# New Mexico Educational Retirement Board

## Combined Portfolio Quarterly Board Summary

September 30, 2011

*Presented By*

REAL ASSET Portfolio Management
Real Estate
Natural Resources
Infrastructure

## *Table of Contents*

# Portfolio Summary

## Portfolio Review

As of September 30, 2011, New Mexico Educational Retirement Board ("NMERB") had a fund balance of $8,682,276,955. NMERB's target allocations to real estate and natural resources are 6% ($520,936,617) and 3% ($260,468,309), respectively, for a total target allocation of 9% of the Portfolio or $781,404,926. Net asset value ("NAV") of the combined portfolio at September 30, 2011 was $471,612,133 with $105,815,337 of capital committed but uncalled, for a total allocation of $577,427,470, or 73.9% of the target .

As of September 30, 2011, NMERB had $279,225,316 in commitments to private real estate and natural resource investments and $325,344,681 invested in REIT funds, leaving $176,834,929 remaining to reach the target allocation. Since inception in 2007, NMERB made $962,249,459 in capital contributions, including $281,702,084 to recognize the value of in-house REITs at inception. Distributions and Redemptions since inception totaled $67,764,831 and $371,218,620 respectively, as of September 30, 2011.

## Summary of Current Quarter Returns

Net Asset Value $471,612,133 as of Quarter Ended 9/30/2011

| | Current Quarter | Since Inception 4/19/07 |
|---|---|---|
| Total Return, Gross | -11.02% | -3.78% |
| Total Return, Net | -11.13% | -4.04% |
| | | |
| Benchmark | | |
| NCREIF ODCE | 3.52% | -5.59% |
| CPI (All Consumers) | 0.52% | 1.75% |

### Portfolio Highlights

The real estate portfolio is expected to generate returns in excess of the National Council of Real Estate Investment Fiduciaries Index ("NCREIF Index") over rolling five year investment time horizons.

Since Inception Net IRR

Total Portfolio -4.17%

Current Quarter

Paid in Capital (PIC) 0.64 x

Distribution Paid in Capital (DPI) 0.21 x

Residual Value Paid in Capital (RVPI) 0.94 x

Total Value Paid in Capital (TVPI) 1.16 x

## Summary of Time Weighted Portfolio Returns

Net Asset Value $471,612,133 as of Quarter Ended 9/30/2011

| | QTR. | 1 YEAR | 3 YEAR | 5 YEAR | SINCE INCEPTION |
|---|---|---|---|---|---|
| **Total Return, Gross** | -11.02% | 5.60% | -0.74% | N/A | -3.78% |
| **Total Return, Net** | -11.13% | 5.27% | -1.06% | N/A | -4.04% |
| | | | | | |
| **Benchmarks[1]** | | | | | |
| **NPI** | 3.30% | 16.10% | -1.45% | 3.40% | -1.13% |
| **NCREIF ODCE Index[2]** | 3.52% | 18.27% | -6.40% | 0.01% | -5.59% |
| **EPRA NAREIT Equity Index** | -15.07% | 0.93% | -1.99% | -2.43% | -1.61% |
| **NCREIF Agriculture Index** | 1.97% | 12.08% | 9.57% | 1.71% | 11.18% |
| **NCREIF Timberland Index** | -0.35% | 0.26% | -0.42% | 5.83% | 4.59% |
| **CPI (All Consumers)** | 0.52% | 3.87% | 1.22% | 2.26% | 1.75% |

## Portfolio Statistics

| | CURRENT QUARTER | 12/31/2010 | 12/31/2009 | 12/31/2008 |
|---|---|---|---|---|
| **Portfolio Market Value** | $471,612,133 | $476,599,485 | $390,763,309 | $298,239,466 |
| **Committed Uncalled** | 105,815,337 | 46,411,118 | 50,752,104 | 17,813,753 |
| **Portfolio Market Value + Committed Uncalled** | $577,427,470 | $523,010,603 | $441,515,413 | $316,053,219 |
| | | | | |
| **Total Number of fund Investments** | 12 | 7 | 7 | 5 |
| **Total Number of Managers** | 10 | 8 | 8 | 6 |



[1] All benchmark data is presented gross of fees.

[2] The NCREIF Fund Indexes (NFI)-Open-End Diversified Core Equity ("ODCE") is a capitalization-weighted, time weighted return index. Since Inception returns are calculated to match the inception date of the Fund.

## Calendar Year Time Weighted Returns

Net Asset Value $471,612,133 as of Quarter Ended 9/30/2011

| | YTD | 12/31/2010 | 12/31/2009 | 12/31/08 |
|---|---|---|---|---|
| **Income Return, Gross** | 2.74% | 4.67% | 6.49% | 2.74% |
| **Appreciation Return, Gross** | -5.25% | 22.10% | 15.62% | -37.35% |
| **Total Return, Gross** | -2.60% | 27.53% | 23.05% | -35.25% |
| **Total Return, Net** | -2.84% | 27.18% | 22.62% | -35.38% |
| | | | | |
| **Benchmarks** | | | | |
| **NPI** | 10.98% | 13.11% | -16.86% | -6.46% |
| **NCREIF ODCE Index** | 12.65% | 16.36% | -29.76% | -9.99% |
| **EPRA NAREIT Equity Index** | -6.05% | 27.95% | 27.99% | -37.73% |
| **NCREIF Agriculture Index** | 5.94% | 8.81% | 6.32% | 15.84% |
| **NCREIF Timberland Index** | 1.06% | -0.15% | -4.75% | 9.52% |
| **CPI (All Consumers)** | 3.52% | 1.50% | 2.72% | 0.09% |

## Fund Multiples

| | 9/30/2011 | 12/31/2010 | 12/31/2009 | 12/31/2008 |
|---|---|---|---|---|
| **PIC Multiple**[3] | 0.64 x | 0.77 x | 0.72 x | 0.87 x |
| **Distribution Multiple**[4] | 0.21 x | 0.01 x | 0.01 x | 0.18 x |
| **Residual Value Multiple**[5] | 0.94 x | 1.08x | 0.90 x | 0.67 x |
| **Total Value Multiple**[6] | 1.16 x | 1.09 x | 0.90 x | 0.85 x |

[3] The PIC Multiple is the cumulative drawdown amount divided by committed capital. This multiple indicates how much of committed capital has been drawn down. As the REIT funds do not have capital commitments, they are excluded from the calculation of the PIC Multiple.

[4] The Distribution Multiple ("DPI") measures the portion of fund returns distributed to investors. When DPI is the equivalent of 1, the Fund has broken even. A DPI of greater than 1 indicates that the Fund has generated profit to the investors.

[5] The residual Value Multiple ("RVPI") measures the portion of returns that are unrealized.

[6] The Total Value Multiple ("TVPI") provides information regarding the value of the investment relative to its cost basis, not taking into consideration the time invested.

## Portfolio Component Returns

| | CURRENT QUARTER | 1 YEAR | 3 YEAR | 5 YEAR | SINCE INCEPTION[7] |
|---|---|---|---|---|---|
| **Private Real Estate** | -0.24% | 16.80% | -0.03% | N/A | -1.47% |
| **NCREIF ODCE Index** | 3.52% | 18.27% | -6.40% | 0.01% | -5.59% |
| | | | | | |
| **REIT Funds** | -15.23% | 1.34% | -2.41% | N/A | -4.83% |
| **NAREIT Equity REIT Index** | -15.07% | 0.93% | -1.99% | -2.43% | -1.61% |
| **Total Real Estate** | **0.16%** | **18.01%** | **1.09%** | **N/A** | **-0.22%** |
| | | | | | |
| | | | | | |
| **Natural Resources** | -0.30% | 3.12% | N/A | N/A | -0.04% |
| **Mitigation Banking** | -8.79% | N/A | N/A | N/A | -8.79% |
| **Timber** | 0.65% | 3.69% | N/A | N/A | 0.18% |
| **NCREIF Agriculture Index** | 1.02% | 4.18% | 4.16% | 4.19% | 4.16% |
| **NCREIF Timberland Index** | 1.00% | 4.06% | 4.06% | 4.12% | 4.06% |



[7] Since inception benchmark returns calculated using match inception date of the related portfolio segment.

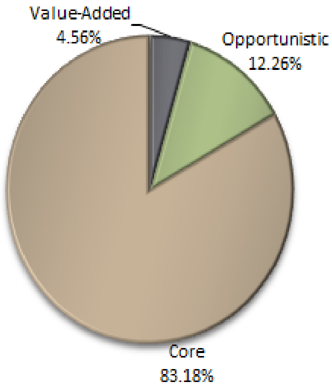
# Portfolio Diversification and Concentration of Risk

## Top Ten Portfolio Exposures by At Share Market Value

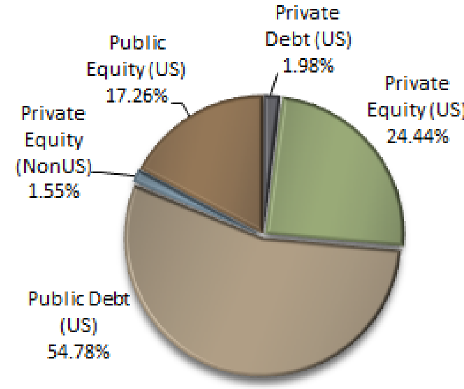
| | | | | | |
|---|---|---|---|---|---|
| 1 | *Simon Property Group Inc. - REIT Securities* | | | | |
| | Market Value | $35,196,020 | Allocated Market Value | $35,196,020 |
| | Cost | $24,836,886 | Allocated Cost | $24,836,886 |
| 2 | *Public Storage - REIT Securities* | | | | |
| | Market Value | $23,402,541 | Allocated Market Value | $23,402,541 |
| | Cost | $12,393,338 | Allocated Cost | $12,393,338 |
| 3 | *Boston Properties Inc. - REIT Securities* | | | | |
| | Market Value | $14,675,839 | Allocated Market Value | $14,675,839 |
| | Cost | $12,252,016 | Allocated Cost | $12,252,016 |
| 4 | *Ventas Inc. - REIT Securities* | | | | |
| | Market Value | $14,331,088 | Allocated Market Value | $14,331,088 |
| | Cost | $11,620,633 | Allocated Cost | $11,620,633 |
| 5 | *Equity Residential Properties Trust – REIT Securities* | | | | |
| | Market Value | $12,379,813 | Allocated Market Value | $12,379,813 |
| | Cost | $ 7,778,091 | Allocated Cost | $ 7,778,091 |
| 6 | *HCP Inc. - REIT Securities* | | | | |
| | Market Value | $11,489,968 | Allocated Market Value | $11,489,968 |
| | Cost | $10,015,274 | Allocated Cost | $10,015,274 |
| 7 | *Vornado Realty Trust – REIT Securities* | | | | |
| | Market Value | $11,075,772 | Allocated Market Value | $11,075,772 |
| | Cost | $10,157,265 | Allocated Cost | $10,157,265 |
| 8 | *Prologis Inc. – REIT Securities* | | | | |
| | Market Value | $ 8,957,829 | Allocated Market Value | $ 8,957,829 |
| | Cost | $14,485,876 | Allocated Cost | $14,485,876 |
| 9 | *Avalonbay communities - REIT Securities* | | | | |
| | Market Value | $8,630,049 | Allocated Market Value | $8,630,049 |
| | Cost | $6,054,530 | Allocated Cost | $6,054,530 |
| 10 | *Hospitality Portfolio – Joint Venture – Northeast* | | | | |
| | Market Value | $312,841,871 | Allocated Market Value | $7,900,196 |
| | Cost | $208,275,256 | Allocated Cost | $5,259,575 |

## Portfolio Diversification[8]

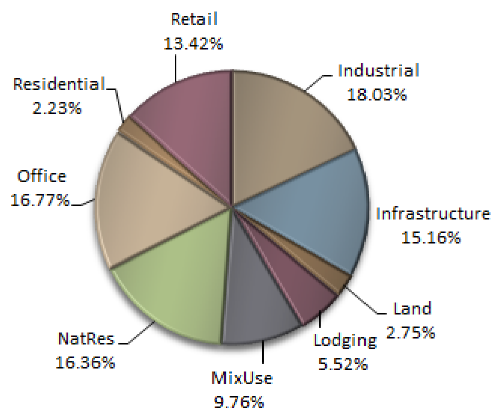
### *Diversification by Risk Category*



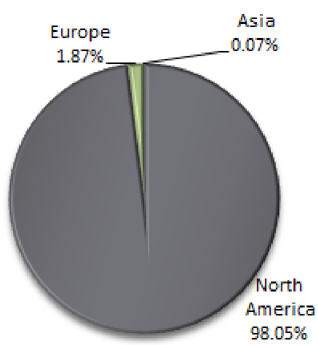

### *Diversification by Investment Type*



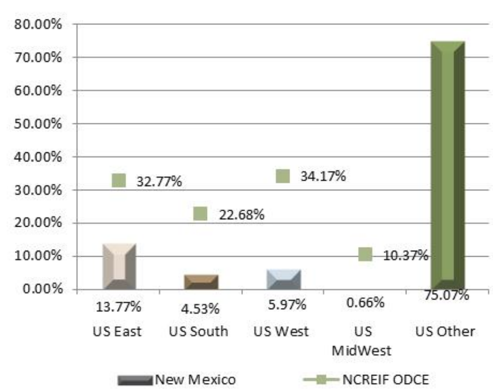

### *Diversification by Property Type – Private Equity*




### *Global Diversification*




### *United States Diversification*




[8] Diversification data is based on net investment asset values.

# Market Overview

## Real Estate Capital Market Conditions

Troubled residential and commercial real estate and loan portfolios held by the world's largest financial institutions appear to finally be coming to market. Transaction volume continues to increase as evidenced by Moody's Real CPPI statistics through September 2011 that report average monthly transaction volume of 192 transactions, versus 144 in 2010 and 96 for 2009. Distressed transactions have consistently represented about 25% of all transaction volume. Despite the increase in transaction activity, it is difficult for investors in the market to assess the magnitude assets that will trade in the near term as many lenders continue to extend loan maturity dates in return for partial principal pay downs. We expect the percentage of all trades represented by distressed transactions to increase over 2012. The result could be a long drawn out bottoming in pricing.

Patience and discipline have historically been rewarded in the real estate markets and this is a time for both. This is not the time to swing for the fences or to concentrate investment exposure. As a result, we believe RAPM clients should be focused on funds where the manager has a keen eye on intrinsic value metrics such as discount to replacement cost, yield on in-place (not forecasted) rents and occupancy, and sound first-to-lease locations. High quality real estate owned in distressed capital structures and by under-capitalized owners should be the focus of these managers and funds.

Institutional investors seemingly seeking the safety of core real estate have driven up prices in particular in major markets such as NYC, the San Francisco bay area, and less so Washington DC. Year-to-date NCREIF NPI total return of 10.97% (16.1% for the year ended 9/30/11) is evidence of the strong appetite for leased core properties. In the midst of this increase, during Q3 lenders decided to begin pulling back on proceeds available to fund core transactions. Debt availability for value added transactions remains limited. This pullback in loans for core properties should temper further price increases. As a result, after recovering approximately half the peak to trough decline, we expect appreciation to moderate in 2012.

# Market Conditions by Property Type

## Apartments

- NATIONAL VACANCY RATE DECREASED 30 BPS FROM 5.9% AT THE END OF Q2 TO 5.6% AT THE END OF Q3
- DEMAND CONTINUED AT THE SAME PACE AS Q2 WITH NET ABSORPTION OF 36,000 UNITS
- 8,200 APARTMENT UNITS WERE DELIVERED IN Q3, DOWN SLIGHTLY FROM Q2
- ASKING AND EFFECTIVE RENTS INCREASED 0.6% AND 0.7% RESPECTIVELY OVER Q3 WITH RENT GROWTH EXPECTED TO ACCELERATE IN THE COMING QUARTERS
- MARKETS REPORTING RENTAL GROWTH INCLUDE SAN JOSE, SAN FRANCISCO, SEATTLE, NEW YORK AND WASHINGTON DC
- TRANSACTION VOLUME WAS $13.3 BILLION IN Q3, AN INCREASE OF 31.0% FROM THE SAME PERIOD IN 2010; AVERAGE TRANSACTION CAP RATES DECREASED BY 10 BPS TO 6.3%

## Industrial

- NATIONAL VACANCY DECLINED BY 20 BPS TO 13.7% DURING Q3
- IN THE LAST FOUR QUARTERS, OVER 125.3 MSF OF INDUSTRIAL SPACE WAS ABSORBED, WITH 35.5 MSF ABSORBED IN Q3 ALONE, THE HIGHEST QUARTERLY ABSORPTION RATE SINCE THE INDUSTRIAL SECTOR BEGAN TO RECOVER IN 2010
- SIGNIFICANT DEMAND FOR LARGE WAREHOUSE SPACE REPRESENTED THE BULK OF LEASING ACTIVITY DURING THE QUARTER
- RENTS FOR INDUSTRIAL SPACE APPEAR TO HAVE STABILIZED AND REMAINED UNCHANGED DURING Q3 AFTER FALLING 6.5% IN 2010
- TRANSACTION VOLUME WAS $6.6 BILLION DURING Q3, A 37% INCREASE OVER THE SAME PERIOD IN 2010; CAP RATES WERE UNCHANGED AT 7.9%

## Office

- OFFICE VACANCY REMAINED UNCHANGED AT 16.2% IN Q3, FOLLOWING FIVE CONSECUTIVE QUARTERLY DECLINES; CBD AND SUBURBAN OFFICE VACANCY REMAINED AT 13.0% AND 18.0%, RESPECTIVELY
- ACCORDING TO CBRE-EA, VACANCY FELL IN 33 OUT OF 62 MARKETS DURING THE QUARTER, WITH THE LARGEST DECLINES IN AUSTIN AND SAN JOSE; THE LARGEST VACANCY INCREASES WERE IN CINCINNATI, MIAMI AND JACKSONVILLE
- SUPPLY OF NEW OFFICE SPACE GREW BY 2.2 MSF IN Q3
- SALES CONTINUE TO BE DRIVEN MOSTLY BY CBD PROPERTIES IN MAJOR MARKETS, MAINLY WASHINGTON DC AND NEW YORK CITY; CAP RATES FELL TO 7.3% NATIONWIDE
- TRANSACTION VOLUME FOR THE QUARTER WAS $14.8 BILLION, A 40.0% INCREASE OVER THE SAME PERIOD IN 2010

## Market Conditions by Property Type – Continued

### Retail

- RETAIL SALES CONTINUE TO IMPROVE
- NEIGHBORHOOD AND COMMUNITY SHOPPING CENTER OCCUPANCY REMAINED UNCHANGED AT 11.0% DURING THE QUARTER; ASKING AND EFFECTIVE RENTS WERE ALSO REPORTED TO BE UNCHANGED
- 812,000 SF OF NEW SPACE WAS DELIVERED IN Q3
- SPACE AVAILABILITY IN THE REGIONAL MALL SECTOR CONTINUES TO INCREASE AS VACANCY ROSE ANOTHER 10 BPS, MARKING THE THIRD CONSECUTIVE QUARTERLY INCREASE
- ASKING RENTS FOR REGIONAL MALLS INCREASED SLIGHTLY TO A LEVEL MATCHING THE PEAK ACHIEVED IN THE SECOND QUARTER OF 2006
- RELATIVE TO Q2, WHICH INCLUDED THE $9.2 BILLION BLACKSTONE/CENTRO TRANSACTION, Q3 TRANSACTION VOLUMES ACROSS THE ENTIRE RETAIL SECTOR FELL TO $8.2 BILLION; AVERAGE CAP RATES REMAINED UNCHANGED AT 7.6%

### Hotel

- RISING CORPORATE TRAVEL AND INTERNATIONAL TOURISM CONTINUE TO DRIVE HOTEL PERFORMANCE. HOTEL PROPERTIES REPORTED THE SIXTH CONSECUTIVE QUARTER OF POSITIVE (REVPAR) GROWTH
- KEY PERFORMANCE METRICS CONTINUE TO IMPROVE, INCLUDING OCCUPANCY GAINS OF 4.0% TO 66.5%; AVERAGE DAILY RATE (ADR) INCREASED BY 3.8% TO $102.96 AND REVPAR CLIMBED BY 7.9% TO $68.44
- LARGER GATEWAY CITIES AND MAJOR TOURISM DESTINATIONS SUCH AS NEW YORK, WASHINGTON DC, MIAMI AND SAN FRANCISCO CONTINUE TO SHOW STRONG DEMAND
- TRANSACTION VOLUME ROSE SUBSTANTIALLY TO $5.4 BILLION, UP FROM $2.9 BILLION IN THE SAME PERIOD IN 2010; CAP RATES ROSE BY 50 BPS TO 7.5%

# Natural Resources Capital Market Conditions

## Timber Market Commentary

Asian timber demand, particularly Chinese demand, drives global timber markets. During the first half of 2011, the Pacific Northwest (PNW) region had been selling large volumes of wood to China for form use in concrete construction. This flow of PNW wood to Asia increased the volume of wood imported to the US from Eastern Canada. A slow-down in both the general Chinese economy and the construction industry in particular, has tempered both prices and volumes shipped in Q3. The China housing outlook is difficult to decipher at this time. Capital Economics notes that newly completed units are rapidly coming to market as sales are declining. It is too early to tell if this is a short-term cyclical adjustment or if the softening will persist.

The timber industry in the Southeast US continues to be generally steady, though transaction activity remains at an extremely low level. Southern pine saw-timber and chip stumpage (standing in the field) prices were lower in Q3 2011. Pulpwood prices held steady. Lumber and wood products markets were stable at low levels while paper and paperboard markets were down slightly.

US home prices are still declining with a monthly 0.6% decrease in value in September compared with a 3.9% decline year over year. The national and annual price changes mask the fact that in some regions prices have been stabilizing. Home prices in the Midwest region, where there was less excessive run-up, have been increasing for several months. Pockets of strength are expected to precede overall improvements. More foreclosures are expected to keep pressure on prices, and consequently new construction and timber demand, for the next two years.

## Mitigation Banking Market Commentary

The National Mitigation Banking Association continues to work with the Army Corps of Engineers to streamline and standardize the process of plan and credit approval. The execution and implementation of the 2008 ruling that set banks as the preferred mitigation is still developing which presents both challenges and opportunities requiring knowledgeable specialists to address. The delineation of “Service Areas”, the area in which a mitigation bank serves, is an example of implementation inconsistencies. A wetland Service Area is typically a single watershed. Watersheds can be defined as larger areas or comprised of smaller areas that are a subset of the larger areas. This has made first time banks much more difficult to permit as the local decision maker goes through the process for the first time. Some districts address this by defining a “primary” and a secondary” Service Area. A secondary service area is where there is ecological similarity but no approved bank in the primary Service Area.

In 2010, The Army Corps of Engineers approved 104 new mitigation banks bringing the total to 975 banks nationwide, an increase of 12% from 2009. Of the new banks, 23% were in Texas, Louisiana, and Mississippi due to demand from the oil and gas drilling and pipeline industry.

## Natural Resources Capital Market Conditions – Continued

### Agriculture Market Commentary

Rent increases lag commodity prices. In Central Illinois, expectations are that rents will increase approximately 12% in 2012 from 2011. Corn prices traded at over $6 per bushel for most of the 3rd quarter. These price levels support current returns to both the operator and the farmland owner. Provided commodity prices stay at or near current levels, higher rents are likely achievable by farmland owners.

Concerns in other parts of the capital markets lead farmland buyers to be more aggressive in pricing and farmland sellers to be more reluctant to sell. With 10 year Treasuries yielding only 2% and farmland rents providing a net of over 3-5%, farmland currently provides a return premium. When, not if, interest rates increase, land rents have room to increase while capital markets discount prices on fixed income assets. In our view this makes farmland a better investment than Treasuries at this time.

Recently farmland values have increased at a greater rate than rents due to the expectation that commodity prices will continue to increase. Annual world grain production and use continues to grow despite current elevated commodity prices. Coarse grain use is forecast to increase 3.1% from 2009 to 2012 while ending stocks (inventory carried over from one crop year to the next) are drawn down to only 13.5% of annual use, a level that puts upward pressure on price.

# Appendix A

## Summary of Portfolio Cash Flows

| Quarter | Capital Contribution | Distributions | Redemptions | Total |
|---|---|---|---|---|
| Q2 2007 | 354,666,230 | - | (41,000,000) | 313,666,230 |
| Q3 2007 | 277,650,000 | - | (77,410,778) | 200,239,222 |
| Q4 2007 | - | - | (58,200,000) | (58,200,000) |
| Q1 2008 | 82,200,000 | - | (23,500,000) | 58,700,000 |
| Q2 2008 | 25,500,000 | (446,462) | (50,454,058) | (25,400,520) |
| Q3 2008 | 44,852,570 | (1,019,994) | (4,400,000) | 39,432,576 |
| Q4 2008 | 85,979,025 | (1,223,450) | (79,450,000) | 5,305,575 |
| Q1 2009 | 55,122,204 | (1,142,560) | (2,650,000) | 51,329,644 |
| Q2 2009 | 3,720,837 | (2,831,451) | (2,200,000) | (1,310,614) |
| Q3 2009 | 2,182,090 | (3,883,030) | (52,000,000) | (53,700,940) |
| Q4 2009 | 7,213,749 | (1,450,747) | (2,400,000) | 3,363,002 |
| Q1 2010 | 4,451,516 | (846,291) | (1,350,000) | 2,255,226 |
| Q2 2010 | 767,315 | (1,188,459) | (500,000) | (921,144) |
| Q3 2010 | 1,174,065 | (853,205) | (27,600,000) | (27,279,140) |
| Q4 2010 | 13,741,534 | (1,926,081) | (2,600,000) | 9,215,454 |
| Q1 2011 | 3,250,560 | (4,011,073) | (2,050,000) | (2,810,513) |
| Q2 2011 | 17,910,020 | (4,020,435) | (800,000) | 13,089,584 |
| Q3 2011 | 106,831,890 | (7,521,595) | (98,503,785) | 806,510 |
| Total | 1,087,213,605 | (32,364,831) | (527,068,620) | 527,780,153 |