NORTH DAKOTA LEGISLATIVE MANAGEMENT

Minutes of the

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD

Tuesday, April 2, 2013
Medora Room, State Capitol
Bismarck, North Dakota

Representative Keith Kempenich, Acting Chairman, called the meeting to order at 2:49 p.m.

Members present: Representatives Keith Kempenich, Gary Kreidt; Senators Jim Dotzenrod, Jerry Klein; Bank of North Dakota President - Eric Hardmeyer; Office of Management and Budget Director - Pam Sharp; Tax Commissioner - Cory Fong

Others present: Darren Schulz, Retirement and Investment Office, Bismarck

Connie Flanagan, Retirement and Investment Office, Bismarck

Ronald Klotter, R. V. Kuhns & Associates, Inc., Chicago, Illinois

Joshua Kevan, R. V. Kuhns & Associates, Inc., Boise, Idaho

John McLaughlin, R. V. Kuhns & Associates, Inc., Chicago, Illinois

It was moved by Mr. Hardmeyer, seconded by Senator Dotzenrod, and carried on a voice vote that the minutes of the November 15, 2012, meeting be approved as distributed.

SELECTION OF ADVISORY BOARD CHAIRMAN AND VICE CHAIRMAN

It was moved by Senator Dotzenrod, seconded by Representative Kreidt, and carried on a roll call vote that the Legacy and Budget Stabilization Fund Advisory Board select Representative Kempenich to serve as advisory board Chairman. Representatives Kempenich and Kreidt, Senators Dotzenrod and Klein, Ms. Sharp, Mr. Fong, and Mr. Hardmeyer voted "aye." No negative votes were cast.

It was moved by Mr. Fong, seconded by Representative Kreidt, and carried on a roll call vote that the Legacy and Budget Stabilization Fund Advisory Board select Senator Klein to serve as advisory board Vice Chairman. Representatives Kempenich and Kreidt, Senators Dotzenrod and Klein, Ms. Sharp, Mr. Fong, and Mr. Hardmeyer voted "aye." No negative votes were cast.

ASSET ALLOCATION AND SPENDING POLICY PROJECT OF THE LEGACY FUND

Chairman Kempenich called on Mr. Joshua Kevan, CFA - Senior Consultant, R. V. Kuhns & Associates, Inc., to lead a discussion regarding the asset allocation and spending study for the legacy fund. Mr. Kevan presented a discussion outline (appendix), including topics related to fund revenue, asset allocation, and spending for consideration by the advisory board. Advisory board members and the representatives of R. V. Kuhns & Associates, Inc., discussed the topic areas relating to the potential asset allocation portfolios for the legacy fund.

Mr. Kevan discussed the lifecycle of the fund and said the legacy fund is in the accumulation stage. He discussed anticipated revenue, the fund's ability to absorb capital market risk, and the correlations between the market and anticipated revenue. He said R. V. Kuhns & Associates, Inc., compared various investment portfolios to various market scenarios--both optimistic and pessimistic--during the analysis to provide the best-suited portfolios for the fund.

Mr. Kevan reviewed the two key concepts used during the R. V. Kuhns & Associates, Inc., analysis. First was the focus on building a corpus for future generations, and second was the focus on preserving purchasing power. He said there is a need for a rate of return of 6.6 percent per year in order to preserve the future purchasing power of the fund.

Mr. Kevan recommended the advisory board revisit the allocation portfolio of the funds in three years to four years to reevaluate the conditions of the fund.

In response to a question from Mr. Hardmeyer, Mr. Kevan said it is appropriate to consider the expected spending rate in the analysis example due to the long-term planning of the fund.

REVENUE FORECASTS - BACKGROUNDS AND ASSUMPTIONS

Mr. John McLaughlin, CFA - Consultant, R. V. Kuhns & Associates, Inc., discussed the revenue forecasts used in the analysis. He said R. V. Kuhns & Associates, Inc., worked closely with the Tax Department to gather effective and forecasted tax rates, average oil barrels in production per day, production cycles, and current and forecasted assumptions of oil prices for the analysis.

Mr. McLaughlin provided the formula R. V. Kuhns & Associates, Inc., used to forecast the total monthly revenue from current production and the total monthly distribution to the legacy fund. He discussed the two cashflow scenarios that R. V. Kuhns & Associates, Inc., created for the legacy fund--a base case scenario and an adverse case scenario. He said the adverse case reduces the base case scenario's average daily production levels and oil prices by 50 percent and reduces the effective tax rate for oil revenue decreases from 10.8 to 9.0 percent.

Mr. McLaughlin said the analysis provided a sufficient baseline and adverse scenario for the accumulation phase of the fund. In addition, he said, R. V. Kuhns & Associates, Inc., analyzed the cashflows of the fund during the permanent phase of the fund. He said within the modeling assumptions after year 2016, R. V. Kuhns & Associates, Inc., assumed that monthly cashflow into the fund was static. In the base case scenario, this represents a monthly fund income of $65.8 million, and in the adverse case scenario, this monthly income is reduced to $11.8 million. He said the legacy fund is currently in the accumulation phase which means the liquidity requirements are unnecessary, regular cash inflows create a natural dollar cost averaging process, and the inflows are large relative to the size of the existing assets.

In response to a question from Representative Kreidt, Mr. Kevan said the assumptions and data used may be conservative.

Mr. Fong said the forecast used by R. V. Kuhns & Associates, Inc., is from the executive budget forecast for the 2013-15 biennium.

ASSET ALLOCATION STUDY

Mr. Kevan discussed the analysis of the correlation statistics between the revenue and the asset class returns. He said R. V. Kuhns & Associates, Inc., measured the change in the price of West Texas Intermediate crude oil and the correlation between monthly change percentages for the past 10 years and the returns experienced in the different asset classes.

Mr. Kevan discussed the asset class selection. He said R. V. Kuhns & Associates, Inc., received input from the State Investment Board for guidance in choosing the asset classes available for investing the legacy fund. He said the asset classes identified include large and small domestic equity, international equity, fixed income, and diversified real assets. He said during the analysis, the restriction of the assets of pooling of the funds was taken into consideration and made a policy recommendation to allow the assets of the legacy fund to be pooled in order for cost-savings and cost-efficiencies.

Mr. Kevan reviewed six possible portfolios at different levels of equity exposure. He said each portfolio shows the composition, expected return, and expected risk. He discussed the downside risk analysis. Based on the analysis, he said, during the accumulation phase the legacy fund over the next 4.5 years showed the base case annualized return ranges from approximately 5.4 percent (30 percent equity) to 7.0 percent (75 percent equity). He said the worst-case scenario during the analysis resulted in the returns ranging from an annualized loss of approximately 1.4 percent (30 percent equity) to an annualized loss of approximately 7.4 percent (75 percent equity). He said in the best-case scenario, the annualized returns range from 11.4 to 18.6 percent.

SPENDING POLICY - CONSIDERATIONS AND ASSUMPTIONS

Mr. Ronald Klotter, Senior Consultant and Director of Midwest Consulting, R. V. Kuhns & Associates, Inc., discussed the permanent spending phase of the legacy fund post-June 2017. He said given the positive cashflow characteristics during the accumulation phase, the corpus will increase during the phase under every modeling scenario considered by R. V. Kuhns & Associates, Inc. He said there is a wide range of potential values for the fund as of June 2017; however, all of the projected values are higher than the current market value. He said R. V. Kuhns & Associates, Inc., tested three spending scenarios--spending only income, modeled at 3 percent per year paid at the end of each biennium; spending 5 percent of the fund per year paid at the end of each biennium; and spending the 10.5 percent per year paid at the end of each biennium.

In response to a question from Representative Kempenich, Mr. Klotter said if the Legislative Assembly would spend the maximum amount of funds allowed, none of the simulations R. V. Kuhns & Associates, Inc., analyzed would produce a high enough return in order to protect the corpus.

In response to a question from Mr. Fong, Mr. Klotter said the simulated target percentages do not consider inflation; however, the probabilities of the equity mixes do consider inflation.

SUMMARY OF CONCLUSIONS

Mr. Kevan discussed the conclusions of the analysis. He said R. V. Kuhns & Associates, Inc., considered the primary mission of the legacy fund--which is to preserve the real, inflation-adjusted purchasing power of the money deposited into the fund while finalizing the recommendation process. He said the most difficult aspect of determining an appropriate asset allocation recommendation is not knowing future spending from the fund. He said R. V. Kuhns & Associates, Inc., recommends the advisory board assume a traditional "endowment-like" long-term level of spending, which is 4 to 5 percent per year for the purpose of asset allocation planning. He said assuming a higher level of spending would require a very aggressive portfolio allocation. He said there is risk in assuming that only income will be spent, as it could lead to portfolio allocations that fail to meet the real wealth preservation objectives of the fund.

Mr. Kevan said R. V. Kuhns & Associates, Inc., recommends the selection of one of the target asset allocation portfolios investing between 50 and 60 percent in equities. He said in the next 4.5 years the fund has no liquidity requirements; therefore, the fund may be exposed to higher risks. He said the fund will eventually enter the permanent phase, in which there will be both revenue into and disbursements out of the fund. He said at that point it will be become very important to provide a balance between long-term growth objectives and near-term liquidity needs--which are uncertain at this point. He said even though the permanent phase will not commence for approximately 4.5 years, R. V. Kuhns & Associates, Inc., believes it is appropriate to develop a long-term asset allocation policy now, that will not likely need significant alteration within a relatively short period of time.

In response to a question from Representative Kempenich, Mr. Kevan said R. V. Kuhns & Associates, Inc., focused on asset classes that were currently being used in the State Investment Board's insurance investment pool in the analysis.

In response to a question from Representative Kreidt, Mr. Kevan said the broad international equities include mostly Western Europe and Japan.

In response to a question from Representative Kempenich, Mr. Kevan suggested to separate the long-term policy decisions from the implementation decisions. He said the advantage of not having liquidity requirements now is the ability to average into the long-term target.

It was moved by Mr. Fong, seconded by Mr. Hardmeyer, and carried on a voice vote the R. V. Kuhns & Associates, Inc., report be approved as distributed.

ADVISORY BOARD DISCUSSION AND STAFF DIRECTIVES

In response to a question from Mr. Fong, Mr. Darren Schulz, Interim Chief Investment Officer, State Investment Board, discussed the current asset allocation policy of the legacy fund. Mr. Schulz said the advisory board selected an asset mix in December 2012 that was recommended to the State Investment Board and accepted the portfolio that consisted of 100 percent short-term fixed income which is currently managed by two managers--Babson Capital and JP Morgan.

In response to a question from Representative Kempenich, Mr. Schulz said the management fees are approximately 35 base points. He said the average annualized returns of the fund have been approximately 2 percent compared to the annual consumer price index which is approximately 1.6 to 1.7 percent.

In response to a question from Mr. Hardmeyer, Mr. Schulz said the State Investment Board will consider the recommendation from the Legacy and Budget Stabilization Fund Advisory Board and make a decision on whether to accept the recommendation or not. He said pooling of the fund would result in cost-efficiencies in comparison to being a stand-alone portfolio. He said in addition to cost-efficiencies, operational advantages within the internal management would also result.

In response to a question from Representative Kempenich, Mr. Schulz said the legacy fund would be accounted for separately, but the ability to pool the funds would result in cost-savings.

In response to a question from Ms. Sharp, Mr. Schulz said State Investment Board policy provides that the legacy fund not be pooled with other funds.

In response to a question from Representative Kreidt, Mr. Schulz said the investment programs of the State Investment Board utilize external managers. He said during the manager selection process, the State Investment Board reviews the firm's institutional grade, fixed income, equity, real estate, and other alternative investment managers to meet the investment objectives of individual clients. He said staff internally conducts due diligence--both monitoring existing managers, as well as reviewing other investment managers that may be well-suited to offer investment programs for which the State Investment Board oversees.

Representative Kempenich requested a list of investment managers currently utilized by the State Investment Board.

It was moved by Mr. Fong, seconded by Mr. Hardmeyer, and carried on a roll call vote that the Legacy and Budget Stabilization Fund Advisory Board adopt for incorporation into the legacy fund investment policy statement the 50 percent equity portfolio recommendation of R. V. Kuhns & Associates, Inc. Representatives Kempenich and Kreidt, Senators Dotzenrod and Klein, Ms. Sharp, Mr. Fong, and Mr. Hardmeyer voted "aye." No negative votes were cast.

Mr. Schulz asked the advisory board to consider making a recommendation regarding the pooling of the legacy fund with other funds.

Mr. Fong asked Mr. Schulz to provide the current State Investment Board policy precluding the pooling of funds to board members.

Mr. Hardmeyer suggested the committee receive information on how the 50 percent equity model would be implemented.

No further business appearing, Chairman Kempenich adjourned the meeting at 4:44 p.m.

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Brittani S. Reim
Fiscal Assistant

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Allen H. Knudson
Legislative Budget Analyst and Auditor

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