NORTH DAKOTA LEGISLATIVE MANAGEMENT

Minutes of the

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD

Wednesday, December 2, 2015
Harvest Room, State Capitol
Bismarck, North Dakota

Representative Keith Kempenich, Chairman, called the meeting to order at 9:00 a.m.

Members present: Representative Keith Kempenich, Gary Kreidt; Senators Jerry Klein, George Sinner; Citizen Members Eric Hardmeyer, Ryan Rauschenberger, Pam Sharp

Others present: Representative Wesley R. Belter, Fargo, member of the Legislative Management
Adam Mathiak, Legislative Council
Allen Knudson, Legislative Budget Analyst and Auditor, Legislative Council
See Appendix A for additional persons present.

It was moved by Senator Klein, seconded by Representative Kreidt, that the minutes of the June 15, 2015, meeting be approved as distributed.

STATUS OF THE BUDGET STABILIZATION FUND

At the request of Chairman Kempenich, Mr. David J. Hunter, Executive Director and Chief Investment Officer, Retirement and Investment Office, presented information (Appendix B) regarding the status and asset allocation of the budget stabilization fund. He said in June 2015 approximately $23 million was transferred from the budget stabilization fund to the general fund, of which approximately $11 million was principal and $12 million was earnings. He said since its inception, $567.4 million has been deposited into the budget stabilization fund, investment income has totaled $70.5 million, and distributions from the fund have totaled $64.3 million, resulting in net assets of $573.6 million as of June 30, 2015. He said the market value of the fund as of June 30, 2015, was approximately $574 million. He said the asset allocation of the fund is 100 percent short-term fixed income and Bank of North Dakota certificates of deposit (CDs). He said the Bank's CDs are less liquid than short-term fixed income investments, but in a declining interest market they provide a better return. He said over 80 percent of the account is highly liquid and could be accessed in 5 to 10 business days. He said the investment office works with the Bank regarding the liquidity of the fund's investment in bank CDs and anticipates the liquidity of the CDs could be between 90 to 120 days, depending on market conditions.

Mr. Hunter presented information (Appendix C) regarding the returns of the budget stabilization fund. He said investment returns, net of fees, have averaged 2.28 percent during the five years ended June 30, 2015, compared to a policy benchmark of .42 percent. He said fund performance for the year ended June 30, 2015, net of fees, was 1.86 percent compared to a policy benchmark of .75 percent.

Mr. Hunter provided information (Appendix D) regarding investment management fees paid by the budget stabilization fund. He said investment management fees, as a percent of average assets under management, were .15 and .12 percent in 2015 and 2014, respectively. He said investment expense during the year ended June 30, 2015, totaled $737,159, but the fund outperformed the policy benchmark by 1.11 percent, generating approximately $5 million of incremental income from active management, while paying less than $1 million in fees.

Mr. Hunter presented information (Appendix E) regarding the asset allocation of budget stabilization fund assets. He said market value of the fund as of September 30, 2015, was $575.7 million, of which $10 million (2 percent) is invested in cash equivalents, $91 million (16 percent) is invested in CDs at the Bank of North Dakota, and $474.7 million (82 percent) is invested in short-term fixed income securities with Babson Capital and JP Morgan.

Mr. Hunter provided information (Appendix F) regarding budget stabilization fund performance compared to policy benchmarks and the manager effect on return for the 1-, 3-, and 5-year periods ended September 30, 2015. He said the manager effect is the difference between the target return and the actual return over a period of time. He said the unaudited actual return for the year ended September 30, 2015, was 2.14 percent compared to a target return of .98 percent, the difference (1.16 percent) represents the manager effect. He said the unaudited actual return for the 5-year period ended September 30, 2015, was 2.12 percent compared to a target return of .47 percent.

Mr. Hunter provided a copy of the current budget stabilization fund investment policy statement (Appendix G). He said policy changes recommended by the advisory board in December 2014, including a 35 percent limit on Bank of North Dakota CDs, have been incorporated into the policy and guidelines section of the policy statement.

In response to a question from Senator Klein, Mr. Hardmeyer said the investment in Bank of North Dakota CDs funds the Bank's match program. He said the 35 percent limit on investment in Bank CDs results in a limit of approximately $200 million. He said the current budget stabilization fund investment in Bank CDs totals approximately $91 million, leaving an additional $109 million available for investment in the CD program. He said the funds available for the program are appropriate at this time. He said projects that caused concern regarding the availability of funds a year ago did not come to fruition.

In response to a question from Senator Sinner, Mr. Hunter said the advisory board recommended changes to the investment policy statement in December 2014 and the State Investment Board approved the changes in August 2015.

STATUS OF THE LEGACY FUND

At the request of Chairman Kempenich, Mr. Hunter presented information (Appendix H) regarding the status of the legacy fund. He said from inception through June 30, 2015, $3.106 billion has been deposited into the legacy fund. He said income retained in the fund totaled $219.6 million, and net assets of the fund as of June 30, 2015, totaled $3.326 billion. He said the market value of of the fund as of June 30, 2015 was approximately $3.329 billion.

Mr. Hunter provided information (Appendix I) regarding the legacy fund policy timeline and the legacy fund strategic asset allocation. He said the strategic asset allocation, fully implemented in January 2015, remains 30 percent broad United States equity, 20 percent broad international equity, 35 percent fixed income, 10 percent diversified real estate, and 5 percent core real estate.

Mr. Hunter presented information (Appendix J) regarding the returns of the legacy fund. He said, from the fund's inception through June 30, 2015, unaudited investment returns of the legacy fund, net of fees, have averaged 3.24 percent compared to a policy benchmark of 2.33 percent. He said unaudited fund performance for the year ended June 30, 2015, net of fees, was 3.31 percent compared to a policy benchmark of 2.56 percent.

Mr. Hunter presented a summary (Appendix K) of legacy fund investments by asset class and firm as of June 30, 2015, including unaudited net returns compared to policy benchmarks for the current year, prior year, and 3 years ended June 30, 2015. He said returns are reviewed for each manager and compared to their respective policy benchmark. He said the overall long-term return expectation of the legacy fund is approximately 6.4 percent.

Mr. Hunter provided information (Appendix L) regarding investment fees by asset class. He said from fiscal year 2014 to fiscal year 2015, investment management fees increased from 27 to 33 basis points, based on unaudited fund performance. He said the legacy fund received better than a 2 to 1 return on investment management fees during each of the past 2 years.

Mr. Hunter provided information (Appendix M) regarding the legacy fund asset allocation and performance, compared to policy benchmarks for the 1-, 3-, and 4-year periods ended September 30, 2015. He said the unaudited actual return for the year ended September 30, 2015, was .52 percent compared to a target loss of .19 percent. He said over the 4-year period ended September 30, 2015, based on unaudited fund performance, the actual return was 1.88 percent compared to a target return of 1.12 percent. He said asset allocations as of September 30, 2015 varied less than 2 percent from target asset allocations.

Mr. Hunter provided a copy of the current legacy fund investment policy statement (Appendix N). He said the advisory board recommended changes to the investment policy statement in December 2014 and the State Investment Board approved the changes in January 2015.

In response to a question from Mr. Hardmeyer, the Legislative Budget Analyst and Auditor said the 2013-14 interim Government Finance Committee studied the definition of income as it related to the legacy fund, including how income would be determined and whether or not earnings prior to June 30, 2017, should be transferred to the general fund or included in the principal of the fund. He said a bill, recommended by the committee and approved by the 2015 Legislative Assembly, clarified the determination of legacy fund principal balances and earnings; however, he said, the bill was vetoed by the Governor. He said provisions included in a separate bill, approved by the Legislative Assembly in 2013, exclude unrealized gains and losses from the determination of income for the purposes of legacy fund distributions.

In response to a question from Chairman Kempenich, the Legislative Budget Analyst and Auditor said the 2017 Legislative Assembly could again consider a bill to define legacy fund principal and earnings to determine amounts that may be available for appropriations or transfers from the legacy fund.

In response to a question from Senator Sinner, Mr. Hunter said as of June 30, 2015, the income available for transfer would be less than the $219.6 million earned by the fund which includes unrealized gains.

At the request of Chairman Kempenich, Mr. Adam Mathiak, Fiscal Analyst, Legislative Council, presented a memorandum entitled *Legacy Fund - "What If" Scenario*. Mr. Mathiak compared the May 2015 legislative forecast to a "what if" scenario for the legacy fund. He said the "what if" scenario is based on actual oil tax revenue collections and allocations for the biennium to date through November 2015 and forecasted amounts from December 2015 through the remainder of the biennium, based on the following:

- Oil prices increasing from $29.80 to $36.56 ($16 less than the May 2015 legislative forecast);
- Oil production decreasing from 1.16 million barrels per day to 1 million barrels per day by the end of the first fiscal year and remaining at 1 million barrels per day for the second year of the biennium; and
- No impact from the "large trigger" because the provisions of the "large trigger" did not become effective.

Mr. Mathiak said based on the "what if" assumptions, deposits into the legacy fund would be an estimated $211.9 million less than the amounts included in the May 2015 legislative forecast. He said lower deposits would be offset to some extent by the 2013-15 biennium ending legacy fund balance exceeding the forecast by $28.8 million. He said the estimated June 30, 2017, ending legacy fund balance is estimated to be $4.1 billion under the "what if" scenario, $183.1 million less than the May 2015 legislative forecast.

Ms. Pam Sharp, Director, Office of Management and Budget, presented information (Appendix O) regarding the potential effects of revenue shortfalls on the budget stabilization fund, including the effect of funds available in the foundation aid stabilization fund on amounts withdrawn from the budget stabilization fund. She said the amount transferred from the budget stabilization fund, upon order of the Governor, may not exceed the difference between a revised general fund revenue projection for the biennium and 97.5 percent of the general fund revenue projection for the biennium approved by the Legislative Assembly. She said an allotment is made by fund and all executive branch agencies receiving funding from the general fund during the 2015-17 biennium would be required to reduce their general fund appropriation by the allotment amount, which she anticipates would be 2.5 percent. However, she said, any general fund allotment of state school aid, transportation aid, and special education aid provided to the Department of Public Instruction would be offset by a transfer from the foundation aid stabilization fund. She said an estimated revenue shortfall of $300 million would not require an allotment or a transfer from the budget stabilization fund because the 2013-15 biennium ending general fund balance was approximately $130 million higher than estimated and the Legislative Assembly budgeted for a $211 million 2015-17 biennium ending general fund balance. She said an estimated revenue shortfall of $400 million would likely result in a 1.85 percent allotment and not require a transfer from the budget stabilization fund. She said a shortfall of $600 million would likely result in a 2.5 percent allotment and a transfer from the budget stabilization fund of approximately $171 million, which is less than the $313 million budget stabilization fund transfer that would be allowed based on an estimated $600 million revenue shortfall.

In response to a question from Senator Klein, Ms. Sharp said the Office of Management and Budget anticipates reviewing revenue trends through November before determining whether or not a new forecast is needed.

In response to a question from Mr. Hardmeyer, Ms. Sharp said the revenue shortfall through October 2015 was $112 million.

In response to a question from Mr. Hardmeyer, Ms. Sharp said the balance in the foundation aid stabilization fund is approximately $675 million.

Chairman Kempenich asked the Legislative Council staff to provide information regarding the 2013-14 interim Government Finance Committee study relating to the legacy fund. The Legislative Budget Analyst and Auditor said the Government Finance Committee study final report could be sent to the advisory board members.

Chairman Kempenich suggested the committee receive information from the Retirement and Investment Office regarding legacy fund income, excluding unrealized gains.

Chairman Kempenich announced the next advisory board meeting will likely be scheduled for June 2016.

No further business appearing, Chairman Kempenich adjourned the meeting at 11:12 a.m.

Sheila M. Sandness
Senior Fiscal Analyst

ATTACH:15