

Legacy and Budget Stabilization Fund Advisory Board

June 18, 2012

Darren Schulz

Interim Chief Investment Officer

ND Retirement & Investment Office (RIO)

State Investment Board (SIB)

Presentation Agenda

- ▷ Recruitment status of Executive Director/CIO position
- ▷ Investment history and returns of the Legacy Fund and Budget Stabilization Fund
- ▷ Investment process in the formation of investment policy
- ▷ Legacy Fund mission, objectives and constraints
- ▷ Concluding thoughts regarding asset allocation

State Investment Board (SIB) Update

- ▶ The State Investment Board has established a Search Committee to lead the search for a permanent Executive Director/Chief Investment Officer.
- ▶ The Search Committee includes representation from the various SIB client groups.
- ▶ Discussion of the job duties is in the early stages, and a timeline for hiring a replacement has yet to be determined.
- ▶ The Board expects to utilize the services of an executive search firm, which will be selected using a competitive bid process as required by state law.
- ▶ Until a permanent replacement is hired, the SIB has made the following interim appointments:
 - ▶ Fay Kopp, Interim Executive Director
 - ▶ Darren Schulz, Interim Chief Investment Officer

Legacy Fund

Investment History and Returns

Legacy Fund

Preliminary information through May 31, 2012

	New Money In	Net Increase	Income Distributions Out	Net Assets End of Period	Net Return
FY2012 (Initial Funding - Sept. 2011)	351,974,105	1,081,013	-	353,055,118	N/A partial year
	<u>351,974,105</u>	<u>1,081,013</u>	<u>-</u>		
Net Increase - Inception to Date	1,081,013				
Income Distributions Taken	-				
Income Retained in Fund	<u>1,081,013</u>				
May 31, 2012 MV	<u><u>353,055,118</u></u>				
Return Inception to Date (8 months)		0.88%			
Policy Benchmark <i>(not relevant)</i>		0.21%			
<i>Benchmark 13</i>					

Budget Stabilization Fund

Investment History and Returns

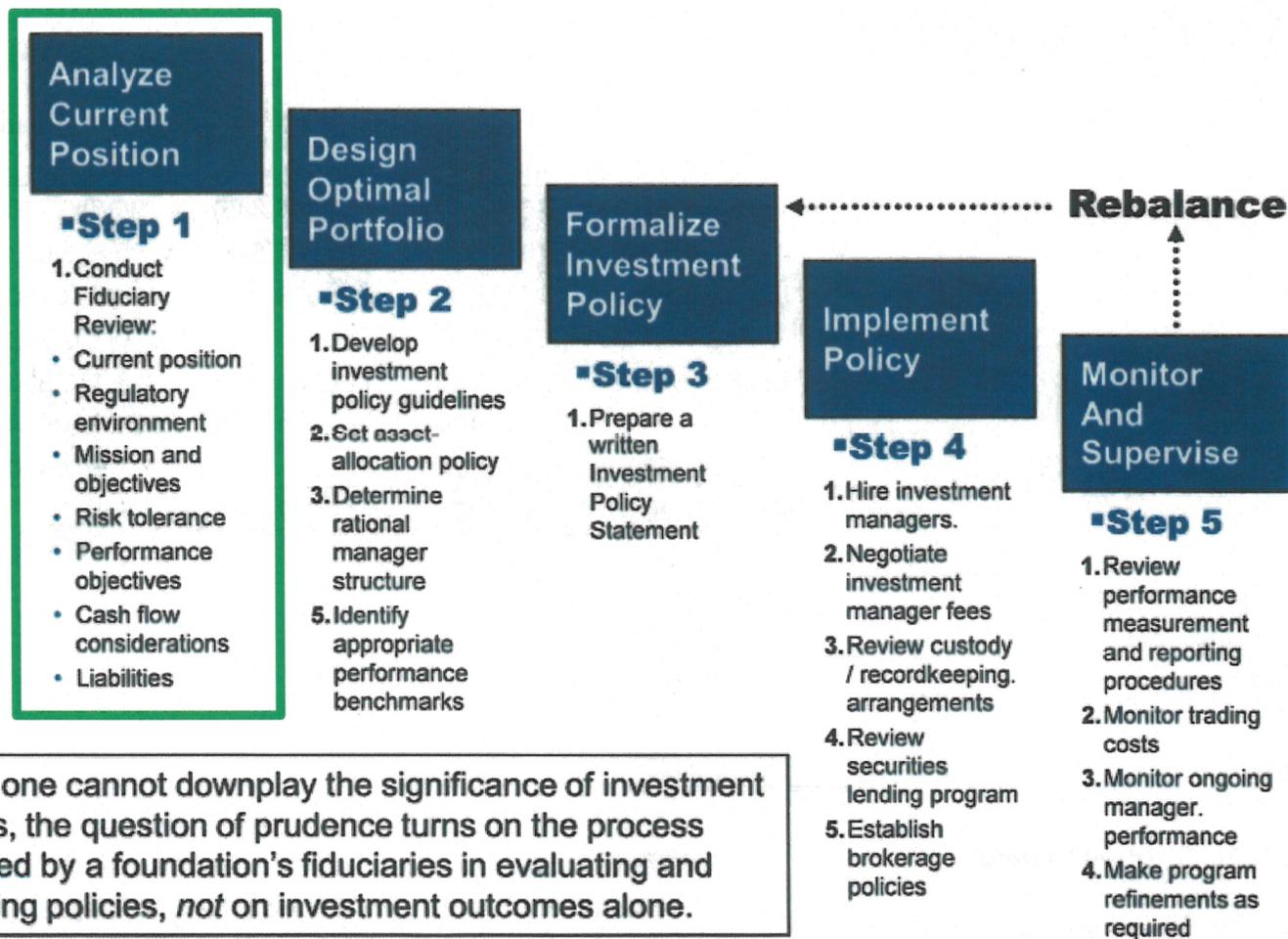
Budget Stabilization Fund

Preliminary information through May 31, 2012

	New Money In	Net Increase	Income Distributions Out	Net Assets End of Period	Net Return
FY2006 (Initial Funding - Sept. 2005)	99,472,631	3,611,730	(3,207,845)	99,876,516	N/A partial year
FY2007	-	4,980,987	(4,981,500)	99,876,003	5.12%
FY2008	100,527,369	122,430	(1,688,532)	198,837,270	0.01%
FY2009	-	(8,736,058)	-	190,101,212	-4.23%
FY2010	124,936,548	21,464,258	(11,385,172)	325,116,846	7.38%
FY2011	-	12,031,101	(11,474,863)	325,673,084	3.63%
FY2012 (preliminary through 5/31/12)	61,414,562	6,610,774	-	393,698,420	1.46%
	<u>386,351,110</u>	<u>40,085,222</u>	<u>(32,737,912)</u>		
Net Increase - Inception to Date		40,085,222			
Income Distributions Taken			<u>(32,737,912)</u>		
Income Retained in Fund			7,347,310		
May 31, 2012 MV				<u>393,698,420</u>	
Cumulative Return Inception to Date		17.66%			
Average Annualized Return (6 2/3 Years)		2.44%			
T-Bill Return		1.97%			

Fiduciary Best Practices

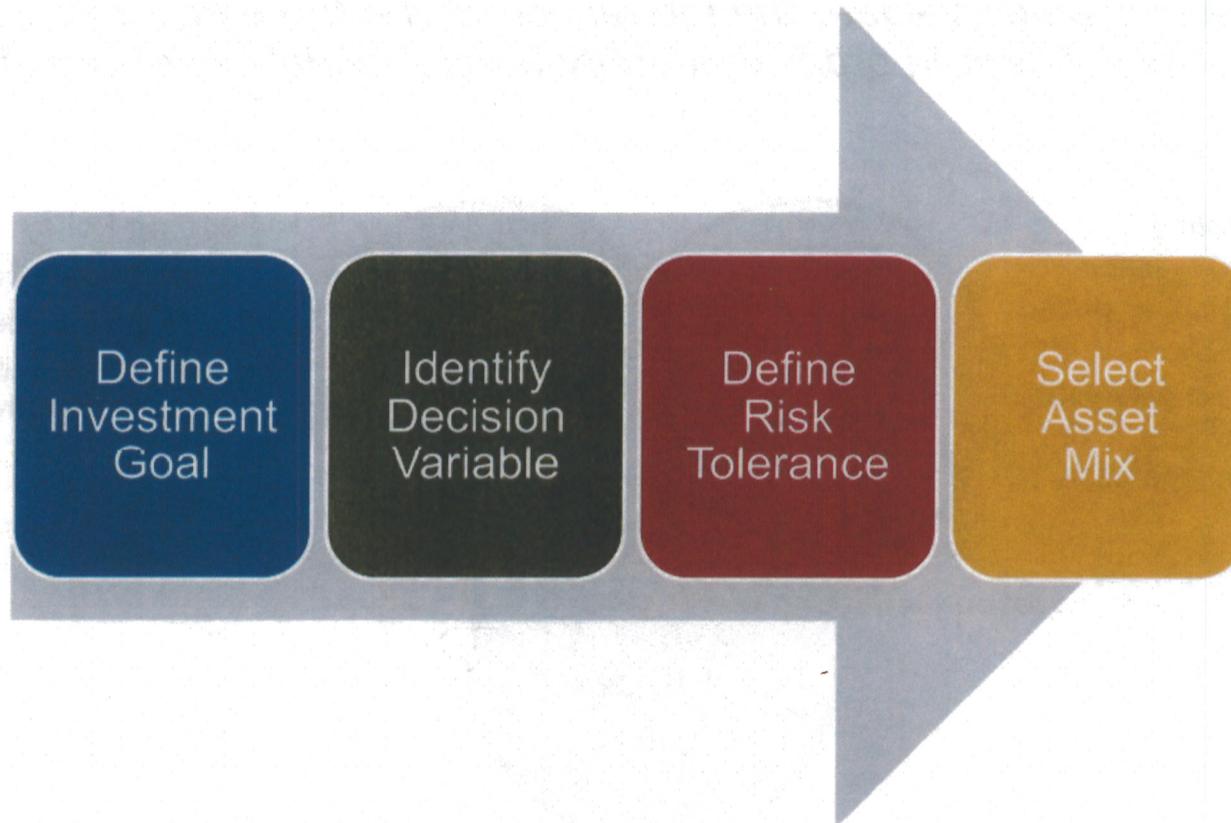
A Recommended Fiduciary Process for all Types of Funds



While one cannot downplay the significance of investment results, the question of prudence turns on the process followed by a foundation's fiduciaries in evaluating and adopting policies, *not* on investment outcomes alone.

Source: Callan Associates

First Step: Determining Investment Goals and Objectives



The investment goal and risk tolerance must be compatible.
That is, the level of return an investor can achieve is inversely proportional to the amount of risk the investor can tolerate.

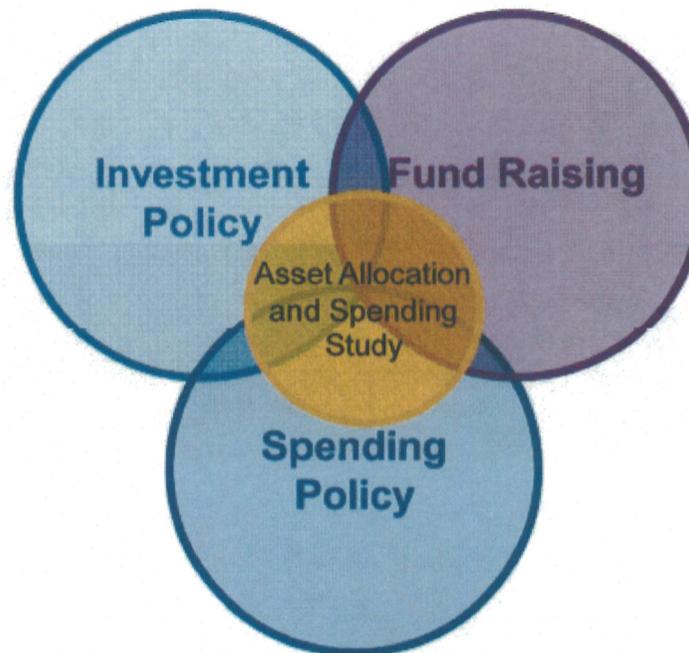
Source: Callan Associates

Determination of an Investment Policy

The investor should evaluate the interaction of the three key policies that govern the endowment in order to identify an appropriate investment policy

Investment Policy

- How will the assets supporting the spending be invested?
- What are the risk/return objectives?
- How to manage cash flows?



Funding Policy

- Revenue expectation
- Near-term policies?
- Consistency of policy and amounts derived thereof?

Spending Policy

- What are the objectives of the distribution policy?
- What level of spending?
- Expectations for fees?

Source: Callan Associates

Purpose of the Assets: Defining the Liability

- ▶ A liability is simply a future outlay of money
- ▶ For an endowment, spending is equivalent to a liability
- ▶ Legacy Fund liability is mostly undefined
 - ▶ No mandated spending requirement until June 30, 2017, after which time accrued interest earnings are transferred to the general fund at the end of each biennium
 - ▶ Not more than 15% of principal may be spent after June 30, 2017 each biennium, subject to a supermajority vote by each house of the Legislative Assembly
- ▶ While defining the liability is one of the greatest challenges faced by endowments, the unique attributes and constraints of the sponsoring entity can guide investment strategy

Fund Objective: Risk Tolerance

Considerations

▶ **Ability to take risk**

- ▶ The greater the dependence on funding from the endowment, the less the ability to tolerate risk
- ▶ Generally low spending requirements imply a greater ability to tolerate risk
- ▶ High spending variability implies a lesser ability to tolerate risk
- ▶ High contributions relative to spending imply a greater ability to take risk
- ▶ The longer the time horizon, the greater the ability to weather short-term fluctuations to achieve long-term spending objectives

▶ **Willingness to take risk**

- ▶ Loss aversion: Having greater concern about avoiding losses than acquiring gains
- ▶ Regret avoidance: Postponing decisive action because of the fear that whatever course is taken will prove less than optimal
- ▶ Recency bias: Recalling and emphasizing recent events and observations more prominently than those that occurred in the distant past

Fund Objective: Return

- ▶ In order to provide a permanent asset base for funding specific activities, attention to preserving the real purchasing power of the asset base is vital. Two implications:
 - ▶ Balancing the need for stable cash flows in the short run with long-term protection of principal
 - ▶ Ensuring that purchasing power is not affected by the ravages of inflation
- ▶ The return objective depends on the stated time horizon
- ▶ A total return approach is common = current income + capital appreciation
- ▶ To maintain purchasing power, the fund's total return should equal a comfortable maximum spending rate plus an adjustment for expected inflation

Constraint: Time Horizon

- ▶ Since the goal of most endowment funds is to provide a permanent source of funding – hence, the need to preserve the real corpus is a critical component of investment strategy – the time horizon is typically long term.
- ▶ The actual tolerance for short-term volatility needs to be objectively assessed and, if necessary, enhanced before embarking on strategies that are consistent with a long-term investment horizon.

Constraint: Liquidity

- ▶ Emergency needs and current spending are typical liquidity needs for an endowment.
- ▶ Large outlays (e.g. capital improvements) may require higher levels of liquidity.
- ▶ Legacy Fund liquidity requirement is low through June 2017 and moderate thereafter.

Conclusions

- ▶ One of the challenges is maximizing spending today while preserving purchasing power for posterity.
- ▶ Higher expected returns from asset classes such as equities may address the inherent conflict between providing for today while preserving real value.
- ▶ Additionally, vulnerability to inflation directs investment away from fixed income towards equity.
- ▶ Funds with long-term horizons invest in assets capable of generating equity-like returns, including public and private equity, and strategies that aim to deliver absolute returns.
- ▶ To mitigate equity risks, portfolios may incorporate fixed income, real estate, and other assets such as commodities.
- ▶ Non-traditional assets are not only strong diversifiers; they can also serve to enhance returns.

Contact Information

▶ **Phone:**

701-328-9885 or

1-800-952-2970 (outside Bismarck/Mandan)

▶ **Mailing Address**

ND Retirement and Investment Office

1930 Burnt Boat Drive, P.O. Box 7100

Bismarck, ND 58507-7100

▶ **E-mail Address:**

rio@nd.gov or djschulz@nd.gov

▶ **Website Address:**

www.nd.gov/rio