

**LEGISLATIVE EDUCATION STUDY COMMITTEE
BILL ANALYSIS**

Bill Number: SJR 4a

51st Legislature, 2nd Session, 2014

Tracking Number: .195043.2SA

Short Title: Land Grant Fund Care & Investments, CA

Sponsor(s): Senator Timothy M. Keller

Analyst: Kevin Force

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FOR THE INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE

AS AMENDED

The Senate Rules Committee amendment adds language so that investment and management of the fund shall be in accordance not only with the *Uniform Prudent Investment Act*, but also with any other act that may succeed it.

Original Bill Summary:

SJR 4 proposes to amend Article 12, Section 7 of the Constitution of New Mexico regarding conditions and restrictions placed on the State Investment Council (SIC) when performing their duties to properly manage and safeguard the investments of New Mexico:

- The proposed amendment strikes language, which directs the council to apply the “Prudent Man Rule” in the exercise of their fiduciary duties when managing investments for the Land Grant Permanent Fund (LGPF), in favor of direction to “invest and manage the fund in accordance with the *Uniform Prudent Investor Act*.”¹ (See “Background,” below.)
- SJR 4 strikes the 15 percent cap on the portion of the fund that may be invested in international securities at any single time.

Fiscal Impact:

According to the Fiscal Impact Report (FIR) from the Legislative Finance Committee (LFC), the approximate cost per constitutional amendment is \$46,000, including publishing the amendments in newspapers statewide, publishing the voter guide, and recording and broadcasting the constitutional amendments in Native American languages on radio.

¹ §§ 45-7-601 through 4-7-612 NMSA 1978

Fiscal Issues:

As noted by LFC staff in the FIR:

- The fiscal impact of SJR 4 is indeterminate, as it would depend on any change in portfolio allocation and the investment performance in those asset classes whose allocation would be changed to reflect the removal of the cap on international investment.
- Increases in investment returns would help to support high LGPF market values, and would subsequently contribute to higher distributions from that fund to its beneficiaries, including the general fund. (The LGPF distribution is a significant general fund revenue source, estimated to be nearly \$490 million in FY 15.)

According to the SIC:

- Costs associated with not amending the constitution as proposed are indeterminate, but those costs seriously impact the prudent investment of the funds in a much greater magnitude by artificially depressing returns over time, especially during times of economic growth. For example, even 1.0 percent outperformance on a billion dollars is \$10.0 million in value.
- The primary investment change being addressed by SJR 4 is the 15 percent cap on investments in international securities, which has restricted the SIC from acting prudently as fiduciaries, forcing it to structure the portfolio in accordance with the limit, sometimes in a manner that is less than optimal. For example, over the last 10 years:
 - the Russell 3000 Index has produced annualized returns of 8.09 percent;
 - the MSCI Emerging Market Index produced annualized returns of 12.11 percent;
 - the SIC had domestic equity exposure of more than \$6.7 billion, compared to capped international allocations of \$2.6 billion; and
 - had the 15 percent restriction not been in place, even a slight shift in allocation (putting SIC closer to its institutional peers), would potentially have added hundreds of millions in returns to the LGPF.
- Since the international investment cap was put in place, 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 – is generated outside US borders, where the best economic growth rates are available 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 in increasing amounts with competitive, and often better, expected returns than in the US.
- By both statute and fiduciary responsibility, the SIC is required to diversify its investments, and since the Council has reached its 15 percent cap, the constitution is overly restrictive and may itself violate prudent investment standards.
- Many institutional investors now have targeted international allocations upwards of 20 percent, and have been rewarded for this strategy, for the most part. The LGPF, however, lags behind peer funds in this regard. For example, as of the third quarter of FY 13:
 - Public Employees Retirement Association (PERA) had structured its portfolio with international investments of more than 24 percent; and
 - the Educational Retirement Board (ERB) had 16 percent invested internationally.

- Neither the PERA nor ERB funds have a constitutional cap on international investment; in fact, SIC has not found such a cap among any peer funds in the country.
- The following annualized return compare benchmark indices for the Russell 3000, MSCI International Developed, and MSCI International Emerging stock indices:

	1-Year	3-Years	5-Years	10Yrs
Russell 3000 Index	31.71	17.79	18.54	8.09
MSCI EAFE Index (Intl Dev)	24.84	10.46	13.42	7.56
MSCI Emg Mkts Index (Intl)	3.66	.70	16.87	12.11

(Note that, while international markets can be more volatile in the short term, over the course of the last decade, they may have provided greater returns.)

- Should SJR 4 pass and then be approved by the voters, the SIC would be free to consider greater international investment, but would not be bound to do so.

Technical Issues:

Currently, the constitution calls for a lower standard of care in investment practices than does state statute. This joint resolution would resolve this conflict by raising the standard of care imposed by the constitution to the level required under statute.

Substantive Issues:

According to the State Land Office (SLO):

- While existing state statutes require the SIC and State Investment Officer (SIO) to invest in accordance with the *Uniform Prudent Investors Act*, that language does not necessarily conflict with the current language of Article XII, Section 7, but rather clarifies and expands the standards of care that trustees of the funds must use when making investment decisions by:
 - focusing on the relationship between trustees and fund beneficiaries by considering the purpose, distribution requirements and other circumstances of the trust;
 - specifying a total portfolio investment approach, so that individual investments are evaluated less on their individual merits and more on their impact on the trust as a whole; and
 - including a specific statement of investment objectives beyond mere preservation of capital to include consideration of liquidity and consistency of income.
- The removal of the 15 percent cap on investment in international securities is endorsed by the Investments and Pensions Oversight Committee. Minutes from that committee’s June 6, 2013 meeting indicate that the change was recommended by the SIO, and that the SIC views the 15 percent cap as outdated.²

² “The SIC has some legislative priorities for the 2014 legislative session, including proposing a constitutional amendment removing the outdated 15 percent cap on investment in international securities and improving the standard of care the SIC must use in investing assets.” Minutes of the First Meeting of the Investments and Pensions Oversight Committee, June 6, 2013.

Background:

When making investments, the standard of care currently imposed upon the SIC by Article 12, Section 7 of the Constitution of New Mexico is known as the “Prudent Man Rule.” Under this rule, fiduciaries are required to invest trust assets as a “prudent man” would invest his *own* property, considering the following factors:

- the needs of beneficiaries;
- the need to preserve the corpus of the trust; and
- the amount and regularity of income.

Under this rule, a fiduciary must consider each investment upon its own merits, without necessarily considering the effect of each investment upon an investor’s total portfolio, with speculative investments disfavored.

Since the inception of the “Prudent Man Rule,” different investment practices, investment products, and the effects of a global economy have become both more prevalent and more significant. Reflecting these changing conditions, in 1992, the *Uniform Prudent Investor Act* was adopted by the American Law Institute’s Third Restatement of the Law of Trusts. The act applies what may be known as the “Prudent Investor Rule,” which, reflecting a fiduciary duty more focused on the welfare of an investor’s total portfolio, might allow speculative or other investments that, of themselves, would not necessarily yield the greater return, but would incur greater benefit to the entirety of the portfolio. It differs from the Prudent Man Rule in four particular ways:³

- A trust account’s entire investment portfolio is considered when determining the prudence of an individual investment, so that a fiduciary would not be held liable for individual investment losses so long as the investment, at the time of acquisition, is consistent with the overall portfolio objectives.
- Diversification is explicitly required as a duty for prudent fiduciary investing.
- No category or type of investment is deemed inherently imprudent. Rather, suitability to the trust account’s purposes and beneficiaries’ needs is the determining factor. However, while the fiduciary is now encouraged to develop greater flexibility in overall portfolio management, speculation and outright risk-taking are not sanctioned by the rule, and remain subject to criticism and possible liability.
- A fiduciary is permitted to delegate investment management and other functions to third parties.

In 1995, the Legislature adopted the *Uniform Prudent Investor Act*,⁴ but the pertinent sections of the Constitution of New Mexico have not yet been amended. SJR 4 proposes to remedy that lack.

According to the SIC:

- While the direct impact of removing the international investment cap from the LGPF is difficult to determine, failure to remove the cap could result in limited or artificially depressed investment returns over time, especially during times of market expansion.

³ Federal Deposit Insurance Corporation

(http://www.fdic.gov/regulations/examinations/trustmanual/section_3/fdic_section_3-asset_management.html)

⁴ Sections 45-7-601 through 45-7-612, NMSA 1978.

- While the original intent of the constitutional limitation on international investment is not fully understood today, it is believed that when it was put in place, international investments were viewed as highly volatile.
- The artificial 15 percent cap may unintentionally restrict the SIC from making the most prudent and productive, and least risky investment decisions to achieve its mandate.
- In the 2012 legislative session, a constitutional amendment was proposed that would have retained the cap on international investments, but at a higher level of 25 percent:
 - SJR 4 (2012) passed five committees and the Senate, time ran out when it was being considered by the House; and
 - SJR 4 (2012) was criticized, and even opposed, by some legislators who preferred the elimination of the cap, as is currently proposed, and placement of full fiduciary responsibility on the SIC, as intended by statute, and as a matter of best investment practices.
- In 2013, a similar bill was voted down in the House in the closing moments of the session, but a number of points in the debate were incorrect, most notably the notion that the SIC, without the restriction would be free to invest up to 100 percent of its investments overseas. This contention, however, fails to consider that:
 - asset allocations are voted on by the entire council, after months of vetting; and
 - any such action would leave the council open to legal consequences for taking such imprudent action regarding funds for which they have fiduciary obligations and liabilities.
- In January 2010, Ernest Knupp presented the SIC with the findings of their independent operational and fiduciary review,⁵ specifically noting the conflict between existing statute and Article 12, Section 7 of the Constitution of New Mexico, and recommended that it be resolved soon, particularly since, in a conflict between statute and constitution, the constitutional provisions prevail.

Committee Referrals:

SRC/SJC/SFC

Related Bills:

HJR 3 *Land Grant Fund for Education Reforms, CA*

SJR 12 *Land Grant Fund Balance & Education, CA*

⁵ <http://www.sic.state.nm.us/PDF%20files/1-11-10%20SIC%20Index%20&%20Minutes%20-%20Final.pdf>