

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD - STATUS REPORT TO THE BUDGET SECTION DECEMBER 7, 2016

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 advisory 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 (SIB). The advisory 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 House of Representatives appointed by the House Majority Leader (Representative Keith Kempenich and Representative Gary Kreidt), two members of the Senate appointed by the Senate Majority Leader (Senator Jerry Klein and Senator Jim Dotzenrod), the Director of the Office of Management and Budget 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. The advisory board selected Representative Keith Kempenich to serve as Chairman and Senator Jerry Klein to serve as Vice Chairman.

BUDGET STABILIZATION FUND

The Legacy and Budget Stabilization Fund Advisory Board continues to receive updates regarding the status and returns of the budget stabilization fund. Based on 2015-17 biennium general fund appropriations and budget stabilization fund earnings, \$8.6 million of interest earnings was transferred from the budget stabilization fund to the general fund to reduce the balance in the budget stabilization fund to its maximum balance. Interest earned on the fund is deposited in the general fund because the balance in the fund is at the maximum allowed under Section 54-27.2-01. The asset allocation of the budget stabilization fund is 100 percent short-term fixed income and Bank of North Dakota certificates of deposit (CD). Unaudited investment returns, net of fees, have averaged 2.03 percent during the 5 years ended September 30, 2016, compared to a policy benchmark of .69 percent. Unaudited fund performance for the year ended September 30, 2016, net of fees, was 1.97 percent compared to a policy benchmark of 1.14 percent.

Market value of the fund as of September 30, 2016, was \$578.3 million. Section 3 of 2015 Senate Bill No. 2379, as approved by the Legislative Assembly during the August 2016 special legislative session, authorizes the Director of the Office of Management and Budget to transfer up to \$572,485,452 to provide for a positive balance in the general fund on June 30, 2017, from the budget stabilization fund to the general fund during the 2015-17 biennium. As directed by the Office of Management and Budget, the Retirement and Investment Office (RIO) transferred \$375 million from the budget stabilization fund to the general fund in October 2016 and approximately \$203.6 million remains in the budget stabilization fund as of October 31, 2016. Information regarding market value of the budget stabilization fund by asset class as of October 31, 2016, prepared by RIO is attached as Appendix A.

Due to the transfer of funds from the budget stabilization fund to the general fund, the budget stabilization fund will not have adequate funds to maintain its investment in the Bank of North Dakota's Match Loan CD Program. In June 2016 the advisory board recommended amending the budget stabilization fund investment policy statement to remove reference to the investment in the Match Loan CD Program. The policy statement revisions were approved by SIB in July 2016 and in August 2016 the budget stabilization fund investment policy statement was revised to provide for the transfer of the Bank of North Dakota's Match Loan CD Program from the budget stabilization fund to the legacy fund on or before July 1, 2017.

LEGACY FUND

In 2011 the Legacy and Budget Stabilization Fund Advisory Board selected a legacy fund asset mix that it recommended to SIB. The State Investment Board accepted the recommendation of a portfolio that consisted of 100 percent short-term fixed income investments managed by two managers--Babson Capital and JP Morgan. In September 2012 SIB selected a consultant--R.V. Kuhns & Associates, Inc.--to conduct an asset allocation and spending policy study for the legacy fund. R.V. Kuhns & Associates, Inc., considered the primary mission of the legacy fund, which is to preserve the real, inflation-adjusted purchasing power of the money deposited into the fund. In April 2013 the advisory board recommended the following asset allocation mix for the legacy fund, which was approved by SIB and fully implemented as of January 2015:

- Broad United States equity - 30 percent;
- Broad international equity - 20 percent;
- Fixed income - 35 percent;

- Core real estate - 5 percent; and
- Diversified real assets - 10 percent.

Prior to July 1, 2015, pursuant to Section 15-08.1-08, if the unobligated balance of the strategic investment and improvements fund (SIIF) exceeded \$300 million at the end of any month, 25 percent of any revenues received for deposit in SIIF in the subsequent month was deposited instead into the legacy fund. During the 2013-15 biennium, SIIF exceeded \$300 million beginning in June 2014 and 25 percent of revenues were transferred to the legacy fund from July 2014 through March 2015. House Bill Nos. 1176 and 1377 (2015) removed the provisions directing the deposit of 25 percent of revenues into the legacy fund rather than SIIF if the SIIF balance exceeds \$300 million beginning July 2015. Deposits into the legacy fund from its inception through September 2016 total \$3.64 billion as follows:

Month of Deposit	Tax Revenue Deposit	Transfers From the Strategic Investment and Improvements Fund	Total Legacy Fund Deposit
September 2011	\$34,311,020		\$34,311,020
October 2011	32,666,664		32,666,664
November 2011	33,217,752		33,217,752
December 2011	36,470,942		36,470,942
January 2012	40,086,657		40,086,657
February 2012	42,775,292		42,775,292
March 2012	45,333,698		45,333,698
April 2012	42,276,824		42,276,824
May 2012	44,835,258		44,835,258
June 2012	44,611,553		44,611,553
July 2012	49,749,192		49,749,192
August 2012	43,464,073		43,464,073
September 2012	45,425,341		45,425,341
October 2012	53,869,764		53,869,764
November 2012	57,588,723		57,588,723
December 2012	60,838,521		60,838,521
January 2013	54,982,692		54,982,692
February 2013	57,830,728	\$21,442,938	79,273,666
March 2013	62,299,929	24,641,387	86,941,316
April 2013	57,078,037	23,471,883	80,549,920
May 2013	65,856,565	26,507,127	92,363,692
June 2013	61,033,491	25,046,090	86,079,581
July 2013	65,809,822	26,581,015	92,390,837
August 2013	64,370,737		64,370,737
September 2013	76,184,497		76,184,497
October 2013	78,609,984		78,609,984
November 2013	78,485,734		78,485,734
December 2013	74,578,510		74,578,510
January 2014	69,929,468		69,929,468
February 2014	69,581,856		69,581,856
March 2014	69,458,394		69,458,394
April 2014	72,333,974		72,333,974
May 2014	81,701,649		81,701,649
June 2014	79,589,331		79,589,331
July 2014	88,319,151	23,492,658	111,811,809
August 2014	89,840,261	27,318,132	117,158,393
September 2014	92,997,837	21,600,134	114,597,971
October 2014	86,826,687	25,662,832	112,489,519
November 2014	84,354,826	28,953,305	113,308,131
December 2014	77,843,898	27,278,909	105,122,807
January 2015	70,401,034	25,185,786	95,586,820
February 2015	54,147,416	19,260,193	73,407,609
March 2015	39,248,769	1,438,668	40,687,437
April 2015	38,706,412		38,706,412
May 2015	41,626,258		41,626,258
June 2015	46,839,874		46,839,874
July 2015	53,878,193		53,878,193
August 2015	52,445,900		52,445,900
September 2015	46,082,947		46,082,947
October 2015	35,621,356		35,621,356
November 2015	36,388,263		36,388,263

Month of Deposit	Tax Revenue Deposit	Transfers From the Strategic Investment and Improvements Fund	Total Legacy Fund Deposit
December 2015	40,656,758		40,656,758
January 2016	38,535,656		38,535,656
February 2016	31,728,506		31,728,506
March 2016	22,976,563		22,976,563
April 2016	20,466,184		20,466,184
May 2016	27,754,538		27,754,538
June 2016	28,319,084		28,319,084
July 2016	32,497,395		32,497,395
August 2016	35,333,461		35,333,461
September 2016	31,922,522		31,922,522
Total	\$3,292,996,421	\$347,881,057	\$3,640,877,478

The market value of the legacy fund as of September 30, 2016, was \$4.07 billion. Information regarding market value of the legacy fund by asset class as of September 30, 2016, prepared by RIO is attached as Appendix B. Unaudited fund performance for 1 year as of September 30, 2016, was 10.18 percent compared to a target return of 8.85 percent. Over the 5-year period ended September 30, 2016, the return was 3.49 percent compared to a target return of 2.52 percent. Net earnings in the fund totaled \$426 million from inception through September 30, 2016. The constitutional measure which created the legacy fund was silent with regard to legacy fund earnings from inception through June 30, 2017; however, a November 2016 Attorney General's opinion stated those earnings should become part of the principal of the legacy fund and may only be expended by the Legislative Assembly with a two-thirds vote. Therefore, investment earnings of \$426 million through September 2016 and any additional earnings accruing through the remainder of the 2015-17 biennium will become part of the principal of the legacy fund. Earnings accruing after June 30, 2017, must be transferred to the general fund at the end of the biennium and are available for the 2017-19 biennium.

Based on actual oil and gas gross production tax and oil extraction tax revenue allocations through July 2016 and forecasted amounts based on the August 2016 revised legislative estimate, the balance in the legacy fund on June 30, 2017, is estimated to total \$4.267 billion.

Because the budget stabilization fund will be liquidated, RIO suggested that the legacy fund's fixed asset investment portfolio include the Bank of North Dakota's Match Loan CD Program. In June 2016 the Legacy and Budget Stabilization Fund Advisory Board recommended amending the investment policy statement of the legacy fund to permit investment in the Match Loan CD Program. The policy statement revisions were approved by SIB in July 2016 and in August 2016 the legacy fund investment policy statement was revised to provide for the transfer of Bank of North Dakota CDs from the budget stabilization fund to the legacy fund on or before July 1, 2017. The Match Loan CD Program is limited to the lesser of \$200 million or 5 percent of the legacy fund. The Bank will be requested to guarantee a minimum 1.75 percent investment return. The minimum return requirement will be periodically reviewed in connection with the legacy fund's overall asset allocation. The Retirement and Investment Office began transferring Bank of North Dakota CDs from the budget stabilization fund to the legacy fund in October 2016.

ATTACH:2