*State of New Mexico*
**LEGISLATIVE FINANCE COMMITTEE**

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# LFC INVESTMENT REPORT FOR THE QUARTER ENDING MARCH 31, 2018

This report details the comparative investment performance of the three investment agencies: the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA), and the State Investment Council (SIC) which manages the land grant permanent fund (LGPF) and the severance tax permanent fund (STPF). This report derives agency performance and market environment information from the investment performance reports submitted by PERA, ERB, and SIC for the quarter ending March 31, 2018.

## INVESTMENT PERFORMANCE HIGHLIGHTS

- In the last year, the aggregate value of the state's combined investment holdings for the pension and permanent funds grew by over $3 billion, or 6.9 percent, to end the quarter at $50.7 billion. However, returns for the quarter were less than 1 percent or negative. After considering distributions from the funds, the aggregate value of the state's combined investment holdings for the quarter declined by $236.9 million.
- One-year returns ranged from 9.1 percent to 10.8 percent, outperforming each of the funds' long-term targets. The PERA fund and the LGPF outperformed their policy benchmarks for the one-year period, while the ERB and the STPF underperformed their policy benchmarks over the last year.
- When compared with peer funds greater than $1 billion on a net-of-fee basis, the ERB fund and the permanent funds' investment returns ranked above the median for the quarter, three-, five-, and 10-year periods. Only the LGPF performed above the 50th percentile for the year. PERA's investment returns were below the median for all periods reported.

## PERFORMANCE VS. INTERNAL BENCHMARKS

**Returns as of March 31, 2018 (Net of Fees)**

| | PERA | | ERB | | LGPF | | STPF | |
|---|---|---|---|---|---|---|---|---|
| Returns (%) | Fund | Policy Index | Fund | Policy Index | Fund | Policy Index | Fund | Policy Index |
| Quarter | -0.2 | -1.4 | 0.4 | 0.7 | 0.5 | 0.2 | 0.3 | 0.2 |
| 1-Year | 9.1 | 7.3 | 9.7 | 10.4 | 10.8 | 9.8 | 9.9 | 10.0 |
| 3-Year | 5.7 | 6.0 | 7.2 | 7.0 | 6.9 | 6.5 | 6.6 | 6.6 |
| 5-Year | 7.1 | 7.0 | 7.8 | 7.3 | 7.9 | 7.9 | 7.7 | 7.9 |
| 10-Year | 5.3 | 5.7 | 6.5 | 5.8 | 6.1 | 5.9 | 5.4 | 5.9 |

The table above provides the funds' investment returns for the quarter and one-, three-, five-, and 10-year periods ending March 31, 2018 compared with the funds' policy indices, which are a custom benchmark that show the returns that would have been generated if a passive investor consistently followed the agency's asset allocation targets according to their investment policy.

The state's investment funds each generated returns above their long-term targets for the one-year period. ERB and the permanent funds also generated returns above the long-term targets for the five-year period. The long-term return targets are 7.25 percent (PERA), 7.25 percent (ERB), 7 percent (LGPF), and 6.75 percent (STPF). The first quarter of 2018 was marked by low returns, with the ERB and permanent funds returning less than one percent, and the PERA fund losing $171.1 million, or 0.2 percent. Low returns were due in part to stock market losses, with the U.S. equity benchmark S&P 500 returning -0.8 percent and the international equity benchmark MSCI EAFE (Net) returning -1.5 percent for the quarter. Although stock performance faltered this quarter, domestic and international equities posted double-digits returns for each of the four funds over the one-year period.

Despite negative returns this quarter, PERA outperformed its policy benchmark for the quarter, one-, and five-year periods. The LGPF outperformed its policy index for all periods reported and posted double-digit returns for the one-year period. The ERB fund fell short of its policy index for the quarter and one-year periods; however, the fund beat its policy index for the 10-year period and generated the highest percentage return among the four investment funds for the 10-year period.

## FUND ASSET VALUES

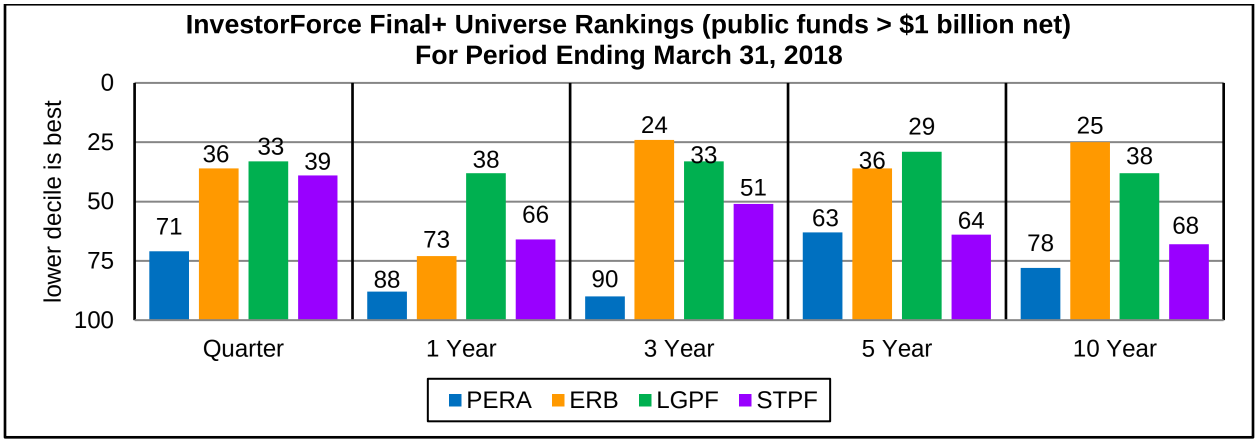
Fund balances grew over the last year, as shown in the table below. The aggregate value of all four of the state's investment funds grew by almost $3.3 billion, or 6.9 percent, in the last year. The land grant permanent fund, which is the largest of the four funds, added over $1.5 billion to the fund balance in CY17. Both ERB and PERA added just over $730 million to their fund balances in the last year, and the STPF added $260 million. All amounts displayed in the table above are net-of-fees and represent annual growth in fund balances less any distributions. In particular, pension fund balances tend to grow at a slower rate than the permanent funds, since distributions must be made to retirees regardless of fund performance, whereas permanent fund distributions are calculated as a percentage of the five-year average of the fund.

**Current Asset Values ($millions, net-of-fees)**
**For One-Year Period Ending March 31, 2018**

| | ERB | PERA | LGPF | STPF | TOTAL |
|---|---|---|---|---|---|
| **Current Asset Value** | **$12,809.7** | **$15,402.4** | **$17,358.1** | **$5,806.5** | **$50,656.8** |
| **Annual Change** | | | | | |
| Ending Asset Value (03/31/2017) | $12,706.8 | $14,668.1 | $15,809.7 | $4,826.3 | $47,380.9 |
| Value Change – Year Over Year | $732.9 | $734.3 | $1,548.4 | $260.3 | $3,276.0 |
| % Change – Year Over Year | 6.1% | 5.0% | 9.8% | 5.4% | 6.9% |

## PERFORMANCE RELATIVE TO PEERS

Using the InvestorForce Final+ Universe, the state's investment fund returns are evaluated on a net-of-fee basis alongside approximately 60 public funds, each with more than $1 billion in assets. The following figure shows net-of-fee total return rankings for the quarter, one-, three-, five-, and 10-year periods. A lower number (1 is best) denotes better performance when compared with other public funds within a comparable investment universe.




With net-of-fee returns in the last year ranging from 9.1 percent to 10.8 percent, New Mexico's pension funds and the STPF performed below the median ($50^{th}$ percentile) for the one-year period (the median one-year return was 10.4 percent), although the LGPF returned above the median in the $38^{th}$ percentile. The ERB fund and the LGPF performed above the median for the quarter-, three-, five- and ten-year periods. The STPF performed above the $50^{th}$ percentile for the quarter and near the median for the three-year period, but performed below the median for all other periods. The PERA fund returns ranked below the median for all periods reported.

Notably, return-based peer rankings do not account for funds differences in asset allocation and risk tolerance. For example, funds with higher equity exposure will rank higher during stock market rallies but risk significant losses in the event of a market crash. The agencies have each pursued diversifying strategies to mitigate risk, with the understanding that diversifying away from heavy stock market exposure means the funds give up potential returns (and potentially higher peer rankings) in bull markets in favor of additional stability in moderate or negative return markets.

To demonstrate this point, the LGPF ranked below the median for the one- and three-year periods at the end of calendar year 2017, which was marked by strong stock market performance. However, one quarter later and with a market environment of negative returns from stocks, the LGPF now ranks above the median for all periods reported. Despite negative stock market returns for the quarter, the strong equities market over the last year pushed the ERB and PERA funds below the median for one-year period. Additionally, PERA's poor performance relative to peers at least partially reflects its asset allocation – PERA not only has less exposure to public equities than its peers but also less exposure to private equities, which also posted double-digit returns in the last year.

**RECENT UPDATES**

During the first quarter of 2018, the PERA Board adopted an Active Risk Budget and Active Strategy Return Target for its active management strategies within the portfolio. Active risk budgeting is a method to balance risk tolerance with desired excess return. Through this framework, PERA will seek to minimize inadvertent risk while maximizing excess return per unit of intentional active risk. ERB and SIC did not report any significant changes to investment strategies in the last quarter.

## ATTACHMENT 1 – INVESTMENT RETURNS