F I S C A L   I M P A C T   R E P O R T

ORIGINAL DATE 01/31/12
SPONSOR Trujillo **LAST UPDATED** **HB** 21

SHORT TITLE Limit International Equity **SB**

ANALYST Walker-Moran

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Nonrecurring	Fund Affected
FY12	**FY13**	**FY14**		
		+/- Indeterminate*	Recurring	Land Grant Permanent Fund

(Parenthesis ( ) Indicate Revenue Decreases)

* See Fiscal Implications

Duplicates: SB 41
Companion to SJR 4 and HJR 1

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)

SUMMARY

Synopsis of Bill

HB 21 seeks to limit the amount of international equity investments made by the Land Grant Permanent Fund (LGPF) to no more than 25% of the fund. The bill is a companion bill to SJR4 (and HJR 1) and is contingent on the passage of a constitutional amendment by the legislature and voters removing the current constitutional cap of 15% international equity investment by the LGPF.

SIC: The Council believes the limits on international investing should be governed first by the Council itself through policy and the already statutorily-required practice as prudent investors, and then further overseen by the legislature through statute. By changing the restriction to a level set by statute rather than Constitution, it would allow greater flexibility in properly diversifying the Permanent Fund investments in the future, while at the same time maintaining a layer of oversight by the legislature.

The Investments & Pensions Oversight Committee agreed with this concept and endorsed this legislation.

FISCAL IMPLICATIONS

According to SIC, the changes to be made by HB21 and SB 41 are contingent on the passage of SJR4 and approval by the voters in a statewide election. Should that happen, and should the legislature pass HB21 and if it is signed by the Governor, the next step would be assessing an appropriate level of international investment for the LGPF. The Council, in conjunction with its investment advisers, would work to develop an investment policy that sets a new target/range for this asset strategy. It is unknown if it in fact would be 25% at this time, but the Council would have that option.

Currently the SIC is limited to a 15% allocation, and their expert financial consultant RV Kuhns has indicated a higher target would be prudent based on the current asset mix and investment goals. Overall, 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%, for which they have been largely rewarded. The following annualized return numbers are based on 12/31/11 reporting, and compare benchmark indexes for the S&P 500, MSCI International Developed and MSCI International Emerging stock indexes.

	1-Year	3-Years	5-Years	7-Years	10Yrs
S&P 500 Index	2.11	14.11	-0.25	2.64	2.92
MSCI EAFE Index (Intl Dev)	-12.14	7.65	-4.72	1.71	4.67
MSCI Emg Mkts Index	-18.42	20.07	2.40	10.36	13.86

While domestic markets saw short term out-performance last year, over the past 10-years, greater exposure to emerging markets in particular helped improve returns for many investors.

SIGNIFICANT ISSUES

Per SIC, the current 15% restriction deviates greatly from industry norms and best practices. Most public and private institutional investors will establish targets/ranges/caps on investment allocations through investment policy, in coordination with rebalancing practices. Comparable Constitutional restrictions around the country are unknown to the SIC.

It should be noted that there is no constitutional (or statutory) restriction on the Severance Tax Permanent Fund, or on the funds managed by NM PERA or NM ERB.

When these issues were discussed by the IPOC, legislators noted that while the changes and reforms at SIC have been significant over the past 18 months with arrival of a new Chair, new Council, and new Investment Officer, they felt that a compromise that left a layer of oversight and control in the hands of a third party – the legislature – was appropriate and probably more palatable to the public given the high profile events at SIC in the past. It was the Council's Governance Committee that originally suggested the compromise under SB 41 be structured in this manner.

PERFORMANCE IMPLICATIONS

According to SIC research, many economists see a significant potential that the economic recovery from the 2008/2009 market collapse will be cautious and methodical. It may in fact lead to many years of slow domestic growth, and since GDP often drives investment returns, this could result in depressed US equity returns. While International markets are often affected by US investors and economic conditions, their performance is only partially correlated, can offer a portfolio stabilizing effect through diversification, and certainly today's "world economy" has been established at least in part due to the massive growth seen in emerging markets.

The Council is working to optimize returns for the LGPF and its other funds, and to do this, is seeking the ability to make the most prudent, most beneficial investments it can for the long-term health of the fund and while maximizing benefits for New Mexicans today and in the future.

Along those lines it is taking into consideration the following:

- Today, about 55% of the global publicly-traded equities market capitalization (global stock market value) is represented by shares of companies domiciled outside of the US.
- 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.
- Contribution to global GDP growth is increasingly shifting to the emerging markets. GDP growth drives investment opportunity and return.
- 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.

As fiduciaries to the Fund, the Council should have the ability to assess and accept various levels of investment risk if they feel the potential returns are appropriate. This would reflect adherence to the prudent investor required standard, and would also be in lockstep with the actions of our peer investors and the recommendations of our investment advisors.

ADMINISTRATIVE IMPLICATIONS

Should the bill pass and the Constitutional amendment be approved by voters, the SIC will revisit investment allocation targets and portfolio re-balancing policies.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

HB21 and SB41 relate to SJR4 & HJR1, which seek to remove the international investment cap on the LGPF from the Constitution. (NOTE: Duplicates for HB21 & HJR1 were dropped in the Senate and will be pursued there due to concerns the Council had regarding a perceived conflict between other LGPF-related legislation pre-filed by Rep. Trujillo. Both the Representative, Senator Cisneros and the LCS are aware of this duplicate bill issue, and requested the exception be made to standard legislative practice restricting duplicate bills).

Per the AOC, SB 41 cap limit for international investments of the Land Grant Permanent Fund needs to conform to the NM Constitution, Article 12, Section 7 (D) (4). Currently, that section of the constitution limits investment of the Land Grant Permanent Fund to no more than fifteen percent of the book value of the fund invested in international securities at any single time. The contingent effective date in HB 21, Section 2 addresses this disconnect by making this statute effective only when the constitution is changed.

TECHNICAL ISSUES

To reiterate, at the core of the bill lies a significant technical issue: the bill only takes effect contingent on the passage of the companion constitutional amendment by voters in 2012.

OTHER SUBSTANTIVE ISSUES

This bill moves the Council toward observance of its governing statute, the Uniform Prudent Investor Act (UPIA). The UPIA is the industry standard observed by most institutional investors and more than 40 states, and establishes that as fiduciaries, investors should not be hindered by artificial restrictions when seeking optimal risk adjusted returns for its beneficiaries. Though not formally determined, the current constitutional cap of 15% is likely in conflict with UPIA.

In summary, an investor governed by one law requiring that they invest to the very best of their capability, faces a dilemma when an opposing law then tells them they may not make certain investments due to geographic concerns rather than prudent, investment-related factors.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

The SIC will continue to prudently invest LGPF dollars, while working diligently to minimize the detrimental restrictions which are currently in place, limiting Fund diversification and overall optimization of returns.

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