NORTH DAKOTA LEGISLATIVE MANAGEMENT

Minutes of the

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD

Thursday, November 15, 2012
Harvest Room, State Capitol
Bismarck, North Dakota

Senator Randel Christmann, Chairman, called the meeting to order at 1:30 p.m.

Members present: Senators Randel Christmann, Jim Dotzenrod; Representatives Keith Kempenich; Dave Weiler; Bank of North Dakota President - Eric Hardmeyer; Office of Management and Budget Director - Pam Sharp; Tax Commissioner - Cory Fong

Others present: See Appendix A

It was moved by Representative Kempenich, seconded by Representative Weiler, and carried on a voice vote that the minutes of the September 28, 2012, meeting be approved as distributed.

CHIEF INVESTMENT OFFICER POSITION - RETIREMENT AND INVESTMENT OFFICE

Chairman Christmann called on Ms. Kelly Schmidt, State Treasurer and member of the State Investment Board, to provide information regarding the recruitment of a new Chief Investment Officer. She said a committee established to conduct a search to fill the State Investment Board Chief Investment Officer and Retirement and Investment Office Executive Director position is still examining its options. Ms. Schmidt said the committee is reviewing the business model of the Retirement and Investment Office and how it relates to the State Investment Board. She said the committee continues to meet and is developing its plan for filling the position.

INVESTMENT HISTORY AND RETURNS OF THE LEGACY FUND AND BUDGET STABILIZATION FUND

Mr. Darren Schulz, Interim Chief Investment Officer, State Investment Board, provided information regarding investment performance reports of the legacy and budget stabilization funds as of September 30, 2012 (Appendix B) and the investment history and returns of the legacy and budget stabilization funds since inception (Appendix C). He said deposits into the legacy fund during fiscal year 2012 totaled $396.6 million and fund earnings provided an additional $2.3 million for an ending balance of $398.9 million. He said through September 2012, $138.6 million has been deposited into the fund and earnings totaled $3.7 million for a balance of $541.2 million as of September 30, 2012. Mr. Schulz said monthly transfers to the legacy fund over the nine-month period from January 2012 through September 2012 ranged from $40.1 million in January 2012 to $49.7 million in July 2012. He said the October 2012 transfer into the legacy fund totaled $53.9 million.

In response to a question from Senator Christmann, Mr. Schulz said the cumulative return on investment inception to date for the legacy fund of 1.86 percent is also the average annualized return on investment for the first full year of the fund.

Mr. Schulz said the balance in the budget stabilization fund as of June 30, 2011, was $325.7 million. He said deposits into the budget stabilization fund during fiscal year 2012 totaled $61.4 million and fund earnings provided an additional $7.9 million for an ending balance of $395 million as of June 30, 2012. He said the return on investment for fiscal year 2012 was 1.67 percent and the cumulative return on investment since the fund's inception in September 2005 is 18.95 percent. He said the average annualized return over the seven-year period is 2.51 percent. He said through September 2012, earnings totaled $3.4 million for a balance of $398.4 million as of September 30, 2012.

ASSET ALLOCATION AND SPENDING STUDY OF THE LEGACY FUND

Chairman Christmann called on Mr. Josh Kevan, Senior Consultant, R. V. Kuhns & Associates, Inc., to lead a discussion regarding the asset allocation and spending study for the legacy fund. Mr. Kevan presented a discussion outline, including topics related to fund revenue, asset allocation, spending, and governance, for consideration by the advisory board (Appendix D). Advisory board members and the representatives of R. V. Kuhns & Associates discussed the topic areas relating to the development of an asset allocation policy for the legacy fund.

Senator Christmann said more stringent future regulations on the oil industry could negatively affect future revenues to be deposited into the legacy fund.

In response to a question from Mr. Hardmeyer, Mr. Kevan said generally, asset allocation policies of funds are revisited at least every three years.

Mr. Ron Klotter, Senior Consultant and Director of Midwest Consulting, R. V. Kuhns & Associates, Inc., said the advisory board's level of acceptable risk will determine the range of options available in the investment model proposal developed for the board.

Representative Kempenich said there must be some risk to earn a return. He said the fund's goal should be to earn a return equal to or greater than the rate of inflation each year.

In response to a question from Mr. Hardmeyer, Mr. Kevan said the ability to preserve the real, inflation-adjusted purchasing power of the fund without investing in equities will depend on spending from the fund. He said if nothing is spent from the fund, preservation of the inflation-adjusted purchasing power of the fund may be achieved by investing in the higher yielding sectors of the fixed income market. However, he said, because earnings of the fund will be transferred to the general fund and spent beginning in 2017, it is likely the fund would need to achieve target rates of return that require investment in equities.

Senator Christmann expressed concern regarding the current national investment environment. He said it may be difficult to preserve the real, inflation-adjusted purchasing power of the fund with any types of investments in the current investment environment. He said it would be worse if the advisory board invested money in the fund too aggressively and the fund lost value than if the advisory board took a more conservative approach and earned only a small return. He suggested 15 percent of the fund be invested in cash or cash equivalents to ensure funds are available if the Legislative Assembly in 2017 chooses to spend the maximum amount allowed.

Representative Weiler expressed concern regarding investing 15 percent of the fund balance in cash or cash equivalents. He said if the funds are readily available, the Legislative Assembly may be more likely to spend them. He said if the Legislative Assembly in 2017 decides to spend from the fund, the State Investment Board would have some time to generate the cash needed.

Mr. Kevan said liquidity appears to be important. He said risk can be balanced in many ways.

Ms. Sharp suggested the portfolio be balanced and include equities which would mitigate a decline in the bond market. She said if 15 percent is needed from the fund in the future, by developing a balanced portfolio, more types of assets would be available for liquidation, thus lowering the risk of liquidating certain assets at a loss.

In response to a question from Senator Christmann, Mr. Kevan said the benchmark for many long-term portfolios, including pension funds, is 60 percent equity and 40 percent bonds; however, endowment funds are typically invested in 70 percent equity and 30 percent bonds. Mr. Klotter said endowment funds are typically invested for a longer term than pension funds; therefore, the endowment funds are invested more aggressively.

Senator Dotzenrod said during the 2009 legislative session, the Senate Finance and Taxation Committee discussed the purpose of the fund and its duration. He said the committee agreed the purpose of the fund is to allow for the sharing of current natural resource revenues with future generations at a time when natural resource revenues begin to decline.

Mr. Fong said the ability of future Legislative Assemblies to spend up to 15 percent of the fund is a factor even if it doesn't drive the investment model. Mr. Klotter said investment models will be prepared to include scenarios that show both the impact of withdrawing the maximum 15 percent from the fund each biennium and if none of the principal is withdrawn.

Senator Christmann asked if any of the advisory board members objected to including equities in the investment model. None of the advisory board members objected.

Ms. Schmidt said the Uniform Principal and Income Act defines earnings as they relate to government funds. She said earnings are reinvested in the fund, but are separately recorded.

Ms. Cindy Ternes, State Investment Board member, suggested the advisory board receive information regarding the risk of holding cash. In response to a question from Senator Christmann, Mr. Kevan said there is an opportunity cost to maintaining investments in cash. He said cash does not preserve purchasing power over time.

In response to a question from Representative Kempenich regarding the costs of various types of investments, Mr. John McLaughlin, R. V. Kuhns & Associates, Inc., said the consultants will provide a comparison of investment expenses by asset class.

In response to a question from Senator Christmann regarding tactical investment options, Mr. Klotter said the consultants will include tactical investments in one of its investment model alternatives.

Representative Kempenich said it would be useful for R. V. Kuhns & Associates, Inc., to analyze the fund's current investments and compare various investment scenarios, including a scenario based on the Wyoming model.

In response to a question from Senator Dotzenrod, Mr. Kevan said Wyoming has some of the same funding streams and competing goals as the legacy fund. He said investment will be heavily influenced by how the legacy fund fits into the overall funding picture of the state. He said North Dakota is already economically sensitive because of its exposure to the price of oil. He said a worst case scenario would be a deflationary environment where both energy prices and the value of investment assets with more risk are declining. He said the Wyoming portfolio is a long-term portfolio and includes investment assets with some level of risk. He said Wyoming statute restricts the level of equities in their permanent funds to 55 percent.

Mr. Klotter suggested the advisory board consider investment in real estate or other real assets which would protect the fund's value during periods of inflation. He said publicly traded real estate and real estate partnerships which are diversified across the country would make investment in real assets more liquid. He said real estate-related investments could be included the modeling, and the advisory board could determine its willingness to invest in this type of asset later.

In response to a question from Mr. Kevan, Senator Christmann said he would be opposed to investing in a specific type of asset for social reasons only. He said investment decisions should be based on security and financial income reasons.

In response to a question from Senator Christmann regarding the format of the consultant's final report to the committee, Mr. Klotter said a typical report includes an executive summary, findings, an investment modeling section, and policy comments.

Mr. Kevan said R. V. Kuhns & Associates, Inc., is available to support the advisory board's needs and is available to assist in educating legislators and committees on investment concepts and proposed investment models.

Mr. Kevan said he anticipates completing this project in approximately two months, but would attempt to complete it sooner if possible.

Senator Christmann said it would be beneficial to deliver the report as early as possible during the 2013 legislative session. He said if there are still important questions after R. V. Kuhns & Associates, Inc., has met with the State Investment Board, another meeting of the advisory board could be scheduled.

Mr. Howard Sage, State Investment Board member, commented on the development of the investment allocation policy. He said R. V. Kuhns & Associates, Inc., needs to know the state's investment goal for the fund. He said if the goal for the fund is to preserve purchasing power only, then an investment portfolio that earns a return equal to inflation will be sufficient and R. V. Kuhns & Associates, Inc., can build an investment model to achieve that. However, he said, if the goal is to earn more, the consultants should be directed to develop more aggressive models.

ADVISORY BOARD DISCUSSION AND STAFF DIRECTIVES

No further business appearing, Chairman Christmann adjourned the meeting at 3:32 p.m.

Sheila M. Sandness
Senior Fiscal Analyst

Allen H. Knudson
Legislative Budget Analyst and Auditor

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