Legislative Council
600 East Boulevard Avenue, Bismarck, ND 58505

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD

Tuesday, March 23, 2021
Brynhild Haugland Room, State Capitol
Bismarck, North Dakota

Representative Keith Kempenich, Chairman, called the meeting to order at 8:00 a.m.

Members present: Representatives Keith Kempenich, Gary Kreidt; Senators Kathy Hogan, Jerry Klein; Citizen Members Eric Hardmeyer, Joe Morrissette, Ryan Rauschenberger

Members absent: None

Others present: See Appendix A

It was moved by Senator Klein, seconded by Senator Hogan, and carried on a voice vote that the minutes of the February 16, 2021, meeting be approved as distributed.

STATUS OF THE LEGACY 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 of the legacy fund. Mr. Hunter said the market value of the legacy fund was $8.17 billion as of January 31, 2021. He said as of January 31, 2021, investment allocations included 50.3 percent global equity, 35.2 percent global fixed income, 13.9 percent global real assets, and .6 percent global cash. He said target allocations of the fund include 50 percent equity, 35 percent fixed income, and 15 percent real assets. He said there is a 3-month delay in the reporting of the market value for real assets and the value of real assets as of December 31, 2020, will be reported in March 2021.

Mr. Hunter said Phase 2 of the asset allocation review, prepared by Callan LLC, includes the most recent budget forecast for oil price and production, the recent investment policy change to include a 3-percent private capital target asset allocation in the legacy fund asset mix, and two spending policies (100 percent of earnings and percent of market value (POMV)). He said the Legislative Assembly is considering legislation regarding in-state investments and POMV spending policies.

Mr. Hunter said because returns are higher, the majority of states with in-state investment programs invest via private markets, rather than public markets. He said an asset allocation to in-state investments, including private equity and private capital, should have a goal of meeting institutional best practices. He said Callan has observed existing in-state investment programs typically have begun with low single-digit allocations. He said the recommendation of the advisory board to adopt a target private capital allocation of 3 percent, plus or minus 3 percent, has been approved by the State Investment Board (SIB). He said the 3-percent private capital allocation is in addition to the existing 5 percent invested in the Bank of North Dakota CD match loan program. He said SIB is seeking a qualified program manager for private market investments and is reviewing three candidates.

Mr. Hunter said the Callan study reviewed the impact of POMV distributions of 6 percent, 8 percent, and 10 percent of market value each biennium on the earnings and growth of the legacy fund over the next 20 years. He said, based on the analysis, distributions based on 6 percent of market value per biennium would be lower than the current distribution policy of 100 percent of earnings. He said because the distributions are lower under the POMV method, the balance in the legacy fund would increase to an estimated $38 billion in 2040, compared to an estimated $23 billion in 2040 if distributions were continued at 100 percent of earnings.

At the request of Chairman Kempenich, Mr. Paul Erlendson, Senior Vice President, Callan LLC, provided information (Appendix C) regarding Phase 2 of the asset allocation review. Mr. Erlendson said Phase 1 of the study reviewed risks and returns of private market investments, but did not review the economic impact on the value of the legacy fund. He said Phase 2 of the asset allocation review confirms the addition of private market investments to the asset mix is reasonable. He said the Legislative Assembly has the option to spend up to 15 percent of the fund. He said if a distribution would occur, private market investment, as a percent of the fund, would increase and impact liquidity. He suggested the advisory board monitor the strategic asset allocation to maintain target private market exposure.

Mr. Jay Kloepfer, Executive Vice President and Director, Capital Markets Research, Callan LLC, reviewed the benefits and considerations of changing the method of determining legacy fund distributions from income to POMV. He said the POMV model is an industry best practice for endowment and other natural resource-based trust funds. He said the POMV model is stable and predictable, which allows for easier budgeting. He said earnings-based models are volatile and may result in no income distribution in some years. He said considerations under the POMV model include the annual percent to be distributed, number of years to be averaged to determine average market value, and length of time the distribution calculation will lag the average market value calculation. He said the common goal of a fund like the legacy fund is intergenerational equity, or balancing current spending with future spending. He said to achieve this balance, spending should not exceed the fund's return, less inflation. He said a fund, which no longer receives deposits, that earns 7 percent, with 2 percent inflation, should not spend more than 5 percent. He said funds that continue to receive cash deposits may spend more; however, if spending is held low the principal of the fund will grow faster. He said the current definition of legacy fund earnings to be distributed includes interest, dividends, and realized capital gains. He said earnings of the legacy fund through January 31, 2021, eligible to be distributed based on this definition, total $636 million. He said Callan estimates total earnings to be distributed for the biennium will be approximately $750 million, which is the equivalent of 4.5 percent annually of fund assets.

Mr. Kloepfer compared nominal distributions and fund growth based on earnings distributions to distributions of 6 percent of market value per biennium (3 percent annually), using a 5-year average market value and a 1-year lag. He said distributions based on earnings exceed distributions based on POMV. He provided a comparison of gross outflows and net outflows, which offsets the distributions with fund deposits. He said, using a 6 percent of market value distribution with a 5-year market value average and a 1-year lag, the actual market value of the fund will grow due to investment returns and new deposits, resulting in a calculated transfer rate in July 2024 of approximately 4 percent (2 percent annually) of assets rather than the stated 6 percent. He said distributions based on earnings result in much larger transfers to the general fund which, when offset by new deposits, result in net outflows of 6 percent to 7 percent per biennium. He said nominal and real market values increase under both asset distribution policies; however, there is more growth under the 6 percent of market value distribution policy than under the 100 percent of earnings distribution policy. He said using asset mix 3, approved by the advisory board and SIB last month, and a 6 percent of market value per biennium (3 percent annually) distribution policy, the legacy fund is estimated to grow to $17 billion by 2030 and $38 billion by 2040. He said using the same asset mix and the 100 percent of earnings distribution policy, the legacy fund is estimated to grow to $14 billion by 2030 and $23 billion by 2040. He said the analysis was done on a deterministic basis, assuming results are the same each year and there is no volatility in fund returns. He said the impact of capital gains and losses on the earnings of the fund can cause wide fluctuations in the distributions under the 100 percent of earnings distribution policy and make budgeting more difficult. He said, under a POMV distribution policy, earnings volatility is absorbed by the principal of the fund, rather than the fund recipient. He said the legacy fund is a long-term pool of assets and is better suited to absorb earnings volatility than the short-term (2 year) budget process.

Mr. Rauschenberger said under the current earnings distribution policy, gains could be realized and distributed in one biennium at the expense of another biennium.

Mr. Hunter said the Callan analysis also includes analyses of an 8 percent of market value per biennium distribution policy and a 10 percent of market value per biennium distribution policy. He said an annual 4.5 percent of market value distribution policy is currently the market standard.

Mr. Hunter said the Phase 2 asset allocation review provides information regarding the impact of adopting a private market investment strategy. He said the analysis indicates the addition of private market investments modestly improves the long-term expected rate of return of the fund with minimal additional risk.

In response to a question from Chairman Kempenich, Mr. Hunter said Callan has recommended three private market program managers for consideration by SIB, including GCM Grosvenor, 50 South Capital, and Sun Mountain Capital.

No further business appearing, Chairman Kempenich adjourned the meeting at 8:44 a.m.

Sheila M. Sandness
Senior Fiscal Analyst

ATTACH:3