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SPONSOR Varela **DATE TYPED** 3/3/05 **HB** 389/aHAFC

SHORT TITLE Permanent Fund Investment Limitations **SB**

ANALYST Geisler

REVENUE

Estimated Revenue		Subsequent Years Impact	Recurring or Non-Rec	Fund Affected
FY05	**FY06**			
	$42,000.0	Significant. See Narrative	Recurring	Pension and Trust Funds

(Parenthesis ( ) Indicate Revenue Decreases)

Relates to: HB 55, SB 60
Duplicates: SB 392

SOURCES OF INFORMATION
LFC Files
State Investment Council (SIC)
Educational Retirement Board (ERB)
Public Employees Retirement Association (PERA)
Attorney General (AG)

SUMMARY

Disclosure of Bill Language Issue

Legislative Council Service staff has identified an issue with Section 8. Act Not Severable. The current language of section 8 reads: "If any part or application of this act is held invalid, the remainder or its application to other situations or persons shall likewise be invalid. The provisions of this act are not severable."

Council service staff indicate that the language as written might not ensure failure of the whole bill if it does not receive 75% of the votes as required to amend the portions of the bill applying to the land grant permanent fund statutes. If a 75% vote requirement to pass the entire bill is desired, consideration should be given to amending section 8 of the bill to clarify this point. If the intent is for the provisions of the bill to apply to ERB and PERA if more than 50%, but less than 75% of the votes are received, consideration should be given to amending the bill to strike Section 8.

Synopsis of HAFC Amendment

The House Appropriations and Finance Committee amendment to House Bill 389 clarifies that the Uniform Prudent Investor Act and generally accepted accounting standards apply to the State Investment Council's differential rate investments. (Differential rate investments are those targeted to NM economic development, such as the film program and regional private equity.)

Synopsis of Original Bill

House Bill 389 is Legislative Finance Committee sponsored legislation that would eliminate the current "legal list" of permissible investments and replace it with the guiding principles of the Uniform Prudent Investor Act ("UPIA") for the Public Employees Retirement Association (PERA), Educational Retirement Board (ERB), and the State Investment Council (SIC). House Bill 389 also requires investing agencies to report quarterly to the Legislative Finance Committee and Department of Finance and Administration on investment performance and annually on any changes in written investment policies.

The UPIA sets a higher standard of care for a fiduciary or trustee, above and beyond the current standard and guiding principles in law. The UPIA requires fiduciaries or trustees to take into account the condition of the entire trust and other modern economic factors in making investment decisions instead of just considering individual assets as the old standard and "legal lists" dictates.

Under the UPIA, trustees shall invest and manage the trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust. To satisfy this higher standard, trustees shall exercise reasonable care, skill, and caution. As a result of the standard of care, trustees' investment and management decisions respecting individual assets must be evaluated in the context of the trust as a whole and part of an overall investment strategy with specific risk and reward objectives identified by the trust.

Significant Issues

- The UPIA holds trustees to a higher standard by requiring investment decisions to be made prudently and be supported by expertise with the sole interest of the beneficiaries in mind.

- The higher standard of prudence applies to the entire trust not just assets in isolation (as the current guiding principles dictate).

- The UPIA requires that trustees set investment strategy based on the risk and reward objectives suitable for the trust and its beneficiaries.

- House Bill 389 eliminates legal lists and allows trustees to invest in any asset that conforms to the prudence standard and achieves the risk/reward objectives of the trust. New asset types may include real estate, private equity, and hedge funds.

- Given changing and dynamic investment markets, UPIA allows trustees to invest in any asset that meets the higher standard of prudence. This provides the trust greater flexibility and options to improve the performance of the fund while holding or decreasing risk.

- Concerns about implementation of UPIA for the investing agencies include the financial expertise of board members and the applicability of UPIA to State Investment Council differential (or "below market") investments in New Mexico private equity funds and businesses.

PERFORMANCE IMPLICATIONS

State investment agencies believe that their investment performance will improve by having investments governed by the UPIA instead of legal lists.

FISCAL IMPLICATIONS

According to the state investment agencies, moving from the current "legal list" to the UPIA can have a significant positive impact on the future investment performance of the agencies, in particular given the modest return predicted in investment markets during the next five years. For example, PERA's investment consultant projects stocks to only average 6% to 10% growth annually and annual fixed income return to be in the 4% to 6% range. Alternative investment types are expected to offer higher returns (real estate 7.6%, private equity 12%, and hedge funds 6.5%). Adding additional asset classes to a portfolio also diversifies it, which helps minimize investment losses during negative market periods. (See additional discussion under substantive issues)

- PERA's projection for investment return with their current portfolio of mostly stock and bonds for the next five years is 7.35% annually, which is .65% (or 65 basis points) less than their actuarial target of 8% return. Under the UPIA, if approximately 16% of PERA assets are allocated to new assets classes such as real estate, hedge funds, and private equity, PERA projects expected investment return of 8%, an increase in 55 basis points.

- ERB's projected investment return for the same 5 year period is approximately 7.65 % with a similar mix of assets, which is .35% (or 35 basis points) less than their actuarial targeted return of 8%. By adding new asset classes ERB projects a minimum gain of .26 basis points, which brings them closer to their targeted return.

- SIC projected annual investment return of 8.51% over the next five years barely meets the 8.5% target return necessary to meet their constitutionally mandated payout obligations. By adding new asset classes, SIC projects a minimum increased return of 8.85%--a increase of 34 basis points.

The table below shows the four year estimate of added investment returns in dollars by moving to the UPIA and adding new asset classes.

Projected Increase in Investment Return for First 4 Years of UPIA Implementation (000's)

	ERB	PERA	SIC	Total
FY 06	$ 8,000	$ 10,000	$ 24,000	$ 42,000
FY 07	$ 30,000	$ 71,200	$ 76,176	$ 177,376
FY 08	$ 55,000	$ 142,000	$ 137,249	$ 334,249
FY 09	$ 83,000	$ 223,000	$ 208,373	$ 514,373
Total	$ 176,000	$ 446,200	$ 445,798	$ 1,067,998

Because new asset classes could not be fully implemented for FY06, the positive fiscal impact is approximately $42 million in FY06. However, when the changes can be fully implemented the positive fiscal impact will be larger; $177.3 million for FY07, $334.2 million for FY08, and $514.3 million for FY09. To put these projected increases in returns in perspective, it is important to note that ERB, PERA, and SIC have combined assets of approximately $27.3 billion as of June 30, 2004.

ADMINISTRATIVE IMPLICATIONS

If this bill were to become law, ERB, PERA, and SIC would not be able to invest in any new options until such time as alternative investments were approved as eligible investments by its board.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Duplicates Senate Bill 392. SB 60 also will eliminate the state investing agencies (SIC, PERA, ERB) current legal lists of permissible investments and replace them with the higher standard of the UPIA. The major difference between HB 389 and SB 60 are that SB 392 reflects the latest edits coordinated with PERA, SIC, and ERB and adds a requirement for the investing agencies to report performance quarterly to the Legislative Finance Committee and the Department of Finance and Administration, as well as report annually on any changes in written investment policies.

Another bill, HB 55, sponsored on behalf of the Legislative Education Study Committee, eliminates the current legal lists of permissible investments for ERB and replaces it with the higher standard of the UPIA

OTHER SUBSTANTIVE ISSUES

<u>Board Expertise in the Investment Area</u>

One area of concern is that the removal of the legal list in favor of UPIA assumes that the investment agency "trustees", as defined in the UPIA, possess sufficient expertise in modern portfolio management theory and practice and are therefore in a position to strategically and vigilantly oversee the portfolio under the prudent investment standards. For example, the Educational Retirement Board is composed of seven members, consisting of the following: the superintendent of public instruction; the state treasurer; one member to be elected for a term of four years by the New Mexico association of educational retirees; one member to be elected for a term of four years by the members of the New Mexico education association; one member to be elected for a term of four years by the New Mexico members of the American association of university professors; and two members to be appointed by the governor for terms of four years each. <u>Although all of these are distinguished policy makers and citizens, only a few of these positions are filled by members with financial or investment experience</u>.

<u>SIC Targeted Economic Investments and UPIA</u>

The AG notes that the bill expressly states that "market rate investments" are subject to the Uniform Prudent Investor Act. It does not expressly state this for "differential rate investments." (Differential rate investments are allowed to balance non-rate of return factors in different proportions than market rate investments.) However, the Attorney General's office has previously opined that the Uniform Prudent Investor Act governs both types of investments.

Differential rate investments are SIC investments of Severance Tax Permanent Fund monies in New Mexico private equity funds and businesses for the purpose of stimulating the New Mexico economy (return considerations are secondary). Since maximizing return is not the primary objective, this may appear to conflict with the standards of the UPIA. Clarifying language in statue may be required to facilitate continuation of investment in New Mexico private equity funds and businesses under UPIA.

Brief History of the Uniform Prudent Investor Act

Before the Uniform Prudent Investor Act, the previous investment standard was the 'Prudent Man Rule'. However, in 1974, the Employee Retirement Security Act (ERISA), adopted by Congress, recognized the shortcomings of the 'Prudent Man Rule' by setting a standard of prudence more in step with economic realities and modern portfolio management. After adjustments to ERISA's standard, the National Conference of Commissioners on State Laws formally approved a model Uniform Prudent Investor Act in 1994, which is in use in almost 40 states and the District of Columbia today.

Advantage of UPIA over Legal Lists of Investments

The current "legal list" is a confusing and cumbersome list of what assets may be invested in by the investing agencies. Some persons may be interpret the legal list to include certain investments, yet others may not have the same interpretation. The UPIA removes the confusion resulting from different interpretations and legal opinions and places this responsibility, within the standard of the UPIA, with the trustees. Elimination of the legal list also reduces the multi-year lag time between getting legislative approval for a new asset class, getting board approval, and procuring new investment managers.

Projected Investment Return and Risk for Asset Classes

PERA provided the following information from their investment consultants, Callan Associates.

Callan 5-Year Annualized Capital Market Projections		
Asset Class	Expected Return	Risk
Equities		
Broad Domestic Equity	9.00%	16.90%
Large Cap	8.80%	16.20%
Small/Mid Cap	10.10%	23.50%
International Equity	9.30%	20.30%
Emerging Markets	9.80%	33.00%
Fixed Income		
Domestic Bonds	4.75%	4.50%
Non-US Bonds	4.65%	9.60%
High Yield	6.75%	12.10%
Alternatives		
Real Estate	7.60%	16.50%
Private Equity	12.00%	34.00%
Hedge Funds	6.50%	10.50%

It should be noted that while the alternative investment classes such as real estate, private equity, and hedge funds offer higher return they also have higher risk ("standard deviation"). An assets standard deviation is a measure of the volatility of its likely investment return. For example, as noted above PERA's projects 7.35% annual return over the next five years with their current mix of assets (approximately 60% stocks and 40% bonds). The standard deviation associated with that portfolio is 10.65%. If PERA diversified their portfolio by adding 16% alternative asset classes (reducing bonds by that amount) projected return would increase from 7.35% to 8% but the risk of volatility in return would increase from 10.65% percent to 12.3%.

It would appear that adding new investment classes would therefore be riskier, but the investing agencies disagree—in their view the increase in added investment return from asset diversification (both in good years and down markets) outweighs the added increase in risk from a more diversified portfolio.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL?

The investing agencies will continue to invest under the rules of the current statutory provisions and their respective board's investment guidelines. The investing agencies believe failure to pass legislation of this type will hamper future investment performance.

POSSIBLE QUESTIONS

1) How has the investment performance of PERA, ERB, or SIC been harmed by the legal list?

2) If the legislature provides additional investment flexibility to the investing agencies by implementing the Uniform Prudent Investor Act, what other statutes or rules will protect the fund by regulating the conduct of the investing agencies boards and staff?

3) What are some of the risks associated with new assets classes such as real estate, private equity, and hedge funds?

4) Would it be appropriate for there to be limits in statute on the amount of the fund which can be invested in alternative/more volatile asset classes?

5) Elaborate on how the UPIA provides for a higher standard of care by the board trustees and staff.

GGG/yr:sb