

**MINUTES  
of the  
FOURTH MEETING  
of the  
INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE**

**September 15, 2015  
Central New Mexico Community College Workforce Training Center  
Albuquerque, New Mexico**

The fourth meeting of the Investments and Pensions Oversight Committee for the 2015 interim was called to order by Representative Monica Youngblood, vice chair, on Tuesday, September 15, 2015, at 9:14 a.m. at the Central New Mexico Community College Workforce Training Center in Albuquerque, New Mexico.

**Present**

Sen. George K. Munoz, Chair  
Rep. Monica Youngblood, Vice Chair  
Sen. Sue Wilson Beffort  
Rep. Miguel P. Garcia  
Rep. Larry A. Larrañaga  
Sen. Bill B. O'Neill  
Rep. William "Bill" R. Rehm  
Rep. Jim R. Trujillo  
Rep. Luciano "Lucky" Varela

**Advisory Members**

Sen. Ted Barela  
Sen. Stuart Ingle  
Sen. John C. Ryan

**Absent**

Sen. Jacob R. Candelaria  
Sen. Carroll H. Leavell  
Sen. Steven P. Neville  
Rep. Jane E. Powdrell-Culbert  
Sen. William P. Soules

Sen. Carlos R. Cisneros  
Rep. Roberto "Bobby" J. Gonzales  
Rep. Patricia A. Lundstrom  
Sen. Mary Kay Papen  
Sen. William H. Payne  
Rep. Tomás E. Salazar  
Sen. Michael S. Sanchez  
Rep. James E. Smith  
Rep. Sheryl Williams Stapleton

**Staff**

Lisa Sullivan, Staff Attorney, Legislative Council Service (LCS)  
Ric Gaudet, LCS  
Amy Chavez-Romero, Assistant Director for Drafting Services, LCS

**Guests**

The guest list is in the meeting file.

## **Handouts**

Copies of all handouts are in the meeting file.

## **Tuesday, September 15**

### **Joint Presentation by the Public Employees Retirement Association (PERA), the Educational Retirement Board (ERB) and the State Investment Council (SIC)**

Jon Grabel, chief investment officer, PERA, Bob Jacksha, chief financial officer, ERB, and Vince Smith, deputy state investment officer, SIC, gave a presentation to the committee on investment strategies, asset allocation and investment-related fee reporting. The three agencies met three times during the summer to develop a joint methodology of reporting fees and asset allocation in order for the committee and public to better understand the costs incurred by the state's investment agencies. The unique mission of each agency drives its strategic asset allocation, which, in turn, impacts its risk/return profile and cost structure. Merely comparing the cost structure incurred by the respective agencies does not result in an accurate comparison. Each agency has a different strategic asset allocation with varying amounts invested in public equities, fixed income, absolute return, global asset allocation, private equity, real estate, inflation-linked assets and cash. This asset allocation means that each agency also has a different cost structure. Asset allocation is the primary driver of returns, and fee savings have only a marginal benefit.

The PERA reported having a total of 42 basis points (bps) (equivalent to .01%) in management fees for fiscal year (FY) 2015; the ERB reported 73 bps; and the SIC reported 57 bps. This disparity in total bps cost can be partially explained by looking at the asset allocation of each agency. The ERB has more assets invested in "high-fee" categories than the other agencies. For example, the ERB reported \$18.3 million in management fees for the private equity sector, or 98 bps, while the PERA reported \$7.6 million in management fees for that same category, or 67 bps. However, the ERB reported only 56 bps for the real estate category, while the PERA reported paying 118 bps.

The agencies also reported how they manage risk in their investments. The PERA mitigates risk at the asset allocation level by better diversification of asset categories; the prudent use of risk-seeking and risk-reducing assets; a methodical approach to rebalancing of investments; and the positioning of the portfolio for multiple economic and market scenarios. The PERA also has mitigated risk by reducing the number of investment managers to reduce asset overlap and strategy drift; tightening investment management guidelines; approaching portfolio construction with an overall view rather than viewing each mandate separately; and improving asset return expectations while lowering fees. The other agencies reported using similar strategies to those of the PERA. The SIC also separates risk into two types: market risk and specific risk (or systemic and non-systemic risk). Market risk is necessary to earn an investment return, and very little can be done to mitigate it, except by not investing. Specific risk is associated with the risk of a particular asset class. The SIC reduces the risk exposure to specific risk by having broad asset diversification. For example, the Land Grant Permanent Fund

(LGPF) investments were restructured over the past few years to reduce the over-reliance on U.S. public equity markets and increase the income-producing power of the portfolio relative to its exposure in the equity market.

Questions and comments from committee members included the following.

- The SIC, with a net asset value (NAV) of \$20 billion, paid \$170 million in management and profit-sharing fees. The PERA, with a NAV of \$14.7 billion, paid \$90 million in total fees. The ERB, with a NAV of \$11.4 billion, paid \$130 million in total fees. Why is there such a large discrepancy in the amount of fees paid? Mr. Jacksha said that fees are largely driven by an agency's strategic asset allocation. Mr. Smith said that the size of a fund also drives the amount of actual fees paid. Mr. Grabel said that private equity investment fees are much higher than public equity investment fees. However, in the past fiscal year, private equity returned a 17% profit, while public equity only earned 6%.
- How can agency staff be certain that they are getting the highest-performing investment managers? Mr. Jacksha said that ERB staff does much research before choosing investment managers, but there is no guarantee that the managers will perform in the top tier of managers.
- Why does the amount of management fees increase as the NAV increases? Mr. Jacksha said that public equity managers usually charge a flat fee based on the size of assets, measured in bps.
- Do investment managers manage multiple investment categories for an agency? Mr. Grabel said that all investment decisions begin with the strategic asset allocation, followed by mandates for each asset category. The PERA then looks for the best manager in each asset category, using fairly complex data analysis to rank managers.
- Is there a difference in the asset allocation of endowment funds and pension funds? Mr. Smith said that the SIC is able to have less liquidity than pension funds and therefore take on more risk. The SIC distributions are based on asset valuations, while pension distributions are based on benefit requirements. Mr. Grabel said that the PERA fund has 20% in liquid assets, because the PERA cannot ever miss a benefit payment.
- Each agency has different asset allocation targets, which appear to be somewhat random. Mr. Smith said that each agency board has slightly different asset investment preferences but that, overall, the asset allocation goals are similar. Mr. Grabel agreed and said that there are more similarities than differences in the asset allocations of each agency. Each agency has a very diverse portfolio.

- The ERB has 49% of its assets in high-fee categories, while the PERA has 17% and the SIC has 30%. Why does the ERB have such a large percentage of those assets? Mr. Jacksha said that the fixed-income category includes opportunistic credit, which has seen very good returns. Mr. Smith said that diversification is the only option for pension funds with a low funded ratio.
- What is the importance of a strategic asset allocation versus fee savings in the long term? Mr. Grabel said that the asset allocation is much more important than fees. Mr. Grabel emphasized that fees need to be viewed in the context of returns, volatility and access to liquidity. Ninety to 95 percent of a fund's returns can be attributed to its asset allocation versus the individual stocks chosen. Mr. Smith said that fees are not a driver of asset allocation or risk management. Mr. Jacksha said that the ERB negotiates fee savings when appropriate, but sometimes good investment managers attract plenty of demand for the quality of services and products they provide. Mr. Jacksha also agreed with Mr. Grabel that asset allocations drive the fee profile and the risk profile.
- Some investment agencies in Canada are using in-house investment managers, with great returns. New Mexico's investment agencies should consider doing the same. Mr. Jacksha said that the ERB is unable to hire high-quality managers at the going salary range that they require. The ERB is open to hiring an in-house manager, but only if that decision is good for the ERB fund. The ERB does manage some of its fixed-income assets in-house, because the staff has the right skills to manage those assets. Mr. Grabel said that having internal investment managers at the PERA would be a big mistake, because in-house managers would not have the information edge, access to huge pools of money or human capital needed to make optimal investments. Successful managers in big investment companies have all of the tools and information needed. The PERA does not have any in-house investment managers. Mr. Smith said that the SIC does not have any in-house investment managers but does have 11 staff members to oversee all of its contract managers.

### **June 30, 2015 Investment Reports by the PERA, the ERB and the SIC**

Mr. Grabel, Mr. Jacksha and Mr. Smith each presented an investment report for the previous fiscal year for his agency. Mr. Grabel began with the investment returns of the PERA. The PERA fund balance was \$14.5 billion on June 30, 2015, with an investment return of 1.87% for the fiscal year. FY 2015 was a difficult year for capital investment, compared to the nearly 17% gains from FY 2014. The PERA paid \$989 million in pension benefits in FY 2015. The fund has grown steadily since the 2008-2009 downturn, from a low of \$8 billion to today's figure, nearly double that amount. The PERA has made significant progress in implementing its new strategic asset allocation, with 77% of investments being at the new asset target level. Alternative investments, such as private equity, take longer to re-invest, but those categories should reach their target levels within a couple of years.

Mr. Jacksha reported the ERB's investment returns for FY 2015. The ERB fund was valued at approximately \$11.4 billion on June 30, 2015. The ERB earned \$449 million, a return of 3.9% for the fiscal year. The best asset category earners were private real estate, with a 19.2% return, and private equity, with a 17.1% return. Those top-earning categories are also the high-fee classes. Emerging market assets performed the worst this past fiscal year, losing more than 5% in value. The fund did better than a peer policy index of 2.9%, but far short of the expected 7.75% rate of return. However, the aggregated three-year and five-year rates of return have exceeded that benchmark, as well as the 30-year rate of return.

Mr. Smith reported the SIC's investment returns for FY 2015. The LGPF and the Severance Tax Permanent Fund (STPF) totaled \$20.6 billion on June 30, 2015, with an investment return of 2.31% for the fiscal year. Mr. Smith presented a detailed report of the performance of each asset category, along with each manager. The best-performing asset categories were real estate, returning 13%, and domestic equity, returning 6.3%. Poor-performing categories included international equity, losing 4.3%, and absolute return, gaining only .2%. Mr. Smith said that the SIC will soon review its expected rate of return of 7.5% to see if it is still realistic for the long term. He said that if the Federal Reserve System raises interest rates, it will be much easier for the SIC to achieve a 7.5% rate of return.

Questions and comments from committee members included the following.

- Each investment agency will probably need to reduce its expected rate of return, because 7.5% and 7.75% are no longer achievable. Mr. Smith said that the SIC is currently conducting a study of its rate of return. Models predict that there is less than a 50% chance that the SIC will be able to earn 7.5% in the next 10 years. If interest rates increase, the chance of achieving the rate of return improves somewhat, he said. Mr. Jacksha said that the ERB decided to keep its 7.75% target for the next three years. However, he said, it will be difficult for the fund to earn at that rate for a few years. Mr. Grabel said that the net rate of return, or the nominal rate less inflation, is the most important figure to take into account. The PERA periodically reviews its expected rate of return.

### **Approval of Minutes**

The minutes of the August 18, 2015 meeting of the committee were approved without changes. The minutes of the July 21, 2015 meeting of the committee were approved a second time, in order to include the previous inadvertent omission of the approval of the June 16, 2015 minutes of the committee in the July minutes.

### **Report on the Economic Impact of the PERA, the ERB and the SIC**

Wayne Propst, executive director, PERA, Jan Goodwin, executive director, ERB, and Steven K. Moise, state investment officer, SIC, discussed with the committee the economic impact in the state of the investments and activities of those agencies. Ms. Goodwin began by reporting to the committee that the ERB distributed \$901 million to retirees in FY 2015. The

average annual retirement benefit in FY 2014 was \$21,480 for the ERB's 42,000 retirees, which replaced approximately 59% of those retirees' pre-retirement income. The ERB also employs 67 full-time-equivalent employees, with an annual payroll of \$4.9 million. Those employees live and spend their salaries primarily in Santa Fe and Bernalillo counties. The ERB estimates that there is \$4.48 in economic activity in New Mexico for each \$1.00 of employer contributions paid. Ms. Goodwin estimated that in 2012, ERB retirees created \$1.2 billion in economic output, with more than 9,000 jobs created by that output.

Mr. Moise next discussed the economic impact of the SIC in New Mexico. The LGPF distributed \$596 million in FY 2015 and is expected to distribute nearly \$700 million by FY 2018. The STPF distributed \$183 million in FY 2015 and is expected to distribute more than \$200 million in FY 2018. These distributions play a significant role in state and local government budgets. That money is spent as employee payroll and other services, resulting in a significant boon to the economy. The SIC also invests the smaller Tobacco Settlement Permanent Fund and the Water Trust Fund, as well as managing investments for many local governments. The SIC provides high-quality and low-cost asset management for these clients. Finally, the SIC manages economically targeted investments of the STPF. The New Mexico private equity program has invested \$390 million in 70 New Mexico companies. These investments have resulted in more than \$150 million in increased New Mexico payroll. In addition, the SIC estimates that for every \$1.00 invested by the SIC, an additional \$6.20 is invested by other investors. Finally, Mr. Moise said that the SIC invests in the Small Business Investment Corporation, which in turn has made more than 3,000 loans and \$32 million in equity investments since 2001.

Mr. Propst discussed the economic impact of the PERA in New Mexico. The PERA currently serves more than 49,000 active members and pays retirement benefits to nearly 37,000 retirees. Most of those retirees live in New Mexico and spend their pensions in the state. FY 2015 benefits totaled \$1 billion, which includes pension benefits and refunded member contributions. The average annual pension for a retired member in FY 2014 was almost \$30,000, with an average age of retirement of 55 years. The PERA estimated that pension benefits had a total of \$1.36 billion in economic output in the state, with more than 10,000 jobs created.

Questions and comments from committee members included the following.

- What effect do state agency and school district vacancy rates have on the pension funds? Ms. Goodwin said that there has been no net increase in educational employment for several years. If there are more employees contributing, with a corresponding increase in employer contributions, the ERB will reach a funded ratio of 100% sooner. Mr. Propst said that the PERA has a similar situation to that of the ERB.

- Why does the SIC oppose a distribution from the LGPF for early childhood education services? Mr. Moise said that SIC is acting as the fiduciary for the fund. The SIC does not oppose those programs but needs to protect the corpus of the fund.
- Why do so many retirees leave the state? The interim legislative Jobs Council is trying to attract more retirees to move to New Mexico in order to spur job creation. Mr. Propst said that he would be happy to include that question on the PERA's next survey of retirees.
- The SIC should have a more holistic approach to differential-rate investments, looking at more than just rate of return. The amount of capital investment made in the state, in addition to job creation, needs to be part of the calculations.
- Staff of the ERB and the PERA were asked to provide a comparison of retiree benefits by county versus county gross domestic product.

### **Local Impact of Governmental Accounting Standards Board (GASB) Statement 68**

Santiago Chavez, finance director, New Mexico Association of Counties, and Edwin S. Zendel, risk services director, New Mexico Municipal League, discussed with the committee the possible impact on local governments of GASB Statement 68. The local impact of the new standard is still unknown, because it is unclear how the apportioned pension liabilities required to be reported by each local government will appear on its financial statement. The added liability will affect the overall net position, but enterprise programs may actually be required to report a negative net position. This may negatively affect the ability for these programs to borrow money at affordable rates, which could result in increases in utility rates for customers. In addition, existing bond covenants that require a certain equity coverage may now be violated by the addition of pension liabilities to their net position, which could also lead to increases in utility rates if the bondholders demand reissuance of the notes at a higher interest rate. There is also a possibility that bond ratings agencies will downgrade local governments or their enterprise functions. There has been no guidance from the GASB on how local governments should allocate their share of pension liability between enterprise and general fund accounts.

Questions and comments from committee members included the following.

- Very small local governments cannot afford to have any more risk in their enterprise funds. Mr. Chavez said that some small municipalities and districts may see their bond ratings downgraded because of the new reporting requirements. Natalie Cordova, chief financial officer, PERA, said that the reporting requirements should not affect any business operations of a local government, other than its accounting.

### **Potential Legislation — Municipal Post-Employment Benefit Trust**

Lou Hoffman, director, Finance and Administrative Services Department, City of Albuquerque, gave a presentation to the committee about the possible endorsement of legislation

allowing certain municipalities to establish post-employment benefit trusts. In the 2015 regular legislative session, House Bill 577 was introduced. House Bill 577 would have allowed Albuquerque to establish these trusts, which would have the effect of reducing the city's unfunded accrued pension liability by nearly \$14 million. The bill originally was written to only allow the state's largest municipality to set up a trust, but Mr. Hoffman said that other municipalities have expressed interest in the idea. Mr. Hoffman said that the upcoming 30-day legislative session may not have the ability to address this issue, so the proposal may need to wait until the 2017 legislative session.

The committee directed Mr. Hoffman to work with LCS staff to draft the legislation to allow other municipalities to establish a trust.

### **Adjournment**

There being no further business, the committee adjourned at 2:18 p.m.