Legislative Council
600 East Boulevard Avenue, Bismarck, ND 58505

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD

Tuesday, February 16, 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 Mr. Rauschenberger, and carried on a voice vote that the minutes of the January 29, 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 $8.2 billion as of December 31, 2020. He said the legacy fund gained 9.25 percent compared to a policy benchmark gain of 8.6 percent for the 5 years ended December 31, 2020. He said the fund had a net gain of 12.22 percent compared to a policy benchmark gain of 12.08 percent for the year ended December 31, 2020. He said the fund had a net gain of 14.37 percent compared to a policy benchmark gain of 13.32 percent fiscal year to date through December 31, 2020. He said legacy fund earnings have totaled $2.705 billion since inception. He said earnings, as defined in North Dakota Century Code Section 21-10-12, have totaled $1.484 billion since inception, of which $437 million was added to the principal of the fund. He said $455 million was transferred to the general fund in July 2019 for the 2017-19 biennium. He said from June 2019 through December 2020, earnings, as defined in Section 21-10-12, have totaled $592 million.

Mr. Hunter reviewed the original asset allocation and spending policy study conducted by R.V. Kuhns & Associates, Inc., in 2013. He said the focus of the R.V. Kuhns & Associates study was building a fund for future generations and preserving purchasing power. He said current income is not the primary focus of the strategy. He said because the legacy fund is intended to create generational equality, emphasis is on growth and long-term investment. He said the preservation of real, inflation-adjusted purchasing power implies the need for assets to grow by a rate that exceeds a combination of the rate of inflation, the spending rate, and expenses. He said if the Legislative Assembly established a spending rate of 3.5 percent, based on a February 2021 inflation rate of 2 percent and expenses of 0.5 percent, the required rate of return to preserve inflation-adjusted purchasing power would be 6 percent.

At the request of Chairman Kempenich, Mr. Paul Erlendson, Senior Vice President, Callan LLC, provided information (Appendix C) regarding an asset allocation study, including an evaluation of the potential impacts of adding private equity to the legacy fund's strategic asset allocation policy. Mr. Erlendson said Callan's analysis reviewed only rates of return and the volatility of those returns through time. He said unlike public markets, because private market funding commitments are made for several years into the future, capital is committed for the long term. He said Retirement and Investment Office (RIO) is recommending a Phase 2 study to analyze the impact of private capital investments by measuring the dollar-based future variations in the legacy fund's market value, the ranges of expected deposits (based on projected oil price and production), and distributions transferred to the general fund based on projected earnings. He said approximately 15 percent of the current asset allocation is invested in private market credit, infrastructure, and real estate. He said the majority of in-state investment is done in the private market, including private debt and private equity.

Mr. Jay Kloepfer, Executive Vice President and Director, Capital Markets Research, Callan LLC, reviewed the benefits and considerations of investing in private capital. He said in exchange for committing fund assets for an extended period, private markets can expect higher returns than in public markets. He said if successfully implemented, private equity can be expected to generate a 1.5 percent compound return over public equity and private debt can be expected to generate a 4.5 percent compound return over public fixed income. He said the advisory board should consider the time it takes to invest in private markets, the lack of liquidity related to assets invested in private capital, including the impact on the ability to generate cash for distributions, and the size and pace of deploying the target amount of assets into the investment opportunities. He said the ability of the Legislative Assembly to appropriate up to 15 percent of the fund must be considered when determining the portion of the fund to be invested in private capital. He said an in-state program manager will develop a multi-year plan to deploy the target amount of assets into investment opportunities.

In response to a question from Chairman Kempenich, Mr. Erlendson said unlike the Bank of North Dakota Match Loan CD Program, investment in private capital is an investment directly into an institution where the fund assumes the risk. He said private market companies do not draw down all the capital at once. He said funds are invested over a number of years and investment returns could take a decade to be realized.

Mr. Kloepfer reviewed the projected 10-year geometric returns of various asset classes, including private equity and private credit investments. He said the outlook for all asset classes is subdued, with fixed income negative when assuming a 2 percent inflation rate. He said projected 10-year geometric returns are 8 percent for private equity, compared to 6.6 percent for broad U.S. equity and 6.25 percent for private credit compared to 1.75 percent for core fixed income. He said while private market equity and credit include investment premiums, they also hold more risk and lack liquidity in exchange for a higher return. He said the report includes a standard deviation column to provide a measure of the range of potential outcomes. He said the standard deviation of projected risk is higher in private markets than public markets. He said the increased risk makes program implementation even more important. He provided a summary of alternative mixes to add from 1 to 5 percent private capital to the legacy fund's investment policy. He said a target of 3 percent with a plus or minus 3 percent could be adjusted as it is implemented over time.

In response to a question from Chairman Kempenich, Mr. Hunter said if the advisory board approves adding a private market in-state investment program to the asset allocation, RIO will seek State Investment Board approval of the legacy fund's revised investment policy statement. He said Callan and RIO anticipate advancing at least one investment management firm with experience in implementing in-state investment programs in the private market for advisory board consideration in March.

In response to a question from Mr. Morrissette, Mr. Hunter said the purpose of the adding private capital to the strategic asset allocation policy statement is the expansion of the legacy fund's in-state investment program and that purpose could be part of the policy statement.

Mr. Rauschenberger said the advisory board should move forward with the in-state investment program and the percentage of investment could be reviewed again in the future. He said because private capital investments can take years to develop, a range of percentage investment in private capital is important.

Senator Klein said there is a desire to invest in private capital in the state. However, he said, private capital investment will require patience and the investment policy may experience scrutiny if the fund balance does not grow as fast as expected.

It was moved by Senator Klein, seconded by Mr. Rauschenberger, and carried on a roll call vote that the Legacy and Budget Stabilization Fund Advisory Board revise the legacy fund's strategic asset allocation policy to allocate 2 percent of broad U.S. equity and 1 percent of broad international equity to the optimal mix 3 recommended by Callan LLC, which includes a private capital target of 3 percent, with a range of plus or minus 3 percent, to expand the legacy fund's in-state investment program, which would include an expanded Phase 2 of the asset allocation study proposed by Callan LLC. Representatives Kempenich and Kreidt, Senators Hogan and Klein, and Citizen Members Hardmeyer, Morrissette, and Rauschenberger voted "aye." No negative votes were cast.

No further business appearing, Chairman Kempenich adjourned the meeting at 8:46 a.m.

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Sheila M. Sandness
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