

## LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD - STATUS REPORT TO THE BUDGET SECTION MARCH 13, 2012

The Legacy and Budget Stabilization Fund Advisory Board was created by 2011 Senate Bill No. 2302, codified as North Dakota Century Code Section 21-10-11. The board is established for the purpose of developing recommendations for the investment of funds in the legacy fund and the budget stabilization fund to present to the State Investment Board. The board is to report at least semiannually to the Budget Section.

Pursuant to Section 21-10-11, the Legacy and Budget Stabilization Fund Advisory Board is comprised of two members of the Senate appointed by the Senate majority leader (Senator Randel Christmann and Senator Jim Dotzenrod), two members of the House of Representatives appointed by the House majority leader (Representative Keith Kempenich and Representative Dave Weiler), the director of the Office of Management and Budget (OMB) or designee, the president of the Bank of North Dakota or designee, and the Tax Commissioner or designee. Section 21-10-11 provides that a chairman be selected by the advisory board. At its first meeting, the advisory board selected Senator Christmann to serve as chairman. The advisory board has held five meetings to date—June 28, 2011, August 11, 2011, September 6, 2011, October 27, 2011, and December 9, 2011.

### BUDGET STABILIZATION FUND

The Legacy and Budget Stabilization Fund Advisory Board continues to evaluate the current budget stabilization fund investment policy statement (Appendix A). The advisory board has heard recommendations from representatives of the Retirement and Investment Office and Callan Associates Inc., an investment consultant, regarding suggested changes to the current budget stabilization fund investment policy statement. Comments from other interested persons have also been heard.

At the beginning of the 2011-13 biennium, the balance in the budget stabilization fund was \$386.4 million after the \$61.4 million transfer into the fund at the end of the 2009-11 biennium. Currently, the investment policy statement asset class mix provides that a minimum of 90 percent of budget stabilization fund assets be held in short-term fixed income and Bank of North Dakota CDs, a maximum of 5 percent may be held in bank loans with floating yield, and a maximum of 5 percent may be held in absolute return strategies. As of January 2012 the balance in the budget stabilization fund was \$391 million, budget stabilization fund assets were held \$97.4 million in Bank of North Dakota CDs, \$9.1 million in cash equivalents, and \$284.5 million in short-term fixed income accounts with Prudential (\$8.8 million), Babson Capital (\$137.9 million), and JP Morgan (\$137.8 million).

Due to the increase in general fund appropriations for the 2011-13 biennium, approved by the Legislative Assembly during its November 2011 special session, the maximum balance allowed in the budget stabilization fund is now \$402.5 million. Therefore, income earned by the fund will be retained in the fund rather than transferred to the general fund until the maximum balance is reached. Based on the fund's most recent three-year average return rate, investment earnings for the remainder of the 2011-13 biennium are estimated to be \$12.5 million.

### LEGACY FUND

At its December 9, 2011, meeting, the advisory board approved an investment policy statement for the legacy fund (Appendix B). The advisory board developed the investment policy statement to focus on the goal of the legacy fund provided for in Senate Bill No. 2302 as approved by the Legislative Assembly—to preserve the principal while maximizing total return. The investment policy statement includes language indicating that "the board recognizes that the plan will evolve as the fund matures and economic conditions and opportunities change." Currently, the investment policy statement asset class mix provides that 100 percent of legacy fund assets be held in bonds or fixed income. In the future, the advisory board anticipates considering plans for including stocks and equities as a part of the asset class mix.

The legislative revenue forecast for the 2011-13 biennium projects oil and gas gross production tax and oil extraction tax revenues to total \$2,041,560,997. Thirty percent of the projected revenues to be deposited to the legacy fund total \$612,468,299. To date in the 2011-13 biennium actual revenue collected each month has been more than the legislative revenue forecast. Deposits into the legacy fund through February 2012 total \$219.5 million as follows:

Month of Deposit	Tax Revenue Generation Month	Amount
September 2011	July 2011	\$34,311,020
October 2011	August 2011	32,666,664
November 2011	September 2011	33,217,752
December 2011	October 2011	36,470,942
January 2012	November 2011	40,086,657
February 2012	December 2011	42,775,292
Total		\$219,528,327

### FUTURE ADVISORY BOARD ACTIVITIES

The advisory board plans to continue to meet to further develop the investment policy statement asset class mix for the legacy fund and to evaluate and consider changes to the investment policy statement for the budget stabilization fund.

ATTACH:2

## NORTH DAKOTA BUDGET STABILIZATION FUND

### ❖ND Budget Stabilization Fund Investment Objectives and Policy Guidelines

#### Fund Characteristics and Constraints

The Budget Stabilization Fund (Fund) is a special fund created in 1987 under Chapter 54-27.2 of the North Dakota Century Code used to deposit general fund moneys in excess of appropriations. Notwithstanding the provisions of sections 54-27.2-01 and 54-27.2-02, \$124,936,548 was required to be transferred by the state treasurer to the budget stabilization fund from the general fund on July 1, 2009. This transfer will provide for a total of \$324,936,548 in the budget stabilization fund for the biennium beginning July 1, 2009 and ending June 30, 2011. The state investment board shall supervise investment of the budget stabilization fund in accordance with chapter 21-10.

Any interest or other budget stabilization fund earnings must be deposited in the fund. Any amounts provided by law for deposit in the fund and any interest or earnings of the fund which would bring the balance in the fund to an amount greater than five percent of the current biennial state general fund budget, as finally approved by the most recently adjourned special or regular session of the legislative assembly, may not be deposited or retained in the fund but must be deposited instead in the state general fund.

If the director of the office of management and budget projects that general fund revenues for the biennium will be at least two and one-half percent less than estimated by the most recently adjourned special or regular session of the legislative assembly, and if the governor orders a transfer, the state treasurer shall transfer the appropriate funds from the budget stabilization fund to the state general fund to offset the decrease in general fund revenues. The amount transferred from the budget stabilization fund upon order of the governor may not exceed the difference between an amount two and one-half percent below the general fund revenue projections for the biennium and the general fund revenue projections for the biennium by the director of the office of management and budget.

#### Responsibilities and Discretion of the State Investment Board (SIB)

The Fund is charged by law under NDCC 21-10-02.1 with the responsibility of establishing policies on investment goals and asset allocation of the Fund. The SIB is charged with implementing these policies and asset allocation and investing the assets of the Fund in a manner consistent with the prudent investor rule as provided in NDCC 21-10-07.

At the discretion of the SIB, the Fund's assets may be pooled with other funds. In pooling funds, the SIB may establish whatever asset class pools it deems necessary with specific quality, diversification, restrictions, and

performance objectives appropriate to the prudent investor rule and objectives of the funds participating in the pools.

The SIB may delegate investment responsibility to professional money managers. When a money manager has been retained, the SIB's role in determining investment strategy and security selection is supervisory, not advisory. In accordance with this Investment Policy Statement, the Fund's assets may be invested directly or through collective investment vehicles.

The SIB is responsible for establishing criteria and procedures and making decisions with respect to hiring, maintaining, and terminating money managers. This responsibility includes selecting performance measurement services, consultants, and report formats and determining the frequency of meetings with managers.

The SIB will implement changes to this policy as promptly as is prudent.

#### Investment Objectives

The investment objectives of the Fund reflect the relatively unknown life-span and the moderate risk tolerance of the Fund. Operating and statutory considerations shape the Fund's policies and priorities as outlined below:

Objective: Sufficient liquidity is to be maintained to meet known or anticipated financial obligations and preserve the value of the surplus. Cash equivalent investments will be used to achieve this objective.

#### Standards of Investment Performance

The Fund's investment objectives and liquidity constraints give rise to an asset allocation that is considered the most likely to achieve the results desired. For evaluation purposes, the following performance targets will apply:

- a. The Fund should produce a rate of return that meets or exceeds the portfolio policy index.
- b. The annual standard deviation of total returns for the Fund should not exceed that of the policy portfolio.

#### Policy and Guidelines

The asset allocation of the Fund is established by the Office of Management and Budget, with input from the SIB. Asset allocation is based upon the appraisal of projected liquidity and income requirements, and estimates of the investment returns likely to be achieved by the various asset classes over the next five years.

In recognition of these factors, the following allocation is deemed appropriate for the fund:

Short-term Fixed Income and BND CDs	Minimum of 90%
Bank Loans w/floating yield	Maximum of 5%
Absolute Return Strategies	Maximum of 5%

Rebalancing of the Fund to this target will be done in accordance with the SIB's rebalancing policy.

While the SIB is responsible for establishing specific quality, diversification, restrictions, and performance objectives for the investment vehicles in which the Fund's assets will be invested, it is understood that:

- Futures and options may be used to hedge or replicate underlying index exposure, but not for speculation.
- Derivative use will be monitored to ensure that undue risks are not taken by the money managers.
- All assets will be held in custody by the State Investment Board's master custodian or such other custodians as are acceptable to the State Investment Board.
- No funds shall be borrowed.
- No unhedged short sales or speculative margin purchases shall be made.
- Social investing is prohibited unless it meets the Exclusive Benefit Rule and it can be substantiated that the investment must provide an equivalent or superior rate of return for a similar investment with a similar time horizon and similar risk.

For the purpose of this document, Social Investing is defined as *"The investment or commitment of public pension fund money for the*

*purpose of obtaining an effect other than a maximized return to the intended beneficiaries."*

- Economically targeted investing is prohibited unless the investment meets the Exclusive Benefit Rule.

For the purpose of this document economically targeted investment is defined as an investment designed to produce a competitive rate of return commensurate with risk involved, as well as to create collateral economic benefits for a targeted geographic area, group of people, or sector of the economy.

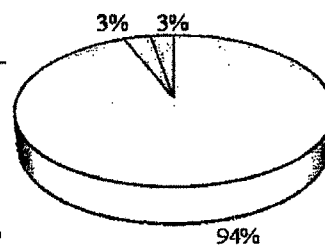
Also, for the purpose of this document, the Exclusive Benefit Rule is met if the following four conditions are satisfied:

- The cost does not exceed the fair market value at the time of investment.
- The investment provides the Fund with an equivalent or superior rate of return for a similar investment with a similar time horizon and similar risk.
- Sufficient liquidity is maintained in the Fund to permit distributions in accordance with the terms of the plan.
- The safeguards and diversity that a prudent investor would adhere to are present.

Where investment characteristics, including yield, risk, and liquidity are equivalent, the Fund's policy favors investments which will have a positive impact on the economy of North Dakota.

❖ **ND Budget Stabilization Fund**  
Actual Asset Allocation – June 30, 2010

Asset Allocation	Fair Value	Percent of Total	One Year Return
Short-term Fixed Income & BND CDs	\$ 305,656,798	94%	
Bank Loans w/floating yield	10,481,431	3%	
Absolute Return Strategies	9,039,328	3%	
<b>Total Fund</b>	<b>\$ 325,177,557</b>		<b>7.38%</b>
<b>Policy Benchmark</b>			<b>0.15%</b>





## LEGACY FUND INVESTMENT POLICY STATEMENT

### 1. PLAN CHARACTERISTICS AND FUND CONSTRAINTS

The North Dakota legacy fund was created in 2010 when the voters of North Dakota approved a constitutional amendment--now Article X, Section 26, of the Constitution of North Dakota--to provide that 30 percent of oil and gas gross production and oil extraction taxes on oil and gas produced after June 30, 2011, be transferred to the legacy fund. The principal and earnings of the legacy fund may not be spent until after June 30, 2017, and any expenditure of principal after that date requires a vote of at least two-thirds of the members elected to each house of the Legislative Assembly. Not more than 15 percent of the principal of the legacy fund may be spent during a biennium. The Legislative Assembly may transfer funds from any source to the legacy fund, and such transfers become part of the principal of the fund. The State Investment Board (SIB) is responsible for investment of the principal of the legacy fund. Interest earnings accruing after June 30, 2017, are transferred to the general fund at the end of each biennium. North Dakota Century Code Section 21-10-11 provides that the goal of investment for the legacy fund is principal preservation while maximizing total return.

### 2. FUND MISSION

The legacy fund was created, in part, due to the recognition that state revenue from the oil and gas industry will be derived over a finite timeframe. The legacy fund defers the recognition of 30 percent of this revenue for the benefit of future generations. The primary mission of the legacy fund is to preserve the real inflation-adjusted purchasing power of the money deposited into the fund while maximizing total return.

### 3. RESPONSIBILITIES AND DISCRETION OF THE STATE INVESTMENT BOARD

The Legacy and Budget Stabilization Fund Advisory Board (the board) is charged by law under Section 21-10-02.1 with the responsibility of establishing policies on investment goals and asset allocation of the legacy fund. The SIB is charged with implementing these policies and asset allocation and investing the assets of the legacy fund in the manner provided in Section 21-10-07--the prudent institutional investor rule. The fiduciaries shall exercise the judgment and care, under the circumstances then prevailing, that an institutional investor of ordinary prudence, discretion, and intelligence exercises in the management of large investments entrusted to it, not in regard to speculation but in regard to the permanent disposition of funds, considering probable safety of capital as well as probable income.

Management responsibility for the investment program not assigned to the SIB in Chapter 21-10 is hereby delegated to the SIB, which must establish written policies for the operation of the investment program consistent with this investment policy.

The SIB may delegate investment responsibility to professional money managers, which are also required to employ investment strategies consistent with the investment policy. Where a money manager has been retained, the SIB's role in determining investment strategy and security selection is supervisory not advisory.

The SIB is responsible for establishing criteria, procedures, and making decisions with respect to hiring, retaining, and terminating money managers. The SIB investment responsibility also includes selecting performance measurement services, consultants, report formats, and frequency of meetings with managers.

The SIB shall notify the board within 30 days of any substantial or notable changes in money managers; performance measurement services; and consultants, including hiring or terminating a money manager, performance measurement service, or a consultant.

The SIB, after consultation with the board, will implement necessary changes to this policy in an efficient and prudent manner.

### 4. RISK TOLERANCE

The board's risk tolerance with respect to the primary aspect of the legacy fund's mission is low. The board is unwilling to undertake investment strategies that might jeopardize the ability of the legacy fund to maintain principal value over time. The board recognizes that the plan will evolve as the legacy fund matures and economic conditions and opportunities change.

## 5. INVESTMENT OBJECTIVE

The board's investment objectives are expressed in terms of reward and risk expectations relative to investable, passive benchmarks. The legacy fund's policy benchmark is comprised of policy mix weights of appropriate asset class benchmarks as set by the SIB:

- a. The legacy fund's rate of return, net of fees and expenses, should at least match that of the policy benchmark over a minimum evaluation period of five years.
- b. The legacy fund's risk, measured by the standard deviation of net returns, should not exceed 115 percent of the policy benchmark over a minimum evaluation period of five years.
- c. The risk-adjusted performance of the legacy fund, net of fees and expenses, should at least match that of the policy benchmark over a minimum evaluation period of five years.

## 6. POLICY ASSET MIX

After consideration of all the inputs and a discussion of its own collective risk tolerance, the board approves the following policy asset mix for the legacy fund as of December 9, 2011:

Asset Class	Policy Target Percentage
Bonds or fixed income <sup>1</sup>	100%
Stocks and equities <sup>2</sup>	0%

<sup>1</sup>It is the preference of the board that investment grade bonds will be purchased to provide a range of laddered maturities not to exceed 10 years with an effective duration not to exceed 3.5 years.

<sup>2</sup>Plans for including stocks and equities as a part of the asset class mix will be finalized by the board in the future.

## 7. RESTRICTIONS

While the SIB is responsible for establishing specific quality, diversification, restrictions, and performance objectives for the investment vehicles in which the legacy fund's assets will be invested, it is understood that:

- a. It is the preference of the board that legacy fund assets not be pooled with any other fund assets managed by the SIB.
- b. Futures and options may be used to hedge or replicate underlying index exposure, but not for speculation.
- c. Derivatives use will be monitored to ensure that undue risks are not taken by the money managers.
- d. No transaction may be made that would threaten the tax-exempt status of the legacy fund.
- e. All assets will be held in custody by the SIB's master custodian or such other custodians as are acceptable to the SIB.
- f. No unhedged short sales or speculative margin purchases may be made.
- g. Social investing is prohibited unless it meets the exclusive benefit rule, and it can be substantiated that the investment must provide an equivalent or superior rate of return for a similar investment with a similar time horizon and similar risk. For the purpose of this document, social investing is defined as the investment or commitment of public fund money for the purpose of obtaining an effect other than a maximized return to the intended beneficiaries.
- h. Economically targeted investing is prohibited unless the investment meets the exclusive benefit rule.

For the purpose of this document, economically targeted investment is defined as an investment designed to produce a competitive rate of return commensurate with risk involved as well as to create collateral economic benefits for a targeted geographic area, group of people, or sector of the economy.

Also, for the purpose of this document, the exclusive benefit rule is met if the following four conditions are satisfied:

- The cost does not exceed the fair market value at the time of investment.
- The investment provides the legacy fund with an equivalent or superior rate of return for a similar investment with a similar time horizon and similar risk.

- Sufficient liquidity is maintained in the legacy fund to permit distributions in accordance with the terms of the plan.
- The safeguards and diversity that a prudent investor would adhere to are present.

Where investment characteristics, including yield, risk, and liquidity, are equivalent, the board's policy favors investments which will have a positive impact on the economy of North Dakota.

## **8. INTERNAL CONTROLS**

A system of internal controls must be in place by the SIB to prevent losses of public funds arising from fraud or employee error. Such controls deemed most important are the separation of responsibilities for investment purchases from the recording of investment activity, custodial safekeeping, written confirmation of investment transactions, and established criteria for broker relationships. The annual financial audit must include a comprehensive review of the portfolio, accounting procedures for security transactions, and compliance with the investment policy.

## **9. EVALUATION AND REVIEW**

Investment management of the legacy fund will be evaluated against the fund's investment objectives and investment performance standards. Emphasis will be placed on 5-year and 10-year results. Evaluation should include an assessment of the continued feasibility of achieving the investment objectives and the appropriateness of the investment policy statement for achieving those objectives.

Performance reports will be provided to the board periodically, but not less than quarterly. Such reports will include asset returns and allocation data as well as information regarding all significant and/or material matters and changes pertaining to the investment of the legacy fund, including:

- Changes in asset class portfolio structures, tactical approaches, and market values.
- Loss of principal, if any.
- Management costs associated with various types of investments.
- All material legal or legislative proceedings affecting the SIB.
- Compliance with this investment policy statement.
- An evaluation of the national economic climate.
- A forecast of the expected economic opportunities and dangers.
- Management of risk by the SIB.

In addition to the quarterly evaluation and review process, the SIB shall notify the board within 30 days of any substantial or notable deviation from the normal management of the legacy fund, including any anomalies, notable losses, gains, or liquidation of assets affecting the fund.

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Mr. John Geissinger  
Chief Investment Officer  
State Investment Board

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Senator Randel Christmann  
Chairman  
Legacy and Budget Stabilization Fund Advisory Board