

September 2011

LEGACY FUND INVESTMENT POLICY STATEMENT SURVEY RESULTS

This memorandum consists of the survey responses submitted by members of the Legacy and Budget Stabilization Fund Advisory Board regarding the development of an interim investment policy statement for the legacy fund. The investment policy statement template provided by Mr. John Geissinger, Chief Investment Officer for the State Investment Board (SIB), is separated by section with board member survey responses following each section:

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.

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| Representative Kempenich | |
| Representative Weiler | |
| Commissioner Fong | |
| Eric Hardmeyer | |

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 moneys deposited into the fund.

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| Representative Kempenich | I think should be like Alaska, at least 5% growth. |
| Representative Weiler | |
| Commissioner Fong | I think the primary mission is more than just "preserving" the purchasing power of the moneys. I think we want to grow them. I suggest the third sentence state the following: "The primary mission of the legacy fund is to grow the real inflation-adjusted purchasing power of the moneys deposited into the fund." |
| | This is my take on it but I am more interested in what the lawmakers, who actually took part in the discussions, will say about what they see as the primary mission. I will be very interested in what Representatives Weiler and Kempenich have to say on this, especially, given their involvement in the crafting of the measure that eventually went on the ballot. |
| Eric Hardmeyer | |

3. Responsibilities and Discretion of the State Investment Board

The Legacy Fund Advisory Board 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 the manner provided in NDCC 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, who 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. Where a money manager has been retained, the SIB's role in determining investment strategy and security selection is supervisory not advisory.

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 the objectives of the funds participating in the pools.

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

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

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| Representative Kempenich | If pooling will give the best returns, advisory board needs to be given the breakdown of fund assets. |
| Representative Weiler | |
| Commissioner Fong | This section looks good to me. The last sentence seems awkward and lacks the involvement of the advisory board. I suggest the last sentence state the following: "The SIB, after consultation with The Legacy and Budget Stabilization Fund Advisory Board, will implement necessary changes to this policy in an efficient and prudent manner." |
| Eric Hardmeyer | |

4. Risk Tolerance

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 principal value over time.

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| Representative Kempenich | Should have a long-term view on this fund. Should change to low. |
| Representative Weiler | |
| Commissioner Fong | Once again, since I think the primary mission is more than just "preserving" the purchasing power of the moneys, we want to grow them, I think our risk tolerance should be a bit greater than what we are willing to tolerate for the Budget Stabilization Fund. As a place holder for discussion, I suggest the first sentence state the following: "The board's risk tolerance with respect to the primary aspect of the fund's mission is low to moderate." Once again, I am more interested in what the lawmakers, who actually took part in the discussions, will say about the risk tolerance. |
| Eric Hardmeyer | I believe we should remove the word extremely. Also I think we should change the next sentence to read: The board strives for an investment strategy that will preserve principal, but will seek a return with a commensurate index. |

5. Investment 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 funds 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 funds 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.

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| Representative Kempenich | No changes |
| Representative Weiler | |
| Commissioner Fong | I believe this section may need to be adjusted depending on the decisions made in Sections 2 and 4 with regard to mission and risk tolerance. If we decide the mission is to grow the fund, resulting in a greater risk tolerance, the rate of return, fund risk, and risk-adjusted performance may need to be adjusted, too. At that point, I would defer to the investment professionals for a recommendation for adjusting these objectives to match a revised mission and greater risk tolerance. |
| Eric Hardmeyer | |

6. Policy Asset Mix

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.

The current policy mix has been approved as of xx/xx/xxx:

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

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

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| Representative Kempenich | I think that this fund should be a longer term look take the cash down to 10%, short term to 35%, long term to 35%, and 20% equities that pay dividends. |
| Representative Weiler | |
| Commissioner Fong | I believe this section may need to be adjusted depending on the decisions made in Sections 2 and 4 with regard to mission and risk tolerance. If we decide the mission is to grow the fund, resulting in a greater risk tolerance, the asset mix may need to be adjusted, too. At that point, I would defer to the investment professionals for a recommendation for adjusting the asset mix to match a revised mission and greater risk tolerance. |
| Eric Hardmeyer | This means we take equities completely out of the equation?? |

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:

- Futures and options may be used to hedge or replicate underlying index exposure, but not for speculation.
- Derivatives use will be monitored to ensure that undue risks are not taken by the money managers.
- No transaction shall be made which threatens the tax-exempt status of the fund.
- All assets will be held in custody by the SIB's master custodian or such other custodians as are acceptable to the SIB.
- 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 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:

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 Board's policy favors investments which will have a positive impact on the economy of North Dakota.

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| Representative Kempenich | No changes |
| Representative Weiler | |
| Commissioner Fong | This section generally looks good to me, although, given its technical nature, I would defer to the investment professionals for their guidance in crafting and/or adjusting this section. Once again, if we decide the mission is to grow the fund, resulting in a greater risk tolerance, some of these restrictions may need to be adjusted to reflect the greater tolerance of risk. |
| Eric Hardmeyer | |

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.

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| Representative Kempenich | No changes |
| Representative Weiler | |
| Commissioner Fong | No changes |
| Eric Hardmeyer | |

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 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 Legacy 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.

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| Representative Kempenich | No changes |
| Representative Weiler | |
| Commissioner Fong | Given the longevity of the fund, I would like to discuss the wisdom of lengthening the emphasis on three-year and five-year results. Perhaps it should be extended to five-year and ten-year results. Once again, if we decide the mission is to grow the fund, resulting in a greater risk tolerance, we may want to adjust the timeline for measuring results. |
| Eric Hardmeyer | Periodic investment reports should be at least quarterly. |

10. Other comments and suggestions

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| Representative Kempenich | Would like to see this follow the Alaska model as close as we can. |
| Representative Weiler | Regarding the "policy statement" about the only thing I would suggest is that we not have a "very low" risk tolerance. Somewhere in the low to moderate range, but we do need to discuss this at length. For instance, how much does the level of risk vary during an unstable market which we currently are in, versus a more stable market. |
| Commissioner Fong | I think our focus needs to be on Sections 2 and 4, regarding the mission and risk tolerance. If we decide the mission is to grow the funds, resulting in a greater risk tolerance, I believe other areas of the policy may be impacted and require additional analysis and input from investment professionals. Assuming that additional analysis and input requires more time, it might be safest to approve the current policy for the Budget Stabilization Fund for the Legacy Fund, with the goal of having a revised policy ready to go by January 1, 2012, or the start of the next fiscal year, whichever makes the most sense. |
| Eric Hardmeyer | |