Permanent Funds & State Investment Council Updates

Investments & Pensions Oversight Committee

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Steve Moise, State Investment Officer
Robert "Vince" Smith, Chief Investment Officer
August 15, 2022

SIC NEW MEXICO STATE INVESTMENT COUNCIL

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Fund Values 6/30/22 & FY23 Distributions

Land Grant
Permanent Fund
$24.38 billion

LGPF Beneficiary
Distributions
FY23: $1,014.32M

Severance Tax
Permanent Fund
$6.83 billion

General Fund
Distributions
FY23: $265.79M

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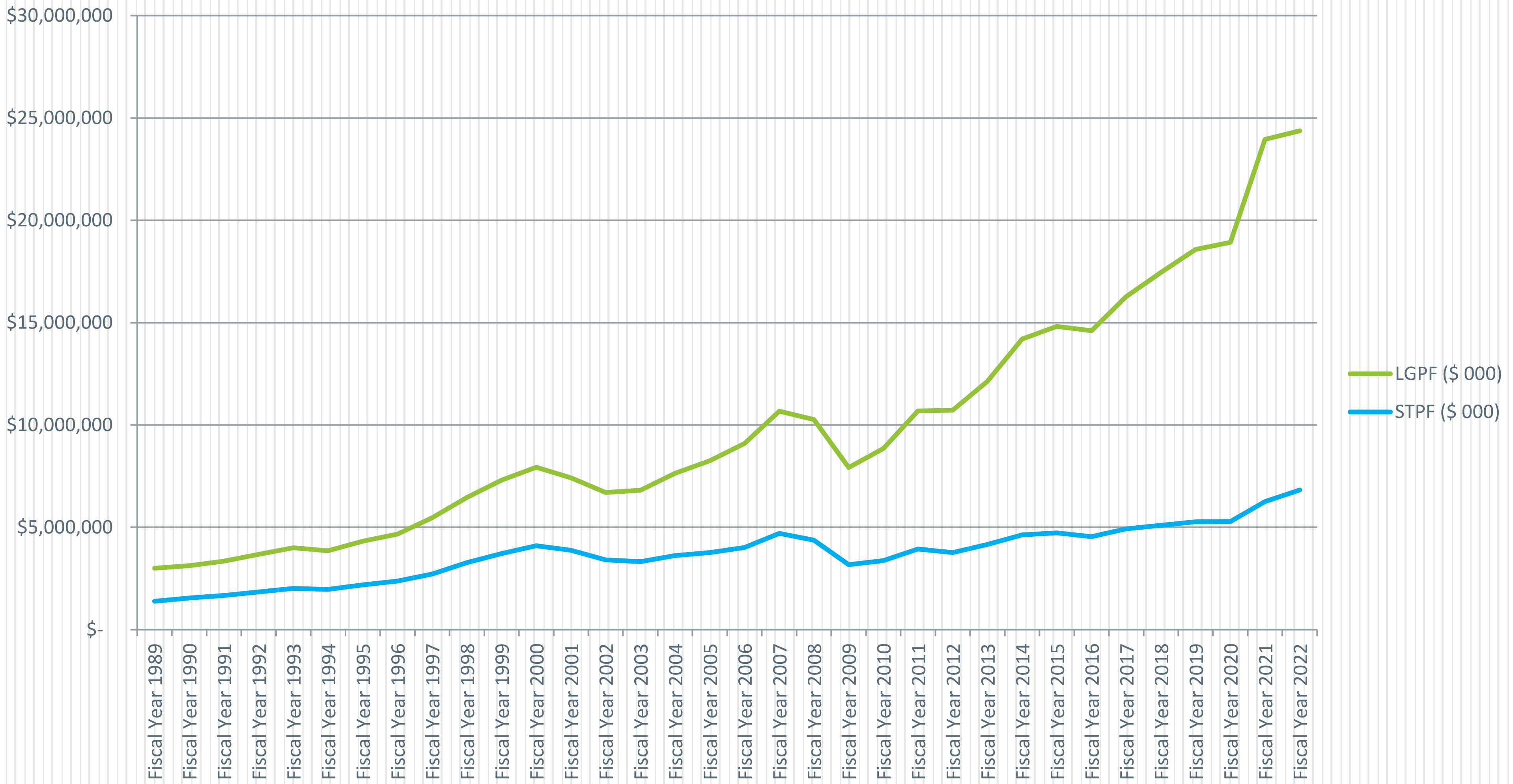
Permanent Fund Growth, 1989-2022



Assets Under Management: $35.7 billion

- Total fund values 2019-2022 YTD through June 2022, in millions

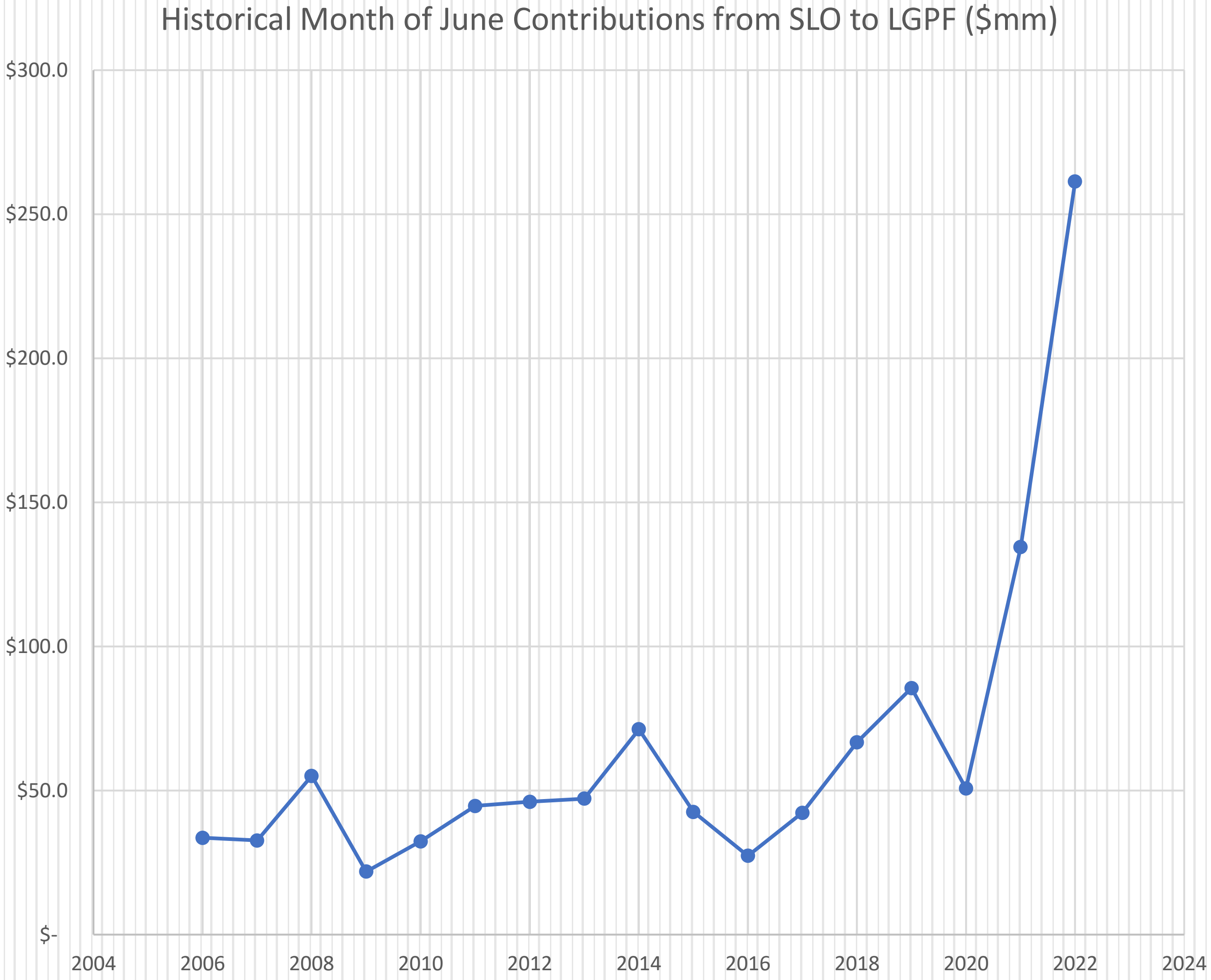
Fund Valuations ($Millions)	**12/31/2019**	**12/31/2020**	**12/31/2021**	**6/30/2022**
Land Grant Permanent Fund (LGPF)	$ 19,724.2	$ 21,599.2	$ 25,766.2	$ 24,379.5
Severance Tax Permanent Fund (STPF)	$ 5,630.3	$ 5,849.5	$ 6,733.8	$ 6,830.0
Tobacco Settlement Permanent Fund	$ 237.0	$ 262.2	$ 298.1	$ 296.8
Water Trust Fund	$ 41.7	$ 39.7	$ 43.9	$ 44.5
Tax Stabilization Reserve	$ 538.6	$ 1,768.2	$ 1,856.5	$ 1,833.2
Rural Libraries Endowment	$ 1.0	$ 3.1	$ 3.3	$ 13.2
Government Clients	$ 1,272.0	$ 1,515.6	$ 1,814.5	$ 1,652.3
Early Childhood Ed. & Care Fund	$ -	$ 306.1	$ 314.1	$ 638.9
Total Assets under management	**$ 27,444.8**	**$ 31,344.0**	**$ 36,830.3**	**$ 35,688.7**

Legislative Support for NM Investments

Funds recently created by the governor & legislature for management and investment by SIC:

- The Tax Stabilization Reserve
  - $526 million transfer in 2019, ~$1.1 billion since
- Rural Library Endowment
  - $1 million appropriation in 2019, $12 million since
- The Early Childhood Education & Care Fund
  - $300 million deposit in 2020, ~$1.8 billion since ($1.5 billion last week)

Permanent Fund Inflows



June	Contributions from SLO to LGPF ($mm)
2022	$ 261.4
2021	$ 134.5
2020	$ 50.7
2019	$ 85.6
2018	$ 66.8
2017	$ 42.3
2016	$ 27.4
2015	$ 42.6
2014	$ 71.3
2013	$ 47.2
2012	$ 46.1
2011	$ 44.7
2010	$ 32.4
2009	$ 21.9
2008	$ 55.1
2007	$ 32.7
2006	$ 33.6

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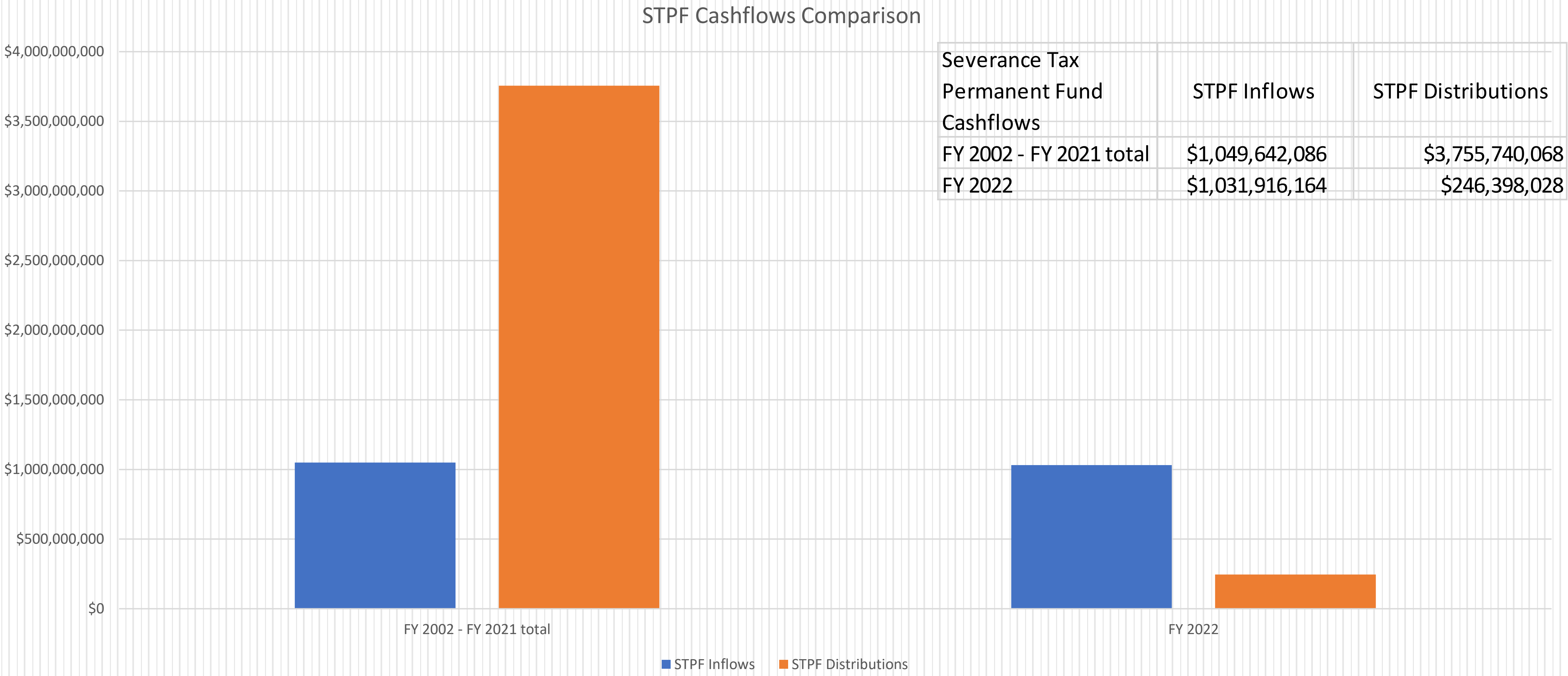
Severance Tax Permanent Fund windfall



Severance Tax Permanent Fund Cashflows	STPF Inflows	STPF Distributions
FY 2002 - FY 2021 total	$1,049,642,086	$3,755,740,068
FY 2022	$1,031,916,164	$246,398,028

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Investment Performance

Returns, net of fees, annualized, as of 6/30/22

	1-year	3-year	5-year	7-year	10-year
Land Grant Permanent Fund	**-2.22**	**7.21**	**7.14**	**6.92**	**7.99**
Benchmark	*-1.72*	*7.54*	*7.37*	*6.97*	*8.07*
Peer Median, public funds >$1B*	***-7.75***	***6.26***	***6.58***	***6.43***	***7.46***
# of Funds in peer comparison	48	46	46	45	44
Severance Tax Permanent Fund	**-4.39**	**5.16**	**5.85**	**5.99**	**7.21**
Benchmark	*-3.73*	*6.43*	*6.74*	*6.54*	*7.77*

***RVK public fund universe**
Long-term investment return targets:
LGPF: 7.0% STPF: 6.75%

Economic Outlook: Growth

- Q2 2022 real GDP in the U.S. declined by 0.9%, marking the second consecutive quarter in the negative. Many economists and market participants consider back-to-back quarterly declines in real GDP to constitute a recession, but this economic period does not have all of the signs of a typical recession:
  - Unemployment is at 50-year lows at 3.5%;
  - Civilian labor force size is about where it was pre-pandemic and growing;
  - Personal income is significantly higher than pre-pandemic;
  - Consumer spending growth, while declining, remains about average compared to the last 10 years.
- We don’t believe that the National Bureau of Economic Research (NBER)—the arbiter of when economic cycles begin and end—will designate this period as the end of the U.S. economic expansion that began in Q2 2020, though that is yet to be seen. It generally takes the NBER 3-6 months to make such determinations.
- Either way, economic fundamentals are deteriorating in a number of areas and the SIC has been preparing for a “traditional” recession in the last quarter of this year or the first quarter of next year.

Economic Outlook: Inflation

- Inflation has been advancing at serious rates and is prompting Federal Reserve action that may well push the economy into a traditional-looking recession by the end of the first quarter next year.
  - The Federal Reserve has lifted the Fed funds rate by 225 basis points (2.25%) this year so far;
  - Further increases are expected this year, with 50 basis points expected at the late-September meeting;
  - Rates have not been increased this fast since 2000, increases which were followed by a moderately difficult 8-month recession in 2001.
  - Total increase to the Fed funds rate in this raising cycle could rival the June, 2004 to September, 2006 cycle of 425 basis points, which preceded a very difficult, 18-month recession from December 2007 through June, 2009.
- While the rate of inflation is of significant concern, it is the increase in the price level over time that causes the most disruption. Consumer prices are up more than 15% since the beginning of 2021 and could be up closer to 20% by the end of the year. Incomes have not kept pace and consumers are feeling squeezed.

Economic Outlook: Interest Rates

- Ten-year Treasury rates more than doubled in 2022 to a peak of 3.25% but have more recently settled down into a narrow range of 2.50%-2.75%.
- The yield curve, an important gauge to future economic activity, has recently become "inverted"--shorter-term interest rates higher than longer-term interest rates--an unusual situation historically.
- The chart below shows the yield on the 10-year treasury minus the yield on the 2-year treasury. Note that periods of inversion precede recessions.

Equity Markets: Recent Activity

- The U.S. stock market has bounced about 12% from its lows of 2022 in mid-June, but remains about 14% below its highs set at the beginning of the year.
- Forecasters seem to have a loose consensus around choppy, range-bound trading over the next year, though a recession could take the market materially lower.
- Valuations have come down somewhat with the Shiller CAPE ratio—our favored measure of long-term valuation of the equity market—down to about 29 today from a high of almost 39 in November of last year.

Equity Markets: Valuation Concerns

- However, regarding Shiller CAPE ratios:
  - Shiller CAPE ratios over 20 have tended to be followed by significant corrections, though the corrections can take some time to develop;
  - Shiller CAPE ratios over 25 have tended to be followed by sharp corrections;
  - Shiller CAPE ratios over 30 happen exceedingly rarely and have been followed by major market (downside) events.
- While we are not forecasting a major market event (they are impossible to forecast with any useful degree of timing), we continue to hold two concerns:
  - High Shiller CAPE ratios correlate to larger selloffs in the market when selloffs do occur;
  - High Shiller CAPE ratios are correlated to low 10-year-forward returns.

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Equity Markets: Future Expectations

The table is from a 2017 academic paper by Robert Shiller, the creator of the Shiller CAPE ratio. Note that from about 2017 forward, the Shiller CAPE ratio has routinely been in the highest decile of readings, portending weak equity market results over the next ten years.

Q1 1926 – Q2 2017					
Starting CAPE Ratio			Real 10-year S&P 500 Annualized Returns (%)		
Average	Low	High	Average	Worst	Best
8.6	5.6	9.6	9.8	4.2	17.2
10.3	9.6	11.0	10.6	3.8	16.9
11.5	11.0	12.1	10.0	2.6	14.7
13.0	12.1	13.9	8.7	0.7	14.1
15.0	13.9	16.1	7.8	-1.6	15.0
17.0	16.1	17.8	5.4	-3.8	14.6
18.7	17.8	19.9	5.0	-4.0	13.5
21.0	19.9	22.0	2.7	-3.3	8.6
24.1	22.0	26.4	2.5	-4.0	7.3
33.2	26.4	44.2	0.9	-6.1	5.8

Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio nor do indices represent results of actual trading. Information from sources deemed reliable, but its accuracy cannot be guaranteed. Performance is historical and does not guarantee future results. Total return includes reinvestment of dividends and capital gains.

Summary, Outlook & Investment Strategy

- In 2017, the Council recognized the potential for weaker returns from the largest investment market that we invest in—the global stock markets:
  - Began lowering exposure to those markets and diversifying into investments in real estate, real assets, credit and private equity.
  - Since that time, the global stock index that we use to measure returns from stocks has underperformed long history, providing less than 7% returns annually
  - Also since that time, stock markets have been quite volatile. In 2018, U.S. equities fell 20% in the last quarter of the year; followed by a 50% rise in 2019, a 35% crash in early 2020, a double from the 2020 lows through 2021, and so far in 2022, a peak-to-trough drop of 24%.

Summary, Outlook & Investment Strategy

- The economic underpinnings for investment markets over the next 7-10 year period look weaker than average:
  - We have a recession in our forecast in the nearer-term.
  - We believe inflation will be much more of an issue over the next ten years than it was in the past ten.
  - We believe that interest rates will move higher over our forecast period.
  - We believe that current global economic issues of supply chain disruption/rebuilding, trade, energy and increasing food security concerns will continue to play out in the period.
  - Demographics globally continue to work against strong economic growth. Germany, Russia, China, Japan are in particularly poor demographic shape. In the U.S., we are still 7-10 years away from the front edge of the large Millennial generation hitting their peak earnings years and the last of the Millennials hitting peak spending years. This while the Boomers will finish moving into retirement, spending less and moving their savings/investments/capital out of stocks and risky assets and into “safe” (non-growth) investments and accounts.

Summary, Outlook & Investment Strategy

- Our basic investment strategies remain consistent with SIC strategy over the past five years:
  - Approach and commit to the stock markets cautiously;
  - Diversify into investments which provide a significant measure of income as a portion of the total expected rate of return;
  - Expect economic growth to be weaker than long-term average;
  - Expect inflation to become more of an investment factor;
  - And (a strategy since 2020) expect interest rates to increase.
- For the 1-, 3-, 5-, 7-, and 10-year periods all ending in June 2022, these strategies (and their predecessor strategies back to 2010) have produced top-half investment results versus a robust universe of peer public funds. Adjusted for risk, those returns move SIC up into the top quartile of public fund results.
- Full results from periods ending in June 2022 will be available soon, and the 2023 Annual Investment Plan—a full discussion of Council investment plans for the next 7-10 year investment period and the 11th annual plan produced by the Council—will be available at the end of September for public review.

Final Thoughts

- Topics for potential future IPOC discussion
  - Staffing & resources
  - Growing interest from state agencies, local governments & other public entities in placing investment dollars with SIC – currently 25 entities with #26 pending ($1.6 billion currently under management)