Care Authority (RHCA) provided an overview of its annual meeting and the progress on unfunded liability and solvency. In 2008, the RHCA decreased its unfunded liability from $4.1 billion to $2.9 billion, and the annual contribution required to fund the benefit fully decreased from $373 million to $273 million. Solvency has been extended from FY 2014 to FY 2028, although deficit spending is projected to begin in FY 2018. The agency has a history of premiums for retirees that have not kept up with medical trends; benefit plans were not rationalized in terms of cost and subsidies. Additionally, the task force had a presentation on actuarial information by Gabriel, Roeder, Smith & Company (GRS), which is the actuarial firm for both the PERA and the ERB. Chris Conradi of GRS provided an overview of the retirement plans used in various states and the risk characteristics of each defined benefit and contribution and of hybrid plans. Mr. Conradi also presented a overview on the role of the actuary in retirement plans and actuarial mathematics, including actuarial accrued liability, actuarial value of assets and unfunded actuarial accrued liability. The task force also discussed a number of measures to be considered for possible eligibility, benefits and funding related to the three retirement systems.

In its third meeting, the task force received a presentation from Ron Snell, a staff member of the National Conference of State Legislatures (NCSL), on an overview of other states' initiatives on retirement systems. Mr. Snell reported that actions by other states for revising retirement plans between 2005 and 2009 have included:

- increases in employee contributions;
- extending the period over which salary is calculated for the purpose of determining retirement benefits;
- increases in age or service requirements;
- anti-spiking provisions;

- reduction in greater controls over post-retirement cost-of-living adjustments; and
- early retirement incentives.

Marcia Beard of RV Kuhns & Associates, Inc., provided the task force with a discussion on strategic asset allocation. She opened her presentation by stating that "greater return equals greater risk". Ms. Beard spoke about the need for each agency to decide on strategic asset allocation that balances how conservative each board needs to be to protect assets versus how conservative each board can afford to be given the need for additional contributions if investment returns fall short.

The October meeting was canceled because of the special session.

The RSSTF last met on November 12. At that meeting, each retirement system presented on the status of its actuarial studies and initiatives. The PERA reported on a cash-flow projection and benefit-adequacy study to be performed by GRS.

In short, the RHCA inherited premiums that are not keeping up with health care plans. The NCSL provided an overview of other states' retirement plans. Some actions include increasing employee contributions and expanding the number of years. The RHCA is in a wait-and-see mode, depending on what may come out of discussions on national health care. The RHCA is getting two actuarial reports completed. The plan at this point is to re-create the task force after the 2010 legislative session.

The members discussed the back-to-work provision and whether it has a significant impact. Mr. Burciaga reported that a cursory view is that its impact is minimal. Some members raised concerns over the long-term impact of the provision and a need to reevaluate it, perhaps by experts.

Committee Business

Representative Heaton told the members that they needed to discuss the five bills the committee is considering for endorsement, and a discussion of the proposed legislation culminated in the committee voting to endorse Senator Keller's bill, which provides the attorney general with similar powers as those set forth in the State of New York's Martin Act; Representative Heaton's bill, which, combined with a similar bill by Senator Keller, would change the board memberships of the ERB, the SIC and the PERA; and a bill sponsored by Representative Trujillo, which would provide for a mechanism whereby PERA members could change their named beneficiaries.

The committee adjourned at 4:40 p.m.