

BUDGET STABILIZATION FUND

INVESTMENT POLICY STATEMENT

1. 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~~ \$61,414,562 was required to be transferred by the state treasurer to the budget stabilization fund from the general fund on ~~July 1, 2009~~ July 1, 2011. This transfer will provide for a total of ~~\$324,936,548~~ \$386,351,110 in the budget stabilization fund for the biennium beginning ~~July 1, 2009 and ending June 30, 2011~~ July 1, 2011 and ending June 30, 2013. 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.

2. FUND MISSION

The Budget Stabilization Fund was established to provide budget relief in the event of unanticipated declines in State revenue. The primary mission of the Budget Stabilization Fund is to maintain liquidity in the event of unanticipated revenue declines, and to preserve the real, inflation-adjusted purchasing power of the monies deposited into the Fund.

2 3. RESPONSIBILITIES AND DISCRETION OF THE STATE INVESTMENT BOARD (SIB)

The ~~Fund-Legacy and Budget Stabilization Advisory Board (Board)~~ is charged by law under ~~NDCC 21-10-02.4~~ NDCC 21-10-11 with the responsibility of establishing policies on investment goals and asset allocation for 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. 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.

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.

4. RISK TOLERANCE

In recognition of the relatively unknown life-span of the Fund, the Board's risk tolerance with respect to the primary aspect of the Fund's mission is extremely low. The Board is unwilling to undertake investment strategies that might jeopardize the ability of the Fund to maintain liquidity and principal value over time.

-3. 5. 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.~~

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

1. The 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.
2. The Fund's risk, measured by the standard deviation of net returns, should not exceed 115% of the policy benchmark over a minimum evaluation period of five years.

3. The risk-adjusted performance of the Fund, net of fees and expenses, should at least match that of the policy benchmark over a minimum evaluation period of five years.

4. 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.~~

5.6. POLICY AND GUIDELINES ASSET MIX

~~The asset allocation of the Budget Stabilization Fund is established by the SIB, with input from the Office of Management and Budget. 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 & BND CDs	Minimum of 90%
Bank Loans w/floating yield	Maximum of 5%
Absolute Return Strategies	Maximum of 5%

After consideration of all the inputs and a discussion of its own collective risk tolerance, the Board approves the appropriate policy asset mix for the Fund.

<u>Asset Class</u>	<u>Policy Target (%)</u>	<u>Rebalancing Range (%)</u>
<u>Cash and Cash Equivalents</u>	<u>20%</u>	<u>15-25%</u>
<u>Short Term Bonds & BND CDs</u>	<u>70%</u>	<u>65-75%</u>
<u>Bank Loans</u>	<u>10%</u>	<u>7.5-12.5%</u>

Rebalancing of the Fund to this target will be done in accordance with the SIB's rebalancing policy, but not less than annually.

7. RESTRICTIONS

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. 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."*

- e. 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.

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.

6 9. EVALUATION AND REVIEW.

Investment management of the Fund will be evaluated against the Fund's investment objectives and investment performance standards. Emphasis will be placed on three and

five year results. Evaluation will be conducted quarterly by the SIB through its review of funds participating in the Insurance Trust 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.

Money managers will be evaluated by the SIB quarterly. In state meetings will be held with the money managers at least annually.

Performance reports will be provided to the Legacy and Budget Stabilization Fund Advisory Board periodically, but not less than annually. 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 Fund, including, but not limited to:

- Changes in asset class portfolio structures, tactical approaches and market values;
- All material legal or legislative proceedings affecting the SIB.
- Compliance with this investment policy statement.

Approved by:

**LEGACY AND BUDGET STABILIZATION
FUND ADVISORY BOARD**

**Senator Randel Christmann
Chairman**

Date: _____

STATE INVESTMENT BOARD

**John Geissinger, CFA
Executive Director/CIO**

Date: _____