



New Mexico Legislative Council Service
Fiduciary Review of the
State Investment Council

February 28, 2010

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INTRODUCTION

Introduction

The State of New Mexico Legislative Council Service (LCS) and the State Board of Finance retained Ennis, Knupp & Associates, Inc. (EnnisKnupp) to conduct an independent operational and fiduciary review of the governance, organizational structure, and current policies, procedures, and practices of the New Mexico State Investment Office (NMSIO),¹ which includes the State Investment Council (SIC or the Council) and the State Investment Office (Investment Office or the Office). EnnisKnupp, an independent consulting firm that specializes in reviewing investment portfolios and governance frameworks, was selected through a competitive bidding process. EnnisKnupp has extensive experience working with public funds on the topics outlined in the request for proposal scope of work.

Purpose

The purpose of this review is to provide LCS with an independent evaluation of the SIC's governance and the Investment Office's operations compared to both common industry standards and best practices. A "common industry standard" is a generally accepted way of doing business used by state investment councils (also referred to as boards) and public funds. A "best practice" is defined as the experience-tested or emerging optimal standard. The best practice for an organization is ascertained by examining how a particular function is carried out and then determining if a different course of action or methodology would enhance the process. The optimal standard for one organization may not be appropriate for another. Each practice must be tailored to suit a particular organization. To appreciate the importance of best practices it is essential to recognize the difference between a function merely being performed adequately and a function being performed in the most effective and efficient manner—the distinction is analogous to the differentiation between being good and being great.

To make this determination, EnnisKnupp relied upon a combination of factors, including acknowledged industry standards (e.g., ERISA, UPIA, UMPERSA, AICPA, IIA, CFA Institute, Stanford Law School),² secondary research from reputable industry sources (e.g., NASRA, NCTR, DOL, SEC),³ empirical facts gained from performing similar reviews of other public funds, independent research, and the extensive experience of our Fiduciary Services team and other consultants in the firm.

¹ For simplicity, we use the "NMSIO" acronym to refer to the full organization. "SIC" or "Council" refers to the State Investment Council governing body, and "Investment Office" or "Office" refers to the State Investment Office. To avoid confusion, we use the "SIO" acronym to refer to the State Investment Officer.

² ERISA: Employee Retirement Income Security Act; UPIA: Uniform Prudent Investor Act; UMPERSA: Uniform Management of Public Employee Retirement Systems Act; AICPA: American Institute of Certified Public Accountants; IIA: Institute of Internal Auditors; Chartered Financial Analyst Institute: Centre for Financial Market Integrity Code of Conduct for Members of a Pension Scheme Governing Body; Stanford Law School: The Stanford Institutional Investors' Forum Committee on Fund Governance Best Practice Principles.

³ NASRA: National Association of State Retirement Administrators; NCTR: National Council on Teacher Retirement; DOL: Department of Labor; SEC: Securities and Exchange Commission.

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Scope of Review

This review's scope of work includes the following:

1. Governance and Organizational Structure – includes composition and size of the NMSIO governing body, terms of service on the Council, expertise of the SIC members, fiduciary duties, ethical considerations and disclosure, SIC responsibilities, delegation by the SIC, staff responsibilities, staff qualifications and adequacy, budget, and financial resources.
2. Policies, Procedures, and Practices – includes asset allocation, Constitutional and statutory investment restrictions, asset classes, rebalancing of assets, investment goals, risk tolerances, written investment policy, manager structure, selection of investment managers, alternative investments, benchmarks, compensation of managers, role and qualification of placement agents, reporting, and compliance.

Findings, analysis, conclusions, and recommendations are set forth in each section. The recommendations state our independent advice about what current practices or policies ought to be reconsidered or changed.

Methodology

EnnisKnupp conducted the following review from October 2009 to January 2010, using the following process:

- Document review – EnnisKnupp submitted document requests to the LCS Project Coordinator and NMSIO staff. The reports, policies, statutes, and other documents we reviewed are listed in Appendix I.
- Interviews – After reviewing the documents referred to above, EnnisKnupp interviewed the SIC members, key Investment Office staff, and select service providers. We interviewed certain individuals numerous times. The list of interviewees is also found in Appendix I.
- Findings – The pertinent facts relevant to NMSIO's governance, organizational structure, policies, procedures, and actual practices were based on documents received, and confirmed with staff and outside service providers.
- Analyses – The EnnisKnupp team of consultants met internally and debated issues, challenged assumptions, discussed alternatives, and incorporated the firm's best thinking into our analyses.
- Recommendations – The EnnisKnupp team and the peer reviewers discussed preliminary recommendations for each area under review. We made sure recommendations were consistent and could be implemented.
- Drafting – A draft of the report was reviewed by all members of the EnnisKnupp team and the facts were checked with the appropriate and relevant sources. A draft was submitted to the LCS Project Coordinator and NMSIO staff for their review and comment.
- Presentation of the report – We made refinements to the draft and this final report was presented in January 2010.

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Acknowledgements

EnnisKnupp thanks the LCS, SIC, Investment Office staff, and outside service providers for their time and effort in answering questions and providing materials for this review. We relied heavily upon these parties for information and received prompt responses to our requests. We especially want to thank the Interim SIO, Senior Deputy SIO, Public Information Officer, and other staff of the Investment Office for being very accommodating in meeting with us, participating in conference calls, and verifying facts and current practices.

Disclaimer

This fiduciary review was limited to those topics outlined in the preceding table of contents. This was not an all-encompassing review of the entire NMSIO operation. This review provides reasonable assurance that the practices we discussed in our findings are accurate. This was not an investigation and should not be construed as an absolute guarantee that all reviewed practices fully meet fiduciary standards.

Our findings and recommendations were based upon information we received from third parties, including but not limited to, the SIC members, Investment Office staff, legal counsel, investment consultants, and custodian bank. Due to the scope and timeframe proposed for this review, we did not independently verify all facts; however, we did request that all sources review the facts we relied upon for our analysis.

The opinions and recommendations expressed in this report reflect the independent judgment of EnnisKnupp. No one associated with the LCS or NMSIO attempted to unduly influence the scope, findings, analyses, conclusions, or recommendations expressed in this report.

This report dated February 28, 2010 contains technical corrections and replaces the original report dated January 11, 2010.

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Overview of Governance and Organizational Structure

The governance and authority of public investment funds is ordinarily established through state laws, administrative regulations, and internal policies created by the fiduciaries of the funds. The laws and regulations generally impose fiduciary duties of loyalty and prudence on the governing bodies to act solely in the interest of the funds' beneficiaries, to follow the terms of the trusts, and to act as experts would act in carrying out their responsibilities. The internal policies usually clarify how the overall responsibility is to be handled by the councils and the staffs. Council members that govern funds are not expected to have the expertise to perform every investment function. They are, however, expected to operate at a policy level, prudently delegate to those with the appropriate expertise, and monitor those delegations carefully.

Well-run public funds, like private sector corporations, are dependent upon sound governance. In a general sense, "governance" refers to the method by which an entity is directed and controlled. Research has shown that poorly governed corporations typically underperform, whereas corporations with good governance practices have stronger performance.⁴ We believe the same holds true for entities in the public sector. Sound governance of public funds is imperative today. The beneficiaries of trust funds, the agencies whose assets are being managed, and the general public deserve to know that business is being conducted in a fair, open, and efficient manner, and that those on the councils and staffs take their responsibilities seriously. Best practices are for accountability, transparency, legal compliance, effectiveness, and efficiency to be built into the governance framework.

Findings and Analysis

Our findings and analysis of issues related to the governance, organizational structure, staffing, and resources of NMSIO were based upon our review of relevant statutes, policies, procedures, meeting minutes, contracts, consultant reports, and interviews. We discussed issues and our analysis internally as we made comparisons. Below we provide background information, common industry standards, best practices, and NMSIO-specific information pertaining to the topic.

Composition and Size of the Council

The governing body of a statewide public fund is often a board or a council whose members are usually appointed by a governmental person or entity (e.g., the governor or the legislature) or serve as ex-officio members as a result of holding a particular public office or position (e.g., governor, treasurer, attorney general, secretary of state, executive director of a retirement system). In some instances, one or more

⁴ Wilshire study of "CalPERS effect." Steven L. Nesbitt, Long-Term Rewards From Shareholder Activism: A Study of the "CalPERS Effect," J. of Applied Corp. Fin. (Winter 1994). and Steven L. Nesbitt, The "CalPERS Effect": A Corporate Governance Update, July 19, 1995. The 1994 and 1995 studies were more extensive and supported Wilshire's initial 1992 study indicating that a company's stock performance seemed to improve as a result of good governance.

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members may be elected or appointed by the beneficiaries of the funds.⁵ In four states the highest fiduciary is a sole trustee, instead of a council or board.⁶

Although there is no optimal size or make-up of governing bodies for state investment funds, large councils can sometimes be difficult to manage in terms of coordinating meetings and maintaining focus, and smaller councils can sometimes suffer from limited perspectives among the members.

In our view, if all council members are acting as fiduciaries, it should not matter whether they are members of a beneficiary agency, elected officials, or members of the general public. Best practices are simply that they act prudently, and in the best interest of the fund and for the sole interest of its beneficiaries.

We conducted research in November 2009 regarding the size and composition of 14 state investment boards and councils.⁷ The SIC is different from these funds because it does not manage pension assets; however, we believe this comparison is relevant given the fiduciary nature of both the SIC and these other boards and councils. Of the 14 funds, 12 manage pension assets along with other types of assets, such as endowments and other trusts, and 2 manage only pension assets. None of them are involved with benefits administration like New Mexico's Public Employees Retirement Association (PERA) and the Educational Retirement Board (ERB).

Council Composition of 14 State Investment Funds

| Average Number of Members on Council or Board | % of Appointed Members | % of Elected Members | % of Ex-Officio Members |
|---|------------------------|----------------------|-------------------------|
| 8.4 | 5.5 (66%) | 0.5 (5%) | 2.4 (29%) |

For many of these funds, the governor, treasurer, and participating entities (e.g., retirement systems) have the authority to appoint council members or are ex-officio members on the councils. We categorized some representatives from beneficiary agencies as ex-officio members if they were on the council based on their position in the agency. On average, the governors appointed 51% of the 14 funds' council members. Additionally, governors themselves (or their designees) were part of 5 of the 14 funds. In this research of 14 state investment funds, governors had direct or indirect influence over 58% of the council memberships, and the influence ranged from 0% to 100%. None of the 14 funds included the SIO (or Chief Investment Officer) on its governing body. Some of these councils had subcommittees, investment advisory committees, and non-voting members, which we did not include in the council size calculations.

⁵ Beneficiaries can be the participating agencies' memberships or the agencies' governing bodies.

⁶ New York, North Carolina, Michigan, and Connecticut state funds.

⁷ Alaska State Pension Investment Board; Florida State Board of Administration; Illinois State Board; Massachusetts Pension Reserves Investment Management; Minnesota State Board of Investments; Montana Board of Investments; Nebraska Investment Council; New Jersey State Investment Council; North Dakota State Investment Board; Oregon Investment Council; South Dakota State Investment Council; Washington State Investment Board; West Virginia Investment Management Board; State of Wisconsin Investment Board.

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New Mexico law⁸ determines the SIC composition. The Council is made up of nine members consisting of five ex-officio members (55%) and four appointed members (45%). The ex-officio members include the Governor, the State Treasurer, the Commissioner of Public Lands, the Secretary of Finance and Administration (Secretary), and the State Investment Officer (SIO). The Governor appoints the Secretary and SIO. The four appointed members include a chief financial officer of a state institution of higher education and three public members, all appointed by the Governor with the advice and consent of the Senate. The Governor serves as the SIC Chair.

The Council size of nine and the composition of ex-officio and appointed members are comparable to the state investment funds in the research group. The Governor has influence over approximately 80% of the Council by being a member and having the direct or indirect ability to appoint six others. This amount of influence is greater than that of most other funds in the research group. It can be balanced by including legislative appointees on the Council or increasing the number of ex-officio members who are not part of the executive branch.

From January 2008 to November 2009, the SIC held 19 meetings. On average, seven Council members attended the meeting either in person or by telephone. The Governor partially attended 10% of these meetings, and the Secretary or the SIO served as the Acting Chair for all 19 meetings. Per statutes,⁹ all actions of the Council require a “double quorum,” which is attendance by at least five members with at least three appointed members. Four of the 19 meetings scheduled did not achieve quorum.

Best practices are for all Council members, especially the Chair, to attend all the meetings in person. Attending meetings via teleconference is disruptive to the rest of the group and does not foster collaboration or help the Council work together as a cohesive body. Other governing bodies of public funds have dealt with these issues through statutes or policies that require a certain level of attendance, such as 80%, and provide for removal of members whose attendance falls below the stated standards. Other boards, such as the ERB, limit teleconference attendance and voting to no more than once every 12 months. Some boards and councils allow ex-officio members, by statute or policy, to assign designees with full voting powers to represent them at meetings. The Secretary and the Commissioner of Public Lands have sent designees in the past; however, these designees are not allowed to vote. Also, they are not included in the Council member count when determining quorum.

Best practice is to allow the Council to elect its own officers, including a Chair and Vice-Chair. Currently, the SIC does not have a Vice-Chair, but one is needed to run the meetings when the Chair is absent. We find that groups generally function more effectively if a leader is determined based upon the group’s confidence in that individual’s leadership abilities and ability to commit extra time.

The inclusion of the SIO on the SIC is unusual and not inline with best practices. The Council’s role in governance is setting policy, while the staff’s role is day-to-day management and implementation of policy.

⁸ NMSA 1978, Section 6-8-2 – State Investment Council.

⁹ NMSA 1978, Section 6-8-2.

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The lines between governance and management are blurred by having the SIO on both the Council and the staff.

Council Members' Terms of Service

The terms of service for board and council members is usually set forth in statutes. For the state investment funds in the research group, the terms ranged from one to six years. By comparison, large public retirement funds have an average term for appointed members of four years.¹⁰ For some funds, the terms vary based on the way the members joined the governing body. The terms for ex-officio members extend to the end of their terms of elected offices. Staggered terms of service are best practices; however, there are no clear best practices with regard to term lengths. In our experience, many board and council members believe that it takes about three years to feel comfortable in their fiduciary role. Given this information, short term lengths are not advisable.

In our experience, there are typically no limitations on the number of terms that a member may serve; however, a few funds have term limits.

The four SIC appointed members serve staggered terms of five years, and serve until their successors are "appointed and have qualified,"¹¹ which, in practice, means until the successors are sworn in. The ex-officio SIC members, including the Chair, serve until the end of their terms in office. The terms of service for SIC members are comparable with public funds' common industry standard.

Council Member Expertise

In recent years, much attention has been focused on the expertise of board or council members of state investment funds and public retirement systems. We believe this is due to the overall market downturn, the widely publicized unfunded liabilities of many pension funds nationwide, the budget deficits of state governments, and the increasingly complex investment vehicles in which funds invest. The complexities of the portfolios and the fiduciary requirement to prudently invest the assets impose a continuing responsibility on council members and staff alike to stay abreast of the trends and ever-evolving best practices among institutional investors.

The need for "appropriately qualified, experienced individuals" as part of a council's composition is endorsed as a best practice by the Stanford Institutional Investors' Forum Committee on Fund Governance.¹² Ideal council members possess knowledge of investment practices, an appreciation of fiduciary responsibilities, and the ability to manage actual or perceived conflicts of interest.

¹⁰ National Educational Association survey, Characteristics of Large Public Education Pension Plans, December 2006 and independent research conducted by other industry organizations.

¹¹ NMSA 1978, Section 6-8-3.

¹² The Stanford Institutional Investors' Forum: Committee on Fund Governance: Best Practice Principles. Peter Clapman, Chair. (Published May 31, 2007 in cooperation with the Stanford Law School, Stanford Program in Law, Economics and Business, the Rock Center for Corporate Governance, and the Stanford Law School Fiduciary College).

The best practices are for those councils without investment expertise to delegate to staff or consultants with the requisite expertise, but to be educated enough on the issues to effectively monitor the functions they have delegated. Lack of experience and knowledge can be a concern if council members become overly reliant on consultants and staff, and do not apply adequate oversight, which potentially could lead to liability. While it is not necessary for all of the council members to be experts in all areas, each should share their experience with others on the councils, and, collectively, they should possess the necessary skills to carry out their duties and responsibilities.¹³

From our research of 14 state investment funds, over half have experience requirements for one or more of its council members. By comparison, at least 33% of the states and the District of Columbia have a requirement that one or more board members on public retirement funds have professional experience.¹⁴ The experience required often relates to finance, investments, or actuarial practices. When an investment expertise requirement is set in law, some view it as a positive factor, enhancing the ability of the council to oversee the investment activities of the staff and the advice of the investment consultants. On the other hand, some view it as creating an increased potential for conflicts of interest if the council members are brokers, investment managers, third party marketers, or those who make their livelihood from institutional investors. Furthermore, in our experience many trustees who are appointed as experts actually have limited or no experience managing or overseeing large institutional portfolios, particularly diverse public investment funds, such as the SIC. Some have experience with smaller portfolios of individual investors, which is helpful but not entirely relevant.

Whether council members have relevant experience or not, most will not have had exposure to all aspects of a complex state investment fund. For this reason, best practices among public funds now include much more intensive orientation for all new members, regardless of their backgrounds. Orientations are best if they are comprehensive, held before the council members assume their seats as fiduciaries, and customized for the particular fund and the individual's knowledge base. Orientation topics can include the history and purpose of the organization, the background on each trust and endowment fund including their required distributions and spending policies, relevant statutes, fiduciary concepts, ethics policies, codes of conduct, disclosure requirements, asset allocation, nuances of various asset classes, investment strategies of institutional investors, the investment policies and guidelines, the role of investment managers, the role of consultants, custodian bank services, reporting responsibilities, the operating budget, current topics among institutional investors, and much more. Some funds also provide specialized training for committee members.

The three public SIC members are required to have experience in the field of investments or finance.¹⁵ The SIC does not have a formal education policy that mandates or encourages orientation or ongoing education. Best practices are to have such a policy.

¹³ Yermo, J. (2008), "Governance and Investment of Public Pension Reserve Funds in Selected OECD Countries," OECD Working papers on Insurance and Private Pensions, No. 15, OECD Publishing. doi:10.1787/244270553278, page 12.

¹⁴ See, National Education Association, Characteristics of Large Public Education Pension Plans, December 2006. The information related to the board membership is not limited to education pension funds.

¹⁵ NMSA 1978, Section 6-8-3.

Intermittently, the investment consultants provide educational presentations, but no regular training is scheduled and no annual fiduciary education session is held. Although the Council members have a certain level of expertise, more structured education on the applicable statutes, current policies, institutional investment practices, nuances of various asset classes, risk management, and the fiduciary nature of their positions would reflect best practices. Furthermore, no specialized training is provided for the committee members.

Upon joining the SIC, Council members receive a few hours of informal education by staff. The staff has also developed and shared an orientation outline with the Council members. The outline is a good foundation for a more formal orientation. Appendix A includes a sample education and orientation policy.

Fiduciary Duty

In the best circumstances, the laws that create the public funds clearly impose the fiduciary duties of loyalty and prudence on the members of the governing bodies. If the public funds are established as trusts, the duty of loyalty applies. It requires trustees to act solely in the interest of the funds' beneficiaries, rather than in the interest of themselves or someone else who is not the intended beneficiary. This duty has been very strictly interpreted by the courts to mean that fiduciaries are to "wear only one hat" when acting on fund's business.

For public funds, the duty of prudence applies as well. Under the common law "prudent man" standard of care, a trustee was expected merely to act as a responsible person would in the handling of his or her own affairs. Therefore, certain investments had to be avoided because of the risk of loss. The common law standard is different than the "prudent investor" or the "prudent expert" standard used today by many public funds. The "prudent investor" standard is the modernization of the "prudent man" standard and recognizes Modern Portfolio Theory, where each investment is not evaluated in isolation for its risk and return expectations, but rather in the context of the entire portfolio. The "prudent expert" standard under ERISA, which governs private sector pension plans and is the model for many public funds, calls for trustees to either be "experts" or hire experts if they lack the relevant expertise. When it is unreasonable to expect the trustees themselves to have the expertise to perform a function, the function must be delegated to someone with the appropriate expertise.

While "prudent man," "prudent investor," and "prudent expert" are often used interchangeably, they do not have the same meaning under the law. The "prudent man" standard is outdated and not the appropriate standard for today's institutional investors because it does not take into account the Modern Portfolio Theory. The "prudent investor" standard and the "prudent expert" standard are equivalent with regard to the expertise required in investment decision-making. In determining the prudence of a trustee's action (or inaction), a court will look not only to the reasonableness of the process that the trustees followed, but also to the process that comparable (public fund) trustees follow in similar circumstances.

Without stringent and clearly understood fiduciary standards, trustees may fail to carry out their fiduciary responsibilities and impair the management of the portfolios they oversee.

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The Investment Office manages the assets of five so-called “fiduciary funds” (STPF, LGPF, TSPF, WTF, and SUTF)¹⁶ and 18¹⁷ clients (governmental agencies, cities, counties, etc.). The NMSIO has the ultimate fiduciary responsibility for the fiduciary funds based on statutes and the authority the SIC holds. The NMSIO has limited fiduciary responsibility for the assets of the 18 clients. The clients themselves establish the policies and asset allocations, and use the Investment Office as an asset management service. Therefore, the fiduciary responsibility of the NMSIO is narrower for the clients than it is for the five fiduciary funds. The clients grant authority to the Investment Office through joint powers agreements.

For the STPF, the functions, power, and duties are transferred to the Council by statute.¹⁸ For the LGPF, the SIO is to invest the fund in accordance with policy regulations promulgated by the SIC.¹⁹ For TSPF,²⁰ WTF,²¹ and SUTF²² the assets are to be invested by the SIO in the same manner as the LGPF.

Although the New Mexico statutes do not explicitly state that the Council and the SIO are the ultimate fiduciaries of the State Investment Office, they do state “all funds [are to be] administered under the supervision of the council in accordance with the Uniform Prudent Investor Act.”²³ This Act imposes a duty of loyalty²⁴ onto the Council members as trustees to invest and manage the trust assets solely in the interest of the beneficiaries. Trustees are implicitly defined as fiduciaries in New Mexico statutes.²⁵ These statutes are not as clear as they could be, but when taken together they make the Council members fiduciaries for the funds.

It is common and best practices for the governing statutes to provide a definition of who is a fiduciary and impose duties of loyalty and care. Thus, while it can be inferred that SIC members are fiduciaries from the various statutes, the laws do not explicitly state such or establish others who may be fiduciaries (e.g., certain staff, consultants, investment managers). Per the 2009 Transparency and Disclosure Policy, the SIC, Private Equity Investment Advisory Committee (PEIAC), and Investment Office have fiduciary responsibilities.²⁶

¹⁶ Severance Tax Permanent Fund (STPF), Land Grant Permanent Fund (LGPF), Tobacco Settlement Permanent Fund (TSPF), Water Trust Fund (WTF), and State Unemployment Trust Fund (SUTF).

¹⁷ As of January 1, 2010.

¹⁸ NMSA 1978, Section 7-27-3.1. Transfer of investment powers.

¹⁹ New Mexico Constitution Article 12, Section 7 (B).

²⁰ NMSA 1978, Section 6-4-9. Tobacco settlement permanent fund; investment.

²¹ NMSA 1978, Section 72-4A-8. Water trust fund; created; investment; distribution.

²² NMSA 1978, Section 51-1-19.1. State unemployment trust fund (A).

²³ NMSA 1978, Section 6-8-7.

²⁴ NMSA 1978, Section 45-7-602. Prudent investor rule. 45-7-606. Loyalty.

²⁵ NMSA 1978, Section 46-1-1. [Definitions.] “fiduciary” includes a trustee under any trust, expressed, implied, resulting or constructive, executor, administrator, guardian, conservator, curator, receiver, trustee in bankruptcy, assignee for the benefit of creditors, partner, agent, officer of a corporation, public or private, public officer or any other person acting in a fiduciary capacity for any person, trust or estate.

²⁶ “It is the policy of the State Investment Council (“SIC”), Private Equity Investment Advisory Committee (“PEIAC”) and State Investment Office (“SIO”) to disclose potential or perceived conflicts of interest and to ensure that any and all investments, advisory contracts, or any other contract are entered into by the SIC, PEIAC, or SIO in accordance with its fiduciary responsibilities.”

To be consistent with common and best practices, the definition of who is a fiduciary, the fiduciary status of the SIC, and the fiduciary status of certain investment staff and others should be explicitly stated in statute (Chapter 6), as well as in policy. The definition of fiduciary should include anyone that exercises discretionary authority or control with respect to the management or disposition of NMSIO assets, the administration of the NMSIO, or anyone that renders investment advice for a fee or other compensation, direct or indirect, with respect to any NMSIO assets or has the authority or responsibility to do so.

The Prudent Investor Act gives wide latitude to the fiduciaries it covers, but it does not grant immunity for those who are negligent and breach their fiduciary duties of prudence or loyalty.²⁷ In the private sector, ERISA's section 410(a) imposes strong personal liability on any person considered a "fiduciary" in violation of their duties, including negligent behavior. ERISA does not apply to public pension funds, but the governing laws of many public funds are modeled after ERISA. The Uniform Management of Public Employee Retirement Systems Act (UMPERSA), an effort by the Commissioners on Uniform State Laws to impose consistent fiduciary standards among public funds, also imposes personal liability on trustees or other fiduciaries for a breach of fiduciary responsibility.

It is our understanding that Council members are indemnified from the state against all liability in the performance of their duties.²⁸ State statutes provide the Council members with coverage under the Tort Claims Act or with immunity. In our opinion, such coverage, indemnification, or immunity lessens the seriousness of a violation and diminishes the high fiduciary responsibility and liability standards intended by the drafters of the Uniform Prudent Investor Act. In other states,²⁹ where the potential for personal liability exists, the members of the governing bodies of public funds have accepted the potential for personal liability as a reasonable trade-off for having the ability to operate under the Modern Portfolio Theory and act as a prudent investor.

Consistent with SIC statutes, the STPF assets are to be managed in accordance with the Uniform Prudent Investor Act.³⁰ It is interesting to note, however, that as to the management of the LGPF, the New Mexico Constitution³¹ requires only ordinary prudence for the SIO, a lower standard than the prudent investor standard in the SIC statutes. The investment management standard in the state statutes and Constitution for the SIO should be consistent.

Ethical Considerations and Disclosure

Conflict of interest and ethics policies define the guidelines that governing bodies and staffs are to use when conducting business for the funds. Best practices in this area are clear; fiduciaries are to avoid conflicts of

²⁷ Generally, a fund is allowed to use trust assets to purchase fiduciary insurance.

²⁸ NMSA 1978, Section 41-4 (Tort Claims Act).

²⁹ Examples include Colorado, Illinois, Nebraska, and West Virginia

³⁰ NMSA 1978, Section 7-27-5.

³¹ New Mexico Constitution Article 12, Section 7 (C): "In making investments, the state investment officer, under the supervision of the state investment council, shall exercise the judgment and care under the circumstances then prevailing that businessmen of ordinary prudence, discretion and intelligence exercise in the management of their own affairs not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital."

interest (actual or perceived) if possible. If avoidance is not possible, they are to disclose conflicts promptly, refrain from discussing the matters involving conflicts, and recuse themselves from voting on issues where conflicts exist. Fiduciaries are to manage conflicts to the best of their ability.

Written policies clearly stating ethical expectations are necessary so that individual interpretations do not lead to unintended violations. In our experience, many policies adopted by public funds tend to be stricter than the policies of private sector companies due to the public scrutiny and fiduciary responsibility the governing bodies have.

Policies often contain restrictions on gifts from parties with whom the entity does business. For example, some policies allow trustees and staff members to accept meals from current vendors in connection with educational sessions, while others permit attendance at meals, but require trustees and staff attendees to pay for their own expenses. Some policies go even further, prohibiting any meals or entertainment in order to avoid even the appearance of undue influence.

A best practice that highlights the importance of ethical conduct is to require annual affirmations from fiduciaries declaring that they have reviewed, understand, and agree to comply with the code of ethics. In some circumstances, outside service providers (investment managers and others who serve the fund) are also required to affirm that they understand the fund's ethics policy. They may be asked to specifically list and value all gifts, entertainment, and meals they have provided to the fiduciaries over the course of a year. While this is not a widespread practice, it is a best practice to which service providers have become accustomed.³²

Per statutes,³³ the SIC members, PEIAC members³⁴, and staff are to adhere to the provisions of the Conflict of Interest Act.³⁵ This Act includes provisions related to ethical principles, political activities, honoraria, disclosure of outside employment, disclosure of confidential information, contracts, adoption of a code of ethics, bidding, disclosure of financial interest, and gifts. Depending on the specific provisions and the definition of the terms, some of the provisions are applicable to the NMSIO.

In the Conflict of Interest Act, the ethical principles include "full disclosure of real or potential conflicts of interest...for determining appropriate conduct. At all times, reasonable efforts shall be made to avoid undue influence and abuse of office in public service. No [SIC, PEIAC, or staff member] may request or receive, and no person may offer [them] any money, thing of value or promise thereof that is conditioned upon or

³² CalSTRS and Ohio PERS have adopted such policies. New Mexico PERA and ERB "may" require such disclosure from its vendors on an annual basis.

³³ NMSA 1978, Section 6-8-3: "During tenure, a member of the council shall not be engaged in any capacity in the sale of securities to the state. Members of the council and officers and employees of the council shall be governed by the provisions of the Conflict of Interest Act [Chapter 10, Article 16 NMSA 1978]. Nothing in this section or in the Conflict of Interest Act shall be construed as prohibiting an officer of a financial institution from participating as a member of the council in setting general policies of the council, nor shall any provision of the Conflict of Interest Act prohibit the council or the state treasurer from depositing funds under the jurisdiction of the council in any financial institution."

³⁴ NMSA 1978, Section 6-8-2- (D) and NMSA 1978, Section 10-16.2.

³⁵ NMSA 1978, Section 10-16.

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given in exchange for promised performance of an official act.”³⁶ Although the intentions behind these provisions appear to be inline with best practices, the statutory language allows SIC, PEIAC, and staff to accept various gifts and things of value if they are not directly contingent upon performance of an official act. Such exceptions are not best practices for a public fund.

The Conflict of Interest Act’s prohibited contributions provisions cover vendors³⁷ and NMSIO, including SIC, PEIAC, and staff members.³⁸ Vendors are prohibited from contributing and NMSIO is prohibited from accepting any thing of value.³⁹ This does not prohibit food with value of less than \$100, and "contribution" means a donation or transfer to a recipient for the personal use of the recipient, without commensurate consideration.⁴⁰ These statutory provisions allow for numerous exceptions due to the required “personal use” criteria of the “contribution.”

Per the statutes, some, but not all, SIC members and the SIO, along with their spouses, are required to disclose sources of income and financial interests, among other things. The disclosures are to be made annually in writing to the Secretary of State before entering state employment or taking office.⁴¹ The statutes further require disclosure by every employee and public officer who has a financial interest that may be affected by his official act or actions of the state agency by which he is employed or affected by his official act or actions of the board or commission to which he is appointed shall disclose the nature and extent of that interest.⁴² These provisions are broad, cover appropriate issues, and cover all SIC, PEIAC, and staff members.

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³⁶ NMSA 1978, Section 10-16-3 (C-D).

³⁷ NMSA 1978, Section “Any business that contracts with a state agency to provide financial services involving the investment of public money or issuance of bonds for public projects shall not knowingly contribute anything of value to who has authority over the investment of public money or issuance of bonds, the revenue of which is used for public projects in the state.”

³⁸ NMSA 1978, Section 10-16-13.3. (B) A public officer or employee of a state agency that has authority over the investment of public money or issuance of bonds, the revenue of which is used for public projects in the state, shall not knowingly accept a contribution of anything of value from a business that contracts with that state agency to provide financial services involving the investment of public money or issuance of bonds for public projects.

³⁹ NMSA 1978, Section 10-16-13.3. (C)(1) "anything of value" means any money, property, service, loan or promise, but does not include food and refreshments with a value of less than one hundred dollars (\$100) consumed in a day.

⁴⁰ NMSA 1978, Section 10-16-13.3. (C)(2) "contribution" means a donation or transfer to a recipient for the personal use of the recipient, without commensurate consideration.

⁴¹ NMSA 1978, Section 10-16A-4.

⁴² NMSA 1978, Section 10-16A-4.

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The statutes also address gifts and all SIC, PEIAC, and staff members are covered under this provision.⁴³ The covered parties cannot accept from restricted parties⁴⁴ a gift⁴⁵ of a market value greater than \$250. Aggregate gifts restrictions are provided for registered lobbyists as anything greater than \$1,000 in a calendar year to a covered party. The covered party is also prohibited from soliciting gifts for the entity for which they work and for charities if it will affect the covered person's official duties. Various items, including campaign contributions, are not considered gifts.⁴⁶ The statutes allow for many exceptions.

To adhere to higher standards, the SIC adopted the Transparency and Disclosure Policy in July 2009. The Policy requires the SIC, PEIAC, and Investment Office, "to disclose potential or perceived conflicts of interest and to ensure that any and all investments, advisory contracts, or any other contract are entered into by the SIC, PEIAC, or SIO in accordance with its fiduciary responsibilities." This Policy includes placement agent prohibition, gift/benefit prohibition, campaign contribution prohibitions, and disclosure from any individual or entity seeking an investment. We address the placement agent issues later in this report.

The gift provisions in the Policy prohibit any recipient of an investment or contract from giving gifts to the SIC, PEIAC, and staff members in connection with the contract. The Policy does not cover potential vendors and does not include the statutory limitations placed on gifts from lobbyists or to charities. A separate gift policy, which was adopted in December 2007, also exists for the Investment Office staff. It includes prospective vendors, examples of prohibited gifts and restricted donors, and reporting guidelines. It is inline with best practices.

Per the Transparency and Disclosure Policy, vendors and third party sales agents cannot make campaign contributions during and for two years after the contract term to those who have influence over the SIC, PEIAC, and Investment Office. Furthermore, the NMSIO is not allowed to give contracts to any party that has made campaign contributions to those who influence the SIC, PEIAC, and Investment Office in the two

⁴³ NMSA 1978, Section 10-16B-2. "state officer or employee" means any person who has been elected to, appointed to or hired for any state office and who receives compensation in the form of salary or is eligible for per diem or mileage." Also, family members are included. "'Family' means a spouse and dependent children."

⁴⁴ NMSA 1978, Section 10-16B-2 (D)Restricted parity includes any one who "(1) is or is seeking to be a party to any one or any combination of sales, purchases, leases or contracts to, from or with the agency in which the donee holds office or is employed (2) will personally be, or is the agent of a person who will be, directly and substantially affected financially by the performance or nonperformance of the donee's official duty in a way that is greater than the effect on the public generally or on a substantial class of persons to which the person belongs as a member of a profession, occupation, industry or region; (3) is personally, or is the agent of a person who is, the subject of or party to a matter that is pending before a regulatory agency and over which the donee has discretionary authority as part of the donee's official duties or employment within the regulatory agency; or (4) is a lobbyist or a client of a lobbyist with respect to matters within the donee's jurisdiction."

⁴⁵ The definition of "gift", per NMSA 1978, Section 10-16B-2. (B): is any donation or transfer without commensurate consideration of money, property, service, loan, promise or any other thing of value, including food, lodging, transportation and tickets for entertainment or sporting events."

⁴⁶ NMSA 1978, Section 10-16B-2. (B): The definition of "gift" includes several exceptions, including "(1) any activity, including but not limited to the acceptance of a donation, transfer or contribution, or the making of an expenditure or reimbursement, that is authorized by the Campaign Reporting Act [1-19-25 NMSA 1978] or the Federal Election Campaign Act of 1971, as amended."

years preceding the date of the contract. The Policy is valuable in eliminating conflicts of interest and the appearance of undue influence.

An alternative way other funds have dealt with such issues is to require written disclosure rather than totally prohibiting contracts with prior campaign contributors. Potential vendors must disclose relationships as well as gifts, expenses, charitable contributions, and campaign contributions made to decision-makers or on their behalf in advance of any investments being made or contracts being entered into. Where this is the practice, the disclosures are included in the evaluation material related to prospective vendors that is provided to the governing board.

Currently, vendors are required to disclose any financial relationship they or their immediate family members have with NMSIO investment consultants, employees, and SIC and PEIAC members, and any campaign contributions made in the past four years to any elected New Mexico state or district officials or those seeking election. The form, timing, and posting of these disclosures, and some exceptions are also stated in the Policy. It appears that these disclosures are required only at the time the contract is entered into. Best practices are to require ongoing disclosures of anything that is considered a conflict of interest.

The Investment Office has also drafted a Code of Ethics for staff that expands the related legal provisions and includes outside employment, personal securities transactions, insider trading, gifts, entertainment, and whistleblower protections. This Code of Ethics has not been approved yet because certain details still need to be solidified. Adoption of strict ethics policies is consistent with best practices; however, when issues, such as gifts, are addressed in several documents (e.g., statutes, SIC policy, and staff policy) overlapping provisions can cause confusion and complexity.

The SIC's Transparency and Disclosure Policy, while very comprehensive, could be improved by summarizing statutory prohibitions related to the Council, PEIAC, and Investment Office regarding the gift limitations, disclosure requirements, and honoraria. Additionally, it is important to ensure that the disclosure statements, including those of SIC members, staff, prospective vendors, and vendors, are being reviewed by all appropriate parties, including the SIC, Governance and Audit Subcommittee, PEIAC, SIO, and/or other Investment Office staff. If the Code of Ethics is adopted for the staff, care should be taken to ensure that various statutory and policy terms do not conflict.

Council Responsibilities

Generally, the responsibilities of public fund governing bodies are only briefly, and often incompletely, stated in statutes. Rarely do statutes cover many details about the fiduciary responsibilities assigned to councils. Such is the case with the law governing SIC.⁴⁷ In some organizations, written council or board charters are established to reflect the consensus view of the scope of responsibilities and operating procedures. Charters cannot exceed the authority set in statutes or otherwise violate legal restrictions. In some cases, they incorporate relevant statutes by reference. Councils and boards have benefited from guidance from the

⁴⁷ NMSA 1978, Section 6-8.

CFA Institute about the proper role of a governing body when creating charters or updating governance policies.⁴⁸

As the fiduciaries, the SIC has the ultimate responsibility for all major functions of the organization. While there is no “bright line” between what is a council function and what is a staff function, most well-operating councils stay focused at a high policy level. On occasion, if problems occur, councils have delved into lower level functions until they are satisfied they can prudently delegate the duties. The degree of delegation is highly dependent on the sufficiency and expertise of staff, the confidence the governing body has in it, the role and function of consultants, and the size and complexity of the fund. The fiduciaries of large funds with experts on staff, adequate resources, and independent investment consultants often delegate more. To reflect best practices, these delegations should be made by the fiduciaries (i.e., the SIC) through policy rather than by legislatures in statutes.

Decisions that are usually retained by the governing bodies and not delegated include selection of the SIO or Chief Investment Officer (CIO), selection of investment consultants, selection of the custodian bank, asset classes to be used, investment policy and guidelines, asset allocation, decisions on internal versus external management, overall portfolio performance evaluation, and compliance with by-laws, rules, and policies. Decisions and functions that are often delegated include active versus passive management, the number of managers in each class, selection of investment managers, selection of fund-of-funds managers, specific mandates for each manager, and selection of securities, private equity deals, and real estate investments.

Best practices are to have a council charter and all major policies compiled in a comprehensive governance manual so that all fiduciaries have a correct and uniform understanding of their roles and responsibilities.

Council Authority and Functions

By statute, the SIC oversees the assets handled by the Investment Office. Per the Constitution, the LGPF and STPF (and indirectly the TSPF, WTF, and SUTF) is to be invested by the SIO in accordance with policy regulations promulgated by the SIC. As the fiduciaries of the five fiduciary funds, the SIC is responsible for establishing policies for the STPF, LGPF, TSPF, WTF, and SUTF.

Based on statutory language as interpreted by the staff, the SIC has limited or no authority over hiring the SIO, hiring auditors, reviewing private equity investments, and approving contracts. Regarding staffing, the Governor appoints the SIO per statute. The State Auditor has the final authority to approve the selection of the outside auditor for the NMSIO. With regard to private equity, SIC does not review private equity investments that have not been vetted by the PEIAC due to staff interpretation of statutes that gives authority to PEIAC.⁴⁹ It is the staff's interpretation of statutes that the SIC does not have authority to bind the NMSIO in contracts or to approve any contracts.

⁴⁸ Code of Conduct for Members of a Pension Scheme Governing Body, CFA Institute 2008.

⁴⁹ NMSA 1978, Section 6-8-20(C) C. The committee shall review and make recommendations to the council on investments authorized pursuant to Sections 7-27-5.15 and 7-27-5.26 NMSA 1978, and all other private equity investments and shall advise the council in matters and policies related to such investments. The committee shall

Besides a general “policy-making” role and some limitations, the statutes do not provide much guidance to the SIC as to its role. Likewise, the SIC has little internal documentation regarding its role and functions. The Investment Policy includes some SIC responsibilities such as managing NMSIO assets, approving asset allocations that are reviewed by the staff and consultant, and permitting external management. The statutory and investment policy language⁵⁰ and terminology contribute to the lack of clarity around the SIC’s role.

In addition to the general lack of documentation, it appears that the actual role of the SIC is not uniformly or clearly understood by the Council or others, and is not consistent with common or best practices. Certain authority and functions that we would expect the Council to have or retain have been delegated by statutes or the Council itself. For example, establishing the asset allocation, approving the investment policy, hiring the SIO and outside auditor, and approving significant contracts. There are also functions, such as those related to oversight of delegations, internal controls, and compliance, where the Council does not appear to be as actively engaged as other public funds boards. This lack of involvement increases the level of risk for NMSIO.

Best practices would be for the Council, with the assistance of staff and consultants, to formally review all statutes and existing policies that impact the NMSIO. Based on this review, a clear and comprehensive outline should be developed regarding the Council’s authority and restrictions. In conjunction with this, the Council should consider all essential functions of the organization and determine the authority and role of various parties (e.g., SIC, PEIAC, Subcommittees, staff, other state agencies, and consultants). In Appendix B, we include a sample accountability matrix for key investment responsibilities. This matrix can be used in discussions about the roles of the Council and other parties as policies are developed. During this exercise, the Council should keep in mind its optimal role as a high level governing body and the fiduciary status of the parties to whom it delegates duties. In Appendix C, we provide examples of responsibilities that could be contained in a charter to explain the actual role of the Council.

Council Meetings

Due to the nature of the business involved, it is commonly accepted that the governing bodies of public funds should meet no less than four times per year. We find that best practice is for the number of meetings to be decided by the councils and boards themselves based on the volume of work and goals. In a recent survey of public investment boards and councils, we found they generally meet between four and fifteen times per year, with the average being nine. The number and length of the meetings varies among the funds because of the scope of responsibility, the issues to be addressed, the degree of delegation to the staff, the use of committees, and the efficiency of the meetings. A benefit of frequent meetings is that trustees can

establish policies for national private equity fund investments, New Mexico private equity fund investments and New Mexico film private equity fund investments not less often than annually and shall make copies available to interested parties.

⁵⁰ For example, NMSA 1978, Section 6-8-6 states, “[a]ny provision of existing law requiring or designating an elected state official to serve by virtue of his office in an active or advisory capacity concerning the investment of the state permanent fund shall be inoperative.” Since the Governor, Treasurer, and the Commissioner of Public Lands are elected officials, this language can cause some confusion.

form a more cohesive group if they spend more time together. Likewise, frequent meetings between the council and staff can be beneficial for the same reason. The downside to more frequent meetings can be a lack of time to sufficiently prepare for meetings by both the council and the staff and an increased focus on operational or managerial issues instead of true policy-level issues.

The SIC is required to meet at least monthly,⁵¹ which it does. The statutes and policies do not address who may call for any special or emergency meetings in addition to the regular meetings. Best practices are to clearly establish a process for calling non-routine meetings.

Some of the other boards of public funds have regularly scheduled off-sites for educational sessions and long range planning. It is our understanding that SIC has not had similar off-sites. We find such off-sites to be very valuable for board and council members as well as staff and consultants.

Council Policies

It is common for public funds to have their authority set forth in state constitutions, state statutes, and internally adopted policies of the governing body. The most common policies are investment policies, conflicts of interest policies, ethics or standards of conduct policies, travel and expense policies, orientation and ongoing education policies, and communications policies. NMSIO has adopted the substance of some of these policies (e.g., Investment Policy and Transparency and Disclosure Policy).

The SIC currently does not have one central document or governance manual that contains all the governance policies it has established. In Appendix D, we include a chart that outlines the contents of a comprehensive governance manual. The SIC has some essential components of a governance manual in statutes and various documents. The SIC would benefit from compiling the existing information in a central place, such as a governance manual, and considering whether additional policies and procedures would add value. A comprehensive governance manual that outlines the Council's expectations will help ensure that through good governance practices and a culture of high fiduciary standards will exist at the organization.

Individual Council Member Responsibilities

With regard to individual council member responsibilities, we believe the development of a position description for council or board members is generally a beneficial exercise. A position description, if carefully conceived and drafted, succinctly communicates expectations to existing members, external stakeholders, and others interested in serving on a council or board.

A position description can include, among other things, the following:

- The responsibility to attend orientation and ongoing educational sessions
- Type of expertise needed for prudent oversight

⁵¹ NMSA 1978, Section 6-8-7 (C).

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- Time commitment required for meetings and preparation in advance of meetings
- Expectations regarding interaction with other council members
- Expectations for serving on committees
- Governance versus management responsibilities
- Elements of “good trusteeship” and meeting protocols
- Fiduciary duties specific to the role on the council
- Expectations of council members as co-fiduciaries
- Affirmative duties regarding disclosure and avoiding conflicts of interest
- Confidentiality requirements in statutes
- Interactions with staff, the membership, the media, and other stakeholders

In Appendix E, we provide examples of responsibilities for individual council members for review and discussion among the Council members. If such a detailed position description is created and made available during the Council appointment process, the Council member candidates will better understand and appreciate what is involved. While it is a great honor to be on the Council, it is not merely an honor. It is a major time commitment and requires a certain aptitude for complex issues, the courage to ask tough questions, and the ability to take action when it is called for.

Currently, the SIC does not have position descriptions for the Council members or Officers. Both are considered best practice.

Delegation by the Council

Fiduciaries are not only allowed to delegate certain tasks but they are expected and encouraged to do so.⁵² Investment boards and councils, especially those that are partially or entirely made up of volunteers, cannot reasonably be expected to fulfill every investment function. To meet fiduciary standards, boards and councils must be prudent in their delegations. This means they must carefully assign work only to those who are qualified to handle it, and their delegations must be clear and unambiguous. Furthermore, they must engage in ongoing monitoring to ensure that those to whom they have delegated certain tasks are actually fulfilling their responsibilities as expected.

Most council delegations related to investments are made to subcommittees of the councils, internal staffs, or outside service providers, including investment consultants and investment managers. While oftentimes delegations are only made verbally, best practices are for major delegations to be documented so that all parties share the same understanding about who has what responsibilities. Clear and documented lines of authority and communication of delegated responsibilities enable all who are involved to acknowledge their roles and responsibilities.

⁵²*Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983).

Delegation to the Committees/Subcommittees

Some functions, such as audit, compensation, budget, and legislation are delegated to committees. Sometimes temporary committees are formed for certain asset classes like real estate or private equity. Committees can provide a systematic way to focus in-depth on important issues, tend to save valuable time for councils, and are more likely to help council members develop greater expertise in specific areas. While additional committees can be useful, an overuse of committees can invite the council into day-to-day management functions that are more appropriately assigned to the staff.

Funds can have advisory committees and/or subcommittees of the council. It is best for the councils to appoint the members of all committees. This allows the council members to have confidence in the members and the recommendations they make. Regardless of the type of committee, best practices are for committees to operate under written charters that include the following elements:

- Purpose
- Authority
- Composition
- Governance
- Meeting frequency
- Responsibility
- Staff assistance
- Reporting requirements

Private Equity Investment Advisory Committee (PEIAC)

NMSIO statutes established the PEIAC.⁵³ It is composed of five members, including the SIO (who is hired by the Governor) and one Council member identified by the Governor. The Governor appoints the three other outside experts who are to be qualified by “competence and experience in finance and investment and knowledgeable about private equity investment process.”⁵⁴ The PEIAC meets at the PEIAC Chair’s or the SIO’s discretion.⁵⁵ On average, eight PEIAC meetings were scheduled annually from 2005 to 2009 calendar year.

The statutes state that the PEIAC is to review and establish policies and make recommendations to the Council for the national private equity fund investments, New Mexico private equity fund investments, and New Mexico film fund. In practice, the PEIAC does not establish any policies without the SIC review and approval, but it does recommend policies to the SIC.

⁵³ NMSA 1978, Section 6-8-20.

⁵⁴ NMSA 1978, Section 6-8-20 (A).

⁵⁵ NMSA 1978, Section 6-8-20 (C).

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The duties of the PEIAC are further detailed in the July 2007 Private Equity Policies and Procedures as evaluating risk tolerances and diversification, reviewing investment opportunities presented by the staff or consultants, monitoring and reporting progress to the Council, and staying abreast of current issues.

The PEIAC fiduciary status is unclear. If PEIAC members are truly fiduciaries, they should be fully apprised of this status and its implications. Although the statutes⁵⁶ and the Private Equity Policies and Procedures state that the PEIAC establishes policies, in practice, the PEIAC does not establish any policies and cannot take action without the approval of the Council. Given this, PEIAC may not be a fiduciary. If it is formally determined that the PEIAC does not have fiduciary status, it should not have the authority to establish policies. It is not a common or best practice for non-fiduciaries to have authority to create policies that bind fiduciaries (the SIC).

It appears the PEIAC is not being used effectively or efficiently. With other advisory groups, we would typically find that staff and consultants provide meeting material and other reports for the committee's evaluation. Based on these materials, the committee would develop recommendations to the board, council, or sole trustee, as the case may be. These recommendations, and the rationale for the recommendations, would then be relayed in the form of a report. We did not find such reports to the Council from the PEIAC. Furthermore, it appears that there is redundancy in what the Council and the PEIAC reviews. The value added by the PEIAC and the time and work saved for the Council is questionable. If it is determined that the PEIAC does add value and its use is maintained, Council should have the authority to appoint the PEIAC members.

Governance and Audit Subcommittee

It is increasingly common practice and a best practice for public funds to have audit committees. Less common but still useful are governance committees. While we have not seen audit and governance responsibilities combined into one committee, there is nothing to preclude this structure.

It is important for fiduciaries to be able to influence the focus of any audits and understand the audit results so that they can improve governance and business practices.

The Association of Public Pension Fund Auditors (APPFA) identified certain areas of oversight that ideally would fall under the purview of an audit committee. While APPFA focused primarily on pension funds, we believe its guidance is relevant to the functions of the SIC as well.

- Financial reporting process
- System of risk management
- System of internal controls
- Internal audit process
- External audit of the financial statements
- Engagement of external audit firms

⁵⁶ NMSA 1978, Section 6-8-20.

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- Organization's processes for monitoring compliance with laws, regulations, ethics policies, codes of conduct, conflict of interest, and fraud policies
- Special investigations and whistleblower mechanisms

The American Institute of Certified Public Accountants (AICPA) also provides guidance to audit committees. We provide a summary of its advice in Appendix F. The advice is that each member of the audit committee be appointed by the council and at least one member should have financial experience. We also believe that there is value in considering an outside expert to sit on the committee as a non-voting member to assist in the establishment of an internal audit program and to ask the internal and external auditors questions on behalf of the council members. While this is not common, it has been helpful to other large public funds.

In addition to audit committees, some funds have governance committees to support the boards or councils in developing sound governance policies and practices that promote transparent, fair, and good decision-making. Governance committees' areas of responsibility may include development and periodic review of policies and governance manuals.

In August 2009, the SIC formed a Governance and Audit Subcommittee (Subcommittee). Currently the Subcommittee has four members, including the three public members of the SIC and the Land Commissioner member of the SIC.

The Subcommittee is to review multiple areas of governance and audit functions. The proposed functions are to "set the agenda for SIC meetings, assist in development of SIC policies, function as an audit committee, and provide additional support as directed by the Council."⁵⁷ As part of the audit committee function, the Subcommittee is to oversee financial reporting, monitor accounting policies and procedures, monitor internal controls (including engaging outside consultants to analyze those controls), be actively involved in the way investments are reported, and participate in the hiring of external auditor. The Subcommittee's functions may change based on future Council's discussions. Initially, the Subcommittee may be more focused on governance than audit functions.

The Subcommittee's attention to SIC meeting protocols, such as agenda setting and meeting material, can aid in ensuring the Council has the appropriate information to make decisions. This Subcommittee can also help in ensuring that the Council has proper oversight and monitors the functions delegated to staff and others by requesting periodic reports on the actions of the staff and service providers. In Appendix G, we provide a list of some useful investment reports for boards or councils.

We believe that establishing an audit committee that reports directly to the Council is consistent with best practices. Unlike the State Auditor, the Council members as trustees have fiduciary responsibility for the fund. Currently, the SIC does not have the authority to select the external auditor or modify the scope of the audit. In 2008, EnnisKnupp conducted a survey of public funds to evaluate their authority to hire and fire an independent auditor. For the 18 large funds we surveyed, eight (44.5%) had complete or significant authority, six (33.5%) had some authority, and four (22%) had minimal authority over this function. By

⁵⁷ SIC August 2009 meeting minutes.

comparison, NMSIO has less authority than 78% of the survey group to hire and fire the independent auditor. The new Subcommittee may provide the SIC an opportunity to have a greater level of influence on both decisions, which would be a better position for the SIC than its current position. It will be beneficial to NMSIO to engage the State Auditor in discussions regarding audit scope, internal control functions, and any expertise needed by an independent auditor.

A written charter that documents the structure and functions of the Subcommittee and its meetings would also be beneficial.

Delegation to the SIO

Delegations at public funds primarily flow from the governing bodies to the executive directors, CIOs, or SIOs, who in turn, delegate tasks to the rest of the staffs. Delegations to staff, like delegations to committees, are best made with some degree of formality and in writing. Generally, when boards or councils delegate investment matters to staffs, documentation exists in one or more of these ways: (1) job descriptions, (2) investment policies, (3) directives made at meetings and recorded in meeting minutes, and (4) strategic planning goals and annual business plans. Best practices are for these documents to explicitly describe the delegation, to make sure they are not contradictory, and to ensure there is no ambiguity about who has implementation responsibility and who has oversight responsibility.

The SIO has the primary management role, and also serves as a member of the SIC and PEIAC per legal provisions.⁵⁸ Some of the SIO's duties are established in statutes and some are delegated by the SIC in the investment policies.

Below are some functions that are listed for the SIO in the statutes:⁵⁹

- Devote entire time and attention to the duties of the Investment Office
- May make purchases, sales, exchanges, investments, and reinvestments of the assets of all funds administered under the supervision of the Council and in accordance with the SIC policies and the UPIA
- See that money invested is at all times handled in the best interests of the State
- Formulate and recommend investment regulations or resolutions to the Council for approval
- Report on and provide information necessary to the performance of Council functions
- May employ investment management services to invest the funds and may pay reasonable compensation for investment management services from the assets of the applicable funds, subject to the approval of the SIC and the budgeting and appropriation by the legislature
- May contract with any state agency (whose sole fiduciary is the state agency, not the SIC or SIO) to provide investment advisory or investment management services
- Provide quarterly performance reports to the legislative finance committee

⁵⁸ Also, per statute, SIO has a four year term of service. Ideally, the SIO should be an "at will" employee with no statutory term of service.

⁵⁹ NMSA 1978, Section 6-8-4 Investment Office; state investment officer; terms.

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- Ratify and provide written investment policies, including any amendments, to the legislative finance committee, annually

In addition to the duties listed above, below are some duties delegated to the SIO by the SIC in investment policies.

- Review asset allocation
- Use appropriate judgment and care when rebalancing style-based portfolios
- Instruct external managers to direct a portion of their brokerage costs to commission recapture managers provided that in doing so, NMSIO will obtain the best execution of its brokerage orders
- Make new commitments in private equity funds and sell limited partner interests in existing funds based on the evaluation of the investment

Ideally, the responsibilities of a CIO or SIO are delegated by the governing body, rather than by a legislature in statutes. An SIO should not have independent authority to make decisions or bind the organization in ways that could cause fiduciary liability for the governing body. By statute, the SIO has the authority to enter into joint powers of agreement with various entities (clients) to manage their assets without the approval of the SIC. Management of these external assets can impact the staffing, budget, and resources of the NMSIO. This is an unusual delegation by statute.

Job descriptions are critical in helping employees understand what is required of them. They are especially important when organizations are seeking to fill top-level positions, as the SIC is now seeking. Many of the SIO's delegated functions are included in statutes and policies. It is important for the SIO's position description to be comprehensive, appropriate, and consistent with these existing laws and policies. A sample position description is included in Appendix H to facilitate dialogue.

Delegation to the Service Providers

When public funds delegate to outside service providers, the delegations are most often made in contracts that contain the scope of work and fees for services. Typically, contracts are signed by the SIOs or board or council chairs after receiving close review by investment staff, investment consultants, and legal counsel. The terms of the contracts vary to some degree, but best practices are for contracts to impose fiduciary standards on investment managers and consultants to the extent of the services they provide, and give the public funds quick termination rights without cause.

According to a Commonfund Institute report,⁶⁰ Benchmark Study of Foundations, 76% of 290 foundations use consultants. In a Greenwich survey, 94%⁶¹ of public funds reported using an investment consultant for advice on investment matters. These statistics are not specific to the type of services the consultants actually provide. Public funds utilize consultants in different ways; some use them minimally for limited due diligence or investment policy related tasks, and others use them substantially for the majority of manager

⁶⁰ Commonfund Benchmark Study – Foundations Report, Commonfund Institute, 2009.

⁶¹ Greenwich Associates 2008 Market Dynamics Survey. Public Funds over \$5 billion.

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searches, ongoing monitoring, recommending policies, and providing performance reports. Consultants provide a different perspective and serve as additional resources. Having multiple views aids decision-makers in evaluating a number of appropriate options and ways of doing things. Best practices are to have investment consultants who work well with the staffs, but owe their highest duty and have an independent reporting relationship to the governing board or council.

The SIC uses consultants as advisors that do not have discretionary authority over the assets. The SIC has retained various investment consultants:

- NEPC (formally known as New England Pension Consultants), General Consultant
- Courtland Partners, Real Estate
- Currently vacant, National Private Equity
- Sun Mountain Capital, New Mexico Private Equity
- Peter Dekom, Film Fund

The NEPC contract is between the consultant and the SIC. The contract includes fees and termination provisions that are standard among institutional investors. The scope of work includes reviewing and/or recommending investment policies and objectives, financial opportunities, anticipated investment vehicles, types and number of investment managers, asset allocation, money manager selections, target rate of return for funds, and other related topics; providing reports and presentations; providing education to the SIC and staff; advising on and assisting in manager selection; etc. Other contracts have a similar format and provisions.

The standard of care language varies in the consultants' contracts. For example, the NEPC contract states, "the Contractor is under a duty to exercise a skill greater than that of an ordinary person, and the manner in which the Contractor carries out its duties under the Contract will be evaluated in light of the Contractor's superior skill," and the Sun Mountain contract includes "prudent person who is a professional expert" standard language. Best practice is for the consultants' contracts to include consistent standard of care language. We further note that fiduciary status is not explicitly stated in the contracts.

Some contracts include a conflict of interest provision in which the contractor certifies that the requirements of the Governmental Conduct Act have been followed, along with other ethics and disclosure related provisions. Best practice would be to reference the Act and the Transparency and Disclosure Policy in all contracts and to attach a copy of each to the contracts since both documents impose certain requirements on the service providers.

SIC currently uses over 175 different investment managers. It is now NMSIO's practice that all contracts be reviewed and initialed by the General Counsel before the SIO executes them. We reviewed an investment manager contract, which we understand is in the standard format for all other manager contracts.⁶² It clearly identified the manager as a fiduciary. Explicit fiduciary designation is best practice.

⁶² July 1, 2007 agreement between SIC and Carret Asset Management LLC.

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The New Mexico Board of Finance has selected The Northern Trust Company (Northern Trust) as the custodian bank for NMSIO, as well as for the ERB and PERA. The Northern Trust contract does not state that it is a fiduciary, which is common if the bank is merely providing recordkeeping services and no investment management or securities lending services.

Staffing

A key element to a successful investment program is staffing—staff roles, skill sets, and size. There is no common industry standard in terms of an ideal staffing model, and therefore a fund's staffing should be based on its purpose, core business functions, and unique circumstances. Staffing decisions in the investments area are often impacted by the type of funds for which the organization has responsibility, asset size, asset classes used, internal versus external management, active or passive strategies used, number of managers, roles and responsibilities of outside consultants, and other available resources.

Best practices for attracting and retaining a strong investment staff are to have clearly defined roles and responsibilities. The Investment Office has general State of New Mexico Personnel Office family group descriptions. These descriptions include general position characteristics, competencies, knowledge, skills, and abilities. Based on our discussions with staff, NMSIO-specific position descriptions do exist and they state actual roles and responsibilities of the NMSIO incumbent staff members.

Two other documents set forth some NMSIO-specific staff responsibilities. First, the Investment Policy states a number of functions for the SIO (noted in the delegation portion of this section) and the general Investment Office. Second, the Private Equity Policies and Procedures document defines specific responsibilities and functions of the “alternative investment portfolio manager” (Private Equity / Film Director). We believe it would be beneficial for NMSIO to review the position descriptions to ensure that they are comprehensive, accurate, appropriate, and consistent with the existing laws, policies, and procedures.

There is no set number or ratio to determine the “right” staff size. Generally, as the assets and complexities within the portfolio grow, so does the number of staff supporting the investment functions. From a process perspective, best practices are for public funds to have autonomy in prudently setting staff size regardless of layoffs, hiring freezes, or furloughs imposed upon other public employees who are not serving in a fiduciary capacity. A prudent process is to set staffing levels by identifying the tasks that must be performed and the time required to perform each task. Indicators of whether staffing is adequate involves assessing (1) how often deadlines have to be extended, (2) how well communication is handled with the council, (3) whether processes and procedures are followed or shortcuts are used, (4) whether proper documentation of the investment process is maintained, (5) employees’ express concerns about their workloads, (6) increases in the incidence of sick leave, (7) how frequently outsourcing has been necessary, (8) how often employees have to work extended hours, and (9) the level of deferred or forfeited annual leave.

Of the 32 positions in the Investment Office, 15 are directly involved with managing assets or overseeing asset management. In addition to them, there is a legal staff, administrative accounting staff, investment accounting

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staff, information services staff, and human resources/administration staff. All positions are filled. The SIC plans to engage a search firm to ensure independence and objectivity during the permanent SIO recruitment process.

A national survey by Greenwich Associates in 2008⁶³ indicates that public funds with over \$5 billion in assets, and internal and external investment management have an average professional investment staff size of approximately 14 (5.8 + 8.1).

| | Select and Supervise External Investment Managers | | | Manage Investments Internally | | | Provide Administrative Services (performance analysis, plan reporting, etc.) | | |
|---------------------------|---|------|------|-------------------------------|------|------|--|------|------|
| | 2006 | 2007 | 2008 | 2006 | 2007 | 2008 | 2006 | 2007 | 2008 |
| All Public Funds | 2.8 | 2.4 | 2.6 | 4.1 | 9.2 | 4.6 | 3.1 | 2.6 | 2.4 |
| State | 3.5 | 3.7 | 4.6 | 5.7 | 12.4 | 8.3 | 4.5 | 4.2 | 3.8 |
| Municipal | 2.2 | 1.7 | 1.6 | 1.8 | 2.1 | 2.0 | 1.9 | 1.6 | 1.6 |
| Over \$5 billion | 4.9 | 4.5 | 5.8 | 5.7 | 11.5 | 8.1 | 5.1 | 4.9 | 4.6 |
| \$1-5 billion | 1.6 | 1.5 | 1.5 | 1.0 | 1.7 | 1.3 | 1.5 | 1.3 | 1.5 |
| \$501 million-\$1 billion | 1.2 | 1.1 | 1.4 | 1.4 | -- | 1.0 | 1.9 | 1.1 | 1.4 |
| \$500 million and under | 1.3 | 0.8 | 0.9 | 1.3 | -- | 0.6 | 1.5 | 1.1 | 1.2 |

The SIC's 15 investment staff positions is comparable to the Greenwich average. The survey did not specifically indicate the staff sizes of those funds that invest in alternative asset classes. Funds with these types of investments would likely have a larger-than-average staff size.

Currently, NMSIO has two staff members dedicated to private equity and one staff member dedicated to real estate. Given NMSIO's asset size and the complexity of these two portfolios, we would expect more staff members for these asset classes. It should be noted, however, that specialty consultants for private equity and real estate investments are available as additional resources and expertise. These additional resources are fulfilling some functions that otherwise might be conducted by staff. Given the assets under internal management, substantial percentage of assets managed actively versus passively, and the number of alternative investments in the portfolio, the staff size should be evaluated.

The Greenwich survey also indicates an average investment support staff size of 4.6, as compared to SIC's 5 permanent staff and 1 temporary position, for those who provide performance analysis, plan reporting, etc. services.

According to the Commonfund report on foundations, the average professional investment staff size of foundations with over \$1 billion was 6 in fiscal year 2008. This average is significantly lower than the 15 NMSIO investment professionals. Factors that could account for this difference are the large asset size and complex portfolios handled by NMSIO, the number of fiduciary funds, the number of clients to which NMSIO is responsible, the public nature of the fund, and the number of Council and committee meetings held.

⁶³ Greenwich Associates – 2008 Investment Consulting Business – Market Dynamics Report.

The SIC Chair (the Governor) has the authority to appoint the SIO. It is uncommon, but not unique, for the highest governing body with fiduciary responsibility not to have the authority to select, monitor, evaluate, and terminate the highest person in a management position. We believe the duties that are delegated to the SIO are the most important ones as related to the management of the fund. Ensuring that the proper person is appointed to this position is crucial, especially considering that the SIO's actions affect the full Council, not just the Council Chair.

Also, the number and type of staff in the organization is almost always the SIO, CIO, or executive director's authority. At the NMSIO, three staff positions⁶⁴ under the SIO are appointed by the Governor. It is not a common or best practice to have staff appointed by someone they do not report to and who does not have day-to-day supervision of them.

Another position that is important for a large public fund with internal management is that of an internal auditor. The role of an organization's internal auditor is to independently examine and provide assurance to management, and ultimately to the council, that appropriate internal controls and risk management processes are in place. Sometimes a fund outsources its internal audit function, sometimes it handles it through a dedicated internal position, and sometimes it uses an arrangement with shared services. The arrangement is not simply dependant on the availability of resources, but also dependent on the size and complexity of the agency's services, including investments, and the level of risks associated with such programs. Although a financial audit is conducted for NMSIO by an outside auditor, internal controls issues are not addressed comprehensively. Best practices are for a large public investment fund to have an internal auditor.

Best practices and increasingly common practices are for investment staffs to be comprised of individuals with advanced degrees or professional certifications (i.e., MBAs, CFAs, CAIAs, and CPAs).⁶⁵ It is also a best practice for continuing education programs and reasonable career paths, given the size of the organization, be offered to the staff members. In our 2008 survey of large public funds,⁶⁶ we analyzed what percentage of the professional investment staffs had advanced degrees or professional certifications. On one end of the spectrum, a fund had all of its investment professionals holding such degrees or certifications, and, on the other end of the spectrum, another fund had 45% of its investment professionals holding similar educational credentials. Using the same criteria, 73% (11 of 15) of the NMSIO investment staff members hold advanced degrees or professional certifications.

It is also best practice to periodically evaluate staff members. The full council should evaluate the SIO annually based on an established written policy that includes predetermined rating criteria, allows the SIO to submit a written self-evaluation, and affords each council member with the opportunity to provide input.

⁶⁴ Senior Deputy SIO, Public Information Officer, and General Counsel.

⁶⁵ Master of Business Administration (MBA), Chartered Financial Analyst (CFA), Chartered Alternative Investment Analyst (CAIA), and Certified Public Accountant (CPA).

⁶⁶ Ten large public funds with assets greater than \$20 billion.

Examples of general evaluation criteria for the SIO include the following:

- Leadership
- Management of the organization
- Management of the portfolio
- Investment performance
- Policy development and implementation
- Staff development
- Communication
- Interaction with the council
- Progress toward strategic goals
- Legislative efforts

There is no performance evaluation process for the SIO or other exempt staff. For the classified staff, a union mandated State Personnel Office process and form are used. This form has generic performance rating areas. The performance evaluation process is also not linked to compensation. Thus, the value of the performance evaluation process used for the classified staff is questionable. We believe all staff members, especially the SIO, should have a formal performance evaluation process that is relevant and specific to the agency, and associated with some form of reward, nominal or monetary.

Budget and Financial Resources

Operating budgets for public funds are either appropriated by legislatures or set by councils or boards themselves. In nearly all situations, the operating budgets are supported directly from the assets of the trusts and not from the general revenue of the states. Legislative control of public fund operating budgets is still common; however, best practice is for the governing body of fiduciaries to set the budget.

If non-fiduciaries (legislative and executive branches of a state) impose unreasonable restrictions on the budgets, they can hinder or even prevent councils from fulfilling their fiduciary obligations. While the potential for this type of occurrence may seem de minimis, the ability to unreasonably cut budgets is inherently present. Investment councils may find themselves constrained in supporting an infrastructure to meet the high fiduciary standards of prudent investors required by law, and with little available recourse to remedy the situation. This may be particularly evident in times of financial and fiscal crisis such as what currently exists.

NMSIO's operating budget is prepared by the SIO and staff, submitted to the DFA (Department of Finance and Administration) and LFC (Legislative Finance Committee) for review, sent to the State legislature for approval and appropriation, and then sent to the Governor to sign or veto. The SIC has played a relatively inactive role in reviewing the budget for reasonableness, which is not typical for governing bodies such as boards and councils.

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The assets of the fund, not the general revenue of the State, pay for the operating budget. Over the past three years, SIC budgetary requests have been approved by the legislature, but in amounts less than requested as illustrated in the following chart.⁶⁷

| FY Year | Budget Amount Requested | Budget Amount Approved |
|---------|-------------------------|------------------------|
| 2009 | \$35,554,200 | \$32,892,600 |
| 2008 | \$29,724,500 | \$29,676,700 |
| 2007 | \$29,646,500 | \$29,576,700 |

From a relative standpoint, there was a meaningful difference between the amount requested and the amount approved in 2009. The difference between the requested and approved amount was minimal in fiscal years 2007 and 2008. The SIC does have the ability to request increases in its budget through a Budget Adjustment Request (BAR) directed to the DFA for approval and to the LFC for review. We were informed that these requests can take one of two forms depending on the reason for the requested increase. For external investment management fee related costs, staff can request up to an additional \$2 million for the budget. If the amount requested exceeds \$2 million, Council approval is required. Other costs that could necessitate an increase, such as for legal services, would be limited to 5% of the original appropriated budget amount. The agency has requested alternative language for the BAR authority contained in the annual fiscal year appropriation that would allow for other investment related costs to be included in the first category of BAR increase described above. These two options provide desired latitude should external investment management or other fees be higher than anticipated. The structure is still not, however, reflective of best practices in setting budgets.

The budget autonomy that exists for fiduciaries in a best practice environment is not an “open checkbook” without restrictions. The strongest controls over budgets are already in place with fiduciary duties of prudence and loyalty. These duties require only reasonable and necessary expenses be incurred. The lowest possible costs are not required, but the costs must be reasonable for the services provided.⁶⁸ If fiduciaries spend trust assets on unnecessary or unreasonable expenses, they could be found to have breached their fiduciary duties, which could lead to personal liability.

The best practice is for fiduciary councils to have discretion about how to allocate resources in the budget to fulfill their responsibilities. Further, best practices are for the budget-setting to be a transparent exercise, subject to open meetings and open records laws, and readily accessible to all interested parties.

Misappropriation of fund’s assets is a legitimate concern and a risk that warrants a corresponding control. Some funds have established an internal control that requires contracts with fees higher than a certain amount must be approved by the council before being signed by the SIO. This arrangement allows the staff to execute contracts that are below the defined amount. We have seen staff authority limits range from

⁶⁷The figures in the chart were provided to us by the NMSIO staff.

⁶⁸ Marc Gertner, Trustees Handbook: A Basic Text on Labor-Management Employee Benefit Plans (New York: International Foundation of Employee Benefit Plans, 1990).

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\$10,000 to \$100,000. Some councils also require monthly or quarterly reports from staff regarding contracts that have been entered into by the staff without the council's approval.

When attempting to determine reasonable costs, several factors should be considered. Those with the greatest impact include:

- Number of separate trust funds managed
- Types of asset classes used
- Internal versus external management of assets
- Active versus passive strategies
- Allocation to alternative investments
- Division of labor between staff and outside consultants
- Revenue from securities lending to offset expenses
- Soft dollar arrangements, rebates, and commission recapture

Details regarding the NMSIO's total fiscal year 2008 operating costs are shown in the following chart.

| FY 2008 Total Operating Costs ⁶⁹ | |
|---|------------------------------|
| Cost Category | Amount |
| External management | \$18,643,252 |
| Consultants and other direct investment costs | 2,593,296 |
| Custodian | 1,889,235 |
| Direct internal investment oversight (salaries, expenses) | 1,696,284 |
| Audit – Financial | 92,926 |
| Audit – Quarterly | 21,340 |
| Other indirect (non-investment) costs (salaries, legal, etc.) | 3,286,858 |
| Total Investment Costs | \$28,223,191 |
| Total Basis Points | 18.5 bps⁷⁰ |

To determine if 18.5 basis points is a reasonable operating cost, it is important to consider the reasonableness of investment management fees since they make up the largest portion of the total operating budget. NMSIO uses a combination of internal and external management. Historically, it has been successful in keeping its fees for external public markets managers very low, as we further explain in the next section of the report (Compensation of Managers). Operating cost of 18.5 basis points seems very low given the complexity of the NMSIO portfolio.

⁶⁹ Figures provided by NMSIO staff.

⁷⁰ Calculated using 2008 budget data (\$28,223,191) provided by NMSIO staff and overall net assets of \$15,218,664,865 as of June 30, 2008 as indicated in 2008 audit report. These net assets include the assets of all of the permanent funds and the underlying client agencies.

To better align with best practices in ensuring fiduciary standards are met, the Council ought to seek an evaluation of the NMSIO's total operating costs from an independent source⁷¹ with an extensive database and the ability to take into account the complexity of the portfolio to set a benchmark for costs. This type of comparison should be conducted periodically.

Conclusions

We conclude that the Council size is reasonable; however, the Council should evaluate some aspects of its composition since one individual's influence, in this case the Governor's, is significant. Meeting attendance and participation via teleconference has been a problem. Allowing each ex-officio member to have a designee may be beneficial. The double quorum requirement is unusual and may not be needed if the composition of the SIC changes.

The terms of service are comparable to what other state investment boards have, and the SIC is not experiencing any problems with the loss of institutional knowledge as the SIC membership turns over.

There is a statutory expertise requirement for some Council members; however, no formal orientation or regular ongoing education session, including annual fiduciary training, is set in policy.

Statutes that impose fiduciary status on Council members and others are convoluted. Also, two different standards of care are cited in the statutes and the State Constitution for the SIO.

New Mexico statutes provide guidance to NMSIO regarding ethical considerations and disclosures. The NMSIO has adopted various standards related to gifts, campaign contributions, vendors, and disclosures through the Transparency and Disclosure Policy. Certain provisions of this Policy, such as those related to disclosure requirements and gifts, need to be modified to be aligned with best practices. NMSIO has a draft code of ethics for staff with an insider trading policy that has not yet been adopted.

Council members do not have a uniform understanding of their role as fiduciaries, and little documentation exists regarding the Council's and individual Council members' roles. Both issues should be remedied.

Delegations to PEIAC, the Governance and Audit Subcommittee, and SIO need to be clarified and documented in a better way. The degree of oversight currently maintained by the Council is less than optimal. The SIO has several responsibilities that the Council ought to retain.

The PEIAC does not appear to be functioning effectively or efficiently. The SIC ought to evaluate the value the Committee provides to the NMSIO.

⁷¹ New Mexico Public Employees Retirement Association relies upon an organization called Cost Effectiveness Measures (CEM). CEM is a recognized leader in analyzing the cost effectiveness of public funds (primarily the investment costs of public retirement systems), obtaining standardized information from peers, and comparing results.

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The Governance and Audit Subcommittee composition seems appropriate. At this time, no documentation of the Subcommittee's authority and responsibilities exist other than what is in the Council minutes. Best practices are to have a comprehensive committee charter.

Functions delegated to the SIO need to be reviewed. Delegations to service providers are made through their contracts. These contracts have some, but not all, the elements they should, such as explicit fiduciary status, prudent investor standard, and reference to applicable disclosure and ethics documents.

For most functions, the NMSIO appears to be adequately staffed; however, the number of staff members dedicated to alternative investments is low. This staff deficiency is balanced with the use of alternative investment consultants. The SIO position is temporarily filled with an interim SIO, and efforts are underway to find a permanent SIO. It may be beneficial for NMSIO to review the staff position descriptions, especially the SIO's, and to ensure that they are appropriate.

The NMSIO does not have autonomy in setting staff size. The SIC should have the authority to select the SIO, and the SIO should have the authority to hire and fire all other staff members. Additionally, an internal audit function should be established. NMSIO does not have a performance evaluation process for all staff members. The performance evaluation process for the classified staff is inadequate.

Although the NMSIO is a unique entity without closely similar peers, SIC's operating costs seem low, but having a customized benchmark for costs would be beneficial.

Currently, the Council lacks autonomy in setting its budget, which could potentially be detrimental to fulfilling fiduciary obligations if non-fiduciaries are unreasonable in the budget approval process.

Recommendations on Governance and Organizational Structure

Composition and Size of the Council

1. Balance the number of Governor appointees with legislative appointees or other ex-officio members who are not part of the executive branch.
2. Reevaluate the public member quorum requirement in light of Council composition.
3. Allow the SIC to elect its own Chair and Vice-Chair.
4. Limit participation and voting at Council meetings by teleconference to no more than once every 12 months by any one Council member.
5. Evaluate whether an ex-officio member should be allowed to designate a specific person to attend, participate, and vote at meetings.
6. Allow for the removal of members when attendance is below 80%.
7. Modify the composition of the Council to prohibit any NMSIO staff from serving as a Council member.

Council Members' Terms of Service

None.

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Council Member Expertise

8. Require formal orientation and more structured ongoing education, including annual fiduciary training.
9. Provide specialized training for committee members.

Fiduciary Duty

10. Include a definition of a fiduciary and explicitly state the fiduciary status of anyone with discretionary authority and control over fund assets, including the SIC, the SIO, and specified staff, in statutes and the investment policy.
11. Examine the intent of the Prudent Investor Act and its application to NMSIO, and determine whether protections, indemnification, or immunity provided under the Tort Claims Act or other laws are appropriate.
12. Raise the Constitutional standard of care from ordinary care to that of a prudent investor to be consistent with statutes.

Ethical Considerations and Disclosure

13. Expand existing annual disclosure requirements to all SIC members and high level staff, and ensure that the disclosure statements are reviewed by the SIC.
14. Amend the Transparency and Disclosure Policy to include applicable statutory provisions such as the details regarding the gift limitations, disclosure requirements, and honoraria.
15. Prohibit all gifts from prospective and current vendors in the Transparency and Disclosure Policy.
16. Require more disclosure from prospective vendors to decision-makers with regard to conflicts of interest in the evaluation material to aid compliance.
17. Require annual disclosures of gifts, meals, entertainment above a certain threshold, and all campaign contributions and charitable contributions made on behalf of the SIC and staff made by vendors.
18. Adopt a comprehensive code of ethics that includes conflicts of interest and insider trading provisions.

Council Responsibilities

19. Clarify the SIC's authority over private equity investments.
20. Clearly establish SIC's authority to bind NMSIO in major contracts, and its delegation to the SIO to be the signatory.
21. Develop and adopt a Council charter.
22. Discuss what value an accountability matrix may have in clarifying and documenting roles and responsibilities.
23. Develop a central governance manual with relevant policies.
24. Develop and adopt position descriptions for Council members and Council Officers.

Delegation by the Council

25. Discontinue the PEIAC unless its value can be established.
26. Ensure the Council receives sufficient reports to fulfill its duty to provide oversight of delegated duties.
27. Engage the State Auditor in discussions regarding audit scope.
28. Develop and adopt a Governance and Audit Subcommittee charter.
29. Refine statutes to clarify the authority of the Council and the SIO.
30. Reevaluate the extent of delegations made to the SIO and other investment staff.

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31. Explicitly state in contracts that consultants work for the Council.
32. Include fiduciary status and the prudent investor standard of care in all applicable contracts.
33. Reference and provide a copy of the Conflicts of Interest Act and the Transparency and Disclosure Policy with all contracts.

Staffing

34. Review NMSIO position descriptions, including the SIO's position description, to ensure they are comprehensive, accurate, appropriate, and consistent with the laws, policies, and procedures.
35. Seek Council autonomy in setting staff size.
36. Evaluate staff size in light of internal management and the extensive use of active management.
37. Allow the SIC to appoint the SIO.
38. Give the SIO the authority in hiring and firing other staff.
39. Add an internal audit function.
40. Develop a formal performance evaluation process for all staff members that is relevant and specific to the agency, and associated with some form of reward.

Budget and Financial Resources

41. Seek budget autonomy, but maintain fiduciary standards, transparency, and reporting requirements.
42. Evaluate the benefit of seeking an operating cost comparison with a peer group.

Overview of Policies, Procedures, and Practices

The most critical policies, procedures, and practices related to the investment of assets by public funds ensure that the governing bodies and staffs fulfill their fiduciary responsibility of prudence. Prudence is an ever-evolving standard that has become increasingly high as the investment vehicles and strategies used by institutional investors have become more complex.

The Prudent Investor Rule⁷² is not only a common standard imposed on those who invest public funds, but it is also the optimal standard. It is stricter than the Prudent Man Rule⁷³ that merely requires fiduciaries to invest assets of others as they would invest their own. The Prudent Investor Rule, on the other hand, says that the actions of fiduciaries will be judged by the care, skill, and diligence that a person acting in a like capacity and familiar with such matters would use under the same circumstances. Essentially this standard means that the contemporary best practices of other relevant institutional investors are the appropriate benchmarks, not outdated standards of the past.

While fiduciaries are not guarantors that every investment decision will be profitable or turn out as expected, they must employ pure, thorough, and scrupulous processes in their decision-making in order to meet the high standards of prudence and avoid personal liability. Anything less is not good enough. Therefore, the policies, procedures, and actual practices of boards, staffs, consultants, and investment managers must reflect sound processes.

Findings and Analysis

Our findings and analysis of issues related to policies, procedures, and actual practices of NMSIO were based upon our review of internal policies, documents, meeting minutes, contracts, consultant reports, and discussions with members of the SIC, PEIAC, staff, and consultants. We discussed issues and debated our analysis internally as we made comparisons to actions of peers, common industry standards, and best practices related to the portfolio.

Asset Allocation

Asset allocation is one of the most important decisions a public retirement board is called upon to make. It is the essential, strategic determinant of the expected long-term rate of return and risk profile for a portfolio. Governing bodies typically set asset allocation with the assistance and advice of investment consultants and professional staff. Asset allocation decisions are usually reviewed annually but changed less frequently. A shift in the asset allocation is usually made to either increase returns, lower risk, achieve additional diversification, or, in some cases, all three.

Asset allocation decisions are typically based on either an asset allocation study or an asset liability study for those governing bodies who also manage pension assets. An asset allocation study is an asset-only

⁷² NMSA 1978 Section 45-7-601.

⁷³ Restatement of the Law, 3rd, Trusts: Prudent Investor Rule.

analysis that determines target allocations based on the risk/return characteristics of various asset classes, their correlation, and the risk tolerances of a council. It is an asset return optimization exercise focused on attaining an assumed asset return target. Typically, asset allocation studies will evaluate several model portfolios that have the highest amount of return for the given amount of risk. The model portfolios that have either the highest level of expected return for a given level of risk or the lowest level of expected risk for a given expected return are “efficient.” There are different efficient frontiers for portfolios that include different asset classes. For example, the efficient frontier for a stock and bond portfolio will be different from the efficient frontier for a portfolio that not only includes stocks and bonds, but also real estate, private equity, or other asset classes.

Traditional asset allocation analysis has not historically emphasized integration of spending policy characteristics (and the associated liabilities) in developing asset allocation targets. A number of leading endowments have adopted this best practice viewpoint to better inform asset allocation decision-making, and the concept is becoming more mainstream.

The Council is responsible for setting the asset allocation and monitoring compliance for the five fiduciary funds (collectively referred to as the “Funds”). The Council is not responsible for the asset allocation decisions of the other long-term trust assets of the 18 agency clients for whom it also invests monies.

Historically, the SIO and NMSIO staff have reviewed the Funds’ asset allocation on an informal basis annually with NEPC, their generalist investment consultant. A more formal asset allocation study and review was performed every two to three years at the discretion of the SIO. While the Council has, in effect, approved the asset allocation by approving the SIC General Investment Policy Statement (“IPS”), it has had limited participation in the process of setting the Funds’ asset allocation and has not formally discussed and clarified its expectations for returns and risk tolerance. This has resulted in what appears to be an unintentional or unknowing delegation of policy-making responsibility to the SIO.

Such delegation by the Council to the SIO, whether deliberate or not, is highly atypical as it grants the authority for making one of the most important fiduciary decisions to one individual. Best practice is for the Council or a sub-committee of the Council to participate in the process, formally discussing risk tolerance, return expectations, and setting the asset allocation for the Funds with the advice of the investment consultant, SIO, and other staff. We understand that the Council has recently become aware of this and will be more involved in this process at the suggestion of the interim SIO.

In addition, the Council has been irregularly involved in monitoring compliance with the asset allocation. As part of its quarterly performance reports, NEPC has provided information regarding the actual allocations to each asset class compared to set target allocations; however, such data has typically been presented as an information only item and not as a discussion item. There have been only infrequent discussions or actions regarding compliance with the asset allocation targets within the last two years. This, too, is atypical and not reflective of either common or best practice.

Another unusual aspect of the asset allocation is the very broad ranges set around each target allocation. For the LGPF, equities may range from 37% to 65%, fixed income may range from 9% to 28%, alternatives

may range from 8% to 35%, and cash from may range from 0% to 10%. For the STPF, equities may range from 37% to 65%, fixed income may range from 3% to 21%, alternatives may range from 11% to 44%, and cash from may range from 0% to 10%. These broad ranges, coupled with the authority given to the SIO by the Council to make defensive or tactical decisions within the broad allocation range limits set, almost renders the asset allocation targets set by the Council meaningless.

We generally recommend against tactical asset allocation. We encourage clients to adopt fixed target allocations for each major asset class along with a relatively narrow range (e.g., +/- 5%) within which the actual allocation is allowed to fluctuate. Any deviations within this range due to cash flows or market movements are generally acceptable, but if allocations fall outside of the established range we advocate taking steps to rebalance the investments to get close to the original targets. Our bias against market timing is based on both empirical evidence as well as the theoretical difficulty of correctly guessing when the time is right to get out of a market and when to get back in it.

Another interesting, but not unique, aspect of the NMSIO asset allocations began in 2007, when the former SIO made the tactical determination to apply a derivative overlay in order to manage equity volatility risk. Using derivative overlays at the portfolio level is not a common practice among institutional investors.⁷⁴ It is more common that derivative overlays are employed at the manager level or during rebalancing. When employed at a broader level, an overlay can significantly impact the overall asset allocation. As such, it is an important determination that is best made at the Council level, rather than at the staff level by the SIO. Any tactical techniques that can materially alter the asset allocation policy ought to be formally discussed and approved by the Council prior to implementation. Once in place, such techniques should receive the same amount of monitoring, compliance, measurement, and reporting as other investment strategies.⁷⁵

While proper asset allocation for a fund ought to be based upon that its purpose, objectives, cash flow, the governing body's risk tolerance, and legal restrictions, some boards and councils find it useful to compare their asset allocations to that of other peers. Even though few funds are completely comparable to those managed by SIC, we compared the asset allocations of the LGPF and STPF to what is perhaps the most comparable source—the average asset allocations for endowments and foundations as reported in two 2009 Commonfund Benchmark Study reports on endowments and foundations. The Study included the asset allocations of 290 non-profit foundations and 629 educational endowments. While a comparison to peers should not drive policy decisions, it can be interesting to know what decisions others have made.

⁷⁴ We do, however, note that derivative overlays of this type have also been used by the Nebraska State Investment Council and the State of Wyoming for its non-pension permanent funds.

⁷⁵ Caution ought to be taken in offering such strategies to underlying agencies so as not to inadvertently assume asset allocation responsibility for the underlying agencies' assets.

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It is important to note that only data points for the LGPF and STPF are represented.⁷⁶ Other agency clients for whom the NMSIO provides investment advisory and management services under joint powers agreements determine their own asset allocations and direct the movement of all funds. As such, their asset allocations are not within the scope of this report.

SIC Target and Actual Asset Allocations as of 6/30/2009

Land Grant Permanent Fund (LGPF)⁷⁷

| Asset Class | LGPF % of Total Assets | LGPF Long-Term Target ⁷⁸ | Range | Average Endowment ⁷⁹ | Average Foundation ⁸⁰ |
|-----------------|------------------------|-------------------------------------|-----------|---------------------------------|----------------------------------|
| Domestic Equity | 45.4% | 51.0% | 37% - 60% | 23% | 27% |
| Non U.S. Equity | 8.1% | 10.0% | 0% - 15% | 18% | 15% |
| Total Equity | 53.5% | 61.0% | <65% | 41% | 42% |
| Fixed Income | 17.9% | 15.0% | 9%-28% | 12% | 16% |
| Alternatives | 26.4% | 24.0% | 8% - 35% | 46% | 36% |
| Cash | 2.2% | 0.0% | 0% - 10% | 1% | 6% |
| Total Assets | 100.0% | 100.0% | N/A | 100.0% | 100.0% |

(This space left blank intentionally)

⁷⁶ The Tobacco Settlement Permanent Fund (TSPF), Water Trust Fund (WTF) and State Unemployment Trust Fund (SUTF) are to be managed by the SIO in a manner similar to the LGPF, pursuant to New Mexico State Constitution and/or State Statute. The TSPF, WTF and SUTF do not have allocations to private equity due to their relatively small asset size.

⁷⁷ For comparison, the average public plan's asset allocation as presented in the 2008 Greenwich Associates Market Dynamics Report is as follows: Domestic Equity – 37%, Non U.S. Equity – 19%, Total Equity – 56%, Fixed Income – 27%, Alternatives – 16%, and Cash – 1%.

⁷⁸ Long-term targets as depicted in SIC General Investment Policy Statement effective March 14, 2008.

⁷⁹ Commonfund Institute, Commonfund Benchmarks Study – Educational Endowments Report (2009).

⁸⁰ Commonfund Institute, Commonfund Benchmarks Study – Foundations Report (2009).

Severance Tax Permanent Fund (STPF)⁸¹

| Asset Class | STPF % of Total Assets | STPF Long-Term Target ⁸² | Range | Average Endowment ⁸³ | Average Foundation ⁸⁴ |
|-----------------|------------------------|-------------------------------------|-----------|---------------------------------|----------------------------------|
| Domestic Equity | 46.2% | 48.0% | 37% - 60% | 23% | 27% |
| Non U.S. Equity | 9.8% | 10.0% | 0% - 15% | 18% | 15% |
| Total Equity | 56.0% | 58.0% | <65% | 41% | 42% |
| Fixed Income | 7.6% | 12.0% | 3%-21% | 12% | 16% |
| Alternatives | 34.7% | 30.0% | 11% - 44% | 46% | 36% |
| Cash | 1.7% | 0.0% | 0% - 10% | 1% | 6% |
| Total Assets | 100.0% | 100.0% | N/A | 100.0 | 100.0 |

Aside from the comparisons to others being interesting from a reasonableness perspective, they should not guide the decision-making for NMSIO. Asset allocations are best determined by considering the purpose of the funds, their unique circumstances, and risk tolerance levels of its governing body. Best practice is for the Council, the staff, and consultants to reevaluate the appropriateness of the long-term asset allocations annually. We understand that such an effort is currently underway, and is being led by the Interim SIO.

Constitutional and Statutory Restrictions

Public funds, like those managed by the NMSIO, that are required to be invested under the mandates and parameters found in the Prudent Investor Act⁸⁵ generally do not need additional safeguards. The Act itself states that the fiduciaries must act responsibly in making investment decisions by taking into account the nature of the funds and their purposes and goals. Best practices are for such funds to be free of constitutional and/or statutory restrictions no matter how well intended they might be. Investment opportunities have increased over time. Some that may have been considered imprudent decades ago are acceptable today.⁸⁶ Constitutional restrictions that would require a vote of the people to change essentially places a very complex investment decision with people who may have little interest or sufficient knowledge about contemporary institutional investing to make a prudent decision. On the other hand, the advantages of Constitutional restrictions are that they cannot be easily changed and they may actually serve as protections.

⁸¹ For comparison, the average public plan's asset allocation as presented in the 2008 Greenwich Associates Market Dynamics Report is as follows: Domestic Equity – 37%, Non U.S. Equity – 19%, Total Equity – 56%, Fixed Income – 27%, Alternatives – 16%, and Cash – 1%.

⁸² Long-term targets as depicted in SIC General Investment Policy Statement effective March 14, 2008.

⁸³ Commonfund Institute, Commonfund Benchmarks Study – Educational Endowments Report (2009).

⁸⁴ Commonfund Institute, Commonfund Benchmarks Study – Foundations Report (2009).

⁸⁵ NMSA 1978 Section 45-7-601.

⁸⁶ For example, it was once unacceptable for many public funds to invest in real estate, private equity, commodities, and hedge funds.

For the NMSIO, the Constitutional and statutory restrictions were imposed on the Funds prior to the imposition of the Prudent Investor Act on the Funds. With the passage of the Act, these restrictions may conflict with the Act and confuse fiduciaries about their authority and responsibilities.

Under the best scenario, the governing body (the Council) is held responsible for making prudent investments by setting policies, establishing reasonable limitations on assets classes, and overseeing the implementation of strategies. Unreasonable acts by a governing body could be deemed to be a breach of fiduciary duty and expose its members to personal liability. The Prudent Investor Act is strict, but it also gives the necessary flexibility to fiduciaries for the prudent investment of the funds. Given the rapidly evolving nature of the investment landscape, having detailed statutory or constitutional restrictions on how to prudently implement an investment strategy is not best practice.

The New Mexico State Constitution and statutes contain restrictions on the level of permissible investment in certain asset categories. In addition, they provide legislative intent for the economically targeted sub-allocations of the Funds.

The New Mexico State Constitution⁸⁷ states that investment of the LGPF is subject to the following restrictions:

- Not more than 65% of the book value of the fund shall be invested at any given time in corporate stocks
- Not more than 10% of the voting stock of a corporation shall be held
- Stocks eligible for purchase shall be restricted to those stocks of businesses listed upon a national stock exchange or included in a nationally recognized list of stocks
- Not more than 15% of the book value of the fund may be invested in international securities at any single time

By New Mexico State Constitution and/or State statute, the WTF, TSPF, and SUTF are to be managed in a manner similar to the LGPF.⁸⁸ The STPF is not subject to the same Constitutional investment restrictions as the LGPF; however, the SIC's IPS applies those same restrictions. This makes the asset allocations of all the fiduciary funds largely uniform, with the exception of the STPF, which is permitted by State statute to invest in economically targeted investments.

The current Constitutional restrictions, while for the most part are reasonable, could impair the construction of the best and most prudent portfolio, especially when international securities are limited to 15%. The 10% voting stock of a corporation could also prove to be an unwise limitation that could cause the Council to forgo opportunities for certain private equity investments.

⁸⁷ N.M. Const. art. XII, § 7(D).

⁸⁸ As previously mentioned, the current asset levels of the TSPF, WTF, and SUTF are so small that there are no allocations to Private Equity. As such, the intended Private Equity allocations remain in Core Bonds until the corpus of the three funds become large enough to make Private Equity investments economically viable.

The New Mexico statutes⁸⁹ allow and encourage economically targeted investments for the STPF. Our understanding is that while the statute only grants permission, it has been and continues to be interpreted by the Council, SIO, and NMSIO staff as a requirement. Economically targeted investments must pass the prudence and loyalty tests of the Prudent Investor Act. Considerations of lower standards for risk and return would not be appropriate.

The Council is in a difficult position as fiduciaries if it is to have dual objectives of earning an inflation adjusted return to fund the statutory spending policy and enhancing the New Mexico economy. It is not clear if the SIC believes the Prudent Investor Act is suspended for these funds or whether it somehow reconciles the two. In either case, the SIC must be prepared to monitor, measure, and report on progress of both objectives. Above all, it must demonstrate prudence in the processes used to achieve the objectives. Doing so means ample time from the NMSIO staff and at Council meetings to address these important issues.

Asset Classes

Asset class diversification is a crucial fiduciary responsibility and is essential to risk management. Thus, exploring and investing in new asset classes requires thoughtful planning and implementation. Institutional investors diversify by asset type (stocks, bonds, real estate, etc.), and then further diversify within each asset class according to factors such as sector, credit quality, and geography. In order to achieve appropriate diversification, a program must have an organized and customized approach to investment selection. In a best practice environment, the governing board, or a subcommittee thereof, actively participates in asset class diversification discussions as facilitated by staff and consultants.

In today's institutional investment arena, Modern Portfolio Theory (MPT)⁹⁰ is used as the overall framework for evaluating investments. It is a portfolio management strategy and quantitative method used by institutional investors to achieve a desired rate of return while minimizing risk. Under this theory, the appropriate way to structure a portfolio is to diversify investments among asset classes, and the proper way to judge investment performance is to evaluate the overall performance of the entire portfolio. No investment is considered, *per se*, imprudent. An investment can be risky in isolation and still be prudent if a particular investment fits within the overall investment portfolio. Asset class correlation is another fundamental tenet of MPT. For example, if one type of investment tends to increase in value during certain market conditions while another one declines, the overall portfolio is strengthened, and risk can be reduced by including both asset classes.

The best approach for portfolio construction will take into account a broad range of asset classes, leveraging the ideas of investment experts both inside and outside the organization. Best practices are to provide advanced education to governing council or board members and staff about the risks and expected returns of various asset classes and strategies before any are introduced into the portfolio. The rationale in support

⁸⁹ NMSA 1978, Sections 7-27-1 through 7-27-5.26.

⁹⁰ Modern Portfolio Theory was developed by Harry Markowitz and is outlined in the paper "Portfolio Selection" published in *The Journal of Finance*, Vol. VII, No. 1 in March 1952. Markowitz later received the Nobel Prize in Economics for his work on Modern Portfolio Theory.

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of a new asset class should be documented in council or board meeting minutes and maintained with any written materials that influenced the decision.

NMSIO's IPS outlines the various permitted asset classes in which the Funds may be invested, subject to Constitutional and statutory restrictions, where relevant.

Traditional Asset Classes

U.S. Large Cap Equity
U.S. Mid/Small Cap Equity
U.S. Fixed Income
U.S. High Yield Fixed Income
International Equity
Emerging Market Equity

Non-Traditional Asset Classes

Private Equity
Real Estate
Hedge Funds

Below is a high level summary of the permitted investment types by asset class as indicated in the IPS. These broad asset classes are comparable to those used by sophisticated institutional investors.

- Equity – Includes domestic stocks listed and actively traded in the U.S. and international stocks which derive a significant portion of profits or revenues from U.S. markets and are listed and actively traded in the U.S. Additionally, initial public offerings of spin-offs from equities held within the domestic large cap active portfolio are also eligible for investment. The developed equity programs are intended to be style neutral portfolios.
- Fixed Income – Authorized investment types are all bonds, notes, debentures, instruments, conditional sales agreements, securities or other evidences of indebtedness of any corporation, partnership or trust. This includes, but is not limited to: government, corporate, asset-backed, mortgage-backed, collateralized debt obligations, and collateralized loan obligation securities. In addition, the Credit Structured Finance Fund may also invest in rated and non-rated securities of collateralized debt obligations, collateralized loan obligations, credit opportunity funds, leveraged loan portfolios, and other structured finance instruments.
- Real Estate – Governed by a separate real estate investment policy statement. Composed of private equity real estate investments, private debt investments secured by first liens, private and public interests in real estate owning and/or operating entities (REITs, REOCs or limited partnerships). Such investments may be either direct or indirect.
- Absolute Returns – Governed by a separate hedge fund investment policy statement. Refers to investments in hedge funds including those that employ relative value, market neutral, arbitrage, and equity long/short.
- Private Equity – Governed by a separate private equity program investment policy. Includes investments in direct private equity investments, co-investments and limited partnership interests. Incorporates a variety of private equity sub-strategies such as start up, expansion, buyout/acquisition, recapitalization, debt financing, and similar business purpose.

In addition, the Funds may invest in derivative instruments, and structured credit instruments.⁹¹ As previously mentioned, the Severance Tax Permanent Fund may also invest in New Mexico direct equity investments, New Mexico film projects, government guaranteed New Mexico home and farm loans, and certificates of deposit in New Mexico financial institutions.

Presently, NMSIO implements its equity strategy with domestic and international mandates. In domestic equity, there is a trend away from investing along capitalization size. For example, rather than splitting equity investments among large, small or mid capitalization limits, these restrictions would be eliminated, effectively allowing active managers to make decisions in unrestrained environments. With this latitude, however, comes a heightened need for accountability and compliance as this approach does not diminish the need for appropriate diversification parameters. NMSIO has adopted this approach to a certain extent, allowing (through its IPS) both internal and external large cap managers the discretion to invest in mid/small cap equities for a portion of their portfolios.

The IPS states that there will be an externally managed small cap portfolio, but in actual practice this portfolio is being managed internally using an active strategy and largely without capitalization limits. This amounts to two different Policy violations and demonstrates a failure on the part of the Council to oversee delegations. Decisions of internal versus external management are best left to the governing body, such as the Council, with guidance and advice from the independent consultants. The decision should not rest with the staff members, who may have a conflict of interest in making such a decision. Staffs who manage assets internally are usually paid more than those who monitor externally managed portfolios. Furthermore, if the Policy is to have a distinct small cap portfolio, then any drift into larger cap securities should be prohibited. Finally, the internally managed small cap portfolio is managed by staff using an active strategy. Prudence would dictate that the Council determine if the staff has the same qualifications and experience that it would require of external managers that manage assets actively rather than passively.

At the broad asset class level, NMSIO clearly delineates equities between domestic and international categories. Some institutional investors are moving away from dividing equities into domestic and international categories, and instead viewing it as one category of global equities. The economic argument for investing on a global basis is compelling. First, the distinction between U.S.-based and international companies is becoming less important from an investment perspective. Also, the definition of what is a U.S. versus a non-U.S. company is becoming increasingly unclear with non-U.S. companies having operations in the U.S. and vice-versa. Thirdly, many companies domiciled in the U.S. derive a significant portion of their revenues overseas just as many large non-U.S. companies receive a large portion of their revenue from U.S. sales.

Another argument for global investing is that that top companies in different industries are located throughout the world. Some are in the U.S. and some are not. For example, the ten largest construction firms in the world are located outside of the U.S. and seven of the ten largest banks are located outside of the United States. Leading information technology firms, on the other hand, are largely domiciled in the

⁹¹ Structured credit instruments are securities created by repackaging cash flows from financial contracts. These instruments include asset-backed securities, mortgage-backed securities, and collateralized debt obligations.

United States. A global portfolio can disregard country distinctions and pick its investments notwithstanding the physical location of the company.

We observed that within equity (U.S. and non-U.S. combined), the Funds have higher than average policy allocations to domestic equity. We typically encourage clients to consider moving up to as high as a 50/50 U.S./non-U.S. equity split, which is more inline with world equity market capitalizations. For instance, the LGPF has about 84% target to U.S. equity versus a 16% target to non-U.S. equity (considering only equities). As of June 2009, U.S. equity represents only 43% of the available investable world equity market capitalization.⁹²

From a clean slate approach, the best way to view equity investing is to think of global equity as an asset class, where U.S. and non-U.S. equity are “market segments” under the global equity umbrella. Modern Portfolio Theory suggests that the “market portfolio,” a market-cap weighted sum of all available asset classes, is the most efficient portfolio (in terms of risk / return trade-off) an investor can hold. Therefore, the most efficient total equity portfolio is one where U.S. and non-U.S. equities are held in proportions approximating that which is available in the marketplace. This would eliminate the “home country bias”⁹³ present in most institutional portfolios.

Rebalancing of Assets

A rebalancing process (or reallocation of assets) ensures that the decided upon asset allocation and resulting risk and return characteristics are maintained. Due to continuous market movements, specific target allocations to an asset class are difficult to maintain, so allowable “ranges” for asset class exposures are typically approved by the governing body (council or board) as part of the asset allocation. Each approved allocation to an individual asset class may then fluctuate from its expressed target as long as it remains within the allowable range. If a range is exceeded, reallocation of assets or rebalancing is triggered to bring the actual allocation back to its appropriate level.

Rebalancing ranges are typically set to represent a reasonable trade-off between risk control and costs. If there were no trading costs to rebalance a portfolio, the optimal strategy would be one of continual rebalancing. It is common practice for public funds or endowments to initiate rebalancing either every quarter or every month when the actual allocations exceed the allowable ranges. Often, public funds and endowments will also use normal cash flows to assist in keeping the actual allocation within the ranges.

Often the same ranges are used for each asset class, although some institutional investors have smaller ranges for asset classes with smaller allocations, like real estate, private equity, and hedge funds. For example, an asset class with a 40% allocation may have a range of +/-5%, but an asset class with a 15% allocation may have a range of +/-3%. The table on the following page depicts SIC's allocation ranges for the LGPF and STPF portfolios only.

⁹² MSCI All Country World Index.

⁹³ “Home country bias” is an overweight to the stock market of the country in which the investor is domiciled.

Land Grant Permanent Fund (LGPF)

| Asset Class | Minimum | Maximum | Current Allocation ⁹⁴ | Long-Term Target Allocation |
|-----------------------|---------|---------|----------------------------------|-----------------------------|
| Broad U.S. Equity | 37% | 60% | 45.4% | 51.0% |
| Broad Non-U.S. Equity | 0 | 15 | 8.1 | 10.0 |
| Fixed | 9 | 28 | 17.9 | 15.0 |
| Absolute | 5 | 20 | 13.1 | 15.0 |
| Private Equity | 3 | 9 | 9.5 | 6.0 |
| Real Estate | 0 | 6 | 3.9 | 3.0 |
| Cash Equivalent | 0 | 10 | 2.2 | 0.0 |
| Totals | | | 100.0 | 100.0 |

Severance Tax Permanent Fund (STPF)

| Asset Class | Minimum | Maximum | Current Allocation ⁹⁵ | Long-Term Target Allocation |
|-----------------------|---------|---------|----------------------------------|-----------------------------|
| Broad U.S. Equity | 37 | 60 | 46.2 | 48.0 |
| Broad Non-U.S. Equity | 0 | 15 | 9.8 | 10.0 |
| Fixed | 3 | 21 | 7.6 | 12.0 |
| Absolute | 5 | 20 | 13.2 | 15.0 |
| Private Equity | 6 | 18 | 16.5 | 12.0 |
| Real Estate | 0 | 6 | 4.9 | 3.0 |
| Cash Equivalent | 0 | 10 | 1.7 | 0.0 |
| Totals | | | 100.0 | 100.0 |

Rebalancing to targets results in a lower benchmark risk than rebalancing to the edge of the range, as the resulting actual allocations will closely match the policy targets. Benchmark risk is defined as tracking error or standard deviation of the difference between actual fund performance and the policy benchmark performance. While reducing benchmark risk is a good outcome, rebalancing to the target typically incurs a higher cost than rebalancing to the edge of the range. Institutional investors must balance goals of reducing benchmark risk and minimizing transaction costs when deciding upon a rebalancing methodology. Special consideration, though, must be given to illiquid asset classes where rebalancing is expensive or not possible.

In most cases, we believe rebalancing back to the edge of the range as opposed to the target provides a superior risk/cost control outcome. Our analysis, based on a simulation analysis⁹⁶ that randomly generated 10,000 observations from distributions built using our capital markets expectations, indicates that in cases

⁹⁴ Current allocation percentages based on 6-30-2009 Performance numbers.

⁹⁵ Current allocation percentages based on 6-30-2009 Performance numbers.

⁹⁶ Assumptions for the simulation analysis included: goal of rebalancing to control risk, 5 years of equity and fixed income returns, policy of 70% equity and 30% fixed income, one way trading costs of 24 basis points for equity and 12 basis points for fixed income, portfolio size of approximately \$1.2 billion.

when managers must buy and sell securities in order to rebalance, it is best to do so only to the edge of the range. This superior risk/cost control outcome assumes that actual securities are being bought and sold during the rebalancing procedure (i.e., separate account managers are being instructed to buy/sell securities to affect the rebalance). In cases where a free trade may exist with an index fund manager or the cost of buying/selling shares of a commingled fund or mutual fund is the same no matter the dollar amount, rebalancing back to the policy target is appropriate.

The NMSIO rebalancing policy calls for the SIO to review the allocation status of the Funds at least quarterly to determine if the actual allocation is consistent with the established ranges. If action is necessary, the SIO directs staff and external managers to transfer funds and rebalance, with subsequent notification to the Council. This is common practice. The IPS instructs NMSIO staff to employ normal cash flows into and out of the various portfolios to assist in the rebalancing effort. This too is common practice. In addition, NEPC monitors the portfolio to ensure that at its fully invested amount, the portfolio is within allocation ranges.

Best practices are for a public fund to have a disciplined approach to rebalancing and a written policy on the matter. The policy should be established by the governing body (the Council) with the advice of the staff and consultant. The Policy should be closely monitored by NMSIO staff on a monthly basis and by the consultant and Council on a quarterly basis. In times of great turbulence in the markets, it is best practice to address asset class swings with the Council more frequently and discuss any exceptions to the rebalancing policy.

Investment Goals and Risk Tolerance

The investment goals of public funds are typically stated in an investment policy. Investment goals can include achieving a specified absolute return (for example, 8%), limiting volatility, earning enough income to fund current year distributions, protecting principal, or a number of other things. Investment goals are best if they are tied to the risk tolerances of the governing council as that tolerance for risk will directly impact the resulting portfolio structure. When investment returns are strong, boards often do not focus on investment goals and risk tolerances. Difficult markets, like those in 2008, highlight the importance of these two issues.

Many governing boards have taken a fresh look at their risk tolerances and corresponding investment goals. More than half the respondents to a recent Greenwich Associates survey⁹⁷ have reviewed or changed their policies in the last 12 months. Cutting volatility while boosting predictability appeared to be the primary goals.

The Council's stated investment goals, as listed in its approved IPS, are as follows:

- Preserve and enhance principal over the long-term, while operating under the Prudent Investor Rule.
- Diversify investments of the fund to minimize the risk of significant losses.
- Maximize total net return.

⁹⁷ Greenwich Associates Market Pulse survey of 152 institutions with assets under management greater than \$1 billion. Among those participating in the survey were 97 corporate pension funds, 34 public funds, and 21 endowments.

We find these investment goals to be reasonable, and similar to goals stated by other endowments and public funds with the exception of the third statement, “maximize total net return.” It would be more consistent with the Prudent Investor Rule to state “maximize total risk-adjusted return” to demonstrate the consideration of risk. In addition, the differential rate program in the Severance Tax Permanent Fund also has an objective of enhancing the New Mexico economy, an issue previously discussed in the context of fiduciary duty.

A developing trend in managing large, multi-manager portfolios in the public sector is to specify acceptable levels of active risk through a risk-budgeting tool. Risk-budgeting establishes active risk targets or ranges for each asset class and the total fund. Active risk is a statistical measure of risk that an active manager assumes relative to the benchmark it seeks to beat. It represents the potential return differential between a manager’s return and its benchmark, and is the quantitative representation of the latitude that the manager has in attempting to add excess return.

Risk budgeting should never be done, however, in isolation. In periods when the market’s risk, or volatility, is higher than normal (as was the case over the last few years), active risk will also be high. As active risk is linked to the market, risk budgeting should take this link into account, and any caps or ranges should be reflective of the changing levels of risk in the market. The SIO, other NMSIO staff, and NEPC presently employ risk budgeting techniques in setting appropriate risk tolerances for the Funds. While this is a best practice, the Council ought to take a more active role in discussions regarding this topic so its preferences for governance, oversight, and ways to control risk are consistently taken into consideration.

Written Investment Policy Statement

An investment policy statement is one of the most important policies of a governing body’s governance framework. The purpose of the investment policy statement is to provide a clear direction for investment program structure and management. It should reflect the investment goals and risk tolerance that the governing body has agreed upon for the fund. It should also take into account the fund’s financial characteristics and delineate responsibilities and reporting lines for all key parties.

We are unaware of any New Mexico statutes that specifically require a written investment policy statement for trust funds, such as those managed by NMSIO. Nevertheless, having a well-crafted investment policy statement is a best practice for all trust funds, public or private. There is no uniform standard for the content or an absolute model to follow. Public sector organizations, however, have provided guidance.⁹⁸ This has led to some elements of an investment policy statement that are considered necessary to reflect best practice within the public funds environment.

⁹⁸ See for example, The Government Finance Officers Association (GFOA) Recommended Practice, Committee on Retirement and Benefits Administration “Investment Policy Checklist for Pension Funds” 2003.

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Below we detail what we believe to be best practice elements of an investment policy statement. It is common for public funds to have an investment policy statement that is less comprehensive than what is outlined in the chart. Some public funds have extensive investment manager guidelines or detailed contract provisions to supplement policies, or may address various subjects in separate documents. The best practice is to have clear documentation of what is expected and who is responsible. Whether this information is contained in one or more documents is a matter of choice. If multiple documents are used, they should not conflict. Further, a compilation of related policies, with cross-references where needed, promotes effectiveness and efficiency.

We have noted with a check mark (✓) those elements that are already included in the SIC's IPS as amended March 14, 2008. We have also noted if an element is located in a separate document, or if enhancement is needed. We understand that that SIO and other NMSIO staff are in the process of revising the general Investment Policy Statement. Best practices would be for the Council to have a solid understanding of the changes NMSIO staff recommends, to seek advice from the investment consultant, and to have a thorough discussion of the implications of the changes before it approves any of them. This is the most important policy that documents the Council's delegation to the Investment Office staff and others.

| Investment Policy Statement Subject Areas | |
|--|---|
| Introduction | |
| Reference to state law creating the funds with specific reference to investment related sections of the law. | Needs enhancement |
| Reference to one or more trusts and trustee(s). | ✓ Best practice (however, no mention of the SUTF) |
| Confirm decision-making authority (e.g., ability to have investment advisors, ability to delegate authority, ability to set policy). | Needs enhancement |
| Description of the purpose of the funds. | Needs enhancement |
| Scope (e.g., limited in application to trust fund assets or may include other assets). | ✓ Best practice |
| Standard of Care | |
| Reference to applicable fiduciary standards. | Needs enhancement |
| Listing of investment goals that could include: | |
| Preserve the principal of the trust in order to meet spending policy requirements. | ✓ Best practice |
| Identify the Council's level of acceptable risk. | Needs enhancement |
| Description of secondary goals for the Funds (e.g., stimulate the state economy through job creation, expand business activity within the state) with specific statutory references. | Needs enhancement |
| Investment objective clearly stated (e.g., goals to obtain a long-term rate of return—one or two market cycles, including whether "market cycle" is defined—net-of-fees, equal to or in excess of the policy benchmark). | ✓ Best practice |
| Meet the policy benchmark and asset allocation targets. | ✓ Best practice |
| Clarification of how investment risks will be managed. | Needs enhancement |

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| | |
|---|--|
| Establishment of the risks that may be taken to achieve return goals. | Needs enhancement |
| Look for reference to operate with transparency. | IPS is silent on the topic of transparency; however, NMSIO does have a separate Transparency and Disclosure Policy |
| Definition of the policy benchmark, asset allocation targets, and expected returns. | ✓ Best practice |
| Reference of the duty to incur only reasonable expenses. | Needs enhancement |
| Roles and Responsibilities | |
| Council members – general and investment related duties. | Needs enhancement |
| Private Equity Investment Advisory Committee – role to make recommendations or final decisions, fiduciary responsibility. | Needs enhancement |
| Internal staff – general and investment related delegations and expectations, particularly as among the SIO, and any other senior investment-related staff (e.g., Legal Counsel). | Needs enhancement |
| Investment consultants – duties, reporting lines, expectations regarding the frequency of communications, and acknowledgment of fiduciary responsibilities. | Needs enhancement |
| Internal and external investment managers – duties, acknowledgement of fiduciary responsibilities, and frequency of communication; could incorporate by referencing their contractual mandates. | Individual managers provided with written investment guidelines per mandate as part of contract |
| Custodian bank – role as custodian versus trustee, cash manager, performance calculations, etc. | Needs enhancement |
| Description of other service providers' duties (e.g., proxy voting, evaluating trading efficiency, portfolio analytics), expectations, and fiduciary status. | IPS references proxy voting and securities lending policies and procedures; however, no formal proxy policies and procedures exist ⁹⁹ |
| Purpose and scope of annual and more frequent reporting. | Needs enhancement |

⁹⁹ The State Investment Office does not currently have a formal proxy policy, although such a policy is referenced in the IPS. While a draft policy was developed several years ago, the State Investment Officer at the time made the determination that individual managers would use their discretion as to how to vote proxies in the best interests of the NMSIO. The interim SIO has indicated this lack of direction is not acceptable and is exploring solutions, including hiring an external firm to manage this for NMSIO. NMSIO staff reported that it anticipates a formal policy to be adopted in 2010.

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| Asset Allocation | |
|---|---|
| Description of the importance of asset allocation, as the most important decision to be made in the investment management process. | Needs enhancement |
| Review stated purpose of asset allocation to provide an optimal mix of investments to produce desired returns and meet spending policy requirements, with minimal volatility. | Needs enhancement |
| Description of the frequency of reviewing asset allocation and resetting, if needed. | ✓ Best practice |
| A description of permissible asset classes is provided along with minimum, maximum, and target ranges. | ✓ Best practice |
| Diversification rules regarding a single issuer, single asset class, economic sector, or country are clearly stated. | IPS is silent; Private equity and real estate investment policy statements contain some relevant language |
| Asset Class Guidelines and Benchmarks | |
| Definition of asset classes and rationale for their inclusion in the portfolio. | Needs enhancement |
| Identification of who sets benchmarks, how often they are revisited, and the process for doing so. | Needs enhancement |
| Identification and description of prohibited investments—short selling, margin, investments precluded by law or regulation. | Needs enhancement |
| Identification of credit risk – minimum credit rating for any fixed income investment as determined by a nationally recognized credit rating agency. | Needs enhancement |
| Rebalancing Activities (Reallocation of Assets) | |
| Statement of the purpose of rebalancing—to ensure that the investment program adheres to its strategic asset allocation. | ✓ Best practice |
| Method used to rebalance is stated—most cost effective manner, use excess cash, index strategies, or liquidation of overfunded managers. | ✓ Best practice |
| Describe how often the portfolio will be reviewed for rebalancing and whether a fixed threshold or proportional threshold will be used. | ✓ Best practice |
| Verify that authority/responsibility for rebalancing is clearly defined. | ✓ Best practice |
| Monitoring and Reporting | |
| The purpose of continuous monitoring is addressed—to ensure compliance with the investment policy and applicable law, to manage risk, and assess the performance of managers. | ✓ Best practice |
| The monthly/quarterly reporting requirement(s) for internal and external managers is addressed. | ✓ Best practice |
| Brokerage commissions as trust fund asset are acknowledged. | ✓ Best practice |
| Required reporting from other external investment professionals is addressed. | ✓ Best practice |
| Expectations on the contents, format, and frequency of reports are unambiguous. | Needs enhancement |

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| Shareholder Activity | |
|---|--|
| A formal proxy policy exists and contains current positions. | IPS references separate proxy voting policies and procedures; however, none exist ¹⁰⁰ |
| Description of the proxy voting policy and how votes are cast and recorded. | Needs enhancement |
| Statement of the circumstances under which the Council will sign on to or initiate a shareholder proposal. | Needs enhancement |
| Statement of how (or if) a focus list of underperforming companies will be identified and what communication the Council takes to engage companies in dialogue. | Needs enhancement |
| Description of the process of opting in and out of shareholder class actions. | Needs enhancement |
| Identification of the core principles of corporate governance (board independence, CEO compensation, access to the proxy, audit committee, etc.) | Needs enhancement |
| Governance | |
| Identify fiduciaries at all levels. | Needs enhancement |
| Reference to responsible contractor policies. | Needs enhancement |
| Statement of delegation to the staff; could incorporate by referencing the SIO position descriptions. | Needs enhancement |
| Alignment of the strategic plan with the annual plan. | Needs enhancement |
| Requirement to annually review investment policy statement. | Needs enhancement |

Overall, the SIC's General Investment Policy Statement addresses some of the fundamental elements of a comprehensive investment policy statement and, when supplementary documents such as the private equity, real estate, and hedge fund investment policy statements are taken into account, many aspects covered by the IPS are fairly thorough. In some areas, however, it is lacking important delegations by the Council. It also needs modernization and better overall organization. We understand that the SIO and staff intend to work with the Council to update the IPS in 2010.

While documented policies convey instruction from fiduciaries to those to whom they have delegated responsibility, the appropriate type and frequency of reporting must be established so that compliance can be checked. Policy compliance is a moving target; allocations and manager structure can be in compliance with policy guidelines at a specific point in time, and out of compliance the following month or quarter. As such, ongoing monthly monitoring by staff (often the internal auditor) is essential. Any deviation from the policy should be promptly discussed and remedied.

There are certain areas where actual SIC practice is out of alignment with the Policy. For example, the IPS specifies that there be a small/mid cap internally managed passive portfolio and a small/mid cap externally managed active portfolio. In actual practice, the Investment Office internally manages a concentrated actively managed strategy. It uses the S&P 500 as its benchmark, not the S&P 400 as stated in the IPS.

¹⁰⁰ See footnote 99.

This type of non-compliance is a problem for the Council and the consultants to promptly address with Investment Office staff. If the deviation from the IPS is intentional and what the Council has instructed, then the IPS language should be changed.

Manager Structure

After the allocation to each asset class in a portfolio has been determined, many decisions need to be made regarding how that allocation will be implemented. These decisions will determine the investment management structure and will directly impact performance and fees. At the most basic level, investment manager structure begins with a determination of how much passive and active management to use. It also includes determining whether and to what extent to include internal and external management in the portfolio. Next, the number and types of managers must be selected. All of these decisions must be made with the overall goals and objectives of the total portfolio in mind.

Modern Portfolio Theory suggests that the most efficient portfolio an investor can hold is the “market portfolio,” which would be the market-cap weighted sum of all available asset classes. Within the public markets asset classes, the market portfolio would suggest a market neutral positioning, absent a particular outlook for one or more segments of the market. For the private markets asset classes, factors such as liquidity requirements, portfolio objectives, and return goals must be considered when setting the structure. The implication for any investment management structure is that attention must be paid to what the portfolio looks like when the individual managers are aggregated. The structure must be in alignment with the investment policy statement and be monitored for compliance. Structural biases toward certain segments of the market can result in unintended misfit risk between the portfolio and the benchmark. It could also result in additional risk, which can be thought of as an unexpected result.

As establishing manager structure is one of the most important functions that boards are required to perform, it is imperative that prudent decision-making processes support the ultimate decisions. Discussions and decisions regarding the structure of an institutional investment program require careful thought and unbiased advice from experts on staff and qualified consultants. Typically, decisions related to manager structure are retained by the board rather than delegated to staff or the investment consultant; however, sometimes investment management decisions are delegated to staff or outside service providers. When this responsibility is delegated, it must be done in a prudent manner. The highest fiduciary must still periodically monitor whether the delegation of responsibilities remains appropriate, and whether it is being done in a satisfactory manner.

The NMSIO staff may invest and reinvest the funds within various asset classes outlined in the IPS, so long as the investment activities comply with the Prudent Investor Act. The IPS permits a combination of both passive and active and internal and external investment strategies to be used to implement the Funds’ assets, and does not restrict the number of managers that can be used within an asset class, which we

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believe is appropriate. The following chart¹⁰¹ shows the percentage of NMSIO assets that are invested actively and passively, as well as the level of external versus internal management, in comparison to peers.

| Asset Range | Percentage Actively Managed | Percentage Passively Managed | Percentage Externally Managed | Percentage Internally Managed |
|-------------------|-----------------------------|------------------------------|-------------------------------|-------------------------------|
| Over \$20B | 77.7% | 22.3% | 67.1% | 33.0% |
| \$10B - \$20B | 71.4% | 28.6% | 67.2% | 32.8% |
| \$5B - \$10B | 81.9% | 18.1% | 97.0% | 3.0% |
| \$1B - \$5B | 87.6% | 12.4% | 95.2% | 4.8% |
| \$500mm - \$1B | 97.0% | 3.0% | 100.0% | 0.0% |
| \$100mm - \$500mm | 88.3% | 11.7% | 98.6% | 1.4% |
| NMSIO | 90.0% | 10.0% | 67.3% | 32.7% |

As shown, NMSIO invests approximately 10% representing \$1.2 billion passively,¹⁰² which is significantly lower than the level of passive management used by peers. We believe a material allocation to index funds may be warranted for most public funds. Compelling research exists indicating that active management implementation is no easy endeavor. Within an equity portfolio, a substantial allocation to index funds serves to anchor the portfolio to the asset class benchmark. The case for passive management is strengthened by the highly efficient nature of the equity and bond markets. Information on publicly-traded companies flows freely, and it is difficult for one investor to have a material advantage over another. Also, broadly representative and investable market indices are available. Finally, the cost differential between active and passive equity managers is significant, and, since active managers have not consistently beaten the market averages after considering all costs, a diversified, low-cost investment approach is a compelling investment thesis.

The decision of whether to use passive index funds or active managers will directly affect the net investment returns. Generally speaking, passive management is less expensive than active management. Index funds offer low-cost, broadly diversified exposure to an asset class or segment of an asset class. Larger index funds offer economies of scale to their investors since costs associated with managing the funds are spread across a larger asset base. Further, larger index funds that also have a widely diversified base of investors offer their investors the ability to minimize costs associated with trading since an investor's trading order may be offset against that of other investors.

Given the investment thesis supporting passive investing strategies, the costs associated with active management, and the amount of qualified staff, resources, compliance, and risk management controls required to manage an active strategy, NMSIO ought to periodically revisit this decision to ensure its continued prudence. Internal portfolios should be held to the same standards (performance, trading efficiency, and operational risks) as externally managed portfolios. Careful monitoring and regular evaluation ought to occur, regardless of performance results. Periodic reporting to the Council on the amount of actual expense associated with the internal management should be supplied and discussed.

¹⁰¹ Per R.V. Kuhns Public Fund Universe Analysis Report.

¹⁰² As of 6/30/2009.

Approximately \$3.8 billion (31%) of SIC's total \$11.8 billion in assets¹⁰³ are managed internally by NMSIO staff. The preceding chart shows that NMSIO's use of internal management is comparable to that of other funds over \$10 billion. On average, other large funds invest approximately 33% of their assets internally. NMSIO's internal management is primarily in the areas of large cap equity, core bonds, and a small/mid cap strategy. Only a small portion of the assets managed internally are managed passively. Staff also has the authority pursuant to the IPS to manage derivatives internally.

To reflect best practices and increase the likelihood of sustained superior performance, the management of these complex, extensive research-driven investment strategies must be carried out by highly-skilled, experienced investment professionals and supported by sufficient resources, such as state-of-the-art securities processing, trade order management, and investment accounting systems. This is difficult for public funds to achieve because they are often hampered by state personnel and procurement requirements, which constrain their ability to attract and retain staff with the requisite investment expertise and obtain up-to-date resources. Consequently, while many public funds manage at least some portion of their assets internally, such management is typically passive, traditional publicly traded equities and fixed income, rather than aggressive, innovative investment strategies.

In our experience, when internal management is used, the most common type of investment to move in-house is a U.S. equity index fund. Public funds sometimes decide to run index funds internally in order to achieve cost savings. There are, of course, risks involved when managing assets internally, but some larger public funds have been able to adequately address those risks. Active strategies, fixed income, cash management pools, or even alternative investments (private equity or real estate) are also sometimes moved in-house, depending on the staffing and resources presently available to the organization, and overall confidence in the ability to retain those resources in the future. Management of active and alternative investment strategies requires a very specialized skill set and a deep staff.

Once the decisions are made regarding whether and to what extent to use active or passive management and internal or external managers, the investment managers must be selected. There is no absolute model for determining the most appropriate number of investment managers to use in structuring a portfolio. Fewer managers can result in larger allocations of assets to a manager, which will usually reduce expenses if certain thresholds are met. On the other hand, larger allocations can increase manager-specific risk. Smaller allocations may diversify manager-specific risk, but could result in increased fees.

NMSIO staff has the responsibility of determining the number and types of managers employed, and to monitor and review all investment portfolios and managers to ensure compliance with the New Mexico State Constitution, relevant statutes, policies, and applicable guidelines. This is a common delegation of duties to staff. SIC external managers are given both general guidelines and specific mandates to invest the Funds' assets according to the investment style for which they were hired.

¹⁰³ As of 6/30/2009.

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The chart below summarizes the number and types of investment managers used within the Funds.

| Asset Class | Number of Managers |
|-----------------------------------|--|
| Large Cap Equities | 10 (9 external and 1 internal) |
| Small / Mid Cap Equities | 5 (4 external and 1 internal) |
| Non U.S. Developed | 2 (external) |
| Non U.S. Emerging | 1 (external) |
| Core Bonds | 1 (internal) |
| Structured Credit Pool | 1 (external) |
| Economically Targeted Investments | 1 (internal) |
| Cash Management | 1 (external) |
| Real Estate | 13 pooled funds, 6 joint ventures (external) |
| Private Equity | 140 (external) |
| Absolute Return (Hedge) | 14 (external) |

A relatively high number of managers are utilized within the U.S. equity asset class. This is not unusual and often corresponds to a “style box” approach, which includes one or more managers in each of the major style (growth, core, and value) and capitalization (large, mid, and small) segments of the market. One potential drawback for this type of structure is the inherent redundancy it creates as different active managers offset the active allocations of other portfolios. This is often referred to as “closet indexing,” where the aggregated exposure of a portfolio of active managers essentially produces an index like return, but at active-management fee levels.

There is a trend to view the market more holistically. Such an approach would begin with anchoring the portfolio to a broad market index fund, such as a Russell 3000 Index Fund or a DJ Broad Market Index Fund, in order to achieve diversified, low-cost exposure to the full opportunity set. This structure corresponds to investment theory that indicates the most efficient portfolio is a “market portfolio.” Active managers would then be selected based on an assessment of their skill and the likelihood that they will be able to add value over their benchmark going forward, instead of their style or capitalization. This type of approach often results in fewer managers being utilized within the portfolio.

Fewer managers are used within the SIC’s non-U.S. equity portfolio, which is also typical. This portfolio has been structured with developed and emerging markets managers. The main advantage to this type of structure is that “specialty” managers with expertise focused on either the developed or emerging markets are hired. One drawback, however, is that many active managers invest in both markets. Essentially, the structure of the international equity portfolio limits the consideration of managers with an all-country focus. Passive management is used within the international equity portfolio. The arguments for passive management apply equally to U.S. equity and non-U.S. equity portfolios.

An active approach within the fixed income portfolio structure has been adopted. Many institutional investors have predominately followed an active approach. The benefits of active management over passive management in the fixed markets had historically been that available fixed income indices were not

sufficiently broad, all encompassing, or did not accurately track to the overall bond market. Instead, they tended to only capture a segment of the bond market. As a result, active managers could improve the efficiency of their portfolios by opportunistically allocating to non-U.S. bonds, high yield bonds, emerging market bonds, convertible bonds, floating rate bonds, etc. More and better passive index funds have become available in the fixed income markets that allow access to these same bond market betas, therefore reducing the need to pay active management fees for these submarket exposures. As such, passive fixed income has become a more appropriate consideration today than several years ago. The fee differential between active and passive fixed income managers, however, is much smaller than in the equity markets. Another question to consider when structuring the fixed income portfolio is regarding the appropriate level of risk to incur. Some fixed income portfolios are structured in a “core plus” manner, meaning investments are made in the core segments of the aggregate bond index (government, corporate, mortgages, and asset backed securities) as well as additional segments of the bond market, including high yield, emerging market debt, and non-dollar bonds.

An alternative approach is to view the fixed income portfolio as a low risk allocation which would serve to dampen volatility of the total portfolio. This approach would result in a structure that consists mainly of Treasury and other low-risk, low-volatility investments. The SIC fixed income structure is currently a hybrid of these two different approaches. Several years ago, a core plus structure was initiated, which included an allocation to structured credit. Since that time, the risk level in the portfolio has been reevaluated by the former SIO, and several of these core plus allocations have been or are in the process of being liquidated.

Within the alternative asset classes (real estate, private equity, and absolute return), it is common for many investment managers to be utilized within the portfolio. This ensures geographic, strategy, and vintage year diversification, all important elements within an alternative portfolio. In this regard, SIC’s portfolio structure mirrors common practices.

It is important for the Council, with the input from NMSIO staff and investment consultants, to periodically assess the structure of each asset class portfolio in order to ensure it remains appropriate for the Funds’ circumstances, and is inline with the Council specified risk tolerances and return objectives.

In addition, Sun Mountain Capital, who is an investment manager, was also hired as an investment consultant. While this type of arrangement is not unique, it does not represent best practices because of the potential for material conflicts of interest, actual or the appearance thereof.¹⁰⁴ We understand when a consultant for the New Mexico private equity program was sought, Sun Mountain Capital was the only firm to submit a proposal. Best practices are for an independent consultant with specific expertise, in this case expertise in private equity, to render investment advice to the Council and NMSIO staff. When an investment manager is used as a consultant, it creates a potential for conflicts of interest, which can sometimes be managed through ongoing and proper disclosure.

¹⁰⁴See Investment Advisers Act of 1940 (Advisers Act), which requires that an investment adviser providing consulting services has a fiduciary duty to provide disinterested advice and disclose any material conflicts of interest to their clients.

It would be best for the Council to reevaluate the need for an investment manager to also serve as a consultant, and, where it is deemed necessary, Council should clearly delineate roles, responsibilities, expectations for transparency, conflicts of interest disclosure, and reporting requirements.

Selection of Investment Managers and Custodian

Prudence includes a rigorous due diligence process which has two phases: the initial selection of managers and the ongoing monitoring of those managers. The selection process begins with the consideration of the entire universe of managers or investment opportunities. This is a very large universe; for example, when considering public markets investment management, approximately 12,000¹⁰⁵ investment managers currently exist in the United States alone. Of these, a much smaller number (5%) may be suitable for a public fund to seriously consider due to the size and structure of the investment portfolio. Therefore, the selection process must effectively screen the opportunity set to identify the managers uniquely skilled for each mandate.

After managers or investments have been selected, due diligence must continue to ensure the selected opportunities remain appropriate for the fund. Due diligence includes a review of the investment's performance against agreed-upon benchmarks and an assessment of whether any of the factors that were considered in the selection of the manager have adversely changed. In addition, due diligence includes a review of compliance with stated guidelines and monitoring of risk in the portfolio. An effective process will trigger action when changes are needed.

It is also important to customize due diligence procedures for each investment opportunity or sub-asset class. For example, private markets investments are often characterized by unique risks and illiquidity. They are long-term obligations that cannot be easily or quickly disposed. The best due diligence processes focus on all success factors of each unique investment. Due diligence can be exemplary, but if the research and analysis are not documented and codified in policies or procedures, these efforts will fall short of best practices. Documentation helps to ensure that trustees' expectations for due diligence are broadly understood and followed.

In the public fund arena, investment managers have historically been selected through a Request for Proposal (RFP) process. Many public funds, like NMSIO, continue to use a formal RFP process, which often parallels the routine other governmental entities use for purchasing goods and services. From a public policy perspective, such a process is designed to offer equal opportunity for doing business with the government and to ensure fairness in the selection process. Certainly, in situations where goods and services are fungible, the process works well as a means to obtain the best price and terms. The RFP process, in theory, opens up the process to a large number of investment managers. We believe, however, that a suitably large number of managers can be considered by using an alternative process that is consistent with the need for fairness.

¹⁰⁵ Source: eVestment Alliance.

Approximately 65% of EnnisKnupp's public fund clients have moved to a search process that does not include a formal RFP. Such a process can be done in as quickly as six to eight weeks. In this type of search process, the investment consultant identifies a list of suitable candidates that are appropriate for the mandate, using a manager database as the starting point. Leading investment consulting firms can have from 4,000 – 6,000 managers in their databases. Of those managers, the investment consultant can readily identify, based on their knowledge of the managers and the client's needs, the firms that they believe would be best suited for the mandate.

Many public funds find that a search process that does not include a formal RFP is more efficient as it avoids the delays associated with issuing RFPs and at the same time is equally accessible, transparent, fair, and prudent. SIC, through its own applicable Procurement Policy, presently has the ability to use such a search process, as well as a formal and advertised RFP process.

NMSIO has undertaken very few public markets manager searches since 2003. Historically, the SIO and other NMSIO staff have been involved, largely to the exclusion of the Council. It is common for staffs at large public funds to handle searches with the assistance of consultants, but, at many funds, the boards and councils are also involved; either way is acceptable. If, however, the search process is delegated to staff, the best practice is for it to be delegated in such a way that requires staff to follow a strict and prudent process, using reasonable criteria. The process should be in writing and documentation should be maintained evidencing that the process was actually followed.

It does not appear that the Council has approved a comprehensive written process or criteria for selecting managers or has monitored what process the NMSIO staff has actually used. Essentially, any decisions to hire or retain managers since 2003 appear to have been at the discretion of the former SIO without regard to any Council approved specific criteria or procedure. This is not a common practice and falls far from best practice, which is to have the governing body at the very least approve the criteria and process for manager selection. Many boards and councils also retain the right to make the final selection of managers.

Best practices are for NMSIO to develop and adopt a policy for manager selection due diligence that addresses at least the following factors, where applicable:

- Biographies of key decision-makers
- Employee turnover
- Team additions/departures
- Portfolio management responsibilities
- Philosophy/process
- Strategy changes
- Perceived skill (cogent investment thesis, information advantage, unusual insight, talent, sound investment process, sustainability)
- Trading efficiency
- Management fees
- Consistency of past performance (short-term trends, results vs. style, themes, risk-adjusted)
- Product fit

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- Product importance
- Ownership structure (depth and breadth of employee ownership, recent or upcoming changes)
- Organizational factors (governance, agency issues, compensation structure, clients gained/lost)
- Meet portfolio manager(s)
- View trading desk
- Administrative issues (SEC action, legal issues, etc.)

Best practices are for the staff to receive a comprehensive search report from the consultants, if staff has been delegated the responsibility for selecting investment managers. If, on the other hand, the board or council has retained the right to make the final decision on manager selection, the consultants' reports would go to both the council and the staff. Such a report would include a summary of the firms and the mandates under consideration, performance records, portfolio characteristics of the strategies, reviews of each candidate, and supporting data. In addition, the search report would assess the strengths and weakness of each manager, and provide a summary analysis of the information that was submitted by manager.

The best search reports provide useful analysis and discussion of the differences between each manager, as well as how the managers' strategies will fit within the existing portfolio (for example, whether there is overlap or redundancies with any of the managers, including internal managers, currently in the portfolio). The best searches also put limited weight on past performance, as past performance has no bearing on future results. The most emphasis should be on organizational and skill factors that would increase the likelihood of a positive outcome in the future.

After a public markets manager is hired to invest a portion of assets, ongoing due diligence is necessary to ensure compliance with the specified mandate and continued prudence of the investment. NEPC currently provides quarterly monitoring as called for by the NMSIO IPS. NEPC reported to us that changes in manager organizational structure or other areas of significant impact are addressed on an ad-hoc basis as they occur.

NEPC has dedicated analysts that cover client retained managers. Its staff speaks in-person to the manager regarding any organizational change and prepares a letter to impacted clients, including NMSIO, explaining the nature of the change within forty-eight hours of the event. NEPC staff is then available to clients, including the SIO, other NMSIO staff, and the Council, to have subsequent conversations regarding its interpretation of the manager change and follow on impact to the client. Up to this point, this process is reasonable and is reflective of common and best practice. It is unclear whether such documentation of ongoing due diligence was retained by the former SIO. If it has not, this lack of documentation would fall short of common and best practices.

We understand that an effort is underway by the Interim SIO and NMSIO staff to develop a more formal due diligence processes for all asset classes, including public markets managers. NMSIO staff is currently working with NEPC to develop quantitative and qualitative criteria to inform decision-making and trigger action when necessary. While not all public funds conduct onsite visits, it is reflective of best practices that NMSIO's public markets manager monitoring process has recently begun to include these onsite visits.

They allow staff to gain critical insights from seeing a manager's operations and facilities and meeting support staff.

In addition to selecting investment managers, many public fund boards and staffs have some involvement in selecting custodian banks. Custodian banks safeguard fund assets and are responsible for arranging settlement of any securities purchased or sold, managing cash transactions, and reporting information to the plan sponsor. The custodian bank often serves as the official "book of record." It is on this information that performance is typically calculated, so ensuring that custodial services are accurate and timely is important. Some custodians also provide other services to clients, such as performance measurement, compliance monitoring, and securities lending.

Custodian banks with sizeable assets benefit from economies of scale and function more efficiently than smaller banks. Further, banks with larger custody businesses accrue more experience and tend to maintain state-of-the-art operations, which is important as the custody business has become an increasingly technology-driven business. Also, banks that derive a significant portion of their revenues from the custody business are likely to be more stable and make the necessary investments to remain competitive.

The best fit for a public fund is to use a custodian bank with sufficient experience and expertise with similar organizations in order to meet their specialized needs. Top-tier custodians will also offer high quality client servicing. NMSIO, like the Public Employees Retirement Association and the Educational Retirement Board, uses The Northern Trust Company (Northern Trust) as its custodian. Northern Trust does not perform securities lending for NMSIO; rather, this function is performed by Credit Suisse.

The May 2008 contract with Northern Trust covers all three agencies and was negotiated by the Board of Finance pursuant to authority under law.¹⁰⁶ While having an outside department or statewide office holder select the custodian bank is not unusual, it does not reflect best practices. We believe that, as the highest governing fiduciary body responsible for the investment program, the Council should have the ability to freely choose its own custodian and negotiate the scope of responsibilities, the service levels, and fees. Likewise, the Council should be able to extend custodian contracts or terminate them at any time in the best interest of the Funds.

Alternative Investments

The private markets universe can offer hundreds, if not thousands, of investment opportunities. It is imperative that an alternatives investment program efficiently, thoroughly, and accurately gauge the quality and risk factors associated with each opportunity before making an investment decision. Many alternative investments, like limited partnership interests, can be illiquid. Exit opportunities for these investments are limited and if exercised, often result in a discount to the fund value. As such, it is very important for the terms, conditions, and investment expectations to be thoroughly understood before a commitment is made.

¹⁰⁶ NMSA 1978 Section 6-1-1.

In the alternative asset classes, namely private equity, real estate, and hedge funds, each investment is unique and impacted by a different set of variables. Best practices are for investors to have pre-planned sub-asset class exposure. Furthermore, portfolios should be constructed over a multi-year period diversified by manager style, strategy, geographic region, and other portfolio characteristics.

Private markets present specific challenges to due diligence procedures. The objective of the qualitative and quantitative due diligence process for alternative investments should be to obtain a clear understanding of the risk and return profile of the investment. The steps in the due diligence process should include identifying skilled managers, validating a verifiable track record, assessing the compatibility of the general partnerships (GPs) with issues of investment strategy, reference checks, understanding the group's economics, achieving a comfort level with their decisions, ensuring proper corporate governance, reviewing legal terms and conditions, and making sure adequate reporting policies and procedures are in place. Internal staff, outside consultants, or both can be used to ensure full-coverage during due diligence.

NMSIO's alternative asset investments program contains private equity (including an in-state focused component), real estate, hedge funds, and film investments. NEPC focuses on private equity (non-economically targeted investments) and hedge funds, while Courtland Partners consults on real estate. Sun Mountain consults on New Mexico-focused private equity and Peter Dekom evaluates and makes recommendations to the Council with respect New Mexico film investments. The NMSIO staff works with these investment consultants to plan overall investment strategy, identify suitable investments, perform due diligence, and ultimately make recommendations to the PEIAC and to the Council¹⁰⁷.

Some aspects of NMSIO's approach to investing in alternative asset classes are in line with common practices, but others are not. The overall approach could be enhanced to meet best practice standards by creating more structure and emphasizing more effective Council participation, education, and authority. As mentioned previously in this report, reevaluating the effectiveness of PEIAC and its interaction with the Council ought to be considered.

Each alternative asset class is referenced in the general IPS. In addition, each asset class has a specialty investment policy statement, all of which could be enhanced. Compared to best practice, aspects of improvement ought to include updating benchmarks, clearly defining fiduciary responsibility associated with delegation of responsibility, delineating monitoring and reporting duties (hedge funds, film investments), updating allowable asset types, emphasizing independent data analysis, recognizing risks, including sub-asset class weightings, and outlining fund selection processes. In addition, each specialty IPS could further augment roles and responsibilities for the Council, including education requirements, should that be the philosophy of the Council. Each document could better define the roles, responsibilities, and composition of each alternative asset subcommittee to align with best practice.

The following chart compares the steps of NMSIO's real estate, private equity, and hedge funds due diligence processes to those of best practices.

¹⁰⁷ In addition, it is our understanding that NMSIO staff has recently created its own real estate committee to guide decision-making for the portfolio. The Council does not have a real estate subcommittee.

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| Best Practices Due Diligence for Private Market Manager Selection | Current SIC Practice | | |
|---|----------------------|------------------------|-------------|
| | Real Estate | Private Equity | Hedge Funds |
| <i>Market scan</i> | | | |
| Screen for available opportunities | ✓ Yes | ✓ Yes | ✓ Yes |
| Identify appropriate mandates | ✓ Yes | ✓ Yes | ✓ Yes |
| <i>Deal/fund screening</i> | | | |
| Initial assessment of portfolio fit and stage | ✓ Yes | ✓ Yes | ✓ Yes |
| Initial assessment of management experience | ✓ Yes | ✓ Yes | ✓ Yes |
| Preliminary assessment of strategy | ✓ Yes | ✓ Yes | ✓ Yes |
| <i>Preliminary due diligence</i> | | | |
| Summary review of strategy | ✓ Yes | ✓ Yes | ✓ Yes |
| Assessment of experience of the general partner | ✓ Yes | ✓ Yes | ✓ Yes |
| Review of track record | ✓ Yes | ✓ Yes | ✓ Yes |
| Examination of offering documents | ✓ Yes | ✓ Yes | ✓ Yes |
| Completion of telephone interviews | ✓ Yes | ✓ Yes | ✓ Yes |
| <i>In-depth due diligence</i> | | | |
| Interview with investment management team | ✓ Yes | ✓ Yes | ✓ Yes |
| Contact references | ✓ Yes | ✓ Yes | ✓ Yes |
| Research of GP's incentives and alignment of interests | ✓ Yes | ✓ Yes | ✓ Yes |
| Review of public information on the fund/management team | ✓ Yes | ✓ Yes | ✓ Yes |
| Review track record | Limited | Limited ¹⁰⁸ | ✓ Yes |
| Recalculate IRRs for each investment | Limited | Limited ¹⁰⁹ | N/A |
| Recalculate IRRs for each portfolio (net-of-fees and profit participations) | Limited | Limited ¹¹⁰ | N/A |
| Benchmark IRRs, cash flow multiples, and distributions | Limited | Limited ¹¹¹ | N/A |
| Independently analyze performance by strategy | Limited | Limited ¹¹² | ✓ Yes |
| Complete in-depth research report | ✓ Yes | ✓ Yes | ✓ Yes |
| Assess perceived skill (industry/market opportunity, information advantage, proprietary deal flow, relevant | ✓ Yes | ✓ Yes | ✓ Yes |

¹⁰⁸ The prior consultant performed this service as part of its contract; however, it is unclear whether it was performed sufficiently. Best practices call for the independent consultant to independently construct and provide such data points as part of a comprehensive due diligence process.

¹⁰⁹ See footnote 108.

¹¹⁰ See footnote 108.

¹¹¹ See footnote 108.

¹¹² See footnote 108.

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| | | | |
|--|-------|-------|-------|
| experience, depth of investment talent, quality of co-investors, stability of strategy, benefit to underlying companies) | | | |
| Review of fund size/competing accounts | ✓ Yes | ✓ Yes | ✓ Yes |
| Review of cost and fees | ✓ Yes | ✓ Yes | ✓ Yes |
| Assess product fit | ✓ Yes | ✓ Yes | ✓ Yes |
| Assess ownership | ✓ Yes | ✓ Yes | ✓ Yes |
| Review partner turnover | ✓ Yes | ✓ Yes | ✓ Yes |
| Review GP's competing lines of business | ✓ Yes | ✓ Yes | ✓ Yes |
| Assess firm culture | ✓ Yes | ✓ Yes | ✓ Yes |
| Review GP's reputation | ✓ Yes | ✓ Yes | ✓ Yes |
| Assess reporting and risk management platforms | ✓ Yes | ✓ Yes | ✓ Yes |
| Review internal process documentation | ✓ Yes | ✓ Yes | ✓ Yes |
| Assess investor relations capabilities | ✓ Yes | ✓ Yes | ✓ Yes |
| <i>Legal review and negotiations – Completed by Internal and External SIC legal counsel</i> | | | |
| Evaluate key man provisions | ✓ Yes | ✓ Yes | ✓ Yes |
| Review distribution waterfall | ✓ Yes | ✓ Yes | N/A |
| Review claw back provisions | ✓ Yes | ✓ Yes | N/A |
| Review side letters | ✓ Yes | ✓ Yes | ✓ Yes |
| Review investment limitations | ✓ Yes | ✓ Yes | ✓ Yes |
| Exhaustive review of Limited Partnership Agreement | ✓ Yes | ✓ Yes | ✓ Yes |

Deficiencies in the alternatives program could potentially detract from its returns, and may increase its risk. It is unclear if the Council members fully understand the risks and benefits of each of the alternative investments and the alternatives portfolio as a whole.

For example, the real estate investment program's management structure is unusual, since there is minimal core real estate investment exposure. This significantly increases the portfolio's risk. Six real estate investments are joint ventures, which are typically high maintenance investments requiring careful and constant monitoring. When evaluating real estate, the availability of adequate staff and independent consulting advice to the Council ought to be in place.

Similarly, the private equity investments include both film and in-state specific investments that not only decrease geographic diversification, but also significantly decrease investment stage diversification by largely focusing on venture capital. In making these statutorily permitted investments to develop the New Mexico economy, NMSIO must reconcile in-state and film investments with the tenets of the Prudent Investor Act so that risk is not unduly increased and returns are not sacrificed in a way that would violate the Act. Currently there is no formal policy for doing this and the informal practices are unclear.

The NMSIO private equity program has a large number of investment relationships. While the overall number of managers is not unusual for an investment organization of NMSIO's size, there are fewer staff resources dedicated to monitoring and reporting activities than is optimal. Likewise, the consulting resources are more limited than they should be. Best practices in this situation would be for the consultants to not only evaluate performance, but also be actively involved in ongoing monitoring of the investments that NMSIO has made.

The current hedge fund-of-funds format is appropriate for a fund of NMSIO's size and profile; however, it appears that contemporary best practice standards for selecting and monitoring fund-of-funds managers are not evident. For example certain aspects, such as addressing fund-of-funds managers' operational due diligence capabilities in evaluating underlying managers, could be significantly enhanced. NMSIO staff and NEPC jointly conduct due diligence, but responsibilities for both pre-investment and ongoing monitoring lack clear delineation and the tasks are not as comprehensive as they should be to ensure full coverage.

Another area the SIC should consider is the potential affect of New Mexico's Open Meetings and Public Records Acts¹¹³ on alternative investment opportunities. Currently, the law requires that all investment related meetings, minutes, and records be open to the public. As the SIC continues to make investments in alternative asset classes, opportunities with certain managers could be missed if, as part of the due diligence process, certain proprietary information or investment strategies must be disclosed to the public before the investments are made or during the life of the fund. Public disclosure regarding private equity investment has been a problem for a number of other public funds. An exemption to the Open Meetings and Public Records Acts would allow certain discussions and materials to be kept confidential.¹¹⁴

Benchmarks

Boards set benchmarks and measure actual portfolio performance against them to determine the success of an investment program. Benchmarks are set for the total fund, each asset class, and each individual investment manager. Best practices are for the total fund to be measured against a policy portfolio benchmark, which is a passive representation of the target allocations of the fund. The most appropriate asset class benchmarks and manager benchmarks are those that broadly represent the entire opportunity set in a particular asset class or within a particular manager's mandate. When measuring actual performance against benchmarks, staffs at large public funds usually track performance monthly and generally report results to the boards quarterly.

A common secondary measure of performance is a universe ranking. Universe rankings give an understanding of how the overall fund or individual asset classes have performed relative to peers. Universe rankings, however, are flawed in that the universe data is often not a close comparison at the total portfolio level because different institutional investors have different asset allocations. Furthermore, the comparisons may not be close at the asset class level either since investors have different investment objectives and risk

¹¹³ NMSA 1978, § 10-15-1 (Open Meetings Act), NMSA 1978, § 14-2-1 (Inspection of Public Records Act).

¹¹⁴ Examples of states that enacted legislation to limit open meetings disclosure requirements related to private equity include the following: Illinois, California, Colorado, Massachusetts, Minnesota, Pennsylvania Texas, and Virginia.

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parameters. Other shortcomings can include inaccurate data (most universes have self-reported returns) and survivorship bias. Survivorship bias exists in manager-level universes because underperforming managers may cease to report their results, skewing the universe returns upward. Because of these shortcomings, the most important performance comparison of investment performance is against the stated benchmarks, which take into account the portfolio's asset allocation and strategy.

In a best practice environment, the general investment policy statement contains clear and unambiguous market-based benchmarks for each asset class and investment strategy that are established by the governing body (council or board). Additionally, the governing bodies, being the highest fiduciaries, regularly evaluate investment performance against these benchmarks. Finally, boards, councils, staffs, and consultants also evaluate whether each manager has added value relative to its respective market benchmark and to its peer group of other similar investment managers, regardless of whether the manager is an internal portfolio manager or external manager.

NMSIO's IPS sets forth performance benchmarks for the total fund and each asset class, which is common and best practice. A custom total fund index is identified within the IPS, and has been constructed by using public market indices to represent each portfolio asset class and is intended to reflect the asset allocation policy of the Funds. Such a "policy portfolio" benchmark is a best practice. The following table shows the benchmark assigned to each asset class in the IPS and used in the performance reports, and our assessment of whether it is appropriate.

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| Asset Class | Benchmark Shown in Performance Reports | Benchmark Per IPS | Assessment |
|--|--|---------------------------------------|--|
| Total Domestic Equity | Russell 3000 Index | Russell 3000 Index | Appropriate; the Russell 3000 Index is a broad measure of the U.S. equity market and an acceptable benchmark for a diversified portfolio. The DJ Total Stock Market Index is also often used as a total domestic equity benchmark and would also be appropriate. IPS and the policy portfolio in the performance reports “match.” |
| Domestic Large Cap | S&P 500 Index | S&P 500 Index | The most appropriate benchmark would be the DJ Total Stock Market Index or Russell 3000 since the managers have the ability to purchase small and mid cap stocks as well as large cap stocks. The S&P 500 Index is large cap specific benchmark and does not represent the small or mid cap portion of domestic equities. |
| Domestic Mid/Small Cap | S&P 400 Index | S&P 400 Index | The most appropriate benchmark would be the Russell 2500. The Russell 2500 is an index that includes both small and mid cap stocks and therefore it is an acceptable benchmark for a diversified small/mid cap portfolio. The S&P 400 Index is a mid cap specific benchmark and does not represent the small cap portion of domestic equities. |
| Non-U.S. Developed Markets | FTSE Developed ex-U.S. Index | FTSE Developed ex-U.S. Index | Appropriate; the FTSE Developed ex-U.S. Index is a broad measure of developed international markets, and is an acceptable benchmark for a diversified international developed market equity portfolio. |
| Non-U.S. Emerging Markets | MSCI Emerging Markets Index | MSCI Emerging Markets Index | Appropriate; the MSCI Emerging Markets Index is a measure of large cap developed, markets and is an acceptable benchmark for an international equity portfolio focused on these types of markets. Of note, both performance report and GIP incorrectly label this index as the MSCI Emerging Markets Free Index. The name of this index changed from MSCI Emerging Markets Index Free to MSCI Emerging Markets Jan 29, 2004. |
| Domestic Fixed Income (Investment Grade) | Barclays Capital Aggregate Bond Index | Barclays Capital Aggregate Bond Index | Appropriate; the Barclays Aggregate U.S. Bond Index is a broad measure of the investment grade bond market and an acceptable benchmark for a core and core-plus portfolio. |

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| Asset Class | Benchmark Shown in Performance Reports | Benchmark Per IPS | Assessment |
|------------------------------------|--|--|--|
| Domestic Fixed Income (High Yield) | None-Indicated | Merrill Lynch BB/B U.S. High Yield Constrained Index | Appropriate; the Merrill Lynch BB/B U.S. High Yield Constrained Index is a broad measure of below investment grade bonds of corporate issuers, and is an acceptable benchmark for a high yield domestic fixed income portfolio. |
| Absolute Return | 90-Day T-Bill +200 basis points | 90-Day T-Bill +200 basis points | The 90 Day T-Bill+200 bps is a common benchmark for absolute return strategies. We believe a better benchmark is the HFRI Funds-of-Funds Composite Index as it reflects a broad universe of investments and the volatility inherent in the portfolio. |
| Private Equity | Cambridge Private Equity Index | None indicated | IPS does not specify a specific private equity benchmark due to the mixed maturities of the private equity allocations in SIC's underlying portfolios. Once the private equity positions mature, the Cambridge Private Equity Index will be an acceptable benchmark for the private equity portfolios. |
| Real Estate | NCREIF Property Index | NCREIF Property Index | Appropriate; the NCREIF index is the common industry standard benchmark for real estate investments. |
| Cash | 90-Day T-Bill | 90-Day T-Bill | Appropriate; the 90-Day T-Bill is the common industry standard benchmark for cash accounts. |

The IPS and quarterly performance reports are very well aligned regarding the benchmarks to use for each asset class. Moreover, most of the benchmarks are appropriate with a few exceptions. Presently, the policy benchmark is the S&P 400 Index; however, internal NMSIO staff is using the S&P 500 as its benchmark. Neither is entirely appropriate. The S&P 400 does not represent the small cap portion of the domestic equities market, whereas the Russell 2500 Index does and, therefore is the most appropriate benchmark for the small/mid cap strategies as it captures performance of both mid and small cap domestic equity markets. Additionally, the current benchmark for the hedge funds (absolute return strategies), while common, is not the best.

Historically, the Council has not taken an active role in setting benchmarks for the portfolio; however, its tacit acknowledgement of the policy benchmarks exists through its IPS. Best practice is for the Council to take a more active role in setting and approving benchmarks, and periodically reviewing their appropriateness over time. There has been recent Council discussion with respect to benchmarks for specific asset classes like real estate, but it has not focused on a broader review of all benchmarks.

Compensation of Managers

Research indicates that, in general, the performance of managed funds suffers dollar-for-dollar as a result of management fees. There is no evidence of a positive relationship between fees and performance. Accordingly, differentials in management fees are assumed to translate directly to differentials in net return.

Consultants, investment managers, and their clients have long debated alternative compensation arrangements for investment managers. Traditionally, managers have charged clients a fee for services computed as a declining percentage of assets, or an asset-based fee. Performance fee arrangements, which are less common for public markets, call for the client to pay the manager a smaller percentage of assets as a base fee, and an additional payment contingent upon good performance, such as a return in excess of an agreed-upon benchmark.

In tying manager compensation to superior performance, rather than solely to asset size, performance-based fees better align the interests of asset manager and client. Under an asset-based fee, the manager has an incentive to increase assets under management through marketing. However, larger portfolios are more difficult to trade profitably, so the growth-oriented manager runs the risk of becoming too large to outperform when trading costs are taken into account. Performance fees, on the other hand, reward the manager for performance, an inducement, in principle at least, to control growth in assets under management. Care must be used in negotiating a performance fee, however, so that meaningful restrictions (e.g., limits on volatility or concentration) exist to prevent underperforming managers from taking extraordinary risk. Ultimately, there is no single correct approach to manager compensation.

The following chart lists NMSIO's investment management fees for all assets classes for fiscal year 2009 and compares them to industry averages as reported in a 2008 Greenwich Study on fees paid by public funds, corporate defined benefit plans, and endowments. In general, our analysis shows that NMSIO's fees are comparable, and often well-within, common industry standards across all asset classes when compared to endowments. We understand that this is partially due to the action taken by the former SIO to cap external manager fees in the public markets asset classes to 25 basis points or less. An effort is presently underway by the interim SIO, NEPC, and the Council to review this practice to ensure that it provides the best opportunity to attract top quality external managers. The relatively low costs to manage the overall portfolio are also due to the use of internal management.

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| SIC Fee Comparison by Asset Class ¹¹⁵ | | | |
|--|---|--|---|
| Asset Class | Fees in bps Excluding Internally Managed Assets | Fees in bps Including Internally Managed Assets ¹¹⁶ | Endowment Funds Over \$1 Billion Asset Class Fee Average ¹¹⁷ |
| Domestic Equities | 25.0 | 16.3 | 60.8 |
| International Equities | 25.0 | 25.0 | 75.3 |
| Fixed Income | -- ¹¹⁸ | 2.1 ¹¹⁹ | 32.9 |
| Real Estate | 100.5 ¹²⁰ | 100.5 | 150 ¹²¹ |
| Absolute Return | 117.5 | 117.5 | 139 |
| Private Equity | 175 ¹²² | 175 | 100 - 200 ¹²³ |
| Total Fund | 74.9 | 50.7 | N/A |

Alternative asset managers (real estate, real asset, absolute return, and private equity) are compensated with a management fee, an incentive-based fee, or both. Closed-end real estate and real asset funds will typically charge an annual management fee of 1.0%-2.0% on total commitments (further reduced over the life of the fund), with an incentive fee (carried interest) of 15%-20% over a preferred return (typically 8-9%). Actively managed REIT strategies will typically charge 50-70 basis points per annum on net asset value. Open-end real estate funds will charge, on average, 100 basis points per annum based on net asset value. Absolute return funds will charge a management fee of 1-2% of net asset value plus a 20% profit sharing arrangement (carried interest). Private equity funds will generally charge an annual management fee of 1.0%-2.5% on total commitments (further reduced over the life of the fund), with an incentive fee (carried interest) of 15%-25% over a preferred return (typically 8.0%).

¹¹⁵ Fees were calculated using data provided by NMSIO staff. This table provides an overview and basic understanding of the fees experience at each asset class level, but should not be considered authoritative.

¹¹⁶ Internally managed money is part of NMSIO's operating budget and includes salary and benefits of the investment staff portfolio manager, other staff, a pro-rata share of office expenses, technology support, and other such items. NMSIO manages four internally managed accounts. The accounts and their associated expenses are as follows: large cap active – 5.2 basis points, large cap index – 0.9 basis points, core bonds – 2.1 basis points, all cap active – 8.4 basis points.

¹¹⁷ Greenwich Associates 2008 Fee Information except where noted. Endowment Funds with assets greater than \$1 billion. Fees reflect actively managed assets only.

¹¹⁸ Currently SIC uses no external managers within the fixed income asset class.

¹¹⁹ Specific fees are representative of the U.S. Core Bonds Strategy only. Fee information for the credit and structured finance pool and economically targeted investment program was not available at the time of report drafting.

¹²⁰ Fee was derived by taking a weighted average of post investment period manager fees on committed capital and is a gross representation of the fees SIC actually experiences. This calculation does not account for performance and/or acquisition based fees or any other fee outlined in the terms specified by each manager.

¹²¹ Industry average based on the portfolio containing closed end commingled value added and opportunistic funds.

¹²² Fee reflects an estimate based upon NMSIO staff provided statement that it is SIC's general policy to pay no more than a 2% management fee and 20% carry on any Private Equity investment. The fee was assessed to the carrying value of Private Equity investments and not on the capital committed as capital commitment data was not available for the drafting this report.

¹²³ Information is sourced from the Dow Jones, Private Equity Analyst, Terms and Conditions Report, Fourth Edition (2008).

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We reviewed nearly all alternative asset fund manager compensation arrangements as provided and reported by NMSIO and found each to be within an acceptable range, in light of the above stated common industry standards and expectations. As previously mentioned, the Council may want to reevaluate its hedge fund-of-funds fees to determine the costs and benefits of some level of direct investment.

The following table compares NMSIO's total investment management fees to several benchmarks, including public funds, corporate defined benefit plans, and endowments. As noted, NMSIO's fees are well in line with these averages; however, it is important to note that the fees were calculated using an estimate of private equity fees.¹²⁴

| Source | Fee (in basis points) |
|--|-----------------------|
| <i>SIC's Investment Management Fees</i> | 50.7 ¹²⁵ |
| Greenwich Average -- All Public Funds | 46 |
| Greenwich Average -- Public Funds >\$5 Billion | 35 |
| Greenwich Average -- Corporate DB Plans | 53 |
| Greenwich Average -- Corporate DB Plans >\$5 Billion | 41 |
| Greenwich Average -- Endowment Funds | 64 |
| Greenwich Average -- Endowment Funds >\$1 Billion | 61 |

The majority of the public funds and corporate defined benefit plans that participated in this survey manage pension assets. Endowment funds typically tend to have a higher allocation to alternatives than public or corporate defined benefit plans. As such, the average fee for endowments will be higher to reflect an increased allocation to the more expensive alternative asset class. While SIC's most appropriate comparative universe is endowment funds; we provide this information to show how competitive is its present fee structure.

Role and Qualifications of Placement Agents

A placement agent is any third-party intermediary that is directly or indirectly hired, used, retained, compensated, or otherwise given anything having monetary value or benefit, tangible or intangible, by an investment manager to assist the investment firm in securing an institutional investor's commitment. For example, many private equity fund managers will enlist the services of placement agent to assist with the marketing and relationship building aspects of raising a fund. Recent investigations revealing abuses related

¹²⁴As mentioned previously, calculating fees for a private equity program is a labor intensive and complex undertaking that involves a manager by manager analysis. NMSIO currently invests with over 140 private equity managers. At the time we drafted this report, manager specific information was not available for calculation purposes. Accurate representation of such fees could materially impact the overall investment management fee for NMSIO's program.

¹²⁵ Fees were calculated using data provided by NMSIO staff. This table provides an overview and basic understanding of investment manager compensation for NMSIO.

to the use of placement agents have resulted in significant controversy and increased scrutiny of conflicts of interest in the management of public fund assets.

In early August 2009, the SEC issued a proposed rule that would prohibit an investment manager and its employees from paying a third party, such as a placement agent, to solicit a government client on behalf of the advisor.¹²⁶ While this proposed rule has not yet been adopted, the institutional investment community has reacted by implementing placement agent policies. Some policies, developed by those who believe that placement agents serve a legitimate purpose, require significant disclosure.¹²⁷ Other policies go even further, such as the New York State Common Retirement Fund¹²⁸ and the public funds in the state of Illinois¹²⁹ adopting a total ban of any investment in a fund that uses placement agents.

Best practice is for public funds to document the method of communicating statutory requirements to the investment managers, the implementation and monitoring process, the procedure for addressing concerns, the staff or committee responsible for these functions, and any additional disclosure or qualification requirements (such as FINRA¹³⁰ registration) of placement agents in a written policy. The following is useful information that should be documented in a policy:

- Identity and domicile of all placement agents utilized by the fund manager, not just the ones involved in raising a particular fund's commitment.
- Placement agent's broker-dealer (SEC, FINRA, or comparable entity) registration information.
- Placement agent fee structure.
- History and qualifications of the placement agent.
- Placement agent's length of employment by the fund manager.
- Actual fee paid to the placement agent for the fund's commitment.
- Terms of the placement agent agreement.
- Previous or anticipated investigations by any federal, state, or local government agencies or regulatory bodies in the last 10 years.
- Direct or indirect relationships with the decision-makers for the hiring of the investment firm, including council members and investment consultants.
- Placement agent's status as a lobbyist with any state or federal government.
- Placement agent's political contributions or gifts made to the decision-makers.
- Placement agent employee's financial brokerage licenses (e.g., Series 7/63).

¹²⁶ The Securities and Exchange Commission ("SEC") proposed rule 206(4)-5.

¹²⁷ Arizona State Retirement System; California Public Employees' Retirement System; California State Teachers' Retirement System; and Teacher Retirement System of Texas.

¹²⁸ On April 22, 2009, New York State Comptroller Thomas DiNapoli imposed a ban on the use of placement agents, paid intermediaries and registered lobbyists with respect to the state's \$122 billion Common Retirement Fund, including arrangements under which any of these persons are compensated on a flat fee, contingent fee or any other basis.

¹²⁹ In Illinois, Public Act 096-0006 became effective on April 3, 2009. One of the reforms adopted in this act is a ban on contingent fee arrangements and placement fees to influence the outcome of an investment decision or the procurement of investment services by an Illinois state or local retirement system, pension fund or investment board.

¹³⁰ Financial Industry Regulatory Authority ("FINRA").

In June 2009, legislation became effective requiring NMSIO's fund managers to disclose the identity and fees paid to placement agents in connection with NMSIO's commitment. Legally, SIC is permitted to invest assets with investment managers who use placement agents as long as the fund manager discloses the identity and the fee paid to any third-party marketer.¹³¹ However, shortly after this legislation was put into effect, the NMSIO adopted a strict Transparency and Disclosure Policy, which appears to ban investments in funds that employed third party marketers. The Policy also allows for an exception to this ban if "(A) seventy-five percent of the SIC members vote in favor of granting an exemption, (B) the exemption granted pursuant to this Policy is clearly documented with an explanation of the basis for such exemption, and (C) a report is made to the SIC and/or PEIAC regarding such exemption at the next applicable SIC/PEIAC meeting." It appears that the Council believes in a legitimate use of placement agents and will consider exceptions to the ban. Due to this exemption, the Policy is technically not an absolute ban.

NMSIO's Policy requires disclosure of the justification of the nature of the services provided by the third party agent; date of hire, engagement, retention, and termination; and a summary of any and all agreements and material terms between the third party and any other individual or entity that may have or will share in the third party fee.

Furthermore, the Policy requires disclosure of marketing employees related to the potential contract, "a list of all individuals or entities that are or may be engaged in any way that may or will receive a third party fee in excess of \$50,000 in any twelve month period," and various related details. Potential vendors are required to provide information related to all of their commitments, not just for the NMSIO's commitment. We believe that best practices require disclosure of any and all compensation of any kind provided or agreed to be provided to a placement agent including the nature, timing, and value.

It is best practice for the NMSIO (or its investment consultant) to send prospective fund managers a copy of the legislation and any disclosure and transparency policies before conducting due diligence.¹³² This action will eventually save NMSIO time, because if a manager indicates it is unable or unwilling to comply with such disclosures, the manager will be removed from NMSIO's due diligence process. NMSIO has not made any of these types of investments since the Policy has been adopted so there has been no opportunity to observe how these disclosure policies are integrated into the due diligence process.

¹³¹ NMSA 1978 Section 6-8-22. Disclosure of third-party marketers; penalty. – (A) Neither the state investment council nor the state investment officer shall make any investments, other than investments in publicly traded equities or publicly traded fixed-income securities, unless the recipient of the investment discloses the identity of any third-party marketer who render services on behalf of the recipient in obtaining the investment and also discloses the amount of any fee, commission, or retainer paid to the third-party marketer for the services rendered. (B) Information disclosed pursuant to Subsection A of this section shall be included in the monthly reports of the state investment officer and the annual reports of the state investment council. (C) Any person who knowingly withhold information required by Subsection A of this section is guilty of a fourth degree felony and shall be punished by a fine of not more than twenty thousand dollars (\$20,000) or by imprisonment for a definite term not to exceed eighteen months or both. (D) As used in this section, "third-party marketer" means a person who, on behalf of an investment fund manager or other person seeking an investment of public money and under a written or implied agreement, receives a fee, commission or retainer for such services from the person seeking an investment of public money.

¹³² Staff reported to us that providing copies of relevant Constitutional articles, statutes, and policies to prospective managers has historically been a part of its manager search process.

Since the new legislation and Policy are only applicable to investments made after the effective dates,¹³³ NMSIO is currently in compliance with both. Notwithstanding the effective date, the NMSIO staff has gathered and tracked prior placement agent fees. According to the NMSIO June 2009 inquiry of all its investment managers, 50% reported not using any placement agents, 30% reported using placement agents, and 20% did not report information. Although the placement agent information is organized and may be accurate, it is best practice for an independent consultant to be responsible for gathering, tracking, and periodically reporting on this information because of their independence.

Current NMSIO Policy provisions related to reporting requires monthly and annual disclosure reports for consummated contracts to the SIC. Typically, all such disclosures related to the Policy are provided to Council at least two weeks prior to contract execution.¹³⁴ All disclosure information is also posted on the NMSIO website for comments from the SIC, staff, and general public prior to contract approval.

We did not review placement agent fee arrangements and have not evaluated all aspects of past placement agent conduct and interactions. It is a common and normal practice for alternative asset investment managers to hire placement agents. We estimate that as many as 75% of all private equity funds employ placement agents. Therefore, based on the statistics provided by NMSIO, the number of investment managers who use placement agents is not cause for concern. Other aspects of placement agent usage, such as placement agent identity, qualifications, relationships, and fee arrangements have previously been called into question and are being more fully assessed by NMSIO.

The Policy's disclosure requirements are very specific and comprehensive, which is commensurate with the goals of the information disclosure; however, in practice, the Policy provisions can be problematic to implement. The requirements cover a broad universe of information (in addition to the rigorous obligation to continue disclosure of this information), and fund managers with reputable placement agents can unintentionally and easily breach these provisions. Given that any breaches, unintentional or not, can result in severe penalties, it is very likely that many desirable investment managers will choose not to comply with the Policy and not seek an investment relationship with the NMSIO. In fact, several current investment managers have declined to sign the current disclosure agreement. The Policy, in turn, can have a negative consequence on the opportunity set available to the Funds.

NMSIO would benefit from reevaluating the current level of disclosure required and associated penalties in light of compliance issues and the negative consequences these provisions may have on investing with certain managers.

Performance Reporting

Regular monitoring and reporting of investment performance are important functions in fulfilling the fiduciary duty of prudence. Fiduciaries who delegate the investment decisions of purchasing and selling securities, as

¹³³ NMSA 1978Section 6-8-22 effective June 19, 2009. SIC Transparency and Disclosure Policy effective July 28, 2009.

¹³⁴ It is important to note that the Council only approves Private Equity and Film contracts. All other contracts are approved by the SIO.

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state investment boards and councils generally do, have a responsibility not only to use care in the selection of the investment managers, but also in the oversight of the managers' performance. When internal management is present, the same standards and criteria applicable to external managers become applicable to staff portfolio managers. Failure to monitor and take action, when warranted, can produce the same degree of fiduciary risk as that resulting from imprudent due diligence in hiring managers.

Periodic performance reports provide the type of information needed by the governing body and staff to make decisions regarding manager retention and termination, portfolio strategy, and structure. They also help the councils or boards and staff to assess strengths and weaknesses in the portfolio. Manager successes and deficiencies are kept in the forefront through these reports. The overall structure of the portfolio and the strategies employed are best evaluated through regular reporting that compares performance of the portfolio and individual managers to reasonable benchmarks.

Having a sound system in place to calculate the rates of return for the portfolio benefits both the board and staff, including any internal portfolio managers. It also gives reassurance to external parties who are interested in the success of the investment program. It is a best practice for investment performance to be calculated and reported quarterly, and for reports to be presented verbally at meetings where questions can be asked and answered. With today's high level of scrutiny of public funds, it is very important to establish and adhere to best practices in performance reporting.

Currently, NEPC is responsible for providing quarterly performance reports to NMSIO. Quarterly performance results are calculated using data from the custodian bank, Northern Trust, and returns are reconciled with manager reported performance. Historically, monthly Council meetings have included relatively little time for reviewing and discussing performance reports. The tendency has been for the Council to devote a significant portion of time to specific private equity investments. Best practice is for the Council to reevaluate the way it spends its time so that the most important issues, like asset class and total fund performance, receive the most attention and the most discussion with the consultants and staff.

The following table lists elements of performance reports that we believe to be best practices and compares those elements to what is found in the NEPC quarterly performance reports. A checkmark (✓) indicates elements that are currently included. Line items marked "consider" indicates elements that are missing and should be requested of NEPC by NMSIO going forward.

| Best Practice Elements included in Performance Reports | Included in NEPC Performance Reports |
|--|--------------------------------------|
| Capital Markets Review | ✓ |
| – Return detail of markets | ✓ |
| – Hedge Fund market review | Consider |
| – Historical asset class summary | Consider |

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| | |
|---|--------------------------------------|
| Asset allocation summary | ✓ |
| – Asset class over/underweight vs. policy | ✓ |
| – Change in asset allocation over the period | ✓ |
| – Asset allocation vs. peers | ✓ (For equity allocation only) |
| – Asset allocation by manager (% and dollars) | ✓ |
| Return summary versus benchmark(s) | ✓ |
| – Total fund level performance | ✓ |
| Total fund rolling excess return | ✓ |
| – Asset class level performance | ✓ |
| – Manager level performance | ✓ |
| – Performance shown net-of-fee | ✓ (Only for alternative investments) |
| – Trailing period returns (including since inception) | ✓ (No since inception data) |
| – Annual period returns | ✓ |
| – Performance versus peers | ✓ |
| Total fund attribution analysis | Consider |
| Asset class attribution analysis | Consider |
| Ratio of cumulative wealth graphs | Consider |
| Annualized risk/return exhibits for the total fund | ✓ |
| Annualized risk/return exhibits for each manager | Consider |
| Equity style analysis | ✓ |
| Manager sector allocation (versus benchmark) | Consider |
| Manager sector performance (versus benchmark) | Consider |
| Manager characteristics (versus benchmark) | Consider |
| Manager peer group scattergram | Consider |
| Manager up/down markets chart | Consider |
| Manager country/region allocations (versus benchmark) | Consider |
| Manager investment philosophy/strategy | Consider |

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| | |
|--|--|
| Manager performance commentary | Consider |
| Attestation of manager guideline compliance ¹³⁵ | Consider |
| Appendix/Glossary | ✓ |
| – Summary of Investment Policy and Objectives | Consider |
| – Definitions and benchmark descriptions | ✓ (Description of total fund benchmark only) |

NEPC's quarterly performance reports could be enhanced. One significant shortcoming is that the quarterly performance reports show most returns gross-of-fees (alternative investment results are reported net-of-fees). The returns are reported this way in order to make an appropriate comparison with the peer universes that show returns gross-of-fees, which is logical; however, measuring returns net-of-fees against market benchmarks is of primary importance and a best practice.

There are several additional elements listed in the preceding chart that the NEPC reports do not include. For example, currently reports do not show risk-adjusted returns for each manager. Reviewing risk-return characteristics for each manager is best practice as it is a good measure of manager effectiveness. Some find it useful to have asset class attribution included in performance reports, as well as more detail on each asset class portfolio, including sector allocations and characteristics versus the appropriate benchmark. This information is crucial to any comprehensive performance report, particularly as it applies to the proper oversight of manager compliance with Council approved investment guidelines. Also, the quarterly performance books do not appear to include since inception performance at the total fund level. Reporting since inception performance for the total fund provides insight into the long-term affects of Council-approved investment policies, and therefore provides a valuable measure of overall investment effectiveness. It is best practice to provide a level of reporting detail in the quarterly performance report that is useful to the fiduciaries.

Having a sound performance reporting process is only one aspect in monitoring performance. Equally important are report interpretation and investment policy and manager structure adjustments. We examined both the LGPF and STPF for their performance over the past ten years. Returns for the LGPF have been favorable for nearly all time periods, underperforming the policy benchmark only in the most current trailing one-year period by 0.1 percent. Returns for the STPF have been less than favorable as the fund has underperformed the policy benchmark in both short- and long-time periods.

In the charts on the following page, we compare the actual rate of return (ROR) of the LGPF and STPF against their respective policy benchmarks, which are a passive representation of the Council's strategic allocations. The table also shows each Fund's rank in a universe of other Endowments and Foundations. A rank of 1 is the best, and a rank of 99 is the worst.

¹³⁵ If manager compliance is monitored and reported via a separate report, it may not be necessary to include it in a performance report.

Land Grant Permanent Fund

| Annualized Performance As of June 2009 ¹³⁶ | 1 Year ROR Rank | 3 Years ROR Rank | 5 Years ROR Rank | 10 Year ROR Rank |
|--|--------------------|---------------------|---------------------|---------------------|
| Land Grant Permanent Fund (LGPF) | -19.8 42 | -3.1 57 | 2.0 57 | 2.2 67 |
| Land Grant Policy Index | -19.7 42 | -4.2 73 | 1.0 79 | 1.6 87 |

Severance Tax Permanent Fund

| Annualized Performance As of June 2009 ¹³⁷ | 1 Year ROR Rank | 3 Years ROR Rank | 5 Years ROR Rank | 10 Year ROR Rank |
|--|--------------------|---------------------|---------------------|---------------------|
| Severance Tax Permanent Fund (STPF) | -22.3 72 | -4.3 74 | 1.2 73 | 1.8 82 |
| Severance Tax Policy Index | -20.0 53 | -4.1 71 | 1.3 71 | 1.9 79 |

While performing a detailed portfolio attribution analysis is not within the scope of this report, we provide some high level observations based upon the interpretation of information obtained via the discovery process. Overall, several tactical and discretionary decisions were made that served as potential contributors to recent disappointing performance results for the Funds. They include:

- Lack of meaningful exposure to emerging markets
- Limitations on exposure to international equities
- Overweight in domestic equities
- Hedge overlay (option collar) limited some periods of key positive performance
- Lack of high yield bond exposure
- Lack of high yield credit exposure¹³⁸
- Lack of debt exposure in key areas, such as real estate and private equity, among others
- Exposure to Collateralized Debt Obligations (CDOs) and Collateralized Loan Obligations (CLOs)¹³⁹

¹³⁶ Returns per the NEPC 2009 2nd Quarter Performance Report for the quarter ended 6/30/2009. Performance is gross-of-fees for traditional assets and net-of-fees for alternative assets. Ranks are calculated versus the Endowments and Foundations universe provided by BNY Mellon Performance & Risk Analytics, LLC and includes 170 such funds as of 6/30/2009.

¹³⁷ Returns per the NEPC 2009 2nd Quarter Performance Report for the quarter ended 6/30/2009. Performance is gross-of-fees for traditional assets and net-of-fees for alternative assets. Ranks are calculated versus the Endowments and Foundations universe provided by BNY Mellon Performance & Risk Analytics, LLC and includes 170 such funds as of 6/30/2009.

¹³⁸ Examples of high yield credit instruments include bank loans, distressed debt, and bankrupt debt.

¹³⁹ Collateralized debt obligations (CDOs) are a type of structured asset-backed security whose value and payments are derived from a portfolio of fixed income underlying assets. Collateralized loan obligations (CLOs) are a form of securitization where payments from multiple middle and large sized business loans are pooled together and passed on to different classes of owners in various tranches.

Some level of tactical decision-making is inherent to portfolio management. While overly tactical decision-making contributed to the recently disappointing returns, we encourage the Council to focus on structuring the entire program at a strategic level to achieve better future results.

Compliance

It is critically important for public funds to have strong systems of controls in place to prevent violations of the applicable constitutional provisions, laws, and policies. Comprehensive compliance programs clearly establish the type and frequency of reporting that is to be provided by those to whom fiduciaries have delegated duties. The programs are to prevent and deter unlawful conduct including inappropriate market timing, late trading, and the misuse of material, nonpublic information about the portfolios. In addition, they serve to prevent staff, consultants, and other service providers who act as fiduciaries from placing personal interests above the interests of funds and thereby breaching their fiduciary obligations.

In best practices, the governing body discusses, adopts, and implements the program, which consists of written policies and procedures reasonably designed to prevent violation of the applicable state and federal laws, including federal securities laws. They review those policies and procedures annually to assess their continued adequacy and the effectiveness. Implementation and responsibility for compliance may be delegated to the general counsel, an inspector general, a chief compliance officer, or an internal auditor so long as an effective and efficient means of direct reporting exists with the council or board.

The need for a comprehensive compliance program is heightened when internal asset management is present. Program policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred. The best compliance programs will first identify factors creating risk exposure for the organization in light of the particular operations, and then design policies and procedures that address those risks.

The SIC does not presently have a formal compliance program for its operations. Historically, we understand that there was an attempt to identify and restrict personal trading for internal portfolio management staff in the late 1990s; however, those efforts were discontinued. Presently, we observed that internal staff is sensitive to the topic, and that efforts are underway to design a comprehensive compliance program and to devote resources necessary, both human and technological, to effectively monitor and report on such issues.

Best practices are for the Council to take an active role in the design, approval, and ongoing evaluation of a compliance program, and ensure that adequate resources exist to support it. The program should, at a minimum, address the following aspects of the investment process:

- Portfolio management processes, including allocation of investment opportunities among the permanent funds and underlying agencies, consistency of portfolios with agency specified asset allocations, and applicable law.

- Trading practices, including procedures by which managers (both internal and external) satisfy the best execution obligation, use brokerage to obtain research and other services (soft dollar arrangements), and allocate aggregated trades among the portfolio.
- Proprietary trading of the NMSIO staff and personal trading activities of persons with portfolio management responsibility and interaction.
 - The accuracy of disclosures made to agency clients including regular statements and interaction.
- Safeguarding of the Funds' assets from conversion or inappropriate use by NMSIO staff, external managers, or consultants.
- The accurate creation of records and their maintenance in a manner that secures them from unauthorized alteration or use, and protects them from untimely destruction.
- Processes to value the Fund's holdings and assess fees based on those valuations.
- Safeguards for the privacy protection, where applicable, of the Funds' records and information.
- Business continuity plans.

While the Council and State Investment Officer are specifically exempted by statute¹⁴⁰ from the New Mexico State Securities Act of 1986 (i.e., the SIO is not subject to the same requirements as private sector investment advisers or companies), due consideration ought to be given to mirroring certain aspects of the law that would serve to better protect the Funds. This type of approach is somewhat similar to what we recommend and find among public pension funds. While they are exempt from the Employee Retirement Income Security Act of 1974 (ERISA), public pension systems and their boards of trustees often look to the law as a model for best practice in operation and function.

Conclusions

In certain respects, the SIO and Investment Office have been permitted to function more independently of the Council than is typical or inline with best practices.¹⁴¹ The Council has approved, but not actively participated in certain critical policy-making and monitoring functions. Two examples are asset allocation and the approval of the due diligence process and criteria to be used for manager selection and retention. Delegation of duties to the SIO, NMSIO staff, and the consultants appear to be unclear in certain areas.

Some Constitutional and statutory restrictions may prevent the NMSIO from achieving the optimal portfolios. It's not clear if implementation of STPF economically targeted investment goals as permitted by statute are made, first and foremost, in accordance with the standards required by the Prudent Investor Act.

NMSIO's asset class ranges are too wide. The actual rebalancing process has deviated from what is called for by the general investment policy statement. Tactical asset allocation authority has been granted to the

¹⁴⁰ NMSA 1978 Section 6-8-7.

¹⁴¹ Based upon information provided, we understand that the Council members have recently become more active in reassessing their role as a fiduciary as well as the amount of authority delegated to the SIO function and NMSIO staff. A Governance and Audit subcommittee of the Council has been established to facilitate a closer working relationship with the Interim SIO, and policy level initiatives such as revisiting the Funds' long-term asset allocation strategy and revising the general investment policy statement are presently underway. We commend the Council members for recent actions taken to clarify its policy-making and oversight role.

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SIO, allowing actual allocations to deviate materially from the target ranges. Such wide ranges and broad discretion given to staff is unusual.

NMSIO's use of active versus passive investment management strategies differs significantly from the peer group.

The broad asset classes employed by NMSIO, including those in the alternatives portfolio, are commonly used by other institutional funds; however, reevaluation of the sub-asset classes employed is warranted to ensure effective and efficient portfolio construction.

The general Investment Policy Statement and asset class specific Investment Policy documents are in line with common but not best practices in many ways. The placement agent policy requirements are strict; however, they may preclude the NMSIO from taking advantage of opportunities for sound investments because of the issues related to compliance and penalties.

Performance reports generally meet common industry standards but not best practices because they do not deliver a complete set of information the Council needs to fulfill its role as a governing body. NMSIO presently lacks a comprehensive compliance program that has been formally adopted by the Council. This makes the organization vulnerable to unnecessary risks.

Requiring the disclosure of confidential information could negatively affect the ability of the SIC to participate in certain alternative investment opportunities.

Recommendations on Policies, Procedures, and Practices

Asset Allocation

43. Formally review the overall asset allocation of the Funds annually with the Council or a sub-committee of the Council.
44. Complete an asset allocation study every two years with the active involvement of the Council, or a subcommittee of the whole, the SIO, NMSIO staff, and the consultant.
45. Formally review the Funds' compliance with the approved asset allocation on a quarterly basis.
46. Evaluate the best manner in which to incorporate the nature and characteristics of the spending policy into the long-term asset allocation.
47. Reevaluate the tactical asset allocation authority granted to NMSIO staff, and update the policy in place to govern such delegation going forward.
48. Formally discuss and approve at the Council level any tactical decisions that will materially alter the asset allocation policy (i.e., the derivative overlay) prior to their implementation, including how their costs and benefits overtime will be reported.
49. Ensure the Council receives ongoing education and information related to the risks in the alternatives portfolio.

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Constitutional and Statutory Restrictions

50. Reevaluate current Constitutional restrictions, especially the limitation on investment in international securities, to ensure that prudent portfolio construction is not impaired.

Asset Classes

51. Ensure thorough education and analysis is presented and discussed with the Council regarding the sub-asset classes included or contemplated for the portfolio.
52. Consider global mandates for equity investments.

Rebalancing of Assets

53. Reevaluate the current rebalancing process as set forth in the investment policy statement versus actual practice.
54. Tighten the allowable ranges for each asset class.

Investment Goals and Risk Tolerance

55. Revise the stated investment objectives in the IPS to include earning an appropriate risk adjusted return compared to the policy portfolio.
56. Increase the Council's role in risk budgeting discussions.

Written Investment Policy Statement

57. Complete a comprehensive assessment of the IPS to identify where deviation from policy currently exists.
58. Update and improve the IPS and its sub-policies with the assistance of the consultant and participation of the Council or a sub-committee thereof.
59. Assign the responsibility for monitoring compliance with the IPS to an independent auditor or consultant and immediately report violations to the Council.

Manager Structure

60. Periodically review the amount of actual expense associated with internal management.
61. Ensure the Council is provided sufficient and unbiased information to periodically assess the costs and benefits associated with active versus passive management.
62. Complete a manager structure review across all asset classes that evaluates the use of passive management and the number and types of managers, as well as any style or market segment biases in the portfolio.
63. Reevaluate the need for certain investment managers to also perform investment consultant functions and if necessary, clearly delineate roles, responsibilities, expectations for transparency, and reporting requirements.

Selection of Investment Managers and Custodian

64. Reevaluate the current level of delegation from the Council to the SIO and NMSIO staff with respect to the selection and retention of managers.
65. Incorporate manager selection criteria and process within the investment policy statement and supporting documentation.

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66. Ensure documentation of the search process is maintained and analysis presented to the Council is complete and useful in fulfilling its fiduciary oversight responsibility.
67. Develop and adopt comparable criteria for selecting and evaluating internal and external managers.
68. Evaluate Investment Office resources available to perform external manager ongoing monitoring and due diligence across all asset classes, including alternatives, and determine whether additional resources are necessary to ensure full-coverage.
69. Seek statutory authority to hire and retain the custodian bank.

Alternative Investments

70. Have NMSIO staff and consultants provide educational sessions tailored to the Council to highlight the benefits and risks of alternative asset portfolio construction.
71. Modify the alternatives performance reports to include sub-asset class exposures to provide a clear picture of asset weightings.
72. Seek a statutory change allowing for an exemption so that discussions and materials related to private market investments or proprietary investment strategies can be kept confidential.

Benchmarks

73. Increase the Council's level of involvement in setting and periodically reviewing benchmarks, and making adjustments, when necessary.
74. Approve a procedure for creating and changing benchmarks for each sub-asset class and ensure they match the General IPS, any applicable specialty IPS, and subsequent performance reports.
75. Evaluate the HFRI Funds-of-Funds Index as the primary benchmark for the absolute return portfolio.
76. Ensure proper benchmarks are set and actually used for the domestic equities portfolio.

Compensation of Managers

77. Reevaluate the costs and benefits of placing broad fees caps on all external investment managers going forward.

Role and Qualifications of Placement Agents

78. Consider delegating placement agent qualification review and monitoring to a qualified external consultant.
79. Revise the placement agent policy with the assistance of a private equity consultant and require an appropriate level of disclosure to the Council for all placement agent use.

Performance Reporting

80. Modify the quarterly performance reports to depict returns net-of-fee and include risk-adjusted returns for the total fund and each asset class.
81. Evaluate whether adding any other elements to the performance reports (as outlined in the table) would be useful to the Council.

Compliance

82. Design a comprehensive compliance program for the Council's approval.

SUMMARY OF RECOMMENDATIONS

New Mexico Legislative Council Service
Fiduciary Review for the
State Investment Office
Summary of Recommendations

Below is a complete list of the recommendations that are included in the review. For ease of reference, the page numbers in which the topic is discussed are provided. We have also listed the initial steps required to address the recommendation, if the Council chooses to do so. The Council has the ultimate authority to prioritize, accept, modify, and reject any and all recommendations based on NMSIO's needs and resources.

| Item Number | Recommendations | Requirement |
|-------------|--|--|
| 1 | Balance the number of Governor appointees with legislative appointees or other ex-officio members who are not part of the executive branch. (see page 7) | Statutory Change |
| 2 | Reevaluate public member quorum requirement in light of Council composition. (see page 7) | SIC Discussion and Possible Statutory Change |
| 3 | Allow for the removal of members when attendance is below 80%. (see page 7) | Policy Development and Possible Statutory Change |
| 4 | Limit participation and voting at Council meetings by teleconference to no more than once every 12 months. (see page 7) | Policy Development |
| 5 | Evaluate whether an ex-officio member should be allowed to designate a specific person to attend, participate, and vote at meetings. (see page 7) | SIC Discussion and Possible Policy Development |
| 6 | Allow the SIC to elect its own Chair and Vice-Chair. (see page 7) | Statutory Change and Policy Development |
| 7 | Modify the composition of the Council to prohibit any NMSIO staff from serving as Council members. (see page 7) | Statutory Change |
| 8 | Require formal orientation and more structured ongoing education, including annual fiduciary training. (see page 9) | Policy Development |
| 9 | Provide specialized training for committee members. (see page 9) | Policy Development |
| 10 | Include a definition of fiduciary and explicitly state the fiduciary status of anyone with discretionary authority and control over fund assets, including the SIC, the SIO, and specified staff, in statutes and the investment policy. (see page 11) | Statutory Change and Policy Enhancement |
| 11 | Examine the intent of the Prudent Investor Act and its application to NMSIO, and determine whether protections provided under the Tort Claims Act or other laws providing immunity or indemnification are appropriate. (see page 12) | SIC Discussion |

SUMMARY OF RECOMMENDATIONS

| Item Number | Recommendations | Requirement |
|-------------|---|----------------------------------|
| 12 | Raise the Constitutional standard of care from ordinary care to that of a prudent investor to be consistent with statutes. (see page 12) | Constitutional Change |
| 13 | Expand existing annual disclosure requirements to all SIC members and high level staff, and ensure that the disclosure statements are being reviewed by the SIC. (see page 14) | Policy Enhancement |
| 14 | Amend the Transparency and Disclosure Policy to include applicable statutory provisions such as the details regarding the gift limitations, disclosure requirements, and honoraria. (see page 15) | Policy Enhancement |
| 15 | Prohibit all gifts from prospective and current vendors in the Transparency and Disclosure Policy. (see page 15) | Policy Enhancement |
| 16 | Require more disclosure from prospective vendors to decision-makers with regard to conflicts of interest in the evaluation material to aid compliance. (see page 15) | Policy Enhancement |
| 17 | Require annual disclosures of gifts, meals, entertainment above a certain threshold, and all campaign contributions and charitable contributions made on behalf of the SIC and staff made by vendors. (see page 15) | Policy Enhancement |
| 18 | Adopt a comprehensive code of ethics that includes conflicts of interest and insider trading provisions. (see page 15) | Policy Development |
| 19 | Clarify the SIC's authority over private equity investments. (see page 17) | SIC Discussion and Documentation |
| 20 | Clearly establish SIC's authority to bind NMSIO in major contracts, and its delegation to the SIO to be the signatory. (see page 17) | SIC Discussion and Documentation |
| 21 | Develop and adopt a Council charter. (see page 18) | Policy Development |
| 22 | Discuss what value an accountability matrix may have in clarifying and documenting roles and responsibilities. (see page 18) | SIC Discussion |
| 23 | Develop a central governance manual with relevant policies. (see page 19) | Policy Development |
| 24 | Develop and adopt position descriptions for Council members and Council Officers. (see page 19) | Policy Development |
| 25 | Discontinue the PEIAC unless its value can be established. (see page 21) | SIC Discussion |
| 26 | Ensure Council receives sufficient reports to fulfill its duty to provide oversight of delegated duties. (see page 23) | SIC and Committee Discussions |
| 27 | Engage the State Auditor in discussions regarding audit scope. (see page 23) | SIC Discussion |

SUMMARY OF RECOMMENDATIONS

| Item Number | Recommendations | Requirement |
|-------------|--|--|
| 28 | Develop and adopt a Governance and Audit Subcommittee charter. (see page 23) | Policy Development |
| 29 | Refine statutes to clarify the authority of the Council and the SIO. (see page 24) | SIC Discussion and Statutory Change |
| 30 | Reevaluate the extent of delegations made to the SIO and other investment staff. (see page 24) | SIC Discussion |
| 31 | Explicitly state in contracts that consultants work for the Council. (see page 25) | Contract Language Change |
| 32 | Include fiduciary status and the prudent investor standard of care in all applicable contracts. (see page 26) | Contract Language Change |
| 33 | Reference and provide a copy of the Conflicts of Interest Act and the Transparency and Disclosure Policy with all contracts. (see page 26) | Contract Language Change |
| 34 | Review NMSIO position descriptions, including the SIO's position description, to ensure they are comprehensive, accurate, appropriate, and consistent with the laws, policies, and procedures. (see page 26) | Documentation Review |
| 35 | Seek Council autonomy in setting staff size. (see page 27) | Statutory Change |
| 36 | Evaluate staff size in light of internal management and the extensive use of active management. (see page 27/28) | SIC Discussion and Evaluation |
| 37 | Allow SIC to appoint the SIO. (see page 28) | SIC Discussion and Statutory Change |
| 38 | Give the SIO the authority in hiring and firing other staff. (see page 28) | SIC Discussion and Statutory Change |
| 39 | Add an internal audit function. (see page 28) | SIC Discussion and Evaluation |
| 40 | Develop a formal performance evaluation process for all staff members that is relevant and specific to the agency, and associated with some form of reward. (see page 29) | Policy and Documentation Development and Enhancement |
| 41 | Seek budget autonomy, but maintain fiduciary standards, transparency, and reporting requirements. (see page 30) | Statutory Change |
| 42 | Evaluate the benefit of seeking an operating cost comparison with a peer group. (see page 32) | SIC Discussion and Evaluation |
| 43 | Formally review the overall asset allocation of the Funds annually with the Council or a sub-committee of the Council. (see page 38) | SIC and Committee Discussions |
| 44 | Complete an asset allocation study every two years with the active involvement of the Council, or a subcommittee of the whole, the SIO, NMSIO staff, and the consultant. (see page 38) | SIC and Committee Discussions |

SUMMARY OF RECOMMENDATIONS

| Item Number | Recommendations | Requirement |
|-------------|---|--|
| 45 | Formally review the Funds' compliance with the approved asset allocation on a quarterly basis. (see page 38) | SIC and Committee Discussions |
| 46 | Evaluate the best manner in which to incorporate the nature and characteristics of the spending policy into the long-term asset allocation. (see page 38) | SIC and Committee Discussions |
| 47 | Reevaluate the tactical asset allocation authority granted to NMSIO staff, and update the policy in place to govern such delegation going forward. (see page 39) | SIC Discussion and Policy Change |
| 48 | Formally discuss and approve at the Council level any tactical decisions that will materially alter the asset allocation policy (i.e., the derivative overlay) prior to their implementation, including how their costs and benefits overtime will be reported. (see page 39) | SIC Discussion |
| 49 | Ensure the Council receives ongoing education and information related to the risks in the alternatives portfolio. (see page 43) | SIC Discussion |
| 50 | Reevaluate current Constitutional restrictions, especially the limitation on investment in international securities, to ensure that prudent portfolio construction is not impaired. (see pages 41 - 43) | SIC Discussion and Constitutional change |
| 51 | Ensure thorough education and analysis is presented and discussed with the Council regarding the sub-asset classes included or contemplated for the portfolio. (see page 44) | SIC Discussion |
| 52 | Evaluate and adjust the domestic equity policy (U.S./non-U.S. equity split) to better reflect world equity market capitalizations. (see page 46) | SIC and Committee Discussions |
| 53 | Reevaluate the current rebalancing process as set forth in the investment policy statement versus actual practice. (see page 46) | SIC Discussion and Evaluation |
| 54 | Tighten the allowable ranges for each asset class. (see pages 38, 46, and 47) | SIC Discussion and Policy Change |
| 55 | Revise the stated investment objectives in the IPS to include earning an appropriate risk adjusted return compared to the policy portfolio. (see page 48) | SIC Discussion and Policy Change |
| 56 | Increase the Council's role in risk budgeting discussions. (see page 49) | SIC Discussion |
| 57 | Complete a comprehensive assessment of the IPS to identify where deviation from policy currently exists. (see pages 49 - 54) | SIC Discussion and Evaluation |
| 58 | Update and improve the IPS and its sub-policies with the assistance of the consultant and participation of the Council or a sub-committee thereof. (see pages 49 - 54) | SIC Discussion and Policy Change |

SUMMARY OF RECOMMENDATIONS

| Item Number | Recommendations | Requirement |
|-------------|---|--|
| 59 | Assign the responsibility for monitoring compliance with the IPS to an independent auditor or consultant; any violations should be reported immediately to the Council. (see pages 49 - 54) | SIC Discussion |
| 60 | Periodically review the amount of actual expense associated with internal management. (see page 55) | SIC Discussion and Reporting |
| 61 | Ensure the Council is provided sufficient and unbiased information to periodically assess the costs and benefits associated with active versus passive management. (see page 57) | SIC Discussion and Reporting |
| 62 | Complete a manager structure review across all asset classes that evaluates the number and types of managers, as well as any style or market segment biases in the portfolio. (see page 58) | SIC Discussion and Evaluation |
| 63 | Reevaluate the need for certain investment managers to also perform investment consultant functions and if necessary, clearly delineate roles, responsibilities, expectations for transparency, and reporting requirements. (see page 59) | SIC Discussion, Evaluation and Contract Change |
| 64 | Reevaluate the current level of delegation from the Council to the SIO and NMSIO staff with respect to the selection and retention of managers. (see page 60) | SIC Discussion |
| 65 | Incorporate manager selection criteria and process within the investment policy statement and supporting documentation. (see pages 60 - 61) | SIC Discussion and Policy Change |
| 66 | Ensure documentation of the search process is maintained and analysis presented to the Council is complete and useful in fulfilling its fiduciary oversight responsibility. (see page 61) | SIC Discussion |
| 67 | Develop and adopt comparable criteria for selecting and evaluating internal and external managers. (see pages 60 - 61) | SIC Discussion and Evaluation |
| 68 | Evaluate Investment Office resources available to perform external manager ongoing monitoring and due diligence across all asset classes, including alternatives, and determine whether additional resources are necessary to ensure full-coverage. (see pages 60 - 61) | SIC Discussion and Evaluation |
| 69 | Seek statutory authority to hire and retain the custodian bank. (see page 62) | Statutory Change |
| 70 | Have NMSIO staff and consultants provide educational sessions tailored to the Council to highlight the benefits and risks of alternative asset portfolio construction. (see page 63) | SIC Discussion |
| 71 | Modify the alternatives performance reports to include sub-asset class exposures to provide a clear picture of asset weightings. (see page 63) | SIC Discussion and Report Modification |

SUMMARY OF RECOMMENDATIONS

| Item Number | Recommendations | Requirement |
|-------------|--|--|
| 72 | Seek a statutory change allowing for exemption of discussions and materials to be kept confidential as related to private market investments or proprietary investment strategies. (see page 66) | Statutory Change |
| 73 | Increase the Council's level of involvement in setting and periodically reviewing benchmarks, and making adjustments, when necessary. (see pages 66 - 69) | SIC Discussion |
| 74 | Approve a procedure for creating and changing benchmarks for each sub-asset class and ensure they match the General IPS, any applicable specialty IPS, and subsequent performance reports. (see pages 66 - 69) | SIC Discussion |
| 75 | Evaluate the HFRI Funds-of-Funds Index as the benchmark for the absolute return portfolio. (see pages 68 - 69) | SIC Discussion and Evaluation |
| 76 | Ensure proper benchmarks are set and actually used for the domestic equities portfolio. (see page 68 - 69) | SIC Discussion and Evaluation |
| 77 | Reevaluate the costs and benefits of placing broad fees caps on all external investment managers going forward. (see page 70) | SIC Discussion and Evaluation |
| 78 | Delegate placement agent qualification review and monitoring to an external consultant. (see page 75) | SIC Discussion |
| 79 | Revise the placement agent policy with the assistance of a private equity consultant and require an appropriate level of disclosure to the Council for all placement agent use. (see page 75) | SIC Discussion and Policy Change |
| 80 | Evaluate whether adding any other elements to the performance reports (as outlined in the table) would be useful to the Council. (see pages 76 - 78) | SIC Discussion |
| 81 | Modify the quarterly performance reports to depict returns net-of-fee and include risk-adjusted returns for the total fund and each asset class. (see page 78) | SIC Discussion and Report Modification |
| 82 | Design a comprehensive compliance program for the Council's approval. (see pages 80 - 81) | SIC Discussion |

Appendix A Sample Council Education and Orientation Policy

General

Fiduciary duties are not limited to investment decisions. All decisions must be made from the perspective of a fiduciary. Fiduciaries have the duties of loyalty to the best interests of the trust, to deal impartially with regard to all beneficiaries, to participate in decision-making, to delegate decisions when it is prudent to do so, to prevent breaches of duties by others, and to compel performance and redress breach of duties by others. This standard recognizes the ever-changing nature of investment issues the council members will encounter.

Education of council members is, therefore, essential to ensure that they meet their fiduciary responsibilities. It is the council's policy that all council members have a full understanding of the issues facing the organization so that they may properly oversee the administration of the fund.

To that end, this policy sets forth the new council member orientation and mentoring programs, the parameters for ongoing council member education, mandatory fiduciary education and ethics training sessions, and the availability of institutional investors' periodicals to foster council member continuing education.

Orientation

Each council member is strongly encouraged to attend an orientation session within the first three to four weeks of being appointed to the council (preferably before having to vote during an actual council meeting). Orientation leaders will be the SIO and other executive staff members. Others inside or outside the organization may also participate, if determined to be appropriate by the SIO.

The orientation sessions will be developed by the SIO and will, at a minimum, include the following topics:

- A brief history and overview of the organization, including the mission and purpose.
- A description of the various beneficiaries of the fund.
- A summary of the laws and rules governing the organization and the council.
- An explanation of the legal status of the organization as a political subdivision of the state in contrast to the status of state agencies.
- An explanation of fiduciary responsibility, conflicts of interest, and ethics.
- An explanation of the strategic plan and the planning process.
- A high level review of existing council policies.
- A briefing on current and emerging issues before the council.
- Biographical information on the other council members and executive staff.
- A review of the council's governance handbook.
- An introduction to the executive staff, and an overview provided by each of them regarding the operations of their various operating divisions.
- A tour of the offices.

At or before the orientation session, the new council members will receive the board governance handbook, minutes from the prior six months of meetings, a sample council packet, a list of upcoming recommended educational conferences, and any other relevant information or documents deemed appropriate by the SIO.

Mentoring

Any new council member may request a mentor to assist them in becoming familiar with their responsibilities on the council. If a request is made, the council chair will designate one experienced council member to be a mentor to the new council member for a period of six to twelve months. The mentor will contact the new council member at least once each month, outside of regularly scheduled council meetings, for consultation or discussion related to new council member orientation.

Ongoing Education

Council members may attend any of the educational conferences approved as shown on the recommended list included in each month's council packet. The SIO will regularly update a list of valuable conferences from which the council members may choose. The list will also be modified to reflect the evaluations from council members who have attended specific conferences to ensure that the conferences remain worthy of the council's time and the fund's expense. Based on the personal education needs of the council members, the SIO will arrange for staff or outside service providers to conduct educational sessions throughout the year at regularly scheduled council meetings or the annual planning session.

Council members are encouraged to attend one educational session or conference designed to give them a general understanding of the responsibilities of a public fund fiduciary. Council members must complete an education evaluation form upon completion of any educational conference and such form must be turned in with any request for reimbursement of expenses associated with the conference.

Fiduciary Education Session

Each year the staff will arrange for a fiduciary education session that will update the council members on issues affecting their service on the council. The session may involve outside speakers. Council members may submit questions in advance of this session so that their concerns can be addressed. This session may also be expanded to include discussion on state and the organization's ethics policies and requirements.

Industry Periodicals

Council members are encouraged to subscribe to periodicals selected from an approved list of investment-related periodicals. The expense for the periodicals will be paid by the fund. The SIO will annually review and update this list with input from the council members.

Appendix B
Sample Accountability Matrix for Key Investment Responsibilities
(This is not an all inclusive list).

Roles of the various parties for each responsibility item may include: Decides; Reviews, Evaluates, Monitors, Advises, Recommends; Gives Input, Provides Information; Reports; etc.

| Responsibility | Council | PEIAC | Gov. & Audit Sub- committee | SIO | Other Staff | Consultants |
|--|---------|-------|-----------------------------------|-----|-------------|-------------|
| 1. Risk tolerance | | | | | | |
| 2. Monitoring risk levels | | | | | | |
| 3. Investment objectives | | | | | | |
| 4. Asset allocation targets and ranges | | | | | | |
| 5. Compliance with asset allocation | | | | | | |
| 6. Active vs. passive strategy (%'s) | | | | | | |
| 7. Compliance with active/passive strategy | | | | | | |
| 8. Types of asset classes | | | | | | |
| 9. Number of external managers | | | | | | |
| 10. Selection of specific external investment management firms | | | | | | |
| 11. Investment manager contracts | | | | | | |
| 12. Performance of external investment managers | | | | | | |
| 13. Selecting custodian and sub-custodian banks | | | | | | |
| 14. Selecting investment consultant for general advice | | | | | | |

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| Responsibility | Council | PEIAC | Gov. & Audit Sub-committee | SIO | Other Staff | Consultants |
|--|---------|-------|----------------------------|-----|-------------|-------------|
| 15. Selecting investment consultant for performance evaluation | | | | | | |
| 16. Selecting specialty investment consultants | | | | | | |
| 17. "Watch list" additions/deletions | | | | | | |
| 18. Rebalancing policy | | | | | | |
| 19. Compliance with rebalancing policy | | | | | | |
| 20. Securities lending costs/benefits | | | | | | |
| 21. Valuation of real estate | | | | | | |
| 22. Purchase and sale agreements on real estate | | | | | | |
| 23. Valuation of private equity | | | | | | |
| 24. Partnership agreements on private equity | | | | | | |
| 25. Documentation of investment decisions | | | | | | |
| 26. Commission recapture/soft dollars policy | | | | | | |
| 27. Compliance with commission recapture/soft dollars policy | | | | | | |
| 28. Statutory compliance of investments parameters | | | | | | |
| 29. Proxy voting issues and positions | | | | | | |
| 30. Class actions – opting out | | | | | | |
| 31. Lead plaintiff role for the organization | | | | | | |

Appendix C
Examples of Council Responsibilities for a Council Charter
(This is not an all inclusive list).

The council has the following responsibilities:

- Adopt a strategic plan including a mission statement and core values that set forth proper standards of behavior.
- Establish governance policies to guide the council in an effective and efficient manner.
- Elect officers through a fair and open process.
- Set a reasonable meeting schedule.
- Establish and disband standing and special committees of the council, as necessary.
- Articulate and adopt a statement of risk management principles.
- Adopt a comprehensive investment policy consistent with statutory requirements and current best industry practices.
- Set and periodically review the asset allocation of the portfolio.
- Hire and monitor the necessary professionals (e.g., actuaries, investment consultants, investment managers, and legal counsel) to support the investment functions.
- Adopt a sufficient operating budget and closely monitor compliance.
- Ensure that an independent audit of the fund's financial statements takes place each year.
- Undertake an annual council self-evaluation to promote continual improvement.
- Evaluate the SIO annually.
- Evaluate key consultants and advisors annually.
- Make relevant information publicly available in a timely manner.

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Appendix D
Sample Governance Manual Table of Contents

| |
|--|
| Introduction |
| Introduction to governance policies |
| Purpose |
| Reference guide |
| Brief Overview |
| History of the council |
| Creation of the council |
| Statistical information |
| Organizational chart |
| Overview of outside service providers |
| Members of the SIC |
| Names, pictures, and terms |
| Contact information |
| Calendar of Meetings and Events |
| Meetings |
| Educational sessions |
| SIC Responsibilities |
| SIC authority and duties |
| Accountability chart |
| SIC orientation and education requirements |
| SIC self-evaluation process |
| SIO evaluation process |
| SIC Meeting Protocol |
| Agenda setting |
| Organization of discussion items |
| Consent agenda |
| Information-only items |
| Rules of order |
| SIC Seats and Position Descriptions |
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| SIC chair and vice-chair position descriptions |
| SIC officer election process |
| Committees and Assignments |
| Process for establishing committees |
| PEIAC charter |
| Governance and audit subcommittee charter |
| Committee evaluation process |

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| SIC Policies |
| Transparency and disclosure policy |
| Ethics policy |
| Conflicts of interest and disclosure policy |
| Investment policy |
| Proxy policy |
| Soft dollar policy |
| Private placement agent policy |
| Communication policy |
| Audit policy |
| Funding policy |
| Trustee education policy |
| Legislative policy |
| SIC travel policy |
| SIC expense reimbursement policy |
| Staff compensation policy |
| Strategic Plan |
| Current strategic plan |
| Progress reports |
| Strategic planning process |
| Miscellaneous |
| SIC application forms |
| Financial disclosure/conflicts of interest forms |
| Educational opportunities |
| Institutional investors periodicals and websites |
| Expense reimbursement form |
| SIO position description |

Appendix E
Examples of Responsibilities for Individual Council Members
for a Council Member Position Description
(This is not an all inclusive list.)

Each council member is responsible for:

- Working constructively with the other council members to govern the organization.
- Interacting appropriately with staff, outside service providers, contributors, beneficiaries, clients, and others.
- Discharging his or her fiduciary duties with care, skill, diligence, and prudence, solely in the interest of all beneficiaries, and for their exclusive benefit, in accordance with the laws governing the organization
- Incurring only reasonable expenses in carrying out his or her duties as a council member.
- Preparing for council and committee meetings by reading materials in the packet in advance of the meeting and asking questions of staff.
- Attending council and committee meetings, and participating in discussions.
- Respecting the time commitment required for meetings by arriving prior to the start of the meeting and staying until its conclusion.
- Refraining from acting on behalf of the entire council unless specifically delegated that authority.
- Respecting open meetings act by not convening meetings, including conference calls or video conferences, with fellow council members outside the properly noticed meetings.
- Attending statutorily and policy required educational sessions.
- Acquiring and maintaining knowledge to effectively make decisions and evaluate those to whom duties have been delegated.
- Promptly reporting any ethical concerns to the council chair, SIO, or general counsel.
- Avoiding conflicts of interest or even the appearance of conflicts of interest, and disclosing conflicts of interest as required by statutes or policy.
- Refraining from any self-dealing with fund's assets or using the fund to promote a personal business or to gain financial rewards.
- Maintaining confidentiality of certain investment activity and information pursuant to law or policy.
- Using reasonable care to prevent any other fiduciary of the organization from committing a breach of fiduciary duty.
- Allowing the SIO to oversee the operational management of the organization with proper oversight.
- Refraining from performing any function delegated or normally assigned to staff unless prior approval is obtained from the council.

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Appendix F

Examples of Functions of a Public Fund Audit Committee

The American Institute of Certified Public Accountants (AICPA) provides guidance to audit committees. In summary, our understanding of its advice as it can be applied to public funds is the following:

1. Ensure that each member of the audit committee is appointed by the council.
2. Have at least one member of the audit committee with financial experience.
3. Review the audit committee's charter annually and reassess it for adequacy.
4. Meet at least four times per year and additional times when necessary.
5. Have the option to discuss matters privately with any of the following: the independent auditors, SIO, CFO, internal auditor, general counsel, outside counsel, director of financial reporting, controller, and anyone else as desired by the committee (please note: open meetings laws come into play in the public sector).
6. Have the authority to hire professional consultants if necessary.
7. Review, evaluate, and concur on the appointment, replacement, reassignment, or dismissal of the internal auditor.
8. Oversee the appointment of the independent outside financial auditors to be engaged for the audited financial statements and establish the related audit fees.
9. Review and evaluate the performance of the independent auditors and inform the full council of any problems with the independent auditors.
10. Establish a regular schedule for periodically re-bidding the audit contract with an outside CPA firm.
11. Review with management the policies and procedures with respect to expense accounts and the personal use of public property.
12. Ask the SIO, internal auditor, and the independent auditors about significant risks or exposures facing the fund; assess the steps management has taken or proposes to take to minimize such risks and periodically review compliance with such steps.
13. Review audit scope and plan of both the internal auditor and the independent auditor. Address the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.
14. Review significant findings on internal audits during the year and management's responses.
15. Ask the SIO and CFO about the budget and expenditures.
16. Review with the independent auditors and the internal auditor the adequacy of internal controls including computerized information system controls and security.
17. Review with management and the independent auditor the effect of any regulatory and accounting industry changes.
18. Review with the independent auditor that performs the financial statement audit all critical accounting policies and practices used by the government organization as well as alternative treatments of financial information within generally accepted accounting principles.
19. Review all significant written communications between the independent auditors and management, such as management letters.
20. Review with management and the independent auditors the financial reports and the audit reports and ask for their independent judgment about the quality, not just the acceptability, of the fund's

- accounting principles. Also ask about any significant changes required in the independent auditors' audit plan and any serious difficulties or disputes with management encountered during the audit.
21. Review with the general counsel and the internal auditor legal and regulatory matters that, in the opinion of management, may have a material impact on the financial statements and compliance with federal and state laws and regulations.
 22. Periodically review the fund's code of conduct to ensure that it is adequate and up-to-date and review how compliance is monitored.
 23. Review the procedures for the receipt, retention, and resolution of complaints regarding accounting, internal accounting controls, auditing matters, or suspected fraud that may be submitted by any party internal or external to the fund.
 24. Review procedures for the confidential, anonymous submission by the fund's employees of concerns regarding questionable accounting or auditing matters, or suspected fraud.
 25. Review and approve the annual audit plan submitted by the internal auditor for the upcoming year.
 26. Review the audit committee's own effectiveness.

Appendix G
Useful Reports for an Investment Council or Board
(This is not an all inclusive list.)

The following outline sets forth the type of information investment councils of large public funds might use in their oversight role. A meaningful exercise for the council, governance and audit committee, and staff is to inventory the reports currently provided to the council and discuss their usefulness and frequency. Once the optimal types and frequency are decided upon, best practices are to document this in a policy, so that the council will have adequate information going forward.

In some instances, the information will be in the form of a written report. In other instances, the reports will be presented in person by the staff or consultants who are the authors of the reports so that the council members may ask questions of them.

Investments

| Description | Current Frequency | Changes to the Frequency |
|---|-------------------|--------------------------|
| A review of the asset allocation of the trust funds presented jointly by the investment consultant and the SIO | | |
| A review of the investment policy statement along with any changes recommended by the investment consultant, the SIO, or other members of the council | | |
| An inventory of investments and their valuations | | |
| An update of the activities of the managers connected with alternative investments | | |
| A report of brokerage commissions paid to each firm and historical information regarding the trends in costs | | |
| A report detailing the deviations from the target allocations for the portfolio | | |
| An investment performance report for the previous quarter and the previous five years prepared by the investment consultant | | |
| Investment manager presentations | | |
| Review of each investment manager's adherence to guidelines; comparison to other similar managers; portfolio risk; material changes in the organization, its philosophy or processes; and analysis of new opportunities | | |
| Securities lending reports prepared by the custodian bank and verified by the investment office or the investment consultant | | |
| Valuations of private equity investments prepared by the investment consultant or staff | | |
| A summary of proxy voting and deviations from the proxy policy | | |
| Shareholder activities in addition to proxy voting such as | | |

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| | | |
|---|--|--|
| submission of resolutions, attendance at annual meetings, correspondence with corporations, involvement with class actions, etc. | | |
| An analysis of the passive/active strategy with recommended changes, if necessary | | |
| A request to allow a deviation from the investment policy statement along with the rationale for doing so | | |
| Profiles of the top money manager candidates for a particular asset category, as recommended by staff and the investment consultant | | |
| Portfolio rebalancing activities | | |
| Information about the departure of key people from staff, current investment management, or consulting firms | | |
| Placement of investment managers on the "Watch List" | | |
| Overall status of investments | | |
| Detailed information about real estate or private equity investments that is needed by fiduciaries | | |
| Review and evaluation of key consultants and vendors, including investment consultant, custodian bank, and securities lending firm within the context of service level agreements | | |
| Requests for adding or deleting permissible asset classes | | |

Audits

| Description | Current Frequency | Changes to the Frequency |
|--|-------------------|--------------------------|
| The independent financial audit of the trust funds along with the organization's responses to any findings and comments in the management letter | | |
| The operational audit report along with the organization's responses | | |
| The organization's plan to address any of the findings or comments in the financial or operational audit reports | | |

Legal Matters

| Description | Current Frequency | Changes to the Frequency |
|---|-------------------|--------------------------|
| A review of all litigation | | |
| A review of claims filed in the class actions | | |
| A report on class actions where the fund is taking the role of lead plaintiff | | |
| Litigation updates regarding progress, strategy, or proposed settlements | | |

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Media

| Description | Current Frequency | Changes to the Frequency |
|---|-------------------|--------------------------|
| Negative publicity about the council, the organization, or any fiduciary connected with the trust funds | | |

Legislation

| Description | Current Frequency | Changes to the Frequency |
|---|-------------------|--------------------------|
| A summary of proposed state and federal legislation affecting the trust funds | | |
| Detailed information about important pending legislation | | |
| Lobbying activities relating to legislation that could affect the council | | |

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Appendix H
Sample SIO Position Description

Title: State Investment Officer (SIO)
Reports to: Council
Department: Executive Staff
Classification: Exempt
Date: January 1, 2010

The state investment officer is the council's and committee's investment expert and performs services that are directed solely toward ensuring the implementation of the investment policies and programs adopted by the council.

General

1. Manage investments in accordance with all relevant laws, policies, and goals.
2. Act as an expert advisor to the council on all matters involving the investment or proposed investment of fund assets.
3. Oversee all investment activities with overall responsibility for achieving investment performance targets.
4. Perform all supervisory functions for management of staff and resources of the organization.

Duties and Responsibilities

The SIO will:

1. Implement the annual goals and objectives for the organization as adopted by the council.
2. Oversee and monitor portfolio management by staff with respect to performance benchmarks and costs.
3. Continuously monitor all external portfolio managers, advisors, and consultants to determine if such are abiding by their respective contracts, and report to the council at least every twelve (12) months with findings and recommendations.
4. Make recommendations to the council with respect to investment related matters including, but not limited to, asset allocation decisions and the structure of the investment program with respect to internal and external managers, advisors, consultants, and short-term and long-term investment strategy.
5. Monitor and report with regard to recommendations accepted by the council.
6. Monitor capital markets, economic forecasts, and provide the council with an ongoing analysis of the state of the global economic situation as it relates to the investment program.
7. Demonstrate a thorough knowledge of the institutional investors' industry, latest investment research, and good judgment in investment issues.
8. Advise the council as to the impact of potential legislation on the investment program.
9. Advise the council as to the impact on the investment program of information released to the public, press, legislature, or other press releases and similar matters, as needed.

10. Constantly reevaluate policies, process, standards, measurements, and methods to incorporate best practices into the management of the investment area.
11. Monitor proxy policies and advise as to recommended changes in such policies.
12. Develop procedures and processes to effectively implement the investment policy statement as adopted and amended by the council.
13. Recommend to the council appropriate investment procedures that ensure due diligence and appropriate written documentation for all actions taken to invest fund's assets.
14. Establish reporting mechanisms to keep the council sufficiently and appropriately informed as to the status of the investment program and procedures used for implementation.
15. Recommend contracts or amendments for investment personnel, investment management firms, investment advisors, and consultants, including compensation structure, content of requests for proposals, and selection of competitor.
16. Make recommendations on expenditures for investment services to be paid out.
17. Monitor the use of directed brokerage fees.
18. Maintain a well-functioning investment team.
19. Serve as a liaison between the staff and service providers and the council.
20. Work with the council, committees, and investment staff to enhance the decision-making process.
21. Develop and enhance the capabilities of other investment staff.
22. Address succession planning for key investment staff personnel.
23. Evaluate overall performance of senior investment staff, including their supervisory duties.
24. As required, on a periodic basis, advise the council as to the status and completion of each of the above duties and responsibilities.
25. Perform other duties as directed by the council that are consistent with and contemplated by the foregoing.

Appendix I
List of Interviewees and Documents Reviewed

INTERVIEWS

To gather relevant information for the review, EnnisKnupp interviewed the following individuals:

Council Members

- Katherine Miller, Council member
- Peter Frank, Council member
- Andrew Davis, Council member
- David Harris, Council member
- Patrick Lyons, Council member
- James B. Lewis, Council member
- Stephen Feinberg, Council member

Private Equity Investment Advisory Committee

- Katherine Miller, Committee member
- Andrew Davis, Committee member

Staff

- Bob Jacksha, State Investment Officer (who is also a Council member and a Committee member)
- Adam Levine, Senior Deputy State Investment Officer
- Greg Kulka, Director of Private Equity
- Scott Smith, Director of Real Estate
- Bryan Otero, General Counsel/Investment Compliance
- Todd Frybarger, Senior Portfolio Manager (Large Cap)
- Robin West, Senior Portfolio Manager (Small/Mid)
- Rick Scroggins, Investment Accounting
- Cyndy Lynch, Investment Accounting

Legislative Council Service

- Paula Tackett, LCS Director
- Raul Burciaga, Assistant Director for Drafting Services

Legislative Finance Committee

- David Abbey, Director

Board of Finance

- Steven K. Moise, Board member

Consultants

- Allan Martin – NEPC
- Joseph Cook – Courtland Partners, Ltd.
- Steven Novick – Courtland Partners, Ltd.

DOCUMENTS REVIEWED

To gather relevant information for the review, EnnisKnupp reviewed the following documents:

- Select laws and statutes:
 - NMSA 1978 Sections 6-8-1-6, 20, 22; 7-27-5.15, 5.26; 10-15-1, 3, 4; 14-2-1, 2.1, 4-7, 9, 11-12; 10-16-3, 11, 13; 47-7-601-612.
 - New Mexico Constitution Articles VIII and XII
- Comprehensive Annual Financial Report (2007 and 2008)
- Audit report (2008)
- Board policies
 - Board policies and procedures
 - Hedge fund investment policy
 - Real estate investment policy
 - Real estate equity strategy
 - Private equity program policy
 - Film institute investment program loan policy (2009)
 - Proxy policy description
 - General investment policy (2008)
 - Transparency and disclosure policy
 - Mortgage participation investment policy
 - Mortgage loan participation approval process
 - Procurement policy
 - Securities lending policy
 - General investment policy
 - Soft dollar policy
 - Trade approval policy
- Staff code of ethics draft
- SIC minutes (2006-2009)
- Private Equity Investment Advisory Committee minutes (2006-2009)
- Third party marketers list
- Basic overview and process detail presentation made to the Investments Oversight Committee
- State of New Mexico Personnel Office select family group descriptions
- Full employee roster (2009)
- Exempt employee roster (2009)
- Organizational chart (2009)
- Budget status (FY2009)
- Budget adjustment request (2008)
- Increasing the budget allocation for additional staff and new technology presentation (2008)
- Operating budget input form (2008)
- Detail of appropriations (2009)
- Quarterly investment report (2Q 2009)
- Active/passive management list

- Assets internally and externally managed
- NEPC asset allocation presentation (2007)
- Semi-monthly and ad-hoc net asset value calculations
- Investment holdings report (2009)
- Investment allocation changes for clients (2008)
- Morningstar box score report first half (2009)
- NEPC draft investment performance report presentation (FY 2009)
- NEPC draft land grant allocation study (2009)
- NEPC Hedge fund-of-funds monitoring report (2007)
- Hedge fund flash report (2007)
- Description from NEPC of the process used for return calculations
- Description of NMSIO staff's replacement manager search for the NMSIC Horizon Fund
- ITB for fund-of-funds manager for the NMSIC Horizon Fund (2009)
- Sample investment manager contract
- Investment consultants contracts
- Custody bank agreement with Northern Trust (2008)
- Northern Trust invoices (June, July, and August 2009)
- Sample due diligence reports
- Accounting policies and procedures
- Sun Mountain Capital private equity investment program update report (2009)
- Sun Mountain Capital Co-Investment Fund, LP fund update (2009)
- Private equity presentation to the Investment Oversight Committee (2009)
- Private equity program review and strategic investment plan (2009)
- Private equity secondary investment strategy (2009)
- Portfolio detail roll forward (2009)
- Real estate investment policy statement draft (2009)
- Courtland Partners real estate program initial implementation timeline
- Real estate performance measurement report (Q1 2009)
- Courtland Partners supplemental PMR letter (Q2 2009)
- Courtland Partners PMR final (Q2 2009)
- Courtland Partners sample joint venture underwriting report (2009)
- Courtland Partners sample pooled fund underwriting report (2009)
- Courtland Partners letter recommending investment in Northstar Capital Investment Corp (2004)
- Measurisk
 - Sample pension total fund report
 - Total portfolio market value summary
 - Independent risk transparency and risk measurement solutions
- K2 betapak (2009)
- K2 stresspak (2009)
- K2 varpak (2009)
- Hedge fund work book
- Hedge fund monthly underlying managers pie chart (2009)
- Hedge fund fee terms

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- External manager fees (FY 2009)
- Real estate fee data summary
- Private equity fee notes (2009)
- Calculated fees (2009)

Please note: Any omission of documents from the list above that we used for the findings and conclusions in this report is unintentional.