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

		ORIGINAL DATE	02/04/14		
SPONSOR	Beffort	**LAST UPDATED**	02/12/14	**HB**	
SHORT TITLE	Combine All State Investment Functions			**SJM**	15
				ANALYST	Armstrong

APPROPRIATION (dollars in thousands)

Appropriation		Recurring or Nonrecurring	Fund Affected
FY14	**FY15**		
	NFI		

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Public Employee Retirement Association (PERA)
State Investment Council (SIC)
Educational Retirement Board (ERB)

SUMMARY

Synopsis of Bill

Senate Joint Memorial 15 requests that the Legislative Council authorize the Legislative Council Service to contract for professional services by a “nationally recognized authority” to thoroughly study and assess the feasibility and potential benefits of consolidating the investment management and related investment functions of all of New Mexico’s investing agencies. The memorial requests that the contracting authority present its findings to the interim Investments and Pensions Oversight Committee and the Legislative Finance Committee by December 1, 2014.

FISCAL IMPLICATIONS

The memorial does not include an appropriation. However, the requested contract will carry costs to LCS.

SIGNIFICANT ISSUES

According to the memorial, the state’s several investing agencies manage tens of billions of dollars worth of institutional investments, and multiple consultants receive millions of dollars to provide similar advice despite only minor differences in the strategies and types of assets owned by these agencies and because the investments are managed separately. Though at least 17 states manage all types of investments through a singular entity – presumably with a high degree of success – it is difficult to gauge the level of effort, resources, and complications New Mexico would face in merging its investment operations. A study would potentially clarify this matter as New Mexico strives to implement best-in-class investment management operations as recommended in the 2009/2010 fiduciary review.

The Educational Retirement Board and Public Employees Retirement Board each exercise the sole and exclusive fiduciary duty and responsibility for the investment of their respective trust funds. Any proposal resulting from the study requested by SJM 15 to combine the investment of the funds would require a constitutional amendment to change the composition and fiduciary duties and responsibilities of the retirement boards.

PERA Analysis

The retirement systems within New Mexico (PERA and ERB) are managed by separate governing boards with the sole constitutional authority over the respective funds they exercise control over. The PERA Board, as trustees for the retirement system, has the sole and exclusive fiduciary duty and responsibility for the administration and investment of the trust fund under the New Mexico Constitutions. NM Constitution, Art. 20, Sec. 22.

The PERA Fund's primary objective is to prudently invest the trust fund's assets in order to meet statutory obligations (retirement benefits) to its members. It is the primary fiduciary responsibility of the Board to ensure the prudent investment and expenditure of the PERA Fund's assets. In order to meet the long-term nature of PERA's pension obligations and the inherent risk of short-term tactical investing, the Board has adopted a long-term rate of return goal commensurate with its actuarial rate of return. Its asset allocation seeks to meet the rate of return goal over long periods of time, while minimizing volatility.

The PERA Board manages its assets in the context of the pension liabilities it is required to meet. Managing funds in relation to liabilities differs even among retirement systems. For example, the actuarial experience of PERA, which manages retirement benefits for public safety members, differs from that of ERB, which administers benefit for retired educators. The PERA Board establishes its asset allocation and investment strategies in the context of these unique liabilities.

ERB Analysis

The differences in the investment strategies utilized by the three agencies are significant and are closely related to their respective purposes. Only PERA has a similar basis as a starting place to ERB, as they both provide pension benefits to their members, but the ERB and PERA Boards take a very different approach in asset allocation and utilization of external vs. internal management of some asset classes. Since 2005, when the legislature increased the variety of assets for ERB to invest in, the board has made a definite allocation away from public equity and their inherent volatility, to alternative assets. Accordingly, ERB's asset allocation is very different from the other investing agencies.

ERB currently manages 25 percent of its assets internally. This allows ERB to maintain good jobs in N.M., rather than send millions more out of state for management fees. ERB is in the process of hiring two fixed investment employees to manage core fixed income (bonds) internally. Once this part of fixed income is managed internally, ERB will be managing 35% of assets internally.

ERB is already sufficiently large ($10.7 billion as of 12/31/13) to get the "best" prices on management fees. The legislature acknowledged this when they permitted the individual investing agencies to secure their own contracts for custodial banking services. ERB regularly negotiates to get the best level of fees with its managers. This has often resulted in significant discounts in fees. In some of the most expensive fee asset classes (private equity, real estate and infrastructure), ERB has entered into co-investing management agreements to get high quality management services at the most optimal rates. ERB has entered into or is about to enter into co-investment funds that when fully funded over the next few years will represent approximately 4-5 percent of assets. One of these investments is under consideration for approval later this week. This is an area ERB will look to expand upon in the near future to represent a greater share of assets.

Regarding investment consultants, it is not truly accurate to state that the different consultants provide similar investing advice. The respective consultants provide each agency advice specific to their identified purpose, and the advice reflects the overall strategy being used to accomplish their funding goals. Combining investment consultants would not eliminate the need for specialized information for each fund. Finally, any potential savings on consultant fees would depend upon whether a general or alternatives consultant is involved. All consultants charge a flat fee per year for their services. However, in the case of a general consultant, the fee is partially determined by the amount of assets under management. Thus, a combined NM entity would pay more in fees than any one of the separate NM entities. It would likely result in only a modest overall savings. For an alternative consultant, such as a private equity consultant, the fee is largely, if not wholly, determined by the amount of assets under management. Thus, combining entities would save little, if any, in fees in this area.

SIC Analysis

Consolidation of all state investment management functions would potentially result in reduced costs, consulting and investment management fees, and to an indeterminate degree, elimination of existing duplication of efforts which currently exist across New Mexico's investment agencies. The outstanding question to be answered by an independent and objective third party analysis would be what unforeseen or operational complications might also result, potentially offsetting those benefits.

Potential benefits include:

- Savings in external investment manager fees due to tiered fee structures (larger funds making larger commitments often receive fee breaks from investment managers)
- Savings in costs of having multiple investment advisors and consultants providing duplicate services to each investment agency
- Savings in costs through reduction of staff task duplication
- Savings on investment management software, investment research services, etc.
- Risk reduction through greater institutionalization and governance with improved processes, reporting and transparency

Potential negatives include:

- Unforeseen complications arising from having a single investment agency being directed by (at least) three separate governing boards, each with different goals and ideas
- Investment concentration risk. This can cut the other way as well, where funds can be over-diversified through lack of focused strategy. For example, ERB could be on one side of a trade, while SIC & PERA are on the other… NM as a whole does not profit
- Lack of focus by the investing agency due to multiple mandates; the pensions have liabilities to address, while the permanent fund payouts are set legislatively through the constitution, and in the case of the STPF also have instances of legislative mandates, like Economically Targeted Investments

A study would help gauge the relative benefits or risks in pursuing consolidation.

ADMINISTRATIVE IMPLICATIONS

The scope of such a study would have to be determined by the funding agency (LCS). An appropriate RFP process would be required.

SIC asks whether such a study include only the three primary institutional investment agencies, or take additional state investments into account. The following NAV chart shows the total assets potentially included to be quite large, at more than $51 billion.

NET ASSETS FOR:	$ (Billions)	As of:
ERB	10.37	9/30/2013
ETB	2.12	6/30/2013
NMFA	1.74	6/30/2013
NMMFA	1.20	9/30/2013
PERA	13.99	12/31/2013
SIC	18.61	2/11/2014
STO	3.7	6/30/2013
$	**51.73**	**Billion**

JA/ds