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FY 2023 Annual Investment Plan

Introduction

It is with pleasure that we present the fiscal year 2023 Annual Investment Plan.

This year's plan is the eleventh iteration of investment plans written since fiscal year 2013. The investment plan uses a 7-10 year forward horizon in the development of an outlook for the economy, financial markets, and for the development of longer term investment themes and strategies. It is written with a ranging readership in mind. We focus discussion on the largest of economic and financial market variables--economic growth, inflation, interest rates and the basic investment markets of stocks and bonds--with as little industry terminology and jargon as possible. Asset class plans for each major asset class employed are presented.

This work is the organized accumulation of investment knowledge, thought and input across as many fund fiduciaries as possible: the Council, the Council investment committee, the investment office management group and investment staff, external investment consultants and external investment managers. It has the purpose of transparency of our investment process as a lead objective, and seeks to be informative, and educational where possible.

Part I: *Expected Macroeconomic & Investment Environment and Broad Investment Strategy*

Macroeconomic and Investment Environment

In recent editions of this Annual Investment Plan series, we have discussed signs that the persistently favorable global macroeconomic trends that we've enjoyed over the last forty years—falling interest rates, above average economic growth, disinflation, massive increases of per-share corporate profits, ballooning equity market multiples, unrelenting excess financial liquidity—and the list goes on —have hit a point of exhaustion and are turning. From the bottom of the 1980-1982 global recessionary period until the peak prior the global Great Financial Crisis (GFC) in 2008-2009, remarkably few events disturbed one of the greatest periods of economic growth and supportive investment market environments in our history. Since the GFC, most of the trends noted have been skidding toward change, and today, the signs of a direction change seem unmistakable.

We attribute the incredibly fortunate 40 year period of prosperity to many things; among them the starting point in 1980-1982: sky-high interest rates (16% on ten-year Treasuries, 19% on Fed funds) and near record low equity market multiples marked on depressed corporate earnings (the Shiller CAPE ratio of the stock market was 6.9x in the summer of 1982). Demographically, the front edge of the largest American generation ever--the Baby Boomers—were entering their peak earnings years and were on the verge of supplying massive amounts of cheap capital to the economy and financial markets. The back half of the Boomer generation had almost all entered their primary spending years--starting families, buying homes, filling living rooms and kitchens and garages with 'consumer assets' and creating a whole new level of 'demand-side economics'. Incredible advances in technology during the period leveraged the raw economic power of the Boomers through boosting workplace productivity and business efficiency. A long period of relatively stable (though notably pock-marked) geopolitics supported a globalization of the world economy and trade, and brought new workers and consumers into the global economy at a faster pace than at any other time, known to us, in history.

The GFC, as little as we may have recognized it at the time but see it in perfect 20-20 hindsight today, constituted an inflection point--the front edge of a "landing zone" for these global macroeconomic dynamics.

Global economic growth rates faltered post-GFC. Interest rates started to slide sideways instead of persistently ever lower. Economists stopped saying "disinflation" with regard to the consumer price index reports as inflation slipped under 2% annually (and in some places such as Japan, fell into outright deflation). The front edge of the Boomer generation began eyeing well-deserved retirement, while the back end increasingly began to slow their spending rate in order to save more for theirs. Productivity growth in the U.S., which centered around 2.5% annually from the 1990s to the GFC, halved to being centered around 1% annually post-GFC.

Since the GFC, excess financial liquidity provided by the global central banks and proliferate spending by governments has steadily been deployed to try to substitute for the waning economic strength and fortuitous financial trends of the 1982-2008 period. It has been met with limited, and distorting, effect on the economy, but sent financial markets to historically high valuations.

The Federal Funds rate, the second most important interest rate on the planet behind the yield on the 10-year U.S. Treasury note, was hammered to zero by the Fed during the GFC, from 5.25% preceding the crisis. It was kept there for seven years, persistently proving unable to help stimulate the economy back to pre-GFC footing, though helped nearly double equity market multiples from 13.3x (Shiller) at the bottom of the market crash in March, 2009 to an airy 24.5x (Shiller) at the beginning of 2016. A brave attempt was made to lift rates from zero beginning in 2016, only to cause the economy to skid and stock markets to collapse into a bear market two years later. The Fed reversed policy, cutting rates, and the COVID-19 pandemic beginning in early 2020 cemented a return to ZIRP (zero interest rate policy). All the while, the Fed's balance sheet of assets purchased with printed money jumped from $500 billion to $4 trillion pre-pandemic--and further to $9 trillion during the pandemic--as officials sought to control longer term interest rates and fund huge federal deficit spends (from the beginning of the economic recovery post-GFC in June 2009 through September 2021, the federal government deficit-spent almost $16 trillion). The 10-year Treasury rate fell below 1.5% and stock market multiples exploded to a jaw-dropping, near-all-time-record of 38.5x (Shiller). Which brings us (almost) to today.

In the eleven-year history of this Annual Investment Plan we have not spent a full page-plus on an economic history recitation. We hope never to do so again. However, we are making a case that things have changed for us as investors and overseers of the permanent funds—a substantial change, we assess and should add—and understanding how we've gotten to where we are is important to sketching out where we may be poised to go in the future.

Some brief comments on the present first, and then we can look forward into the future—which is what this report is primarily aimed at doing.

It is difficult to hold the macroeconomic conditions of 1982 and the macroeconomic conditions of 2022 in one's mind at the same time. They are that dissimilar. We've described the misery of forty years ago—the end of a hyperinflation, deep economic recession, crushed equity markets, usury law-challenging levels of interest rates. On the first day of 2022, by contrast, we were sitting on more than 8% annually-compounded rates of return from our portfolio over the preceding ten years, zero percent interest rates and a stock market--which investors are supposed to value based on forward-looking expectations--priced almost as high as ever before.

Eight months in, 2022 has been rough. Equity markets dropped 24 percent into early summer. We've had a mild rally as of this writing, but are expecting to at least test the lows, if not more, before the end of the year. Our bond portfolio--which is supposed to soften cantankerous moves in the equity market--staged its own bear market simultaneously, with yields on the bellwether 10-year Treasury note more than doubling from 1.50% to well over 3.00%. Inflation has been the problem; the same factor—though hopefully not of the same duration—as in the 1970s that helped create the early 1980s adversity. Demographically, the economy remains in a "saddle"—half or more of the Boomers have left the full-time workforce. The first of the Boomers are in their mid-70s; the last Boomer was born in 1964 and likely would like to retire in 2029, seven years from now. The Boomer's replacements--the stunningly large and inadequately respected (in economic terms) Millennials--are not quite there yet (another 6-9 years) to fill the Boomer's economic shoes.

It isn't, however, as if we have not been expecting a rougher ride. The Council began to recognize in 2014 that the decades-running macroeconomic fundamentals of the past were slowing significantly and running out of room directionally and likely would not to be the fundamentals of the future. By 2017, the

Council had made significant changes to the asset allocation of the permanent funds, in response. Leery of stock market valuations and the underpinnings of such, uneasy about historically-low interest rates, and concerned about almost absent inflation, we shifted the portfolio to depend significantly less upon past trends continuing, and prepared to take on a different future. We made another tweak to asset allocation in 2021. All of that is documented in previous issues of this report. As of our June 2022 performance report, it's been a good call. The permanent funds presently enjoy investment returns across all time frames we track that stack up very well with our public fund peers.

And so, to our future expectations.

Economic Implications

The Council begins work on developing our economic views with the International Monetary Fund's (IMF) popular twice-annual reports World Economic Outlook and the Global Financial Stability Report. The IMF does excellent work and digs deep (which delights us to no end as macroeconomic analysts and strategists). This forms a baseline from which we examine and challenge and verify every part, extensively tapping ranging resources to get to our views for our specific timeframe of 7-10 years forward (roughly the average length of a full economic cycle, historically).

For purposes of keeping the Annual Investment Plan reasonably short and readable, we limit our discussion of economic expectations and implications to the three major areas of growth, inflation, and interest rates.

Growth—In keeping with previous outlooks, the Council continues to expect low rates of economic growth in the U.S. and globally, with limited potential to surprise to the upside in the nearer-term and worrisome potential for surprise to the downside. Though, as we raised last year in this report, there is a light towards the end of our 7-10 year forecast period for the U.S.: the Millennials.

Our discussion above regarding the macroeconomic and investment environment introduced the idea that we believe we've changed directions in many areas of the economy and investment environment from the 1982-2008 period. Real GDP growth in the U.S. is one of the factors which has already changed, falling from an average rate of 3-4% annual real growth in 1982-2008 to half of that over the last decade.

We believe important factors in the slowdown of growth over the last decade had significantly to do with globalization of the economy incrementally becoming less effective in supporting growth, waning productivity, and demographics--the front edge of the Boomers hitting retirement age in the U.S. Populations in Europe and parts of Asia are increasingly aging, too, as demographics globally deteriorate.

Going forward for the next 7-10 years, the Boomer retirement problem will stick with us, but we add to it changes brought by the COVID-19 pandemic. Among other things, the pandemic called into question the degree of international integration and globalization of the economy. Businesses are reviewing the risks uncovered in their far-flung and complex supply chains, 'just-in-time' inventory management schemes, and their processes for transporting and distributing goods and servicing customers globally. Consumers have new emphasis on feeding, clothing and housing their families, securing their employment, and shoring up their personal finances. Governments are reviewing national security and trade strategy considering the challenges presented by the pandemic. These things seem to be leading in the direction of decision-making which could be less supportive of global growth as changes to current practices are determined and implemented.

A re-sorting of how business is done and how consumers respond could lead to relative changes in winners and losers by country and geographical location over our forecast horizon. Countries most at risk likely are ones most exposed to global trade—particularly those who import food and energy in exchange for export of intermediate and finished goods, or small economies which have concentrated economic efforts in a particular supply niche in exchange for a broader menu of food, energy and consumer staples imports. This actually bodes well for relative prospects in the U.S., as we can easily feed our population, supply our own energy needs, and on-shoring some now-outsourced production, to the degree it takes capital expenditure to do so and creates jobs at median wages or higher, could feed an upside surprise in U.S. growth during our forecast period.

We mentioned the Millennials (again) in this section; thank goodness for the Millennials (in an economic sense)! Few other significantly populated countries in the world have a Millennial generation forecasted to be nearly the size of their Boomers (at the Boomers peak), as the U.S. does, and some larger countries have a quite small Millennial generation relative to their Boomers. The front edge of the Millennial generation are in their late-30s and the youngest of the cohort are now out of high school. In less than 10 years time, the oldest of the Millennials will be hitting their peak earning and work productivity years, and the back end will be fully in their high-spending family and household-forming years—just a few years ahead of where the Boomers were in 1982. And their numbers indicate that they could be a force on par with the economic peak of their Boomer grandparents and parents in the U.S. economy.

In all, over our 7-10 year forecast period, we believe the nearer-term growth outlook is weaker than average with a recession to start later this year/early next year which could be protracted; that the early part of the next expansion could be slower than usual; and that mid-cycle in the next expansion could be extended and strong as the Millennials start flexing their economic muscle.

Inflation— The Council continues to expect that there is danger of deflation along with the danger of excess inflation. In statistical-speak, we believe something of a "fat-tailed" probability distribution exists with respect to inflation outcomes: higher than usual probability of excess inflation, a higher than usual probability of deflation, and a lesser probability than usual of "normal" inflation, over our forecast period.

The economy has had two big bursts of inflation since the second world war. The first was from the mid-1940s to the early 1950s when countries were taking advantage of the post war rebuild to industrialize their economies, which pressured prices of raw materials, supplies and labor. Inflation averaged about 5.7% annually in the U.S. in the period, held down to a degree by a nasty recession in 1949. That was an industrial demand-driven inflation. The second came in the mid-1970s through the early 1980s, as the U.S. abandoned the gold standard for our currency in 1971, the OPEC oil cartel managed to seize control of and exploit the energy markets, and about half of the Boomers entered their peak spending years, founding families, buying cars and buying homes. That was a really, really strong combination of inflationary forces upon the economy, and inflation averaged 9% annually over the period.

Today's inflation seems to be a similar witches brew, though not at the same level as in the 1970s: an energy shortage, a massive fiat currency injection into the financial system in response to the COVID pandemic, and the preponderance of the Millennials having moved into their high-spending years (this, though, partially offset, economically, by retiring Boomers).

Our belief is that there seem to be enough inflationary factors presently pushing inflation that the Fed should act decisively and risk erring on the side of too much monetary restriction, if an error is to be made. Fed chair Powell has been clear that he has come to similar conclusions and has pushed the Fed funds rate higher at a very fast pace relative to history, and forecasts of where the Fed stops increasing rates leaves the total increase at a large size relative to history.

There is a risk though, in battling this year's inflation that was not as present in the 1970s inflation: all sectors of the economy are loaded with debt—from corporations to consumers to the government. One argument in favor of hammering inflation now is the knock-on effect of holding down longer-term interest rates and not exacerbating the pain of the debt load by raising debt service costs. The risk though, is that a deep enough or long enough recession because of aggressively fighting inflation has the possibility of setting of a cascading debt default. This is why since the last iteration of the Annual Investment Plan we have concerned ourselves with an increased chance of deflation and need to keep a tool in the portfolio construction tool kit to manage it if it were to come.

Interest Rates—Technically, interest rates are a "financial market", but we upgrade rates to "economic factor" due to their pervasive effects on many other financial markets and the economy.

Last year, we extended the previous two years' expectations that interest rates will rise over the forecast period but be more "back-end" loaded. The current surge in interest rates this year, a doubling from the beginning of the year in response to the surprisingly strong surge in inflation, is not consistent with that expectation, though the rise may be temporary, particularly so if the Fed is successful in breaking inflation but uses enough monetary restriction to cause a recession in the next couple of quarters. That's our current expectation (a near-term recession that would bring rates back down), and we are sticking with our belief that for rates to be structurally higher we need a renewal of the economic cycle complete with the Millennials producing greater economic strength.

<u>Financial Market Implications</u>

The publicly traded equity markets still do not look good to us within our macro view, particularly in the U.S. Every part of how we make money in stocks looks under pressure at present: slow economic growth could pressure revenue growth; inflation is pushing up input costs and hitting gross margins; rising longer term interest rates are increasing operating costs, pressuring net margins; and what earnings do appear on the bottom line are subject to multiple compression as P/E multiples drop. Higher longer-term interest rates also are making it harder for company CFOs to borrow money to buy back shares, which has been a widely-used tool for companies to have boost per-share earnings over the last decade. We cut our global equity exposure in 2017 to levels we feel are near lows of what we'd hold long term, and it has been a reasonable call. For the five years ending in June 2022, our global equity composite returned 6.4% annually, below the return of the portfolio as a whole. Despite the significant correction in stock prices this year, U.S. stocks remain highly valued relative to history at a 29x Shiller ratio—a level that historically has produced weak returns from stocks over subsequent 10-year periods. Our 7-10 year macro view offers little in the nearer-term to encourage us toward publicly traded equity, with our belief in a nearer-term recession occurring and lower than average economic growth until demographics start to improve 5+ years out.

Likewise, core bond markets are difficult to like, and we've been sour on them for a few years. The core bonds portion of the portfolio has been an allocation we felt like was a minimum size in our portfolios since 2017, and since that time through last June produced a paltry 1.69% annualized rate of return. Unless the worst-case scenario happens and we fall into a deflationary environment, it's hard to see core bonds as a strong performer within our 7-10 year macro outlook.

On the other side of the ledger, we still feel like there is some opportunity in the non-core fixed income area, the non-core real estate area, the real assets area, and—for reasons more particular to our portfolio than the market broadly—opportunity in the private equity area.

Broad Investment Strategy

In the longer run, as institutional investors of long-term growth portfolios, it is important to generally stay optimistic, always be looking for opportunity, and stay invested in a well-considered portfolio of risk assets.

The last five years have made it tough to maintain that profile--though, we believe we have--and our current macro and markets outlook does little to improve conditions. Therefore, our broad strategy will seem similar to that of the past five years, with a new feature:

1. **The GFC represented an inflection point and the last ten years have served as a "landing zone" for major economic and investment market trends of the last 40 years. We had a turn in economic growth rates immediately post-GFC. The inflation rate and short term- and longer term-interest rates changed course after the COVID pandemic. Equity market valuations began to turn at the beginning of this year.** *The Council began to recognize this this process as early as 2014 and made asset allocation changes in 2017 and again in 2021 in response. Further allocation changes may be warranted and are planned to be studied in the spring of 2023.*
2. **Increase focus on U.S. based investments (this is new).** *Given our weak outlook for the U.S. and global economy in the nearer-term and the propensity of global investors to move toward U.S. assets in times of stress, this is appropriate in the nearer-term. The post-COVID re-evaluation currently underway of the degree that the global economy is co-dependent and integrated has an outcome potential to advantage the U.S., relative to our position today, in a longer timeframe.*
3. **Continue to focus on assets with a significant yield component.** *Publicly traded equity markets have become more volatile since late 2018. Volatility of both short-term and longer-term interest rates picked up during the COVID pandemic, settled down, and have now become more volatile since the first of the year. It's likely only a matter of time for volatility to spread to other markets if the economy weakens into recession in the near term, as we assume. Income is an elixir for volatility.*
4. **With respect to specific asset classes:**
   a. **Continue to be cautious of the U.S. stock market**. *Valuations are clearly very high and are not advantaged (at least in the first half) of our 7-10 years macro horizon.*
   b. **Continue to find alternatives for core bond exposures**. *As with U.S. stocks, our macro outlook in full is just not a friendly environment for this asset class.*

Part II: *Asset Class Plans*

Public Markets: Equity

Asset Class Summary—The publicly traded equity portfolio is the cornerstone investment of the Permanent Funds and the most liquid of the major allocations within the Funds. The role of this portfolio is to generate meaningful real returns through long-term capital appreciation and dividend income.

Equity exposure is achieved through a combination of low-cost passive investment and targeted active management. In more efficient markets, such as US large-cap stocks, the focus is increasingly on capturing market returns through the use of low-cost index strategies. In less efficient areas, such as emerging markets and small-cap stocks, greater focus is given to identifying skilled active managers that we believe can achieve superior risk-adjusted returns.

The public equity asset class has a target allocation of 40% of Land Grant Permanent Fund and Severance Tax Permanent Fund total assets, with current US and ex-US target allocations of 20% each, or 50% of public equity assets each.

The table below shows the actual and target allocations of the public equity portfolio.

% of Public Equity Asset Class (6/30/2022)						
	Sub-Asset Class	**Target (%)**	**Actual (%)**	**Target ($m)**	**Actual ($m)**	**Strategies (#)**
Global					**$11,347**	
US		**50.0%**	**52.7%**	**$5,673**	**$5,985**	
	Active	16.0%	16.6%	1,815	1,886	4
	Market-cap Passive	34.0%	36.1%	3,858	4,099	1
Non-US		**50.0%**	**47.3%**	**$5,673**	**$5,362**	
	Active	45.0%	40.9%	5,106	4,642	9
	Market-cap Passive	5.0%	6.3%	567	720	1

Portfolio strategy, markets, and recent performance— The publicly traded equity portfolio is primarily constructed to match the market sensitivity of the benchmark while focusing on the efficient deployment of active risk. In-depth studies have been undertaken by staff with the assistance of the general consultant to identify market segments in which managers can more reliably generate long-term excess returns, with market-cap passive strategies receiving higher allocations in more informationally efficient segments.

Active risk strategies have been evaluated and selected in the context of their respective US or ex-US composites, with the objective of maintaining idiosyncratic stock exposures, managing tracking error and managing factor risks. Individual active risk managers are expected to maintain portfolio exposures consistent with their mandates and established risk budgets, while generating positive excess returns against their respective benchmarks, both on the upside and downside. This should result in balanced exposures across size, style and geographic categories, allowing the publicly traded equity composite to consistently generate excess returns in all types of market environments.

For the twelve months to June 30th, 2022, portfolio volatility, tracking error, fees and relative performance are in line with peers and largely consistent with expectations. Calendar year 2021 was characterized by continued leadership by US large-cap tech firms, which at yearend and early CY2022 rotated toward more cyclically sensitive value stocks. The rotation has been fueled by high inflation, gradually tightening financial conditions and exacerbated by a late February Russian invasion of Ukraine. US equities peaked on January 3rd and have dropped 21.1% year-to-date (as of 6/30). The calendar year-to-date disparity

between large-cap value versus growth stocks is 15.2% (-12.9% vs -28.0%). Ex-US markets have followed a similar rotation with emerging markets underperforming developed markets, -17.8% developed vs -25.3% emerging, for the one-year period ending June 30, 2022.

Performance for the US and ex-US composites was within expectations. The US portfolio returned -14.78% versus the Russell 3000's -13.87%, down 0.9% relative for the full year. The portfolio's shortfall can be attributed to US large-cap growth active manager underperformance. This pain was suffered across the US large-cap growth peer universe with 75% of US large-cap growth active managers underperforming for the one-year period (based on data from Jefferies Research). The broad growth universe underperformance can largely be attributed to a narrow back-half 2021 market with returns disproportionately driven by five U.S. large-cap tech companies followed by a 31.8% calendar year-to-date return in the energy sector where most active managers are underweight. The ex-US portfolio beat the MSCI ex-US IMI's return of -19.86 by 0.6%, largely due to active manager outperformance in the developed market space and despite a New Mexico Client overweight to the emerging markets space.

Portfolio activity and forward-looking strategy— Following the substantial restructuring of the US portfolio and re-allocations at the margin in the ex-US portfolio in FY2021, until the recent Franklin Resources Templeton termination, there had been no manager allocation changes to either portfolio. This afforded staff significant time to monitor current managers, particularly important during a period of heightened market volatility. Calendar year-to-date volatility, as measured by the VIX Index has averaged about 6.5 points above its long-term average of 19.75, climbing to a high of 36.5 at the start of the Russia-Ukraine conflict, which is greater than two standard deviations from the average. The reversal of U.S. technology companies with elevated valuations into cyclically sensitive value stocks and the decoupling of the energy sector from the rest of the index resulted in some short-term active manager underperformance. Staff and RVK have spent considerable time meeting with managers and running additional analysis to determine whether active manager portfolios were performing in line with expectations and reasons for any deviations. As a result of the analysis, RVK and staff recommended the termination of one manager. The current environment is ongoing, and it is not clear how long it will last.

Staff continued a project started in late 2020 researching the universe of public equity managers not currently in the SIC's public equity portfolio albeit at a slower pace due to staff turnover. So far in 2022, approximately 30 manager video calls have been conducted with public equity managers. The emphasis of the calls was on assessing qualitative aspects, such as investment team and research platform quality and sustainability, consistency of portfolio philosophy, and application of the portfolio process. About 20 more calls have been scheduled over the next several months. The remote work environment created the opportunity for video meetings with senior managers and investment professionals, which did not exist before. It is expected that this advance research work will continue to be useful for years to come, as firm and team quality is expected to gain a greater role in the due diligence process.

Every five years, according to the SIC's Investment Policy Statement, RVK and staff review the SIC's public equity transition management bench. In September 2021, a Transition Manager Bench RFI begun with a thorough review of six managers transition managers (based on the highest transition management volumes). A comparative analysis was conducted focusing on organizational factors, project management resources, trading and execution resources, operational and reporting resources, and competitiveness of cost structure. In January 2022, the review was completed with the Council's approval to continue with the SIC's current transition management bench of three managers: BlackRock, CitiGroup, and Russell Investments.

Enhancements of internal resources continues. During the year, utilizing the eVestment Analytics platform, a 100-page custom report to monitor current managers more efficiently was created. This project proved beneficial given the subsequent market volatility. Additionally, the implementation process for the Aladdin risk platform was completed in early 2021 but due to the system's complexity, a great deal of time continues to be spent ensuring data quality and building out its functionality.

The public equity team expects to continue and expand on each of these projects into the next fiscal year. While the composite structures for the public equity composites are established for multi-year periods, staff are committed to investing with superior investment managers and strategies, so the potential does exist for new manager searches.

Public Markets: Fixed Income

Asset Class Summary: The objectives of the fixed income asset class are:

- Mitigate against the downside volatility of equity risk and provide diversification benefits to the total portfolio thereby acting to preserve the capital of the portfolio.
- Generate income for current outflow needs and reinvestment through economic cycles.
- Provide liquidity for rebalancing and during times of market stress.

Fixed income portfolios seek to achieve these objectives by investing in a variety of government, corporate, and asset-backed debt in the public and private markets. The primary macroeconomic drivers of fixed income performance are interest rates (combination of real rates and inflation), risk of default and liquidity. The portfolio is divided into Core and Non-Core components.

Core Portfolio

The Core allocation is a highly marketable, low credit risk portfolio with the objective of providing liquidity in the event of a severe market dislocation. Consequently, the Core allocation is further subdivided into Core, Core Plus and Short Duration sub-strategies, each with a specific purpose.

- Core Sub-Strategy: Primarily highly liquid treasury securities and is expected to be the most robust source of liquidity in periods of market stress.
- Core-Plus Sub-Strategy: Enhances current income production with measured exposure to credit risk while maintaining high liquidity to help preserve the real value of capital invested.
- Short Duration Sub-Strategy: Provides both liquidity and a mechanism for managing the portfolio's interest rate risk.

Non-Core Portfolio

The Non-Core allocation's primary objective is to generate returns above those available in publicly traded securities by capturing liquidity and complexity premiums while offsetting downside volatility of the SIC's equity exposures. Investors earn liquidity premia as compensation for making investments that cannot be readily traded in established markets. Similarly, complexity premia are earned by providing custom or specialized capital solutions to borrowers whose financing needs require special structuring. Funds in the Non-Core portfolio typically hold private assets that have a contractual yield component, are secured by an asset such as property or a company and are infrequently traded.

Current Exposures

The Core Fixed Income long-term target allocations are 10% for the LGPF and 12% for the STPF. The Non-Core Fixed Income long-term target allocation is 15% for the LGPF and 12% for the STPF. The portfolio continues to be conservatively positioned with the Core sub-strategy within the Core Portfolio, the portfolio's primary source of diversification, liquidity, and capital preservation, near the high end of its range. The Short-Duration sub-strategy, which lowers the portfolio's interest rate exposure, is slightly above neutral position and the Core Plus allocation is slightly below the midpoint of the long-term target range.

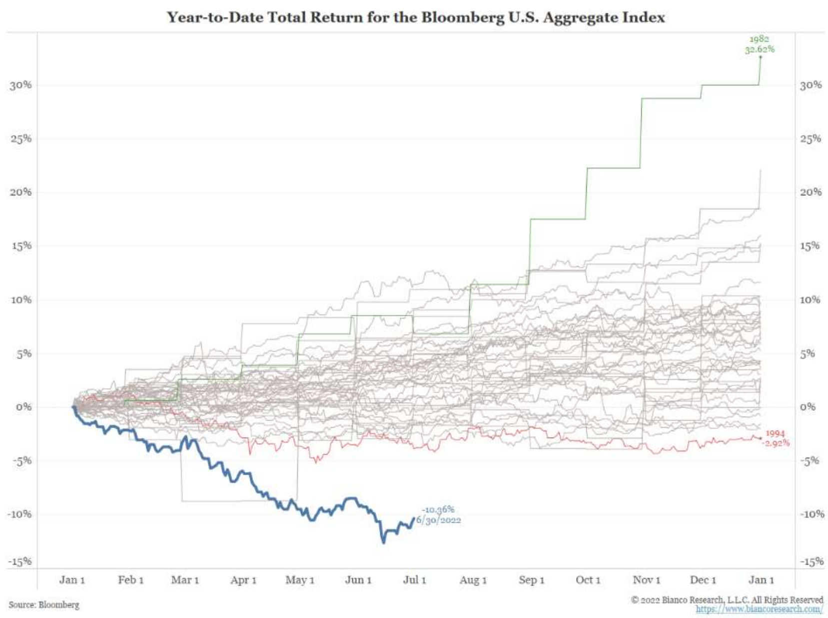
The table below depicts the changes in exposures over the past fiscal year:

Sub-Sector Strategy	Allocation 6.30.2021	Allocation 6.30.2022	Long-Term Target	Primary Purpose
Core Fixed Income Portfolio				
Core Bonds Pool	36.95%	39.53%	20% - 40%	Interest rate exposure
Core Bonds Plus Pool	40.95%	36.42%	25% - 65%	Interest rate & credit exposure
Short Duration Pool	19.41%	24.04%	10% - 30%	Liquidity/Duration mgmt.
Non-Core Fixed Income Portfolio				
Lending Strategies	23.43%	15.51%	20% - 40%	Credit exposure – Corporate emphasis
Distressed & Other	26.95%	30.47%	20% - 40%	Credit/Alpha exposure
Structured Credit	24.08%	25.40%	20% - 40%	Credit exposure – Retail and structural emphasis
Public Market Strategies	25.54%	28.53%	20% - 40%	Duration mgmt./Alpha exposure

<u>Performance</u>

Fiscal year 2021 saw the whiplash effects of economic re-opening catalyzed by fiscal and monetary policies in the second half of 2021. In turn, supply chains were over-burdened causing price inflation in energy, goods and services. Strained, global supply chains were further disrupted by Ukraine-Russia conflict in February 2022. The global political, economic and supply chain realignment resulting from the Ukrainian conflict exacerbated the already inflationary environment and sent inflation and inflationary expectations to levels last seen in the 70's and 80's.

The increasingly inflationary environment came as a significant change from the prior low inflation and low-rate regime. Overlaying several bouts of increased credit risks or liquidity disruptions over the last 30+ years (e.g., Russian default, Asian liquidity crisis, LTCM, dot.com crisis, 9/11, GFC etc.), the global economy experienced a general trend of declining goods inflation and even periods of concern over deflation. World debt markets were fully adjusted to a low inflation ecosystem. Significant percentages of developed economy government debt were priced with negative or very low single-digit yields and had been for some time. Both corporate and government borrowers aggressively took advantage of low yields to term borrowings as long as possible – hence the issuance of 100-year bonds and talk of a US treasury 50-year bond issuance. Major fixed income indices such as the Bloomberg-Barclays Agg reflected the growing preponderance of long-term debt which embedded ever greater susceptibility to a rise in yields. The low inflation regime ended during 2H21 with inflation rising above the Federal Reserve's 2% inflation goal and continuing to rise through 1H22 to double-digits. The Federal Reserve reacted sharply by reducing reserves from the banking system with quantitative tightening and increasing the level of short-term interest rates by increasing the rates paid on bank reserves. The result of restrictive central bank monetary policy should inhibit economic activity and is also expected to reduce private sector profitability and increase credit risk. Consequently, the double whammy of higher rates to compensate for inflation and increasing credit spreads produced record bond market price declines.



Over the fiscal year, the 5-year inflation break-even rate increased from 2.49% to a high of 3.75% in March 2022 only to decline to 2.62% in the face of aggressive monetary policy tightening by the US Federal Reserve. The yield on the 10-year U.S. Treasury started the fiscal year at 1.47% but essentially doubled to end the fiscal year at 3.02%. Credit spreads also widened over the same time frame. The Moody's US Corporate BAA ten-year spread began the fiscal year at 187 basis points and ended it at 231 basis points, a 44-basis point increase.
The benchmark for the Core portfolio is the Bloomberg U.S. Aggregate Bond Index which produced a -10.29% rate of return for the fiscal year ended June 30. The Core portfolio returned -9.54%, outperforming its benchmark by 75bps. Strategies with greater credit risk and longer duration performed worst. Alternatively, strategies with lower credit exposure and lower duration performed relatively better. The Non-Core portfolio returned 3.34% and outperformed its custom benchmark (which returned -5.76%) by 910 basis points.

Forward-looking Strategy and Recent Activity
The Fixed Income portfolio's diversified array of strategies positions it to weather a broad range of economic and liquidity disruptions to offset or dampen downside equity volatility. Allocations approved by the SIC over the prior fiscal year ensure SIC is positioned to be a liquidity provider to markets and borrowers globally as they cope with tightening central bank monetary policies. The table below summarizes new commitments approved this fiscal year:

Fund Name	NMSIC Category	Sector	Strategy	SIC Approval Date	Commitment Amount
Newmarket International Infrastructure Finance Company Fund III	Distressed / Other	Specialty Finance	Regulatory Capital Relief	8/24/2021	150,000,000
Sixth Street Growth Partners II	Distressed / Other	Mezzanine	Structured Equity	10/26/2021	100,000,000
Arbour Lane Credit Opportunity Fund III	Distressed / Other	Distressed Debt & Special Situations	Corporate Distressed	1/25/2022	150,000,000
Shenkman Capital Management	Public Strategies	Short Duration Below IG	Short Duration Below IG	1/25/2022	700,000,000[1]
ACORE Credit Partners II	Lending Strategies	Real Estate Credit	U.S. CRE Transitional Lending	2/22/2022	150,000,000
TSSP TAO	Distressed / Other	Distressed Debt & Special Situations	PC Special Situations	5/24/2022	250,000,000
400 Capital Asset Based Term Fund III	Distressed / Other	Distressed Debt & Special Situations	Opportunistic Structured Credit	5/24/2022	75,000,000

[1]Contract renewal for evergreen separately managed account.

Highly supportive central bank monetary policy since 2020 and which drove return expectations to very low levels has reversed, and interest rates have increased. Restrictive monetary conditions tend to lead to liquidity stress and deteriorating economic conditions. In such an environment, the normal channels providing liquidity (such as banks and public markets) either withdraw or restrict access on the margin. Private market creditors are often in a better position relative to banks and public bond markets to offer customized financing solutions and earn return premia for liquidity and complexity. As businesses and projects search for financing sources in a more difficult operating environment, underwriting discipline (as always) by managers and portfolio diversification will remain key. The SIC has approved several strategies over the prior fiscal year that will focus on providing financing for infrastructure and distressed situations.

Private Markets: Real Estate

Asset Class Summary — The Council's Real Estate portfolio has a target allocation of 12% of the Fund. As of CYE 2021 the Real Estate Portfolio's NAV was $3.534 billion, representing approximately 10.4% of the Fund's assets. The Real Estate Portfolio is well diversified by property type, risk profile, and geography. Relative to property type diversification, the portfolio is guided by the diversification of the National Council of Real Estate Investment Fiduciaries (NCREIF) Fund Index for Open-Ended, Diversified, Core Equity (NFI-ODCE), with a 15% plus or minus relative allocation. In consultation with the Real Estate consultant, staff has the ability to tactically over- or under-weight by property type. The property type composition of the Real Estate portfolio is summarized in the table below:

Real Estate Property Type Exposure as of December 31, 2021

Name	Allocation	Apartment	Industrial	Office	Retail	Other [1]
Core	67.13%	23.99%	34.91%	22.10%	8.77%	10.23%
Core	31.79%	21.78%	29.36%	25.98%	12.30%	10.58%
Core-Plus	35.35%	25.98%	39.90%	18.60%	5.59%	9.93%
Non-Core	32.87%	15.22%	27.00%	12.83%	14.76%	30.19%
Credit	1.42%	0.00%	9.32%	47.75%	1.97%	40.95%
Value-Added	14.64%	23.19%	28.21%	10.31%	26.06%	12.23%
Opportunistic	16.81%	9.57%	27.44%	12.06%	5.99%	44.93%
Total	100.00%	21.11%	32.31%	19.05%	10.74%	16.79%
NFI-ODCE		28.07%	27.67%	26.47%	11.59%	6.19%
Difference		-6.96%	4.64%	-7.42%	-0.85%	10.60%

Source: Staff, eFront, and NCREIF

[1] Other property types include debt, hotel, land, life science, manufactured housing, medical office, mixed-use, parking, residential, self-storage, senior living, and student housing.

Recent Performance, Markets and Portfolio Strategy — The Real Estate portfolio performed exceptionally well in 2021 as asset values appreciated sharply in a rebound from COVID 19. Interest rates generally remaining below 2019 levels provided a material valuation tailwind. Net time weighted return for the year was 28.0%, compared to 21.0% for the NFI-ODCE index.

Fundamentals in industrial and apartment property types remained strong. In both cases, vacancy rates stayed low driving strong rent and NOI growth throughout 2021. Inexpensive mortgages and initial signs of accelerating inflation helped drive strong year over year home price appreciation – 18.87% as measured by the Case Shiller National Home Price NSA Index. Home ownership and single or multi-family rentals are substitute goods and appreciation in home prices often flows through to rents with a 12-to-18-month lag suggesting the top line strength for the rental market likely persists. Rents in Sunbelt markets which are benefitting from long-term demographic trends have grown sharply.

In many instances, the Covid pandemic accelerated trends that were already underway, most notably the ongoing transition from brick-and-mortar retail to on-line shopping. This phenomenon has driven strong returns in the industrial sector, mostly to the detriment of traditional malls. Values of grocery-anchored and lifestyle retail have held up reasonably well. These trends appear to remain largely intact.

Despite strong return-to-work trends and new highs in Total Office Using Employment, average office occupancy relative to pre-covid norms is still under 50% on a national average. The long duration of office leases suggests that it may take years for the office market to fully digest changes in how we work post COVID.

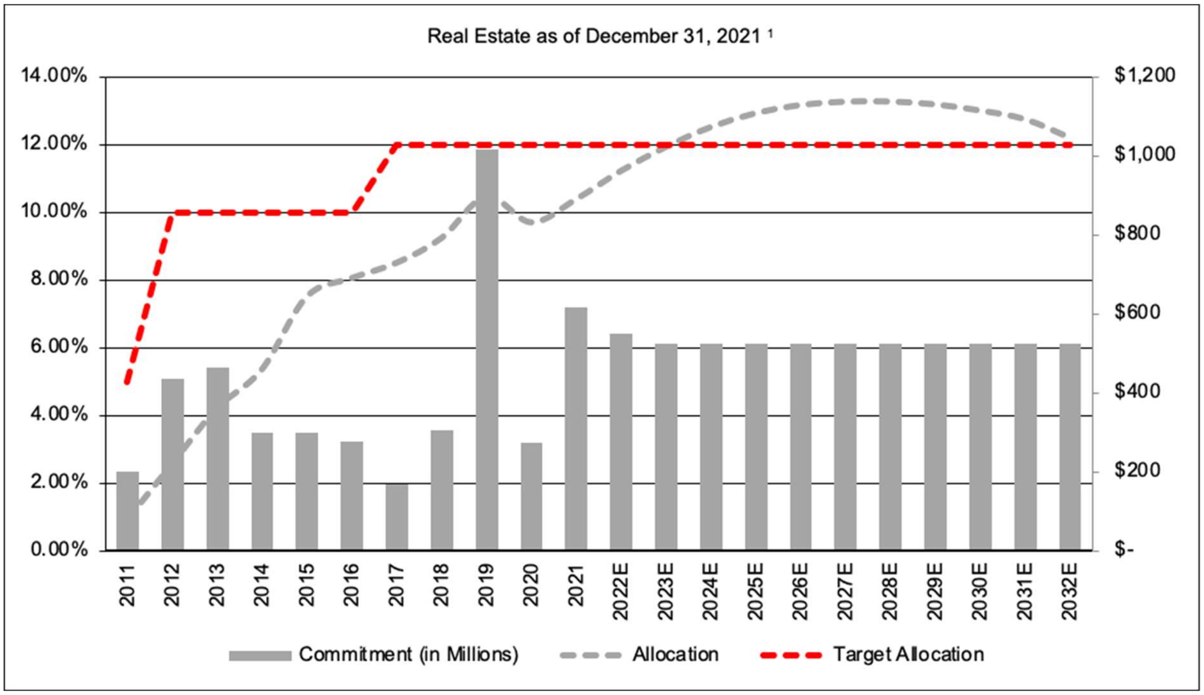
Investors' interest remains focused on industrial and multi-family investments (to the general exclusion of retail and office) due to those segments' superior growth prospects. Consequently, according to Green Street, throughout the year apartment and industrial cap rates remained at multi-decade lows. In response to high valuations, investors are exploring alternative property types to help achieve capital deployment objectives. These alternative property types include single family for rent; manufactured home communities; senior housing; student housing; self-storage; cold storage; data centers; and life sciences facilities.

For the year ended December 31, 2021, seven new commitments were made totaling $516MM:

1. $75MM AEW Partners IX (Non-Core)
2. $100MM Exeter Europe IV (Non-Core)
3. $50MM BPA Life Sciences (Non-Core)
4. $75MM KKR REPA III (Non-Core)
5. $75MM ARES EPEP III (Non-Core)
6. $100MM Carlyle Realty IX (Non-Core)
7. $41MM (€35MM) AXA Euro Life Science (Non-Core)

This year the Federal Reserve has begun an aggressive rate hike cycle to rein in inflation expectations that risk spiraling out of control. The impact on shorter term rates has been substantial. For instance, the Chicago Board Option Exchange 5-Year T-Note Index yield started the year at 1.26% and ended June at 3.04%. Inflation can help the top line of real estate enterprises though their ability to pass on inflation through their leases. Ignoring inflation escalators in lease provisions, most of the benefit derives from the ability to capture a mark to market when leases roll. That can happen quickly for short duration assets like hotels where room rates can reprice daily, and can take time in segments like office where lease durations are much longer. In liquid secondary markets like the one for REITs, the impact of rate driven valuation changes is much speedier than in the private markets. The Dow Jones US REIT Index, a broad proxy of REIT and real estate related public equities declined 20.02% for the first half of the year while private market returns have largely stayed positive. NACREIF reports that Average NPI Cap Rate Spreads to Treasuries are among the lowest seen in 20 years. Similarly, cap rates appear quite low relative to BAA 20-year corporate debt. Taken together this information suggests private market marks may have some catching up to do.

Recent Activity and Forward-Looking Strategy — The SIC Staff pacing model estimates approximately $525 MM of annual commitments will be required to continue to push the invested NAV of the Real Estate portfolio toward the long-term target allocation of 12%. *We caution readers that the output from pacing models is an analytically derived best guess of the rate of capital deployment required to meet long-run allocation targets. It is expected that deployments will deviate from modelled levels based on market conditions and the availability of attractive new offerings.* At year-end 2021, the core component of the NMSIC real estate portfolio represented 67% of the total portfolio against a target of 55%. The focus of new commitments in the near term will be toward non-core investments as we seek to capitalize on market opportunities likely to be created in part by the Fed's aggressive tightening to move closer to the neutral point in our core/non-core mix. Staff now assesses that it will be possible to make this adjustment without new redemptions in the core segment. The anticipated trajectory of SIC's Real Estate exposures, under current assumptions, is illustrated below:



Source: SIC Staff, Invient, RVK
Past commitments shown by vintage year, not commitment year.

In terms of targeted sectors, NMSIC expects to maintain its under-weight to retail and office and over-weight to industrial. Additionally, NMSIC expects to expand its exposure to Europe from the current level of 9% to a target range of 10-20%. Relative to Asia/Pacific, NMSIC intends to maintain exposure in the range of 5-15% against a current actual exposure of 6%.

Private Markets: Real Return

Asset Class Summary—The Council's Real Return portfolio is a multi-asset, multi-market portfolio constructed to generate returns based on factors different than those that drive returns of publicly-traded equity and traditional fixed income investments. NMSIC's Real Return portfolio consists of equity investments in infrastructure, energy (conventional and renewable), agriculture, timberland and financial assets (cash flow yielding investments under-pinned by real assets). Income generation is expected to be a notable part of the total return. These assets are expected to be advantaged over equities and bonds in an economic and financial market environment where growth is a little slower than average and inflation and interest rates are rising.

The Real Return asset class has an allocation of 10% within the broad LGPF and STPF portfolios. As of CYE 2021, the Portfolio represents approximately 8.2% of the Fund on a NAV basis. Within that 10% Real Return allocation, 80% is targeted towards Real Assets and 20% to Financial Assets. Starting in 2011, the Council began building investments in Real Assets of timberland, energy, farmland and infrastructure; and in financial assets via Master Limited Partnerships (MLPs). MLPs are companies that invest in oil and gas pipelines and related energy infrastructure and are similar to REITs in structure. Real estate and real asset debt strategies and liquid real assets may also be considered within the Financial Assets allocation. The table below shows the current allocations of the Real Return portfolio:

	% of Category		Value ($MM)
Category Sector	**Target**	**Actual**	**NAV**
Financial Assets	**10-30%***	**20.2%**	**$577**
MLP's	NA	69.7%	$402
Real Estate Debt	NA	30.3%	$175
Real Assets	**70-90%***	**79.8%**	**$2,284**
Agriculture	0-15%	11.3%	$259
Commodities	0-10%	0.0%	$0
Energy	0-50%	27.1%	$619
Infrastructure	0-50%	48.9%	$1,118
Timberland	0-20%	11.3%	$259
Other	0-15%	1.3%	$29
Total		**100.0%**	**$2,861**

Note: Invested Value (NAV) is as of 12.31.2021
**Target Weights for Financial Assets & Real Assets are reflective of target %'s of the entire Real Return Portfolio. Real Asset Sub-Sectors %'s reflect target and actual %'s of Real Assets only. These targets are subject to change pending an upcoming Structure Study and Investment Policy Statement Review.*

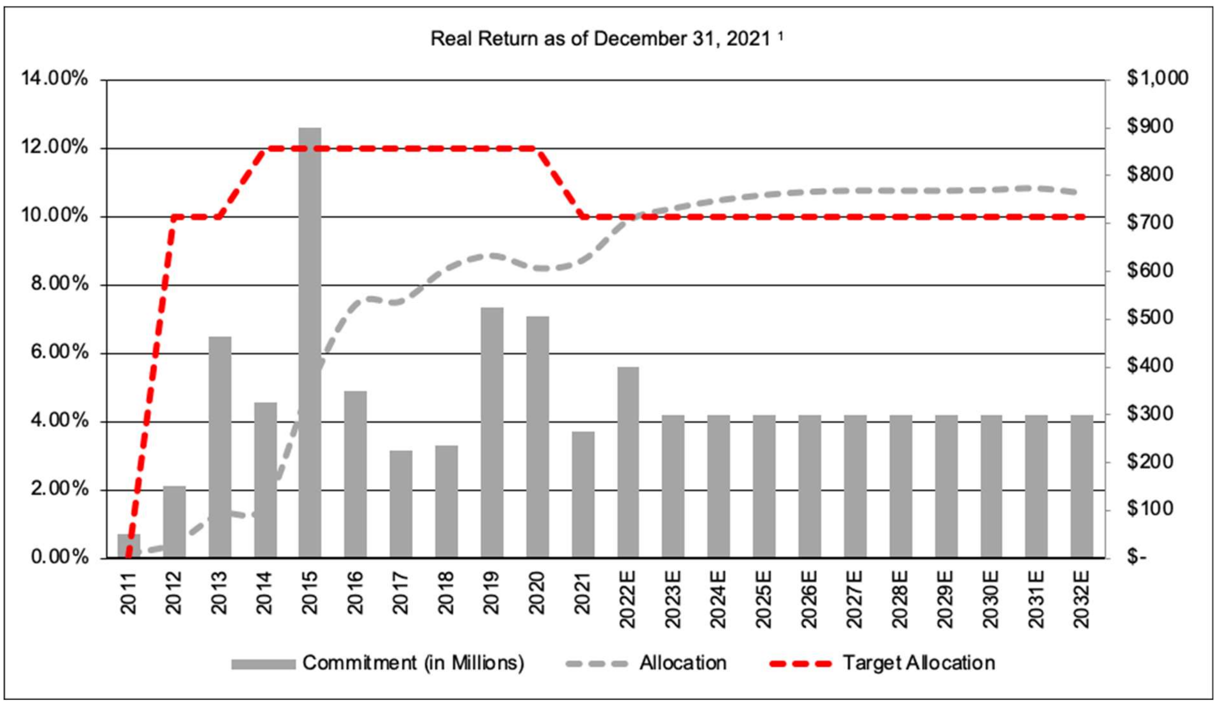
Recent Performance, Markets and Portfolio Strategy — During 2021, the MLP-dominated Real Return portfolio generated a 15.8% net time weighted return (TWR) while the Real Asset component generated a

12.8% net TWR. Robust recoveries in oil and gas prices, which were up 53% and 43% respectively, were the most important driver of these results. Investments in Energy and Infrastructure accounted for 84% of the Real Asset Portfolio's returns. Our Infrastructure basket is a collection of partnerships owning a mix of traditional non-energy infrastructure and predominantly midstream assets so it too benefits from rising Oil and Natural gas prices.

For the year ended 12/31/2021 five new Real Return 2021 commitments were approved totaling $350 MM:

1. $100MM Berkshire MF Debt III (Financial Assets);
2. $65MM Berkshire Bridge Loan II (Financial Assets);
3. $50MM Macquarie Infrastructure Partners V (Real Assets / Infrastructure)
4. $75MM KKR Diversified Core Infrastructure Fund (Real Assets / Infrastructure); and
5. $100MM Berkshire Bridge Loan II-A (Financial Assets).

Recent Activity and Forward-Looking Strategy--As shown below, the SIC Staff pacing model estimates approximately $300 MM of annual commitments will be required to migrate the invested NAV of the Real Return portfolio toward the long-term target allocation. *We caution readers that the output from pacing models is an analytically derived best guess of the rate of capital deployment required to meet long-run allocation targets. It is expected that deployments will deviate from modelled levels based on market conditions and the availability of attractive new offerings.* The anticipated trajectory of SIC's Real Return exposures, under current assumptions, is illustrated below:



Source: SIC Staff
Past commitments shown by vintage year, not commitment year.

Conventional energy has been a roller-coaster for the past couple of years. A demand collapse associated with the Covid pandemic coupled with a too-slow supply response left the globe oversupplied and

resulted, for the first time, in futures prices for oil trading at negative values. A robust recovery from Covid saw prices reach pre-pandemic levels by 1Q21. Though the span of this dislocation was less than one year, the damage to many upstream and midstream conventional energy investments was significant. In addition to poor returns, concerns about global warming further tainted the conventional energy sector and effectively starved the US oil and gas value chain of capital. It is expected that this capital flight will result in some rewarding investment opportunities for investors still willing consider the sector.
At the same time, investor interest in the renewables sector continues to grow as corporate and government mandates push for the development of clean energy sources. Accordingly, investment returns have been squeezed in this sector even as re-contracting risks are ignored. While renewable power generation is richly valued, there may be opportunities in supporting/enabling technology such as battery storage and power distribution infrastructure. Finally, the energy transition is likely to be a decades long process and helping to build natural gas infrastructure that enables the marginal substitution of gas for "dirtier" coal or oil is a benefit to the environment.

Infrastructure investments are valued for their resilience and inflation protection attributes. Core infrastructure investments focus on irreplaceable, long-life assets with inflation linked revenue streams, and ideally, volume characteristics that are minimally GDP dependent. Such assets can generate attractive current distribution yields with distributions that can grow over time, and asset values that should appreciate over time at least in line with replacement costs. Representative investments could include utilities, airports, ports, toll-roads, and railroads. The communications sector which includes towers, data centers, has been a strong performer and is fueled by rapid growth in demand for assets to move, process and store data. The growth, prospective returns, and other characteristics of communications businesses give this segment a risk profile that is more core-plus than core.

Returns in Agriculture have been low but stable as measured by the NCREIF Farmland Index. Over the prior five years, the gross return has been 5.7% annualized. Over longer periods with higher inflation, returns have compounded at low double-digit rates. The Farmland Index has generated negative quarters only twice since 1991. Although viewed as a relatively safe asset class with correspondingly low return expectations, agriculture investments can be exposed to risks from currency movements, commodity pricing, regulatory changes, ESG concerns, weather related events, unforeseen supply/demand shocks, consumer preference shifts and shifting geopolitics.

Timberland returns, measured by the NCREIF Timberland Property Index, have achieved a 4.0% annualized gross return over the prior five years. The US South makes up the largest component of the index and this region has been hampered by oversupply, leading to stagnant log prices over the past decade. Demographic trends and low vacancy rates in single and multi-family rentals in the region should drive improved demand. Recent sawmill capacity additions have eased processing constraints and log prices have improved.

While returns in Timber and Agriculture have over our investment period have been disappointing, both sectors benefit from strong investor interest due to historical inflation protection and environmental benefits such as carbon sequestration.

Financial Asset segment returns have been dominated by the performance of the basket's largest component, the currently 70% invested in Master Limited Partnerships (common vehicles for the ownership of midstream assets). Our MLP portfolio has been a lethargic performer since NMSIC's inception (May, 2015) though a very strong 1Q22 leaves us with a modestly positive IRR. The next structure study will address the merits and demerits of owning midstream assets through the MLP structure.

Going forward, NMSIC's investment focus will be on making new commitments to traditional and energy transition focused infrastructure, while exposure to conventional energy, particularly in the upstream portion of the value chain, will decline. We will likely evaluate select commodity and agriculture exposures as well.

Private Markets: Private Equity

***Asset Class** Summary* – The Private Equity portfolio (aka the National Private Equity Program) consists of four categories – Buyout, Growth Equity, Special Situations and Venture Capital – and continues to serve an important role in enhancing overall portfolio return generation and diversification. This asset class, although correlated to public equity markets, often benefits as private equity managers are afforded additional flexibility to pursue operational excellence and improvement in their company investments without the harsh spotlight of public market scrutiny. Private equity also adds exposure to the long-term growth potential of private companies, which will likely result in an illiquidity premium in this asset class. This is particularly important as more companies are now inclined to stay private for longer time periods than historical averages.

Recent performance, markets and portfolio strategy – Private equity investments have one of the highest long-term return expectations of all the asset classes and for the 12 months through March 31, 2022, the Private Equity portfolio produced a net IRR of 30.7%. This performance was better than the median peer fund private equity portfolio return of ~18.3% (per the Wilshire Trust Universe Comparison Service, aka TUCS) and the 27.6% increase in the Cambridge US Private Equity Index. Historical performance has been impacted by poor performance of many funds in the pre-2011 vintage years, where poor manager / fund selection was likely impacted by pay-to-play considerations. However, the influence of these legacy investments on performance should decline in the future, as funds in the 2009 and prior vintage years now represent ~2% of net asset value, down significantly from ~29% at the end of 2016.

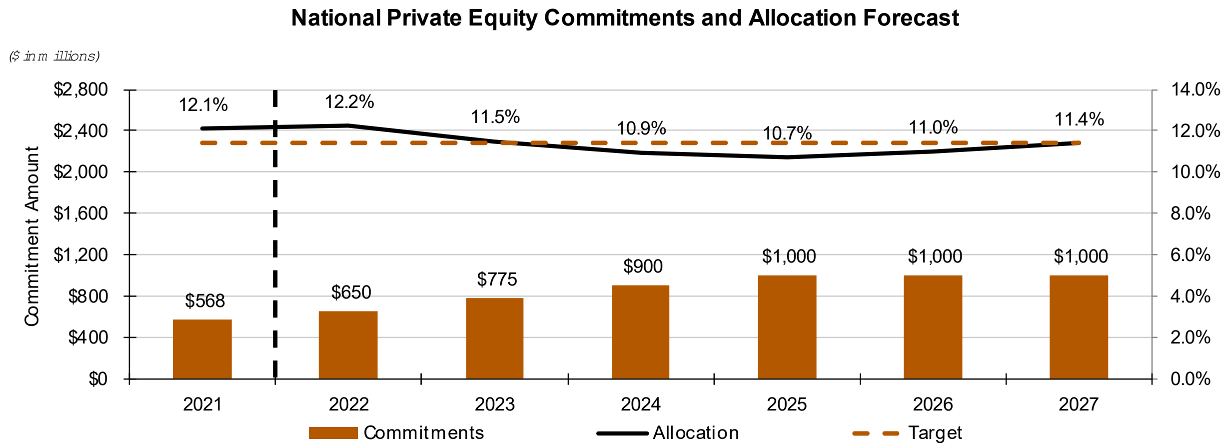
Portfolio strategy continues to focus on identifying a set of "core managers" to build longer term relationships for our private equity program. Since inception performance (net IRR) of the five largest GP exposures as of March 31, 2022 is 20.3%, greatly exceeding the historical net IRR of 13.1% for the program. Larger commitments to successful core managers will *eventually* result in a decrease in the number of GP relationships / fund commitments and will be very beneficial for 1) portfolio monitoring and 2) reducing the administrative burden of a large number of relationships. The number of private equity funds (currently 121), in the absence of a secondary sales option, should continue to gradually decline.

Recent activity and forward-looking strategy – Private equity consultant Mercer utilizes a pacing model to help guide the target range of annual commitments for the National Private Equity Program. The pacing model serves two main functions – 1) to ensure adequate vintage year diversification for the portfolio, and 2) to maintain our long-term target allocation over a 3-5 year time frame.

The current target allocation for the National Private Equity Program is 13% of LGPF and 5% of the STPF, which works out to a weighted average allocation of ~11.4% across the two funds.

This excludes the 9% target allocation in the STPF for the New Mexico Private Equity Program. The total target allocation for private equity in the STPF is 14%, consisting of the 5% for the National Private Equity Program and the 9% for the New Mexico Private Equity Program.

At this time, the pacing model projects near-term annual commitments of approximately $600 million to $700 million would be adequate to achieve our target for the National Private Equity Program in that time frame. The model is re-evaluated annually for potential enhancements.



Source: Mercer.

Each year's private equity commitments are based on a predetermined amount. Model assumes overall portfolio returns of 4.0% (net of all contributions and distributions) and private equity returns of 12%. Different return assumptions may result in a different pacing target. Pacing targets should be evaluated on a regular basis. Aggregate vintage year performance can differ by year and increasing commitments during a lower performing vintage year could lead to lower portfolio performance.

Note that 2021 includes approximately $158 million of commitments that had been approved prior to 2020, but had first drawn capital in 2021, in addition to those commitments approved in 2021.