

# NEW MEXICO EDUCATIONAL RETIREMENT BOARD

## CORE FIXED INCOME INVESTMENT POLICY

October 23, 2015

### **I. Introduction**

The fixed income team of the New Mexico Educational Retirement Board (NMERB) will manage the Core Fixed Income portfolio (Fund) internally and invest in the U.S. dollar (USD)-denominated debt capital markets. Eligible debt instruments include, but are not limited to, U.S. Treasuries, Agency debentures, residential and commercial mortgage-backed securities, asset-backed securities, municipal debt, investment-grade corporate instruments, and cash equivalents. Portfolio managers may use derivatives to take synthetic long positions and to hedge risks associated with credit, duration, idiosyncratic and active risk, but the mandate is primarily a long-only strategy and portfolio managers may not use derivatives as leverage in the Fund.

The investment objective of the Fund is to outperform the total return of the policy benchmark over a full market cycle through active portfolio management. The policy benchmark for the Fund is the Barclays Capital U.S. Aggregate Bond Index. This bond market benchmark is a passive representation of the publicly traded investment grade U.S. debt market.

The NMERB will manage the Fund according to written investment guidelines detailed in the Core Fixed Income Investment Policy. The Fund will generally be diversified across and within sectors to limit the volatility of investment returns and to minimize the impact of large losses associated with individual investments. The fixed income staff (Staff) will be comprised of the fixed income portfolio managers and their supervisor.

### **II. Strategic Objectives**

The Staff will seek to provide the following objectives in the management of the Fund:

- A. Portfolio diversification. The Fund should enhance diversification to the NMERB total investment portfolio because of the historically lower return correlations with other asset classes.
- B. Liquidity. Because the securities held in the Fund are expected to be easily bought and sold and to provide recurring income, the Fund should be able to provide liquidity to the total investment portfolio.
- C. Portfolio volatility reduction. Core bonds have provided lower return volatility than most asset classes and should reduce the NMERB's overall return volatility.

### **III. Benchmark**

The policy benchmark is the Barclays Capital U.S. Aggregate Bond Index, which is a passive market-weighted representation of the publicly traded U.S. investment grade debt market.

### **IV. Investment Objective**

The investment objective is to outperform the policy benchmark over a full market cycle while staying within the specific restrictions and guidelines detailed in this policy. The mandate is to invest in USD-denominated fixed income instruments to earn more than the total return on the policy benchmark. The Fund investments shall be subject to the prudent investor rule as codified in the New Mexico statutes.

### **V. Eligible Securities**

- A. Indexed Bonds. All securities that are included in the benchmark index are eligible for investment.
- B. Non-Indexed Bonds. Non-indexed (securities not included in the Barclays Capital U.S. Aggregate Bond Index) bonds and their restrictions include the following:
  1. Permanently unregistered Rule 144(a) securities and other private placements.
  2. High Yield and Crossover Bonds
    - a. Bonds rated BB+/Ba1 down to D are considered high yield bonds. Only high yield bonds rated B-/B3 or better are eligible for the Fund.
    - b. Crossover bonds hold different credit ratings (investment grade and high yield) between the nationally recognized rating agencies. These split-rated bonds are eligible for the Fund if they also meet the criteria of V. B. 2. a. above.
    - c. The Fund may continue to hold bonds that were purchased within the guidelines of the Core Fixed Income Investment Policy that are subsequently downgraded below B-/B3 at the discretion of the Staff.
  3. Other Non-Indexed Securities

The Fund may hold USD-denominated investment grade securities of the following types:

- a. Securities that would be included in the benchmark sectors but do not meet other benchmark eligibility requirements.
- b. Floating rate securities.
- c. Convertible bonds.

- d. Treasury Inflation-Protected Securities (TIPs), strips and non-agency mortgage-backed securities (MBS).
  - e. Exchange traded funds (ETFs) that hold securities otherwise eligible for investment in the Fund.
- C. Derivatives. The Fund may utilize synthetic financial instruments, both exchange-traded and over-the-counter (OTC), either to establish a long position or for hedging. Derivatives will not be used to leverage the Fund. The Staff will present an informational report at the regularly scheduled meetings of the NMERB Investment Committee that will include the derivative trades in the Fund.
- 1. U.S. Treasuries futures contracts. The Fund may invest in exchange-traded futures contracts on U.S. Treasuries, which are settled through a clearing corporation that is the guarantor of the transaction. Staff will evaluate clearing corporations at the start of the relationship and annually thereafter. This will include ensuring that they are in good standing with the regulatory agencies and review of the annual audit reports.
  - 2. Swap contracts. The Fund may utilize the following types of swap contracts:
    - a. Interest Rate Swaps. The Fund may use swaps as a hedge against rising or falling rates by adjusting the interest rate sensitivity of the portfolio. Swaps must be denominated in USD.
    - b. Credit Default Swaps (CDS). The Fund may invest in single name credit default swaps to hedge against the default risk of a specific bond issue or as an alternative to holding the underlying security if an opportunity exists to own the CDS at a more attractive price than owning the cash bond.
    - c. Credit Default Index Swaps (CDX). The Fund may invest in CDX (indexed baskets of single-name credit default swaps such as the investment grade series of iTraxx) as a hedge against deteriorating credit conditions or as an alternative to holding the underlying index if an opportunity exists to own the CDX at a more attractive price than owning the cash index bonds.

Staff will perform the evaluations described in V.C.1. for clearing corporations that settle swap contracts. Other swap contracts are settled directly with the swap counterparty. The Staff shall ensure that each swap counterparty possesses an A-rating or higher. Staff will perform a credit review of the broker counterparty prior to the start of a trading relationship and at least every six months thereafter. Prior to trade execution, the NMERB and the executing counterparty will have executed an International Swaps and Derivatives Association (ISDA)-compliant counterparty agreement.

## **VI. Ranges for Eligible Securities**

The following ranges will apply to the eligible securities. Unless otherwise specified, the limitations will be measured at the end of the month and the Staff will have ninety (90) days to correct any discrepancies from the guidelines.

- A. Indexed Bonds. At least 70% of the market value of the Fund will be comprised of fixed income securities that are eligible for the benchmark index, including derivatives that reference eligible indexed bonds.
- B. Non-Indexed Bonds. The Fund may not hold more than 30% of the market value of the Fund in non-indexed bonds.
  - 1. The Fund may hold up to 10% of the market value of the Fund at time of purchase in private placements, including Rule 144(a) securities.
  - 2. The Fund may hold up to 10% of the market value of the Fund at the time of purchase in high yield and crossover bonds.
- C. Derivatives. The Fund may hold up to 10% of the market value of the Fund in long derivative instruments. In addition, the Fund may hold up to 10% of the market value of the Fund in short derivative positions for hedging purposes.

## **VII. Investment Guidelines**

- A. Duration of the portfolio may not exceed the duration of the Barclays Capital U.S. Aggregate Bond Index by more than one (1.00) year.
- B. The Fund will maintain an average credit quality no less than A3/A-. The custody bank Government Short-Term Investment Fund and Short-Term Investment Fund will be considered AAA-rated.
- C. No single issuer may comprise more than 5% of the total Fund (excluding Treasuries and GSE issuance).
- D. The Fund will hold a minimum of 50% of the benchmark weighting of Treasuries on a relative basis (for example, if the U.S. Treasury sector weighting in the benchmark is 40%, then the Fund will hold not less than 20%).
- E. The NMERB has adopted a prohibition against direct investment in the securities of companies doing business in Sudan. The Staff will use the Sudan Company Report by the Genocide Intervention Network (<http://www.genocideintervention.net/network>) to implement the prohibition.

## **VIII. Valuation**

The book of record for monthly valuation will be the custody bank. Staff may challenge custody pricing based on independent third party information that would impact portfolio performance.

## **IX. Performance Measurement**

The NMERB's general investment consultant will provide monthly performance compared to the benchmark.

## **X. Risk Management**

The Fund will use a risk management structure to:

- A. Identify and understand relative and absolute risks.
- B. Decompose systematic and idiosyncratic risk exposures.
- C. Examine risk across factors and sectors.
- D. Capture cross-asset and issuer-level exposures in the broader portfolio.

## **XI. Compliance**

To the extent possible, the custody bank will measure compliance with this policy. Staff will be required to have other measures in place to track compliance with the policy in the areas that the custody bank does not measure.

## **XII. Authorized Investment Trades**

The following people are authorized to initiate fixed income trades on behalf of the Fund:

- A. The fixed income portfolio managers.
- B. The fixed income portfolio manager supervisor.
- C. The Chief Investment Officer.

## **XIII. Trade Approval Policy**

Portfolio managers will complete a trade justification for each trade. All trades will require an additional approval from one of the following persons:

- A. Another fixed income portfolio manager.
- B. The fixed income portfolio manager supervisor.
- C. The Chief Investment Officer.
- D. The Deputy Chief Investment Officer.

## **XIV. Broker and Counterparty Relationships**

The Staff will maintain an active list of approved brokers, each of which must complete the approval process prior to being placed on the approved list. The Staff will prepare an approved broker list at least twice a year.

- A. All brokers must meet the following:
  - 1. Net capital must be above \$50 million USD.
  - 2. Audited financial statements must be less than two years old and must have a “clean opinion.”

3. Broker must be able to settle both Depository Trust Company (DTC) and Euroclear.
  4. Broker must demonstrate the ability to maintain business continuity in information technology, communications and management.
  5. Compliance with other ERB Policies, as applicable.
- B. The Staff will consider the following items in evaluating each broker:
1. Liquidity (the ability and willingness to use their balance sheet).
  2. Syndicate involvement (if applicable).
  3. Quality of research and strategy.
  4. Access to staff (traders, analysts, strategists and economists).
  5. Commitment and capabilities of the salesperson covering the NMERB account.
  6. Operations and back-office efficiency, accuracy and prompt settlement.
- C. The Staff may use electronic trading platforms to facilitate trades.
- D. Broker agreements to facilitate trading may be executed by the Chief Investment Officer, the Executive Director, or the Deputy Director.

## **XV. Best Execution**

The Staff shall execute trades on a competitive basis when it is practical to do so in the Staff's judgment. A minimum of three firms will be included on each trade for competitive trades, whenever feasible. This does not include securities issued in the primary market, which are not traded competitively. In addition, certain security issues may not have wide market coverage, negating the ability to receive competitive bids or offers.

## **XVI. Corporate Actions**

The following people are authorized to make elections for fixed income corporate actions on behalf of the Fund:

- A. The fixed income portfolio managers.
- B. The fixed income portfolio manager supervisor.
- C. The Chief Investment Officer.