

MICROFILM DIVIDER

OMB/RECORDS MANAGEMENT DIVISION

SFN 2053 (2/85) 5M



ROLL NUMBER

DESCRIPTION

3037

2005 HOUSE CONSTITUTIONAL REVISION

HCR 3037

2005 HOUSE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. HCR3037

Constitutional Revision

☐ Conference Committee

Hearing Date 2-23-05

Tape Number	Side A	Side B	Meter #
2	x		1 ---43.7
Committee Clerk Signature <i>Maureen Shan</i>			

Minutes:

Chairman Koppelman: (0.0) Opened the hearing on HCR3037.

Rep Kelsch, Dist 34, Mdn: (0.1) I'm the prime sponsor of HCR3037. I'm not feeling well & will be leaving, so my testimony will be brief. There are other people here who will testify on my behalf & will explain things.

Rep Boucher, Dist 9: (0.9) appeared in support of HCR3037 & is one of the cosponsors. After visiting with the people with the Land Dept & the Dept of Public Instruction, the questions I had were answered & I'm comfortable with them. Investments & how we manage our investments at a state level, including the commons schools trust fund, has changed significantly since the constitution was drafted in 1889 & our strategies are different. This bill allows us to take a look at different strategies for handling trust fund investments. I'll leave the details to those that are more versed in these investments.

Sen O'Connell, Dist 6, Minot: (2.2) appeared in support of HCR3037. I think this clears up some language in this bill & makes clearer what the board can & can't do. The board does an excellent job of management & this would make it even more efficient. The Land Dept is here to answer any technical questions.

Al Jaeger, Sec of State: (2.7) appeared in support of HCR3037. I'm the Vice Chairman of the Land Board. The constitution identifies 5 constitutional officers; in addition to myself, there's the Governor, Attorney General, State Treasurer & the Supt of Public Instruct. If we have deputies, they can do almost anything that we can, except in one area. State law is very specific that when it comes to the land lord, we, individually have to be there. We can't give that responsibility to someone else, which explains why I am here. **(see attached testimony)** One of the things as a board member that I feel so fortunate with, is that we have a very competent, professional staff & because of that, they do excellent work for us & the State of ND & for the trust funds. I'd like to defer questions to them.

Chairman Koppelman: (8.0) Can you enlighten the committee as to what the commons schools trust fund is or what it does? Would you explain?

Jaeger: It was created by the state constitution & the constitution is very specific in terms of the funds & trusts that they'll ___?___ it gets used to support schools. Over the yrs there's been other trusts that have been added to that; for instance, we have 15 or 20 trusts in the name of various institutions. The purpose is very restrictive; it's to support schools. It's grown, I think we're at about \$700 Million ...(9.3) ... 5 yrs ago we were about \$500 Million. The board is very careful in how the funds are invested so this change isn't going to change that philosophy regardless of who's on the board.

Rep Kretschmar: (9.9) If this constitutional amendment were adopted, would the land board be able to take money out of the trust corporate, rather than just from the income earned?

Jaeger: I don't believe so, but Mr. Presser will be able to give you the detailed answer.

Rep Klemin: (10.5) My observation is that if the voters don't understand it, it's probably not going to pass. What's the point of putting the kind of formulas that you see on P 3? It's really hard for me to understand. Wouldn't it be more appropriate to put in something that gives the Legislature authority to set the formula, rather than trying to specify this stuff in the constitution, it might be a little more understandable?

Jaeger: I can't technically answer your question & I understand the challenge ... it's not that easy. (11.7) There are times that all the information the public has is what's on the ballot. We're in a tough spot, because as a state agency & legislative body, even if you agree with it, you don't have the resources to go out & promote it. I'll let Gary respond to why they did it that way ... we endorsed it.

Wayne Sanstead, Supt, DPI: (12.3) appeared in support of HCR3037. I recommend that this bill be given favorable consideration by the committee. The common schools trust fund now distributes about \$30 Million/yr to ND schools; per pupil is \$286.61/yr & is really appreciated by the school districts in addition to the foundation payment provided by the legislature. This added funding from the trust fund makes a big difference. Our distribution is about 3.78 of the funds now provided to the school district of the state, so it's a fund that has great meaning & significance. It's my conviction that adopting the total return approach to bring trust fund management as is proposed in the resolution of people, the trust distribution will allow to invest our funds more prudently & have a better return on the final analysis for the schools of the state. I

agree that we have a wonderful land department who has spent a lot of time on the details of this kind of proposal & really feel like it's in the best interest of the people of ND & certainly of our schools. All 5 of the board members will be our making sure the public knows that we feel this is a positive, progressive move by the State of ND & I think that will count once the measure is presented.

Gary Preszler, ND Land Dept Commissioner: (14.2) appeared in support of HCR3037. I serve as secretary to the Board of University School Lands, is responsible for managing the state's 13 permanent educational trust funds. At the time of statehood the federal government granted ND over 3 million acres of land to support the K-12 education system in the state (commonly known as sections 16 & 36 in every township). Additional lands were also granted for other state institutions & various universities; veterans homes, state hospitals, etc. That's what makes up our 13 permanent trust funds. Since the time of statehood the land & the land that was sold is still there in the trust as part of the permanent trust & are earning money for the school system. *Written testimony begins here. (see attached testimony)*

Chairman Koppelman: A question I think will help all of us, based on your chart, the difference if this amendment becomes part of the constitution, is that you could distribute a greater portion of those returns, but would it necessarily affect the way you invest those monies?

Preszler: Yes, because you're looking for the total return of the portfolio as opposed to investing in bonds that have certain interest rates __?__.

Chairman Koppelman: But you now invest in things that are growth related, it's just that you can't distribute the growth. I can see what you're saying, if you were allowed to invest in __?__

instruments across the board, you'd make some investment decisions differently, plus you'd be able to distribute more; is that what you're saying?

Preszler: That's right, our investment decisions today are basically out of 50% of the portfolio & under total return, we'd invest it more as total return on 100%.

Chairman Koppelman: I want to allow the committee to ask any questions you have as you go.

Preszler: (24.4) *continued with written testimony.*

Rep Kretschmar: (32.4) Under this resolution, we would be able to take money from the corpus in the trust.

Preszler: There will be no corpus. If you're thinking what's traditionally corpus, we do that now because of market losses in stocks. As far as distributions are concerned, there could be times when the distribution amounts could be larger then what you would traditionally call interest & income. Over the long term, the goal is that those funds will grow in value & our goal is not to diminish those funds.

Rep Klemin: (33.4) My 1st question is: on Congress acting to amend the enabling act; part of Sect 3, it says 1989 enabling act ... should this be 1889?

Preszler: We need to look at that, the enabling act you're talking about only affects 4 states, the Dakotas, Montana & Washington & I believe it was earlier than that. We'll check with LC.

Rep Klemin: What do you perceive as the process by which we'd have to amend the Federal Enabling Act in order for this to occur?

Preszler: That would only apply to ND, not to the other 3 states. I would envision the same process as NM did when they amended their enabling act. Once the people in the state have

voted on this, Congress has adopted for NM on the same basis ... that is the wish of the people & they understand the modern theory of total return approach.

Rep Klemin: (24.7) So we'd have to ask a Congressman or a Senator to put in a bill to amend an enabling act as it applies to ND?

Preszler: Yes

Rep Klemin: My 2nd question is re: the formula on P.3. I think this will be difficult for the average person to understand; I'm not sure I understand it & I have 4 pages of single line testimony from you talking about this. I'm concerned that if we really want to do this, should we really put something so complicated into the constitution? Based on my observation, if people don't understand something like this, they vote against it. Do you think there might be a simpler way of doing this?

Preszler: (36.9) The 1989 date might be correct, because the enabling act has been amended a number of times, but we'll check that. We think that how to present this to the voters in the most understandable way will be the biggest challenge. We're meeting with various groups in the education field; once we inform those groups in detail & we hope on that basis, we can get their support. Ultimately, we'll have to boil it down to some simple points to be able to communicate to the voters. HCR3048 & HCR3049 are coming up & will create a greater challenge for us. We have looked at a number of alternatives to what other states have done within their constitution, & we looked at allowing a range to be set by the board. What we proposed was what we thought was the simplest & the easiest to understand. We want people to understand that we're not changing or don't intend to reduce distributions or diminish the fund.

Rep Conrad: (40.0) When did NM do this?

Preszler: I believe about 1996.

Rep Conrad: Why did we get to the point where we thought we needed to do this? Was it because of your experience someplace else?

Preszler: The decision preceded my arrival in 1997, at the time they hired the 1st consultant.

Rep Kretschmar: (41.1) South Dakota, Montana & Washington came in the same day we did. Have the other states changed their system? (*?can't understand?*)

Presser: No, I don't believe they have, it's just that Tx & NM have been the 1st ones, but they have larger funds. Each of the other states have different aspects to their trust funds, as to what they have as far as land, etc. I'm fairly certain that neither of the 3 states have, so the federal change would just apply to ND, we wouldn't be changing the law for them.

Klemin: (42.3) A point of order here, in looking in the volume here, it says the Act of Feb, 22, 1889.

Doug Johnson, ND Counsel of Ed Leaders: (43.1) appeared in support of HCR3037. We have met with the staff & the land commission on this issue; they've gone over it in detail with us & we believe this is a good financial way to handle the fund. It does meet the judiciary responsibilities that the commission of land fund needs to carry out. We absolutely give HCR3037 a favorable consideration.

Bev Nielson, NDSBA: (43.8) appeared in support of HCR3037. This fund is a large fund & I think there's always enough money to get our payments out in good order & I think it's a better way for them to invest. It's not an emergency fund, it's a supplemental fund.

Chairman Koppelman: (43.7) Since there's no further testimony in support or opposition, we'll close the hearing on HCR3037.

2005 HOUSE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. HCR3037

Constitutional Revision

☐ Conference Committee

Hearing Date 2-28-05

Tape Number	Side A	Side B	Meter #
1	x		10.7 ---- 17.9
Committee Clerk Signature <i>Maine Haan</i>			

Minutes:

Chairman Koppelman: (10.7) We'll take a look at HCR3037. This is the one that the State Land Dept brought in, having to do with distributions from the common schools trust fund (modernizing it). Before we have a motion, we should take a look at the clerical correction that needed to be made.

Rep Klemin: There's an error in the date on P. 3, L.13. Instead of 1989, in 2 places, it should be 1889.

Rep Klemin moved that amended **Rep Meier seconded it**

Voice Vote 6 Yeas 0 Neas 1 Absent & Not Voting

Rep Kasper moved for a "Do Pass as amended" Rep Meier seconded it

Chairman Koppelman: Any discussion?

Rep Kasper: (11.8) I've been serving on the Employee Benefits Committee where we look at the Pers investment bills & what I saw on this bill is sort of a movement toward a pattern of

investment philosophy the way the Pers Board uses in their handling of investment retirement dollars for the employees of the State of ND. This type of an investment philosophy is used by the big money managers around the US. I think this is a good move; it doesn't mean that the investment people will not use fixed securities, but it gives them an option to move as the markets & economy move & gives them more flexibility. I think it's a safe move & I think it will benefit the fund.

Chairman Koppelman: (12.5) If I'm understanding the testimony correctly, it means that they can distribute the growth as well as the interest & income, so theoretically, they could distribute more from the fund to the schools. But it also might effect the way (*can't understand*) because they have to be a little more restricted because of the interest & income language involved in the Constitution currently & perhaps even increase the performance & return. Am I understanding that correctly?

Rep Kasper: (13.0) That's correct. They can look more long term & not be forced because of the income fixed securities.

Rep Kretschmar: (13.5) I have some concerns about this because it was, I think, the 1st time that we're putting something into the Constitution that this common schools trust fund could be spent (the principle of the fund, corpus of the trust). Also it says, the cost of administration shall come out of the fund. I agree with Rep Kasper that this is a better way to invest upon ... it's true. Times continue to change. I'd be happier if there was something in there that said "the trust has to remain a trust". I still have questions, but will support the resolution because I feel it's a better way to invest then our land board has authority to do now & I believe they're going to invest it in

a prudent manner. There may have to be some tweaking of it as time goes on, but the more serious problem is trying to make the electorates understand. I will support it.

Chairman Koppelman: (15.2) I think what will be happening is, the current level of the funding grows. Up until now, because they haven't been able to distribute growth, the corpus (or the principle) keeps increasing. This would allow them to distribute that as I understand.

Rep Klemin: (15.9) Spending the corpus does not mean that it's not a trust fund. The way I view a trust fund is, it's set for a specific purpose & it doesn't mean that you can't spend the corpus for that purpose. Even under a private trust, the trustees are frequently given the ability to invade the corpus to provide for the purposes of the trust. It does allow that growth to be spent under that total return approach, which seems reasonable. It looks like the amount of that fund is approaching a Billion Dollars & that's not counting the value of the land itself. I think it's time we start using some of that money for the benefit of the current generation, rather than putting it all back in, like we've been doing for the last 100 yr..

Rep Meter: (17.1) I think it's a great idea & I think it's time (*can't understand*).

Rep Klemin: (17.3) I do have a concern about the formula being in here, but I guess the proponents are willing to take the risk of trying to convince the board on that.

Chairman Koppelman: If no further comments, we'll call the roll.

"Do Pass As Amended" 6 Yeas 0 Neas 1 Absent & Not Voting Carrier: Rep Meier

2005 HOUSE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. HCR3037

Constitutional Revision

☐ Conference Committee

Hearing Date 3-1-05

Tape Number	Side A	Side B	Meter #
1	x		53.5 ---- end
		x	0.0 ----- 1.7
Committee Clerk Signature <i>Miane Haan</i>			

Minutes:

Chairman Koppelman: (53.5) We're going to take a look @ HCR3037, which we have acted upon, that based upon getting a fair mix on each ballot so that we're not overwhelmed on election ballots, so we may want to switch. This 1 specifies that it's on the primary ballot, this is the 1 the land dept asked for & deals with the common schools trust fund allowing them to distribute growth as well as interest & income. We're talking about the possibility of making a simple 1 word amendment which would be in L. 15, which would just change the word "primary" to "general". That's my recommendation & in order to accomplish that, what we need to do is reconsider our action by which we passed that.

Rep Kretschmar moved that we "**Reconsider Our Action**", **Rep Kasper** seconded it.

Rep Meier: Have you visited with the land dept about this amendment?

Chairman Koppelman: We have not, we did visit with LC. I don't know that they necessarily have a specific reason for putting in primary. I will speak with them about it if we pass this & if

they have a problem with it, we can discuss it & even when it's on the Senate side. Our problem here is that we're up against a deadline. Hearing no more discussion, our **motion is to**

Reconsider Our Action on HCR3037. Voice Vote 6 Yes 0 No 1 Absent & Not Voting

Rep Kretschmar Made a Motion to Amend the Resolution on L. 15, Deleting "Primary" & Putting in "General". Rep Kasper seconded it.

(turned tape to side B)

Voice Vote: 6 Yes 0 No 1 Absent & Not Voting

Rep Kretschmar made a "Do Pass As Amended" Motion Rep Conrad seconded it

Rep Klemin: Is this reconsidering our previous amendment that we also made to change the date to 1889? We've now reconsidered it.

Chairman Koppelman: We have an amended resolution before us & we've further amended it.

Rep Meier: (.9) Why are we changing it from primary election to the general election?

Chairman Koppelman: At the end of our meeting yesterday, Rep Kretschmar reminded us that in the past, this committee has generally considered which ballot these resolutions will be on, because if there are a stack of resolutions on a particular ballot, be it primary or general election ballot, it gets confusing for the voters & some of these are fairly complex resolutions, so we want to make sure the voters have as few as possible to look at. I think the hope is, that we can stagger them in such a way that full information on each measure will go out in the primary & general election.

Rep Meier: (1.6) I'll be visiting with the land dept.

Chairman Koppelman: Since you are the carrier, if you would do that on behalf of the committee, I would appreciate it & if you would do that & let us know if there's a problem, we could accomplish that on the Senate side by re-amending & we would concur, I'm sure.

Roll Call on a "Do Pass as Further Amended" on HCR3037.

6 Yes 0 No 1 Absent & Not Voting.

(meter reading 2.5)

Roll Call Vote #: /

House **CONSTITUTIONAL REVISION** Committee

Legislative Council Amendment Number _____

Motion Made By Kasper Seconded By Meier

[illegible]

Total (Yes) 6 No 0

Absent /

Floor Assignment Heuer

If the vote is on an amendment, briefly indicate intent:

Q. 3, Sect. 3, A. 13. Amend to 1889

Voice Vote - 6 Yeas - 0 No. 1 Absent

Amend. Motion made by Klein 2nd by Meier

Date: 3-1-05

Roll Call Vote #: /

2005 HOUSE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. *HCR 3037*

House **CONSTITUTIONAL REVISION** Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number _____

Action Taken RECONSIDERATION OF HCR 3037

Motion Made By REP KRETSCHNIAR Seconded By REP KASPER

[illegible]

Total (Yes) 6 No 1

Absent 1

Floor Assignment

If the vote is on an amendment, briefly indicate intent:

53043.0201
Title.0300

Adopted by the Constitutional Revision
Committee

March 1, 2005

House Amendments to HCR3037 - Constitutional Revision Committee 03/02/2005

Page 1, line 15, replace "primary" with "general"

House Amendments to HCR3037 - Constitutional Revision Committee 03/02/2005

Page 3, line 13, replace the first "1989" with "1889" and replace the second "1989" with "1889"

Renumber accordingly

Date: 3-1-05

Roll Call Vote #: 2

2005 HOUSE STANDING COMMITTEE ROLL CALL VOTES

House **CONSTITUTIONAL REVISION** Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number _____

Action Taken AMENDMENT ONLY

Motion Made By KRETSMAR Seconded By KASPER

[illegible]

Total (Yes) 6 No 0

Absent /

Floor Assignment

If the vote is on an amendment, briefly indicate intent:

AMENDMENT ON L.15
FROM PRIMARY TO GENERAL ELECTION

Date: 3-1-05
Roll Call Vote #: 3

2005 HOUSE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. HCR 3037

House CONSTITUTIONAL REVISION Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number _____

Action Taken DO PASS AS FURTHER AMENDED

Motion Made By REP KRETSCHMAR Seconded By REP CONRAD

Representatives	Yes	No	Representatives	Yes	No
Chair Koppelman	✓		Rep. Conrad	✓	
Rep. Kretschmar, Vice Chair	✓		Rep. Sandvig		AB
Rep. Kasper	✓				
Rep Klemm	✓				
Rep L. Meier	✓				

Total (Yes) 6 No 0

Absent 1

Floor Assignment REP MEIER

If the vote is on an amendment, briefly indicate intent:

AMENDMENT TO CHANGE PRIMARY
TO GENERAL ELECTION

REPORT OF STANDING COMMITTEE

HCR 3037: Constitutional Revision Committee (Rep. Koppelman, Chairman)
recommends **AMENDMENTS AS FOLLOWS** and when so amended, recommends
DO PASS (6 YEAS, 0 NAYS, 1 ABSENT AND NOT VOTING). HCR 3037 was placed
on the Sixth order on the calendar.

Page 1, line 15, replace "primary" with "general"

Page 3, line 13, replace the first "1989" with "1889" and replace the second "1989" with "1889"

Renumber accordingly

2005 SENATE EDUCATION

HCR 3037

2005 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. HCR 3037

Senate Education Committee

☐ Conference Committee

Hearing Date 03/15/05

Tape Number	Side A	Side B	Meter #
1 tape failed	x		0-3377 tape is blank
Committee Clerk Signature <i>Patty Wilkins</i>			

Minutes : Relating to distributions from and management of the common schools trust fund and the trust funds of other educational or charitable institutions; and to provide a contingent effective date.

Senator Freborg : Call the meeting to order on **HCR 3037**

Representative R. Kelsch : Introduced the bill, relating to the distributions of trust funds

See attached : written testimony

Al Jaeger : Secretary of State a member of the Board of University and school lands, being the V. Chair of the board. Explained the bill further.

See attached : written testimony

Questions?

Senator Seymour : You speak of the change in the system, could you talk about income and growth?

Al Jaeger : It would be the beneficiary that is distributed to the school districts. There is a formula in resolution to bring about stability. We are dealing with a wide savings in distribution. This can be a difficult thing, but this does help schools, kids and legislature.

Senator Taylor : Are the invested costs deducted cost of the management portfolio?

Al Jaeger : The land board is self-funded. I don't think this would change anything, there is a small cap and large cap. There are benchmarks and if the managers don't meet these, they may be removed. There are about 6 or 7 managers, the cost wouldn't change just the allocations.

Gary Preszler : Commissioner of the State Land Department

See attached : written testimony

Senator Seymour : Would the projections be put on the ballot or would this be put toward the taxpayers.

Gary Preszler : We have met with the beneficiaries, we need this support and we would explain to the people.

Senator G. Lee : How many millions, would this be distributed?

Gary Preszler : Yes, any time there is a change, what will be impacted will be during the interim. 66 is about 5 %. We would not pay out anything unless in the case the market is down. The board may have managed funds differently, we may not pay out as much right away.

Senator Taylor : Could you explain the graph #2 lines. Would they eventually move more parallel, or would you expect more? Is this simplistic?

Gary Preszler : We can get a compounding factor, you may average the #'s and know what the distribution may be.

Senator Taylor : Will this effect how you will manage surface lands?

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Senate Education Committee
Bill/Resolution Number HCR 3037
Hearing Date 03/15/05

Gary Preszler : Wasn't able to get this response.

Doug Johnson : North Dakota Educational Leaders stood in support of this bill, he said that they had met with the land board members and this will be sound funds.

Tom Decker : DPI said this would support tuition and would provide stability. They supported the bill as well.

No Opposition of this bill

Senator Freborg closed the hearing on HCR 3037

2005 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. HCR 3037

Senate Education Committee

☐ Conference Committee

Hearing Date 03/16/05

Tape Number	Side A	Side B	Meter #
2		x	544-884
Committee Clerk Signature <i>Patty Wilkens</i>			

Minutes : Relating to distributions from and management of the common schools trust fund and the trust funds of other educational or charitable institutions; and to provide a contingent effective date.

Senator Freborg : Call the meeting to order on **HCR 3037**

Senator Taylor : Recalling the testimony, fairly technical, as I said, this will be a little tough to sell it. To make sure the voters are up to speed, they are pretty smart people, this is a technical subject. The fact that most of the states, school trust funds, if that's what you want to call it that are under the total return approach rather than income that it spoke something to me in terms of assets are handled these days. It might be the right move, I don't know if I have a complete understanding enough of it.

Senator Freborg : Can you tell me what is in the value of a trust committee?

Senator Taylor : I would assume as you look @ the value there are those things that have somewhat of a ready market, bonds and stocks the land would have somewhat of a market value,

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Senate Education Committee

Bill/Resolution Number HCR 3037

Hearing Date 03/16/05

based on appraisal, anything you can have a balance sheet on you can determine the asset value according to the market.

Senator Freborg : Would you like more time committee. The consensus is yes.

Senator Freborg moved onto other business.

2005 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. HCR 3037

Senate Education Committee

☐ Conference Committee

Hearing Date 03/22/05

Tape Number	Side A	Side B	Meter #
1	x		4040-5049
Committee Clerk Signature <i>Patty Wilkins</i>			

Minutes : Relating to distributions from and management of the common schools trust fund and the trust funds of other educational or charitable institutions; and to provide a contingent effective date.

Senator Freborg : Called the meeting to order on **HCR 3037**

Senator Taylor moved a Do Pass on **HCR 3037**

Senator Seymour second this motion.

Discussion :

Senator Taylor : this has been here a long time, I would say that we should move this out.

Senator Seymour : I think the concept here is that ND has been adjusting in this area in a backwards way, and they are looking at new technology and new ways to do things to get more money out of their investment, so that is why this is here to bring us up to the times.

Senator Flakoll : This sounds like a heck of a floor speech.

Senator Freborg : Senator Seymour because you are so well versed about what is going on here, when they consider the value of the fund, they are considering growth and they are using that to calculate, what it is that they are going to distribute. Does the growth become as we know it now, part of the permanent trust?

Senator Seymour : I don't know.

Senator Freborg : This does allow them to earn more money on the fund to their investments? Right?

Senator Seymour : That is the way I understood it. This could be more of a risk and be more dangerous too.

Senator Freborg : It sounds like we maybe spending some of the principle, I understand what they mean by the value of the fund. That value more than likely would fluctuate, but at whatever point you spend from part of that growth are you not spending principle? Or do you quick spend it before the growth goes down, before the value of the fund decreases.

Senator Seymour : I don't understand that but what you are saying I would agree that it sounds like that. I am not sure.

Senator Freborg : However if you spend it b/c you think the growth will go down doesn't make much difference does it. You have spent the money and then the value of the fund will be less than ever. I am trying to understand Senator Seymour more of what you are thinking than what I think.

Senator Seymour : I wish I had the exact knowledge to help that out but I don't.

Senator Freborg : I wish you did too.

Hearing no other discussion, clerk took the roll. Vote : 3 yea, 3 nay, 0 absent.

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Senate Education Committee
Bill/Resolution Number HCR 3037
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Senator Freborg : I could ask if you need more time as we do have tomorrow.

Senator Flakoll : We may as well try the other way before sending to the floor WRC. I move for
a **Do Not Pass on HCR 3037.**

Senator G. Lee second this motion.

Hearing no other discussion, clerk took roll, Vote : 4 yea, 2 nay, 0 absent.

Senator Erbele will carry this bill.

2005 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. HCR 3037

Senate Education Committee

☐ Conference Committee

Hearing Date 03/23/05

Tape Number	Side A	Side B	Meter #
1		x	0-3700
Committee Clerk Signature <i>Patty Wilkins</i>			

Minutes : Relating to distributions from and management of the common schools trust fund and the trust funds of other educational or charitable institutions; and to provide a contingent effective date.

Senator Freborg : Call the meeting to order on **HCR 3037**

Senator Flakoll : Could you give me a sound bite of thirty seconds of your best stuff. If you were to have a commercial can I have thirty seconds of your best stuff why somebody should vote for this?

Jeff Ingalsen : This proposal will help the land board more efficiently, manage the trust funds, which will allow those trust funds then to grow more over time and based on this proposal, with that growth will come growth and distribution. They will also provide for more certain distribution b/c what we are doing now requires us to make estimate the future market of what is going to happen. Under this proposal we are taking what's happened in the past five yrs. and

using that to establish a distribution. When we tell you your going to get it during this session I can promise you will.

Senator Freborg : Would it have been possible to amend the constitution to allow the legislature through statute to set the standard by which you invest this money? So that it was not constitutional?

Jeff Ingalsen : Yes, it would have been possible, don't take this wrong, one thing in investing is that a long term time frame is what counts. Other members of political parties don't necessarily think long term.

Senator Freborg : I wanted you to be careful in how you say that.

Jeff Ingalsen : If it is in law it can be changed at any time. Right now it can be changed at any time, and those short term decisions are what get investors in trouble.

Senator Freborg : What did you mean that right now it can be changed at any time.

Jeff Ingalsen : Right now the law says the board has to have these dual responsibilities and that the Land Board will determine these distributions, but since the legislature writes the law, that says the land board will determine the distribution. Theoretically the legislature could override the land board and has on occassiomn. The 99- 01 session 01-03 session we paid out for the trust funds other than common schools we paid out far more than we would, based on the legislature saying we are going to ignore that part of the law and so we see that happen.

Senator Freborg : You can't really do the same things today that you could if we were to amend the constitution, giving us the authority to make whatever changes you wanted for investment purposes in statute. Other than the fact that you don't want us to change it every two yrs. What is it that you can't do now, through statute that you could do if we pass this amendment?

Jeff Ingalsen : The Board would be able to more diversify the portfolio. We would, right now we focus on income generating assets b/c we have to pay out the income. That focus on income generating assets, makes us not invest in certain assets. We do not have a growth stock portfolio, large cap growth stock b/c it doesn't generate income. We recently added a report folio b/c it does generate a lot of income. Now at certain times growth stocks do good and at certain times value stocks do good. Value stocks want to get dividends, we have to focus on one side of the market b/c of our focus on income, that actually adds risk to the portfolio b/c those two counteract each other over time. Sometimes growth is good and sometimes value is good and between it, you have a relatively stable line. Whereas when you focus on value we lead the markets hugely in the late 90's b/c we were value oriented and growth stocks were doing good. Our value approach has been very good in the last four yrs. with value stocks, dividend stocks have done well and did not fall as much as growth stocks. Had we been more balanced we probably would have had more than if we would have, if we would have been more balanced over the last ten yrs. We would have more b/c we would have caught a little bit of up side when one was doing good and a little on the other side when it was doing good.

Senator Freborg : So you just told me what you cannot do with out this resolution and amending the constitution.

Jeff Ingalsen : Yes

Senator Freborg : If we were to amend the constitution to allow us to give you that authority through statute. What's the difference? I am coming from the side of the fact that what are we going to do in 50 yrs? Amend the constitution again if we want to make a change? I know you don't trust us. (Laughter)

Jeff Ingalsen : As long as something is in statute it can be changed, if that would be my main argument even within the constitution you say the land board considered. Quite frankly the land board fight politician themselves. They may have short term consideration, they have been very good at not doing that, up till now. This takes the emotion out of it I guess, in the short term decision making and that is really the pure focus of this. To allow the long term investing and not let that be disrupted by short term decisions.

Senator Freborg : My concerns are similar, yours are that what's in statute can be changed, and our are what is in the constitution can't.

Jeff Ingalsen : I understand that.

Senator Flakoll : Based upon your findings, do you really think that bill would have passed easily

Jeff Ingalsen : No, not really.

Senator Taylor : It would be interesting to me regardless what we do with this resolution, but two investment consultants you say did studies, made this recommendation. I would be interested to know who those consultants were, when they did those studies, and if the summary of studies would be available to us.

Jeff Ingalsen : Yes, one was done in 1995 and the other in 1993 by two different firms. These were Yami Bilke and the other was Demayo Schnider and Associates. We can make those available to you, anything that relates to this total return approach VS income approach.

Senator Taylor : You said 95 and 93?

Jeff Ingalsen : I meant to say 95 and 2003. At that time in 95 we were in no position to even think about it, b/c it would have resulted in a drop in distributions of 5 million dollars or 25 % so

we knew better to even ask. Now we are in a position where we can do that transition relatively smoothly with no drop in distribution, and this is why we are proposing it now.

Senator Flakoll : If you equate it to a retirement plan of an individual and your philosophy when you are 30 yrs old is different 50 ys. old VS when you are 70 yrs old. Putting this into human terms at what point in your life, would you think that your portfolio handling, that you are proposing would be applicable to.

Jeff Ingalsen : This will be an individual who will never die, b/c this trust fund is there forever. Unlike an individual who would invest more in equities at a younger age and then go to more fixed income assets as they got older closer to retirement, so they wouldn't lose their money in the stock market, this fund is there forever, by the enabling act. federal government gave it to us and we have to keep it forever for education.

Senator Seymour : I haven't heard any dollar figures, we invest one way we make a million and the other way we make 10 more cents. What are we talking here? I know it is a guess but if it isn't worth it there is no use talking.

Jeff Ingalsen : It would purely be a guess, but just assume, if we could make .25 so $\frac{1}{4}$ of 1 % more a yr. Next yr. would make very little difference, b/c we would have a slight amt. of more money than we do now. Twenty yrs from now, we would have 5-6-7 % more than we would under the current proposal. By investing, you stick it away when you are young and it keeps growing, short term has very little effect. Increments of 5, 6 , 7 % more each yr.

Senator Freborg : We will need it sooner than that.

Senator Flakoll : Maybe next week, You sited TX and NM, how old are their plans and have you seen any results.

Jeff Ingalsen : NM did theirs in 1996, and TX was like 2000-2001. It is hard to say, I haven't seen the details of their programs to know. I know they both are strongly in support of what they are doing. There are many Universities and Endowments, which is what we consider ourselves, I have been doing this for 30 yrs. It is not just NM and TX that make us think this is the way to go. The college endowments, the Yale, the Harvard's, all sorts. ND, UND just switch over there endowment to that. So it is more than just these state trust funds that are doing that, for thirty yrs. a lot of endowments and foundation have been doing this.

Senator Erbele made a motion for a Do Pass on HCR 3037

Senator Taylor second the motion.

Discussion on motion

Senator Erbele : I feel this is an idea worth looking at, I do have a few concerns, but it is not up to this committee to decide that whether the voters will understand it well enough to vote for it, I am willing to put it out there for them.

No further discussion

Hearing None, Clerk took roll: Vote - 5 Yea, 1 Nay, 0 Absent

Senator Freborg : Some of you will have to hang around for a long time to see what happens and hopefully Jeff will still be here. (Laughter)

Do we have a carrier? **Senator Erbele will carry this bill.**

Senator Freborg adjourned the meeting.

Date: 1/22/05
Roll Call Vote #: 1

2005 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 3037

Senate SENATE EDUCATION Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number _____

Action Taken Do Pass

Motion Made By Taylor Seconded By Seymour

Senators	Yes	No	Senators	Yes	No
CH- SENATOR FREBORG		✓	SENATOR SEYMOUR	✓	
V-CH- SENATOR G. LEE		✓	SENATOR TAYLOR	✓	
SENATOR ERBELE	✓				
SENATOR FLAKOLL		✓			

Total (Yes) 3 No 3

Absent Failed

Floor Assignment _____

If the vote is on an amendment, briefly indicate intent:

Date: 3/22/05
Roll Call Vote # 2

2005 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 3037

Senate SENATE EDUCATION Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number _____

Action Taken Do Not Pass

Motion Made By Flakoll Seconded By Lee

Senators	Yes	No	Senators	Yes	No
CH- SENATOR FREBORG	✓		SENATOR SEYMOUR		✓
V-CH- SENATOR G. LEE	✓		SENATOR TAYLOR		✓
SENATOR ERBELE	✓				
SENATOR FLAKOLL	✓				

Total (Yes) 4 No 2

Absent _____

Floor Assignment Erbele - ??

If the vote is on an amendment, briefly indicate intent:

Date: 3/23/05
Roll Call Vote #: 1

2005 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 3037

Senate SENATE EDUCATION Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number _____

Action Taken Reconsideration 3037

Motion Made By Enb. Seconded By Seymour

Senators	Yes	No	Senators	Yes	No
CH- SENATOR FREBORG	✓		SENATOR SEYMOUR	✓	
V-CH- SENATOR G. LEE	✓		SENATOR TAYLOR	✓	
SENATOR ERBELE	✓				
SENATOR FLAKOLL	✓				

Total (Yes) 10 No 0

Absent _____

Floor Assignment _____

If the vote is on an amendment, briefly indicate intent:

Date: 3/23/05
Roll Call Vote #: 2

2005 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 3037

Senate SENATE EDUCATION

Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number _____

Action Taken Do Pass engrossed

Motion Made By Erbele

Seconded By Taylor

Senators	Yes	No	Senators	Yes	No
CH- SENATOR FREBORG	✓		SENATOR SEYMOUR	✓	
V-CH- SENATOR G. LEE		✓	SENATOR TAYLOR	✓	
SENATOR ERBELE	✓				
SENATOR FLAKOLL	✓				

Total (Yes) 5 No 1

Absent _____

Floor Assignment Erbele

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE (410)
March 23, 2005 4:14 p.m.

Module No: SR-53-5967
Carrier: Erbele
Insert LC: . Title: .

REPORT OF STANDING COMMITTEE

HCR 3037, as engrossed: Education Committee (Sen. Freborg, Chairman) recommends
DO PASS (5 YEAS, 1 NAY, 0 ABSENT AND NOT VOTING). Engrossed HCR 3037
was placed on the Fourteenth order on the calendar.

2005 TESTIMONY

HCR 3037

ALVIN A. JAEGER
SECRETARY OF STATE

PAGE www.state.nd.us/sec



SECRETARY OF STATE

STATE OF NORTH DAKOTA
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BISMARCK ND 58505-0500

February 23, 2005

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E-MAIL sos@state.nd.us

2-23-05
HCR 3037

TO: Rep. Koppelman, Chairman, and Members of the House Constitutional Revision Committee

FR: Al Jaeger, Secretary of State, Vice Chairman, Board of University and School Lands

RE: HCR 3037 – Management of Common Schools Trust Fund

Under North Dakota's Constitution and Century Code, along with generally accepted management principles, the Board of University and School Lands has dual fiduciary responsibilities regarding the trust funds under its care. That is, the Board is to preserve the purchasing power of the trusts while maintaining income stability to the beneficiaries of those funds. Not only does the Board need to protect current beneficiaries, it also has an equal fiduciary duty to protect the interests of future beneficiaries.

According to Article IX of the North Dakota Constitution, only the "interest and income" earned by the permanent trust funds may be distributed to beneficiaries. However, by limiting beneficiary distributions to only the "interest and income" revenue generated by the trust funds, the Board is unable to invest trust funds to its full potential. If it could do that, the Board could better meet its dual fiduciary responsibilities to current and future generations of beneficiaries.

The changes proposed in this constitutional amendment would allow the Board to use a "total return" approach in investing trust funds. It would allow trust assets to be managed to maximize returns and still minimize the risk to the entire portfolio. The "total return" approach emphasizes long-term investment goals that maintain the purchasing power of the trust while also providing stability to beneficiaries and lessening the likelihood of wide fluctuations in distributions.

During the twelve years that I have been a member, the Board retained the services of two well-respected and qualified national investment consultants. Both of them recommended the "total return" approach to maximize the return to the trust. This, they concluded, would increase and stabilize the distributions to the beneficiaries.

While the change from an "interest and income" policy to a "total return" policy would not bring about major changes in the Board's traditionally conservative investment strategy, it would still have significant results. For example, some of the allocations among the various investment groups would change because the investment policy would no longer just focus on only generating "income." Rather, it would now focus on generating both "income and growth." This change in emphasis will actually allow the Board's investment portfolio to become more diversified while at the same increasing revenues and reducing overall risk to the trust funds.

Regardless of the persons making up its membership, it has been my observation that each past and current member of the Board has always understood and has taken seriously his or her fiduciary responsibility to the trust fund. That is, to invest the trust funds in a responsible and prudent manner in order to provide the maximum benefit to its beneficiaries. By changing the state's constitution to allow a "total return" approach, the Board believes that the benefit and stability for current and future recipients will be greatly enhanced. Therefore, in keeping with the Board's fiduciary responsibilities and on behalf of my fellow Board members, I respectfully request your favorable consideration of HCR 3037.

**TESTIMONY OF GARY D. PRESZLER
COMMISSIONER
North Dakota State Land Department**

IN SUPPORT OF HOUSE CONCURRENT RESOLUTION NO. 3037

**House Constitutional Revisions Committee
February 23, 2005**

The Board of University and School Lands and its operating agency, the North Dakota State Land Department, are responsible for managing the state's 13 permanent educational trust funds. As Land Commissioner I am responsible for implementing the policies and goals established by the Board.

The purpose of the HCR3037, and the reason the Board is pursuing this resolution with the legislature and seeking a vote by the people of our state, is that the proposed changes will make it easier for the Board to fulfill its dual responsibilities under Article IX of the Constitution. More specifically, the intent of this Resolution is to:

- Protect the permanent trusts against the impact of inflation.
- Provide stable, reliable distributions to trust fund beneficiaries.
- Give the Board the ability to better invest the trust funds for both current and future beneficiaries.

Article IX of the Constitution currently states that only the "interest and income" generated by the permanent trusts can be distributed, and specifies that certain revenues must be permanently added to the trusts. But this interest and income spending policy is based on dividends and interest while the majority of returns generated today come from equity market capital gains. This method focuses on income generating investments and means that investment opportunities in the equity markets can be missed. The proposed changes will help the Board better meet its dual responsibilities under ND law by allowing the Board to better manage the trust funds for both current and future generations.

The goal for changing the Constitution is to allow the Board to invest optimally, with the expectation that over the long term market returns will provide for greater trust fund growth and consequently higher distribution levels. A total return approach accomplishes this goal.

Income Approach vs. Total Return

A brief definition of the income and total return spending methods follows:

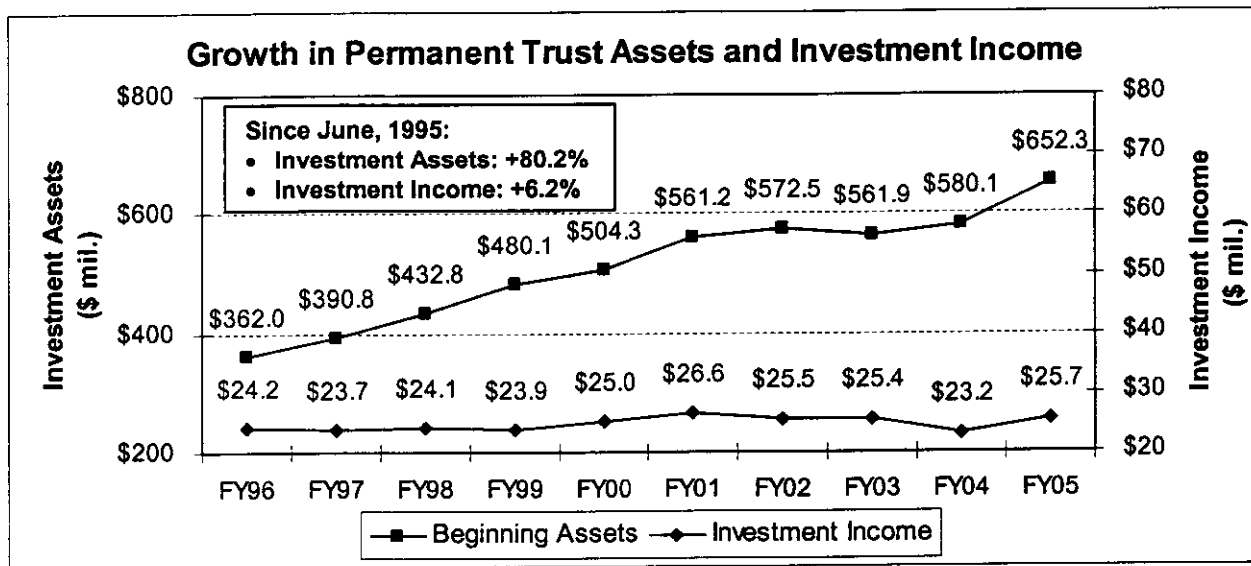
- **Income Approach:** Distributions are based on a portion of the revenues (the "interest and income") generated by the trust funds during a given year. Only certain revenues can be distributed to beneficiaries (rental income, interest, dividends, some realized capital gains), while other revenues, (mineral royalties and bonuses, land sales, etc.) must be added to the trust fund, and can never be distributed.

- **Total Return Approach:** Distributions are based on the value of the financial assets in the trust funds and the growth of those assets over time. As assets grow, so do distributions. All sources of trust revenue are available to distribute to trust beneficiaries.

The differences between the “interest and income” based spending method under the Constitution and the “total return” method we are proposing can be summarized as follows:

#	Income Approach	Total Return Approach
1	Trust assets are managed for two distinct purposes. Some assets are managed for income while others are managed for growth.	Trust assets are managed as one optimum unit in order to maximize returns and minimize the risk of the entire portfolio.
2	The need for income can result in short-term investment decisions being made in reaction to current market conditions, which is often not in the best long-term interest of the trust or future beneficiaries.	Investment decisions are made in a way that emphasizes the long-term goals of maintaining the purchasing power of the trusts and income stability to trust beneficiaries.
3	As assets grow over time, distributions can only increase by the amount of additional income generated by those assets.	As assets grow over time, so will distributions to beneficiaries.
4	Estimates are made prior to each legislative session as to the amount of income that will be available to distribute from each trust fund. These estimates include projections as to interest rates, equity returns, oil prices, and many other factors.	Trust distributions will be known prior to each legislative session and will be based on the average value of trust financial assets over the previous 5 years.
5	If income falls short of projections, distributions may be less than budgeted amounts, causing financial hardship to trust beneficiaries.	Distributions will match budgeted amounts regardless of the portfolio's performance during the biennium.
6	A policy of distributing only the income earned by a trust leaves distributions vulnerable to interest rate swings and can result in more volatile distributions.	The use of the average value of trust assets over a 5 year period to determine distributions helps minimize fluctuations in trust distributions.
7	Only about 3.5% of endowments currently use some form of an “interest and income” model to manage assets and determine distributions.	Over 80% of endowments use a total return approach to manage assets and determine distributions; as do the 3 largest state permanent trust funds (New Mexico Land Grant and Severance Tax Permanent Funds and Texas Permanent School Fund).
8	Investment consultants have recommended that the Land Board not use the “income” approach to manage investments and determine distributions.	Two different investment consultants have performed studies to determine how to best manage the state's permanent trust assets. Both studies recommended the use of the “total return” approach to managing investments and determining distributions.

Under the "interest and income" method, trust asset growth does not always provide for growth in distributions. The chart below shows how permanent trust assets and income have grown over the past 10 years. The chart also shows that, although trust assets have grown by more than 80% since fiscal year 1996, the income those assets generate has grown only 6%. The sharp decline in interest rates over the past 10 years has made it difficult to generate increased income, even though trust assets have grown substantially. Under the "total return" approach, the growth in trust distributions will follow asset growth much more closely than under the current "income" approach.



The methodology for calculating the "total return" amount of distributions is straightforward and removes all revenue forecasting errors. The value of permanent trust financial assets will be determined on June 30th of each fiscal year. Prior to each legislative session, the average market value of trust financial assets for the preceding five years would be determined and distributions for the following biennium would be calculated by multiplying that number by 10%. One half of that amount would be paid out during each year of the biennium.

When trust assets were made up of primarily land, bonds, and loans, it made sense to distribute only the interest and income generated by these assets. This is the way most trusts and endowments were managed 100 years ago, with a focus on avoiding losses and maximizing current income. The permanent trusts are now a \$700+ million endowment, with a diverse portfolio of stocks, bonds, minerals interests and surface lands. Modern investment practices have changed substantially over the past 50 years, as have financial markets and the understanding of the impact on inflation on the value of trust funds and future distributions. The proposed constitutional amendment recognizes these changes and provides the Board with the means to manage the trust funds in a way that meets the best practices for endowments and permanent funds for the 21st century.

Over the previous several months members of my staff and I have discussed the proposed constitutional amendment with many trust fund beneficiaries, stakeholders, and legislative leaders. Several appropriate and important questions are sometimes asked that I would like to address.

How was the distribution formula determined?

The distribution formula was developed in consultation with the Board's investment consultant and designed to grow both trust assets and distributions at the approximate rate of inflation (4%/year). Even investing in a relatively conservative manner the trust funds should be able to earn an average return of 8.40%/year over the long term. Some years the trusts will earn more and some years less, but over the long run, an 8.40% average return is achievable. If the trust funds earn this rate of return over time, a 10%/biennium distribution rate will allow both trust assets and distributions to grow at an average rate of inflation. The return and distribution assumptions above should be achievable even without considering new funds from sources such as mineral royalties and bonuses, oil extraction taxes and other sources. These other sources of trust growth also help to stabilize trust assets during financial market downturns.

Will these changes impact the way the Land Board invests?

If this measure passes, the Board will change the way it invests trust assets; however, that does not mean the Board will increase the portfolio's risk. Because the trust funds will no longer need to focus on generating a specific amount of income each year, the portfolio will most likely become more diversified with less emphasis on income producing securities. A more diversified portfolio should result in increased returns and reduced portfolio volatility (risk) and thus more consistent, growing distributions to trust beneficiaries. Although the specific asset allocation may change, I do not believe the Board's conservative approach to investing would change. The Board has historically viewed minimizing risk to be just as important as generating high returns.

Can corpus be spent under the "total return" approach?

- Under the "total return" approach all sources of trust revenue is treated the same; there is no distinction made between corpus, capital gains, trust additions or income.
- A dollar is fungible and its source does not matter as only the total market value of the investments and the ability to generate a return over the long term will impact the distribution amounts.
- Short term market losses exist with either method.
- Although the "total return" approach allows the spending of what has traditionally been corpus when markets are down substantially it also prevents the overspending of income when markets are doing well.
- A five-year rolling average of the market value of the investments will smooth distributions and insulate against over or under paying distributions due to short term market movements.

Conclusion

Adopting a "total return" spending rate to permanent trust management and trust distributions will allow the Board to manage trust investments more prudently. It will bring the management of the permanent trusts in line with universally adopted investment practices of the largest endowments and trusts in the nation and should improve the long-term performance by allowing the Board to invest in a more optimal way. Adopting the "total return" approach will also ensure that actual distributions from the permanent trust funds equal budgeted distributions each biennium as it eliminates the uncertainty involved in trying to forecast "income" years into the future. Finally, adopting the "total return" approach should result in higher and more reliable distributions to trust beneficiaries because it will allow the Board to manage the trusts more efficiently and effectively to better serve the people of N.D. for generations to come.

I urge the committee to give HCR 3037 a favorable "do pass" recommendation.



SECRETARY OF STATE

STATE OF NORTH DAKOTA
600 EAST BOULEVARD AVENUE DEPT 108
BISMARCK ND 58505-0500

March 15, 2005

TO: Senator Freborg, Chairman, and Members of the Senate Education Committee

FR: Al Jaeger, Secretary of State, Vice Chairman, Board of University and School Lands

RE: HCR 3037 – Management of Common Schools Trust Fund

Under North Dakota's Constitution and Century Code, along with generally accepted management principles, the Board of University and School Lands has dual fiduciary responsibilities regarding the trust funds under its care. That is, the Board is to preserve the purchasing power of the trusts while maintaining income stability to the beneficiaries of those funds. Not only does the Board need to protect current beneficiaries, it also has an equal fiduciary duty to protect the interests of future beneficiaries.

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Regardless of the persons making up its membership, it has been my observation that each past and current member of the Board has always understood and has taken seriously his or her fiduciary responsibility to the trust fund. That is, to invest the trust funds in a responsible and prudent manner in order to provide the maximum benefit to its beneficiaries. By changing the state's constitution to allow a "total return" approach, the Board believes that the benefit and stability for current and future recipients will be greatly enhanced. Therefore, in keeping with the Board's fiduciary responsibilities and on behalf of my fellow Board members, I respectfully request your favorable consideration of HCR 3037.

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COMMISSIONER
North Dakota State Land Department**

IN SUPPORT OF ENGROSSED HOUSE CONCURRENT RESOLUTION NO. 3037

**Senate Education Committee
March 15, 2005**

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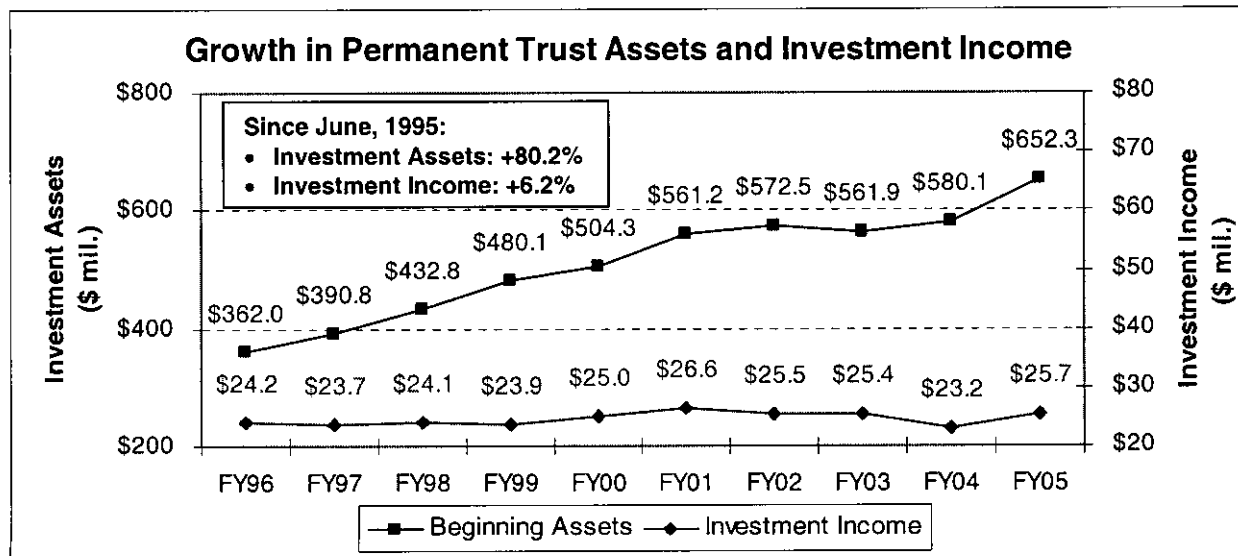
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7	Only about 3.5% of endowments currently use some form of an "interest and income" model to manage assets and determine distributions.	Over 80% of endowments use a total return approach to manage assets and determine distributions; as do the 3 largest state permanent trust funds (New Mexico Land Grant and Severance Tax Permanent Funds and Texas Permanent School Fund).
8	Investment consultants have recommended that the Land Board not use the "income" approach to manage investments and determine distributions.	Two different investment consultants have performed studies to determine how to best manage the state's permanent trust assets. Both studies recommended the use of the "total return" approach to managing investments and determining distributions.

Under the “interest and income” method, trust asset growth does not always provide for growth in distributions. The chart below shows how permanent trust assets and income have grown over the past 10 years. The chart also shows that, although trust assets have grown by more than 80% since fiscal year 1996, the income those assets generate has grown only 6%. The sharp decline in interest rates over the past 10 years has made it difficult to generate increased income, even though trust assets have grown substantially. Under the “total return” approach, the growth in trust distributions will follow asset growth much more closely than under the current “income” approach.



The methodology for calculating the “total return” amount of distributions is straightforward and removes all revenue forecasting errors. The value of permanent trust financial assets will be determined on June 30th of each fiscal year. Prior to each legislative session, the average market value of trust financial assets for the preceding five years would be determined and distributions for the following biennium would be calculated by multiplying that number by 10%. One half of that amount would be paid out during each year of the biennium.

When trust assets were made up of primarily land, bonds, and loans, it made sense to distribute only the interest and income generated by these assets. This is the way most trusts and endowments were managed 100 years ago, with a focus on avoiding losses and maximizing current income. The permanent trusts are now a \$700+ million endowment, with a diverse portfolio of stocks, bonds, minerals interests and surface lands. Modern investment practices have changed substantially over the past 50 years, as have financial markets and the understanding of the impact on inflation on the value of trust funds and future distributions. The proposed constitutional amendment recognizes these changes and provides the Board with the means to manage the trust funds in a way that meets the best practices for endowments and permanent funds for the 21st century.

Over the previous several months members of my staff and I have discussed the proposed constitutional amendment with many trust fund beneficiaries, stakeholders, and legislative leaders. Several appropriate and important questions are sometimes asked that I would like to address.

How was the distribution formula determined?

The distribution formula was developed in consultation with the Board's investment consultant and designed to grow both trust assets and distributions at the approximate rate of inflation (4%/year). Even investing in a relatively conservative manner the trust funds should be able to earn an average return of 8.40%/year over the long term. Some years the trusts will earn more and some years less, but over the long run, an 8.40% average return is achievable. If the trust funds earn this rate of return over time, a 10%/biennium distribution rate will allow both trust assets and distributions to grow at an average rate of inflation. The return and distribution assumptions above should be achievable even without considering new funds from sources such as mineral royalties and bonuses, oil extraction taxes and other sources. These other sources of trust growth also help to stabilize trust assets during financial market downturns.

Will these changes impact the way the Land Board invests? *yes - only slightly -*

If this measure passes, the Board will change the way it invests trust assets; however, that does not mean the Board will increase the portfolio's risk. Because the trust funds will no longer need to focus on generating a specific amount of income each year, the portfolio will most likely become more diversified with less emphasis on income producing securities. A more diversified portfolio should result in increased returns and reduced portfolio volatility (risk) and thus more consistent, growing distributions to trust beneficiaries. Although the specific asset allocation may change, I do not believe the Board's conservative approach to investing would change. The Board has historically viewed minimizing risk to be just as important as generating high returns.

Can corpus be "spent" under the "total return" approach?

- Under the "total return" approach all sources of trust revenue is treated the same; there is no distinction made between corpus, capital gains, trust additions or income.
- A dollar is fungible and its source does not matter as only the total market value of the investments and the ability to generate a return over the long term will impact the distribution amounts.
- Short term market losses exist with either method.
- Although the "total return" approach allows the spending of what has traditionally been corpus when markets are down substantially it also prevents the overspending of income when markets are doing well.
- A five-year rolling average of the market value of the investments will smooth distributions and insulate against over or under paying distributions due to short term market movements.

Conclusion

Adopting a "total return" spending rate to permanent trust management and trust distributions will allow the Board to manage trust investments more prudently. It will bring the management of the permanent trusts in line with universally adopted investment practices of the largest endowments and trusts in the nation and should improve the long-term performance by allowing the Board to invest in a more optimal way. Adopting the "total return" approach will also ensure that actual distributions from the permanent trust funds equal budgeted distributions each biennium as it eliminates the uncertainty involved in trying to forecast "income" years into the future. Finally, adopting the "total return" approach should result in higher and more reliable distributions to trust beneficiaries because it will allow the Board to manage the trusts more efficiently and effectively to better serve the people of N.D. for generations to come.

I urge the committee to give Engrossed HCR 3037 a favorable "do pass" recommendation.

Testimony for Rep. Rae Ann Kelsch on HCR 3037

For the record, my name is Rae Ann Kelsch, a Representative from District 34 Mandan.

As most of you know, the Board of University and School Lands and its operating agency, the North Dakota State Land Department, are responsible for managing the state's 13 permanent trust funds. These trust funds were created at statehood when the federal government gave the state over 3 million acres of land to support K-12 education and certain other state institutions, including various universities, the veterans home, state hospital, etc. Almost 120 years later, these trust funds now consist of approximately \$710 million of financial assets, 2.5 million mineral acres and 700,000 surface acres, all of which are managed exclusively for their respective beneficiaries. Distributions from the 13 trust funds will total \$65.5 million during the 2003-05 biennium.

The purpose or intent of this constitutional amendment is to:

- Preserve the purchasing power of the trusts (protect against the impact of inflation).
- Provide stable and certain distributions to trust fund beneficiaries.
- Allow the Board to better invest the trust funds for growth as well as preservation of principal.

In order to accomplish the three goals stated above, this bill changes the method used to determine distributions from the trust funds. Article IX of North Dakota's Constitution currently states that only the "interest and income" earned by the permanent trust funds may be distributed to beneficiaries, while certain other revenues "shall be and remain a perpetual trust fund". This constitutional amendment changes the method used to determine distributions from the current "income" approach to a "total return" approach.

There are other individuals that will testify as to the details of how the "total return" approach works and how it compares to the current "income" approach to trust management and distributions. However, the simplest way I can explain it is that under the total return approach, distributions are determined based on the amount of wealth accumulated by the trust funds over a 5 year period of time, while under the income approach, distributions are limited to the amount of "interest and income" generated by that wealth during a given one year period.

In the past, when trust assets were made up of primarily land, bonds, and loans, it made sense to distribute only the interest and income generated by these assets. Most trust and endowments were managed this way, with a focus on avoiding losses and maximizing current income. However, the permanent trusts are now a \$700+ million endowment, with a diverse portfolio of stocks, bonds, minerals interests and surface lands. In addition, the art and science of investment management has also developed over the past 50 years, as have financial markets and the understanding of the impact on inflation on the value of trust funds and future distributions.

The proposal before you today recognizes the changes that have occurred over the past 100 years, both in the make up of trust assets under the Land Board's control and in how large institutional trust funds are managed. This proposal will change the way trust assets are managed and distributions are determined from a method that worked well and made sense in the 19th and early 20th centuries to one that allows the Land Board to manage the trust funds in a way the meets the best practices for endowments and permanent trust funds for the 21st century.

I respectfully request that you support this constitutional amendment and give HCR3037 a do pass recommendation.

Various other talking points and issues

1. The reason a constitutional amendment is needed

- ND constitution currently restricts the way the trust funds are managed by limiting distributions to only the "interest and income" generated by the trust funds.
- The constitutional restrictions prevent the Land Board from investing trust assets in an optimal way and hinders them from fulfilling their dual responsibilities under ND law of preserving the purchasing power of the trusts and maintaining income stability to trust fund beneficiaries.
- The proposed changes will help the Board better meet its dual responsibilities under ND law by allowing the Board to better manage the trust funds for both current and future generations.

2. How Does the total return approach work:

- On June 30th of each year, the value of trust financial assets will be determined.
- Prior to each legislative session, the average value of trust assets for the preceding 5 years will be determined.
- The amount to distribute for a given biennium will be 10% of the average market value of the portfolio over the preceding 5 years.
- Equal amounts will be paid out during each year of the biennium.

3. How was the distribution formula determined:

- The distribution formula is based on the assumption that the trust funds can earn an average return of 8.40% on the trust funds' investments over time. This assumes an asset allocation of 60% equities and 40% fixed income investments (bonds).
- Assuming an 8.40% average rate of return over time, a 10% per biennium distribution rate will allow trust fund distributions to increase by an average rate of 8.2% per biennium, which is the equivalent of 4.0% per year, the assumed rate of inflation.
- The average rate of increase in distributions should be achievable even without considering new funds from outside sources such as mineral royalties and bonuses, oil extraction taxes and tobacco lawsuit proceeds.
- New funds from outside sources should allow trust fund distributions to increase by an average rate of 10% - 15% per biennium for the foreseeable future.

4. Will these changes change the way the Land Board invests

- Yes, but not much.
- The trust funds' allocation to stocks will most likely increase from a current 51 % of assets to a figure closer to 60% of trust assets.
- Because the trust funds will no longer need to focus on generating a specific amount of income each year, the portfolio will most likely be more balanced between value oriented (dividend paying) equity securities and growth oriented securities, reducing portfolio risk.
- The asset allocation will also become more diversified, which should also result in reduced portfolio volatility, or risk.
- Although the specific asset allocation may change, the Land Board's emphasis on minimizing portfolio risk should not change as stability of distributions to beneficiaries will still be one of their primary goals.
- The Land Board has historically viewed minimizing risk to be just as important, if not more important than maximizing returns. We don't see that focus changing.

5. Graph on page 9 of our total return slide show?

6. **Conclusion:**

Adopting a "Total Return" approach to permanent trust management and trust distributions will allow the Land Board to manage the trusts more prudently.

- Bring the management of the permanent trusts in line with the investment practices of the largest endowments and permanent trusts in the nation.
- Improve the long-term performance of the investment program by allowing the Land Board to invest in a more optimal way.
- Ensure that actual distributions from the permanent trust funds equal budgeted distributions each biennium.
- Eliminate the uncertainty involved in trying to forecast future "income".
- Result in higher and more reliable distributions to trust beneficiaries over time.
- Allow the Land Board to manage the trusts more efficiently and effectively to better serve the people of N.D. for generations to come.

7. Comparison of Total Return" approach and "Income" approach

Total Return Approach	Income Approach
Trust assets are managed as one optimum unit in order to maximize returns and minimize the risk of the entire portfolio.	Trust assets are managed for two distinct purposes. Some assets are managed for income while others are managed for growth.
Investment decisions are made in a way that emphasizes the long-term goals of maintaining the purchasing power of the trusts and income stability to trust beneficiaries.	The need for income can result in short-term investment decisions being made in reaction to current market conditions, which is often not in the best long-term interest of the trust or future beneficiaries.
As assets grow over time, so will distributions to beneficiaries.	As assets grow over time, distributions can only increase by the amount of additional income generated by those assets.
Trust distributions will be known prior to each legislative session and will be based on the average value of trust financial assets over the previous 5 years.	Estimates are made prior to each legislative session as to the amount of income that will be available to distribute from each trust fund. These estimates include projections as to interest rates, equity returns, oil prices, and many other factors.
Distributions will match budgeted amounts regardless of the portfolio's performance during the biennium.	If income falls short of projections, distributions may be less than budgeted amounts, causing financial hardship to trust beneficiaries.
The use of the average value of trust assets over a 5 year period to determine distributions helps minimize fluctuations in trust distributions.	A policy of distributing only the income earned by a trust leaves distributions vulnerable to interest rate swings and can result in more volatile distributions.
Over 80% of endowments use a total return approach to manage assets and determine distributions; as do the 3 largest state permanent trust funds (New Mexico Land Grant and Severance Tax Permanent Funds and Texas Permanent Fund).	Only about 3.5% of endowments currently use some form of an "interest and income" model to manage assets and determine distributions.
Over the past 10 years, two different investment consultants have performed studies to determine how to best manage the state's permanent trust assets. Both studies recommended the use of the "total return" approach to managing investments and determining distributions.	Both consultants hired by the state over the past 10 years have recommended Two consultants