

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD - STATUS REPORT TO THE BUDGET SECTION SEPTEMBER 15, 2011

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 three meetings to date--June 28, 2011, August 11, 2011, and September 6, 2011.

BUDGET STABILIZATION FUND

The Legacy and Budget Stabilization Fund Advisory Board is evaluating the current budget stabilization fund investment policy statement (attached as an appendix). The advisory board has heard recommendations by Mr. John Geissinger, Chief Investment Officer, Retirement and Investment Office, regarding suggested changes to the current budget stabilization fund investment policy statement as well as comments from other interested persons.

The balance in the budget stabilization fund is \$386.4 million after the \$61.4 million transfer at the end of the 2009-11 biennium.

LEGACY FUND

The advisory board is in the process of developing an investment policy statement for the legacy fund. The advisory board is planning for the investment policy statement to focus on the goal of the legacy fund which is to preserve the principal while maximizing total return as provided for in Senate Bill No. 2302.

The first deposit into the legacy fund totaling \$34.3 million occurred on September 8, 2011. This deposit relates to tax revenues generated from July 2011 production. At its September 6, 2011, meeting, the advisory board approved the following motion:

It was moved by Senator Dotzenrod, seconded by Ms. Sharp, and carried on a voice vote that the Legacy and Budget Stabilization Fund Advisory Board recommends the State Investment Board invest money in the legacy fund with the Bank of North Dakota on a short-term basis until the Legacy and Budget Stabilization Fund Advisory Board develops the investment policy statement for the legacy fund.

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

ATTACH:1

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:

- a. Futures and options may be used to hedge or replicate underlying index exposure, but not for speculation.
- b. Derivative use will be monitored to ensure that undue risks are not taken by the money managers.
- c. 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.
- d. No funds shall be borrowed.
- e. No unhedged short sales or speculative margin purchases shall be made.
- f. 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."

- g. 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:

- (1) The cost does not exceed the fair market value at the time of investment.
- (2) 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.
- (3) Sufficient liquidity is maintained in the Fund to permit distributions in accordance with the terms of the plan.
- (4) 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%	
Total Fund	\$ 325,177,557		7.38%
Policy Benchmark			0.15%

