LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD - STATUS REPORT TO THE BUDGET SECTION DECEMBER 3, 2014

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 Carolyn C. Nelson), the Director of the Office of Management and Budget (OMB) 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 Kempenich to serve as 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 2013-15 biennium general fund appropriations, the maximum balance allowed in the budget stabilization fund increased by $181 million, from $402.5 million during the 2011-13 biennium to $583.5 million for the 2013-15 biennium. Based on the new maximum balance allowed in the budget stabilization fund, OMB transferred $181,060,584 to the budget stabilization fund in August 2013. 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 (CDs). Since the fund's inception, unaudited investment returns, net of fees, have averaged 2.39 percent compared to a policy benchmark of 1.64 percent, and unaudited fund performance for one year as of June 30, 2014, net of fees, was 1.94 percent compared to a policy benchmark of .61 percent. Market value of the fund as of August 31, 2014, was $587.7 million, of which $7.1 million (1.2 percent) is invested in cash equivalents, $105.1 million (17.9 percent) is invested in CDs at the Bank, and $475.5 million (80.9 percent) is invested in short-term fixed income securities with Babson Capital and JP Morgan. Information regarding market value of the budget stabilization fund by asset class as of August 31, 2014, prepared by Retirement Investment Office (RIO) is attached as Appendix A.

The advisory board received information regarding the Match Loan CD Program at the Bank of North Dakota. The budget stabilization fund investment in CDs at the Bank provides funding for the Bank's Match Loan CD Program. The Match Loan CD Program is an economic development program that finances the expansion of financially strong companies. The SIB and RIO invest in CDs that are matched to the terms of the loans under the program. The Match Loan CD Program allows the Bank to fix an interest rate for up to five years. Because the Bank bears the loan risk, the fund assumes no credit risk and loan payments are scheduled to meet CD payments. In addition to the $105.1 million invested in CDs at the Bank, another $94.9 million, for a total of $200 million, has been committed by SIB to the Match Loan CD Program at the Bank. The Bank requested a $100 million increase in the commitment from the budget stabilization fund for a total of $300 million and an increase in the term of the fixed rate CDs from 5 to 10 years. The board learned an increase in the fund's commitment to $300 million and an increase in the term of the fixed rate would substantially change the fund's investments relating to liquidity and inherent interest rate risk. Approval of the increase in investment and the fixed rate term may be contrary to the current investment policy statement for the budget stabilization fund. The advisory board recommended SIB consider investing an additional $50 million, for a total of $250 million of the budget stabilization fund, in CDs related to the Bank's Match Loan CD Program.

The advisory board reviewed the budget stabilization fund investment policy statement signed in 2009 and considered policy updates proposed by RIO. The advisory board approved various updates to the budget stabilization fund investment policy statement, including a 35 percent asset allocation limit on investments in the Bank of North Dakota Match Loan CD Program.

LEGACY FUND

In 2011 the Legacy and Budget Stabilization Fund Advisory Board selected a legacy fund asset mix that it recommended to SIB. The SIB 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:

- 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.

The Retirement and Investment Office consulted with Callan Associates Inc. and R.V. Kuhns & Associates, Inc., to develop a transition timeline, and SIB approved a transition plan to fully implement the new policy allocation over a period of 18 months through the use of existing managers within the insurance trust. The transition plan, initiated in August 2013, includes depositing, pro rata to the new asset classes, all new money combined with a gradual transfer ($71 million per month) of funds out of short-term fixed income. As of August 31, 2014, the asset allocation of the fund includes 15 percent short term fixed income, 31 percent broad United States equity, 20 percent broad international equity, 24 percent fixed income, 6 percent diversified real estate, and 5 percent core real estate. The Retirement and Investment Office anticipates completing the transition to the new asset allocation mix by January 2015.

Pursuant to Section 15-08.1-08, if the unobligated balance of the strategic investment and improvements fund (SIIF) exceeds $300 million at the end of any month, 25 percent of any revenues received for deposit in SIIF in the subsequent month must be deposited instead into the legacy fund. During the 2013-15 biennium, SIIF exceeded $300 million beginning in June 2014 and 25 percent of revenues began being transferred to the legacy fund in July 2014. It is anticipated the transfers from SIIF to the legacy fund will continue through the remainder of the 2013-15 biennium. A summary of monthly deposits to the legacy fund from September 2011 through August 2014 prepared by RIO is attached as Appendix B. Deposits into the legacy fund from its inception through August 2014 total $2.3 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

Month of Deposit	Tax Revenue Deposit	Transfers From the Strategic Investment and Improvements Fund	Total Legacy Fund Deposit
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
Total	$2,125,396,084	$198,501,230	$2,323,897,314

The market value of the legacy fund as of August 2014 was $2,454,742,088. Information regarding market value of the legacy fund by asset class as of August 31, 2014, prepared by RIO is attached as Appendix C. Since its inception, unaudited investment returns on the legacy fund, net of fees, have averaged 3.22 percent compared to a policy benchmark of 2.12 percent. Unaudited fund performance for one year as of June 30, 2014, net of fees, was 6.64 percent compared to a policy benchmark of 5.39 percent.

Based on actual oil and gas gross production tax and oil extraction tax revenue allocations through September 2014 and an updated projection for the remainder of the biennium, the balance in the legacy fund on June 30, 2015, is estimated to total $3.6 billion. The updated projection is based on average daily oil production increasing from 1,140,000 to 1,200,000 barrels and oil prices increasing from $72 to $74 per barrel.

The advisory board reviewed the legacy fund investment policy statement signed in 2013 and considered policy updates proposed by RIO. The advisory board approved the addition of a provision to the legacy fund investment policy statement to recognize the 18-month implementation strategy for the asset allocation policy approved by SIB.

ATTACH:3