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To: SIC Governance Committee and Council
From: SIC Management Team: Steve, Vince, Evan, Brent, & Charlie
Subject: The SIC - Accomplishments (4/17-3/18) and Goals (4/18-3/19)
Date: April 23, 2018

Mission: *To protect and grow the state's permanent endowment funds for current and future generations, through prudent, professional investment management.*

Vision: *To become one of the best performing, most respected sovereign wealth funds worldwide.*

Every 12 months we analyze Council achievements from the previous year, and propose goals for the ensuing year. This memo outlines the accomplishments achieved by the Council, its committees & staff during the past 12 months and our plans for the months ahead.

1. Investment accomplishments:

The twelve months ended March 31, 2018 marked another year of growth in asset values and in distributions from the permanent funds.

During the year:

- Our combined assets under management increased to \$23.7B. FY18 annual distributions to the State are expected to be \$899.5 million, with FY 19 projected to be \$968.2million.
- Our collaborative, open and structured investment management process continued to serve us well. Via our Annual Investment Plan, the collective wisdom of our Council, management group, investment consultants and investment team is funneled into a structured investment process that determines our objectives and direction, our investment outlook, and our investment activities. Our process invites participation and debate by all fiduciaries; allows for clear oversight and transparency; and requires responsibility and accountability at all levels. It succeeded in organizing and focusing us once again in the past year.

The SIC – accomplishments (4/17-3/18) and goals (4/18-3/19)

- This year our investment process has guided us through making nearly \$1.5 billion in investments and investment commitments across the portfolio. The Council, consultants and staff undertook the triennial asset allocation study for the Land Grant Permanent Fund and the Severance Tax Permanent Fund, refreshing targeted allocations to current long term strategy and investment market outlooks. The Council adopted recommendations from a liquidity study, which informed a restructuring of the fixed income allocation to better align with current economic and financial market conditions with respect to liquidity needs. The structure of the national private equity portfolio was reviewed and minor changes approved.
- The comprehensive 2018 Annual Investment Plan was approved by the Council. The medium term (next 7-10 years) outlook remains one of lower than average growth, rising and average inflation, and rising interest rates. Combined with high valuations in the Council’s primary investment markets, a challenging environment remains in place.
- Our investment team continued to advance. We added Chris Cassidy and Maria Korostelev to the team in analyst roles, supporting the private equity and public equity areas respectively. David Lee was promoted from Acting Director of Private Equity to Director. Wade Franks completed the final level of the CFA program and was awarded the charter. Vince Smith continued on aiCIO Magazine’s “Power 100 List”, and was appointed to client advisory boards of two of the world’s largest multi-asset investment managers.

Investment goals:

- Develop and present the 2019 Annual Investment Plan.
- Update the general Investment Policy.
- Position the portfolio to generate investment performance that will support the long-term goal of intergenerational equity of distributions, to the extent practical.
 - LGPF: financial model expectation of 50% probability or higher; and
 - STPF: financial model expectation consistent with a return expectation of no higher than 7.50% (arithmetic).
- Position the portfolio to aim for above-average performance relative to peers, to the extent compatible with the long-term goal of supporting intergenerational equity of distributions (“black dot” chart above average expected returns).
- Continue to improve “risk management” through more effective and better-targeted reporting.

2. Accounting & administrative services accomplishments:

- FY 17 external audit was completed before the new November 22nd deadline. (The FY 17 audit was impacted extensively by three fund reclassifications and a prior period adjustment in the LGPF as impacted by a change in methodology by the State Land Office. Both of these required extensive added time to the year-end audit preparation process.)
- Kept the SHARE system updated in accordance with agreed-upon DFA deadlines. (There was a major upgrade in SHARE which required extensive training and interaction with DFA in order to meet required deadlines.)
- Client billings were submitted according to schedule.
- A physical fixed asset inventory was completed.
- Submitted the FY 18 budget before the May 1st deadline.
- Submitted the FY 19 appropriation request before the September 1st deadline.
- Assisted the compliance officer with several initiatives.
- Attended appropriate DFA and OSA training sessions with accounting staff.

The SIC – accomplishments (4/17-3/18) and goals (4/18-3/19)

- Continued to encourage staff in the areas of professional development and continuing education. Currently, there is one staff member taking the CPA exam and an administrative assistant that is graduating with a Bachelor's degree in May.

Accounting & administrative services goals:

- Ensure that the FY 18 External Audit is completed before the November 21st deadline. (This fiscal year audit will be impacted by the onboarding of a new audit firm after six years with CLA).
- Keep the SHARE system updated in accordance with agreed-upon DFA deadlines. (There are currently on-going discussions with DFA about moving-up the timing of distributions on a monthly basis to avoid due to/from transactions with the related entities.)
- Ensure client billings are submitted according to schedule. Client assets now exceed \$1B and the City of Albuquerque is considering moving some of their investments to the SIC.
- Ensure that a physical fixed asset inventory is completed within the fiscal year.
- Submit the FY 19 budget before the May 1st deadline.
- Submit the FY 20 appropriation request before the September 1st deadline. (This request will also include the impact of a 2 percent compensation increase as approved by the legislature.)
- Assist the compliance officer with various initiatives, including a new fee tracking and validation service provided by Colmore.
- Continue to provide the Audit Committee support, as needed, in directing internal audit areas to be examined, and follow-up on any related internal audit recommendations.
- Complete staffing initiatives within accounting, IT, and administrative accounting areas.
- Complete implementation of assigned items within the strategic plan.
- Attend appropriate DFA and OSA training sessions.
- Continue to encourage staff in the areas of professional development and continuing education.
- Implement a replacement for QED investment reporting services.
- Assure adequate budget availability within state parameters.

3. **Legal, governance & compliance accomplishments:**

In part, via prompt implementation of investment mandates, a comprehensive permanent fund portfolio restructure and build-out has been appropriately accomplished.

The following bullets summarize legal accomplishments over the past 12 months:

- From the second quarter of 2017 (April 2017) to date, we have continued implementing a diversified asset allocation—representing approximately \$2.3 billion in investment transactions across a broad range of strategies.
- In so doing, we have performed extensive legal due diligence on 25+ investment managers/strategies.
- Contemporaneously, legal has endeavored to safeguard the permanent funds through prudent contract negotiation (focusing on fiduciary duties, heightened standards of care, enhanced governance, transparency/detailed ILPA reporting, New Mexico law/rights, and ethical return optimization on a risk-adjusted basis).
- Litigation efforts continue to progress towards trial through the efficient administration of complex proceedings, yielding \$40+ million in recovery monies received/escrowed.

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- Our legal team continues to win court rulings (i) in New Mexico alleged pay-to-play (e.g., summary judgment against Gary Bland) and Texas bankruptcy matters; and (ii) in nationwide securities/bankruptcy cases.
- We have overseen the buildout/administration of an organizational compliance program, with an emphasis on risk mitigation.
- Serving as staff liaison to the Council's Governance Committee, legal has focused on systematizing policies and procedures.
- Over the past year, SIC services for governmental clients continue to be enhanced via several updated joint powers agreements.
- And the legal department continues to operate within (*i.e.*, below) budget.

Implementation Performance Details

Following Council open meeting authorization, legal has overseen operational execution of approximately 30 investment-related transactions over the past 12 months.

I. Private Markets (≈\$1.2B)

A. Private Equity: ≈\$483 million

- ✓ 9 commitments
- ✓ National Program: TPG Asia VII (\$100MM); TPG Growth Fund IV (\$50MM); TPG The Rise Fund (\$50MM); New Mountain Partners Fund V (\$62.5MM); Nordic Capital Fund IX (\$75MM); Affinity Asia Pacific Fund V (\$75MM); Bridgepoint Europe VI (≈\$48MM, €60MM-conversion)
- ✓ New Mexico Program: Kickstart Seed Fund IV (\$7.5MM); Crosslink Ventures VIII (\$15MM)

B. Real Estate: ≈\$440 million

- ✓ 6 commitments
- ✓ Berkshire Multifamily Value Plus Fund IV (\$50MM); Carlyle Realty Partners, VIII (\$100MM); Exeter Europe Value Venture III (\$75MM); KKR Real Estate Partners Americas II (\$75MM); Ares European Real Estate Fund V (€75MM); Almanac Realty Securities VIII (\$75MM)

C. Real Return: \$275 million

- ✓ 4 commitments
- ✓ Macquarie Infrastructure Partners IV (\$100MM); Blackrock Global Renewable Power Fund II (\$50MM); Encap Flatrock Midstream Fund IV (\$50MM); Macquarie Asia Infrastructure Fund (\$75MM)

II. Public Markets &/or Other (≈\$1.1B)

A. Short Duration High Yield: \$350MM

- ✓ Commitment to Shenkman Capital Management

B. Credit: \$400MM

- ✓ 4 commitments

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- ✓ Golub Capital XI (\$100MM); PIMCO Bank Recap Value Opps. III (\$100MM); HPS Specialty Loan Fund (\$100MM); Silver Point Distressed Opportunity Institutional Partners (\$100MM; *pending*)
- B. Continued Unwind of Hedge FOF Structures to Direct Ownership: ≈\$160MM
 - ✓ 2 transactions
 - ✓ Silver Point Flagship Fund (\$100MM); Drawbridge Special Opps. (≈\$60MM)
- C. Additional Restructure of Core & Non-Core Fixed Income Portfolio
 - ✓ Amend BlackRock investment management agreement to Bloomberg US Treasury Index replicating strategy
 - ✓ Amend PIMCO investment management agreement to actively managed investment grade corporate bonds strategy
 - ✓ Increase commitment to King Street & Garda (to \$100MM each)
 - ✓ Redeem from PIMCO Unconstrained account
 - ✓ Aksia advisor-contract extension
- D. Equity Portfolio Facilitation
 - ✓ Transition from Cortina Asset Management to Blackrock Alpha Tilts Small Cap and S&P 600 Index (≈\$83MM)
 - ✓ Contract amendments for domestic equity managers Blackrock, Donald Smith, Seizert Capital, Brown Brothers and T. Rowe Price

Additional Performance Summary

Additional performance items include: (1) legal review of private market manager MFN-right & consent-type documentation; (2) investment transition management contracting; (3) fee reduction contractual implementation; (4) transparency & disclosure protections; (5) private market liquidation processes; (6) IPRA/open meetings compliance; (7) custody banking logistical/legal support (including securities class action administration); (8) international tax reclamation attorney-efforts; (9) anti-money laundering filings/safeguards; and (10) investment fee tracking/validation procurement-facilitation.

Legal, governance & compliance-related goals:

- Further enhancement of investment (operational and administrative) risk management safeguards/systems.
- Continue compliance program augmentation, including implementation of an additional fee tracking and validation system.
- Appropriately resolve (long-term) litigation matters.

4. **Communications, legislative and client relations accomplishments:**

Informing and educating the public about what the Council does, defining what Council's decisions mean for current and future New Mexicans, and explaining the underlying reasoning behind those decisions all remain critical ongoing efforts. Arguably public awareness of the Land Grant Permanent Fund is at an all-time high today, but with that awareness unfortunately comes an abundance of

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inaccurate or partial information, which has sometimes been promoted by those seeking to restructure these funds and their benefits.

Though the 2018 legislative session was only a 30-day session focused primarily on the state’s budget, lawmakers introduced eight separate constitutional amendments targeting additional distributions from the Land Grant and Severance Tax Permanent Funds. This was more permanent-fund-related legislation than we have seen in several years, and almost all of it looked to remove the Governor from the process by amending the Constitution, which requires voter approval, but excludes a balancing check from the Executive. Amendments sought everything from increased recurring distributions of up to \$239 million from the LGPF for early childhood services, to a one-time payout of several billion for education. More worrisome were new proposals that would appear to sidestep existing constitutional protections the permanent funds have against legislative appropriation. One amendment targeted the LGPF for mental health and public safety programs. While obviously those are important issues worthy of receiving appropriate funding, they have a minimal link to public education and the other 20 established LGPF beneficiaries.

From this, it’s a fair expectation, that the trend of looking to the Funds as a solution for many of the state’s problems is unlikely to slow any time soon. For those reasons, we are working to expand the reach of our message, though not the underlying approach of professionalism, openness and clarity. Making more people understand what the funds already do for the schools and taxpayers remains a primary goal, and should be accomplished without spin or political rhetoric in what is a growingly partisan, emotional issue.

Approaching communications, legislative and client-related matters in a straightforward way remains a key goal, and allows us to grow trust among stakeholders, while building broader confidence in our investment strategies, and the professional manner in which we orchestrate our fiduciary efforts. This is also consistent with how the Council approaches delivery of important information regarding our investments, process, performance, and annual audit. The 2017 Council Annual Investment Plan is a very good example of this openness, delivering additional information via an investment roadmap and expectations for the upcoming year.

Outreach at the legislative level has continued to focus on thorough delivery of information and updates on matters of high interest, including long-term risks to the fund, as well as appropriate projections and expectations on what the Fund should deliver depending on how various strategies perform. Individual meetings with legislators and interim committee presentations have been generally effective. Legislative analysis work included updates and educational reports to several interim committees, including additional reporting and context regarding investment management fees.

During the 2018 30-day session, the Council tracked more than a dozen bills with potential impact on the permanent funds, and provided extensive analysis to the legislature when requested. Testimony was delivered, but only upon request regarding specific bills. No measures impacting the permanent funds were passed during the 2018 session.

Communications, legislative and client relations goals:

- Continued education of the public regarding the long-term cost and impact of proposals seeking to increase fund distribution rates above 5%.

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- Using the 60th anniversary of the SIC to increase public awareness and broader understanding of the funds and their value to New Mexico.
- Increased public education regarding the sometimes misunderstood benefits the permanent funds currently provide, the significant positive impact compounding fund investment returns will bring for future generations, and the “expensive” risk of using permanent fund dollars for recurring general fund needs.
- Highlighting the prudent approach currently taken by the Council in seeking high-quality investments in New Mexico industry and technology commercialization, as well as ongoing assessment of whether these efforts are “right-sized” to accomplish sought-after goals of both job-creation and financial returns.
- Improving the methodology and manner in which SIC communicates to its 20 – soon to be 21- clients, regarding their participation in SIC investment pools, performance metrics of their investments, and broader market concerns which might impact their holdings and investment strategies.
- Using milestones like the 60th anniversary of the Council to educate more New Mexicans regarding the benefits the permanent funds provide to them and other beneficiaries, both today and in the future.
- Refining and improving the SIC website to refine public accessibility to its dashboard, investment performance and related reports.
- Continued efforts to improve communication of both standard and critical information provided to the Council, SIC staff, and members of the public interested in SIC matters and the permanent funds.

Strategic Plan implementation (April 2017 - March 2018)

The Council adopted a 5-year Strategic Plan (2014-2019) in December 2013. As specified in the Plan document, the Council, its committees & staff continue to work to address the following:

- Analysis of Council composition
- Strengthening the STPF by increasing annual inflows
- Defining and implementing appropriate executive and legislative oversight mechanisms
- Institutionalization of best practices and state-of-the-art systems
- Analysis regarding costs and benefits of consolidating all NM investment management functions

Going forward, we will present this analysis annually, with no mid-year report, unless requested. We look forward to receiving Council Members’ and committee members’ comments and suggestions. Thank you for your commitment to the Funds and for your support.