FISCAL IMPACT REPORT

SPONSOR Cisneros **ORIGINAL DATE** 02/07/13 **LAST UPDATED** 03/12/13 **HB**

SHORT TITLE Land Grant Permanent Fund Changes, CA **SJR** 1/aSJC/aSFl#1

ANALYST Walker-Moran

REVENUE (dollars in thousands)

Estimated Revenue		Recurring or Nonrecurring	Fund Affected
FY13	**FY14**		
	TBD**	Nonrecurring	General Fund (election)

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY13	FY14	FY15	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total		$46.0		$46.0	Nonrecurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

Relates to SJR 3

SOURCES OF INFORMATION
LFC Files

Responses Received From
Department of Finance and Administration (DFA)
State Investment Council (SIC)
State Treasurer's Office (STO)

SUMMARY

Synopsis of SFl #1 Amendment

The Senate Floor #1 amendment to Senate Joint Resolution 1 removes all the SJC amendments. The bill returns to its original version.

Synopsis of SJC Amendment

The Senate Judiciary Committee amendment to Senate Joint Resolution 1 removes the ability of the legislature to establish criteria for investing the land grant permanent fund if the criteria are enacted by a three-fourths' vote of the members elected to each house.

Synopsis of Original Bill

Senate Joint Resolution 1 (SJR 1) proposed to amend Article 12, Section 7 of the Constitution of New Mexico.

The resolution is amended to make clear that in making investments, the State Investment Officer, under the supervision of the State Investment Council (SIC), shall invest and manage the fund in accordance with the Uniform Prudent Investor Act. The amendment also removes certain investment restrictions.

The following investment restrictions have been removed.

(1) not more than sixty-five percent of the book value of the fund shall be invested at any given time in corporate stocks;
(2) not more than ten percent of the voting stock of a corporation shall be held;
(3) 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; and
(4) not more than fifteen percent of the book value of the fund may be invested in international securities at any single time.

The amendment proposed by this resolution shall be submitted to the people for their approval or rejection at the next general election or at any special election prior to that date that may be called for that purpose.

FISCAL IMPLICATIONS

The approximate cost per constitutional amendment is $46 thousand. The costs include publishing the amendments in newspapers statewide, publishing the voter guide, and recording and broadcasting the constitutional amendments in Native American languages on radio.

**Costs associated with not amending the Constitution are indeterminate, but those costs seriously impact the prudent investment of the funds in a much greater magnitude. For example, even 1 percent outperformance on a billion dollars is $10,000,000 in value.

Put in perspective, in a year where the S&P500 and Russell 3000 indexes produced excellent 16.0 percent and 16.4 percent returns (as of December 31, 2012), Developed and Emerging market international indexes returned 17.8 percent and 18.2 percent respectively. The SIC had US equity exposure of more than $8.3B, compared to a capped international allocation of $2.4B. Had this restriction not have been in place, even a slight shift in allocation, which would merely put the SIC closer to its institutional peers, would potentially have added tens of millions in returns to the LGPF.

SIGNIFICANT ISSUES

The resolution is endorsed by the Investments and Pensions Oversight Committee.

The primary investment change being sought in this amendment allows the Council as fiduciaries to invest the LGPF in international investments at an appropriate level of risk and reward to meet the long term return goals of the Fund. The Council has been restricted from acting prudently and appropriately as fiduciaries by the current 15 percent international cap, and has had to structure the portfolio accordingly, sometimes in a non-optimal manner.

Removal of the other restrictions being sought in SJR 1 would not have any impact under today's market environment because they are already far outside the scope of prudent investment standard, and have not impacted the Council investment strategy or decisions in many years, if ever. Amending the constitution in this manner simply brings New Mexico into alignment with institutional best practices and investment standards.

Some points for consideration identified by the SIC follow:

- Since restructuring by the legislature in 2010 to remove undue political influence from the SIC, the Council and its 11 members have been a balanced, thoughtful and engaged organization, comprised of three elected officials, four governor's appointees and four Legislative appointees. These members are charged with guiding and protecting the second largest sovereign wealth fund in the country, and all take their fiduciary duty seriously.
- It is inappropriate for the Constitution to be in conflict with state statute, and certainly the funds should never be perceived to be managed under mere 'ordinary' prudence. Investment advisor Hewitt EnnisKnupp identified this flaw and recommended it be rectified in their review of the SIC in 2010. They have renewed this recommendation.
- From a macro-economic point of view, since the international cap was previously put in place almost two decades ago, the investment markets have changed, and a "global economy" has emerged.
- More than half of investment opportunity is now found in global equity overseas.
- Most of the world's economic activity – Gross Domestic Product or GDP – is generated outside US borders.
- The best economic growth rates are available outside the US, in rapidly growing and emerging economies. That economic growth is the "raw material" of investment returns.
- Foreign market investment opportunities exist in fixed income, real estate and private equity (each of these an asset class the SIC currently invests in) in increasing amounts with competitive, and often better, expected returns than in the US.
- By prudency as well as statute, the SIC is required to diversify its investments, and since the Council has reached its 15 percent cap, the constitution is restrictive and may violate prudent investment standards.
- Diversification of assets is a critical component of risk control in portfolio construction and the LGPF portfolio could be better diversified with increased access to the international investment markets.
- The SIC lags most peer funds in this regard, with the majority of institutional investors allocating more than 15 percent of their portfolios internationally. As of 3Q 2012, PERA for example, had structured its portfolio with more than 25 percent international equity exposure; ERB had international exposure of 19 percent. Neither has a cap.

PERFORMANCE IMPLICATIONS

According to the State Treasurer's Office (STO), the Uniform Prudent Investor Act was adopted by the state of New Mexico in 1995. Management of the Land Grant Permanent Fund under UPIA will ensure that the long-range investment of the fund will be aligned with the needs of future beneficiaries.

Though direct impact of removing the international investment cap from the LGPF is indeterminate, failure to remove the cap could result in limited or artificially depressed investment returns for the LGPF over time, especially during times of economic growth and market expansion. Today and during the recent decade, many institutional investors have targeted international allocations upward of 20 percent, and for the most part they have been rewarded for this strategy. The following annualized return numbers are based on December 31, 2012 reporting, and compare benchmark indexes for the S&P 500, MSCI International Developed and MSCI International Emerging stock indexes.

While international markets are more volatile in the short term, over the last decade, they typically provide greater returns to investors.

	1-Year	3-Years	5-Years	10Yrs
S&P 500 Index	**16.00**	**10.87**	**1.66**	**7.10**
MSCI EAFE Index (Intl Dev)	**17.78**	**3.56**	**-2.67**	**8.21**
MSCI Emg Mkts Index (Intl)	**18.22**	**4.66**	**-0.92**	**16.52**

ADMINISTRATIVE IMPLICATIONS

Should SJR 1 pass and be approved by the voters at the next statewide general election (likely 2014), the Council would explore whether additional international investments were appropriate at that time, to meet the long-term investment goals of the LGPF. The Council would not be bound by any mandate to invest additional capital overseas, but would act solely on the prudence of the market opportunity at the time.

Regarding the existing statutory/constitutional conflict relative to ordinary prudence versus UPIA standard management of the LGPF, it should be noted that in 2010, Hewitt EnnisKnupp in their independent fiduciary review, specifically identified this problem and recommended it be remedied soon. This conflict is especially problematic as there is a strong possibility that from a legal standpoint, the Constitution will typically override statutory mandate (UPIA vs. "ordinary prudence").

RELATIONSHIP

SJR 1 relates to SJR 3, which also seeks to change Article XII section 7 of the Constitution as it applies to the LGPF.

According to the STO, changes in the proposed legislation are inconsistent with SJR 3 – Land Grant Fund Balance Distribution, CA.

EWM/svb:bm