LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD - STATUS REPORT TO THE BUDGET SECTION DECEMBER 11, 2013

The Legacy and Budget Stabilization Fund Advisory Board was created by 2011 Senate Bill No. 2302 and codified as North Dakota Century Code Section 21-10-11. The 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 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. Since inception, investment returns on the budget stabilization fund have averaged 2.38 percent, compared to a policy benchmark of 1.74 percent.

LEGACY FUND

In 2011 the advisory board selected a legacy fund asset mix that it recommended to the 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 the 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 received the consultant's report. R.V. Kuhns & Associates, Inc., recommended investing between 50 and 60 percent of legacy fund assets in equities with the remainder in fixed income and real estate investments. The recommendation included an equity investment component, in part because over the next 4.5 years the fund has no liquidity requirements. The fund will eventually enter the permanent phase, in which there will be both revenue into and disbursements out of the fund. At that point it will be become important to provide a balance between long-term growth objectives and near-term liquidity needs. The advisory board recommended incorporating the 50 percent equity portfolio recommendation of R.V. Kuhns & Associates, Inc., into the legacy fund investment policy statement, including the following asset allocation mix for the legacy fund:

- Broad US Equity 30 percent;
- Broad International Equity 20 percent;
- Fixed Income 35 percent;
- Core Real Estate 5 percent; and
- Diversified Real Assets 10 percent.

The advisory board approved modifications to the legacy fund investment policy statement to allow the pooling of fund assets and to adjust asset allocation and rebalancing policies.

The legacy fund investment policy statement, as amended, is attached as Appendix A.

At its November 2013 meeting, the advisory board received information regarding the legacy fund asset allocation and the transition from 100 percent short-term fixed income to a diversified allocation. The Retirement and Investment Office (RIO) consulted with Callan Associates Inc. and R.V. Kuhns & Associates, Inc., to develop a transition timeline, and the SIB approved a transition plan to fully implement the new policy allocation over 18 months through the use of existing managers within the insurance trust. The transition plan 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. The Retirement and Investment Office initiated the transition plan in August 2013 and anticipates completing the transition by January 2015. After the new policy allocation is implemented, performance will be measured based on a custom set of benchmarks appropriate for each asset type.

During fiscal year 2013, deposits to the legacy fund from oil and gas tax allocations totaled $670 million and transfers from the strategic investment and improvements (SIIF) fund totaled $121.1 million. During the months of February 2013 through July 2013, $147.7 million was transferred from the SIIF fund to the legacy fund pursuant to Section 15-08.1-08.

Deposits into the legacy fund from its inception through September 2013 total $1.4 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
Total	$1,272,967,772	$147,690,440	$1,420,658,212

The market value of the legacy fund as of September 30, 2013, was $1.44 billion. Information regarding market value of the legacy fund by asset class as of September 30, 2013, is attached as Appendix B. From its inception through September 2013, investment returns on the legacy fund have averaged 1.60 percent, compared to a policy benchmark of 0.41 percent.

The Retirement and Investment Office anticipates management fees to be approximately 33 basis points after the transition to the new asset allocation policy is complete in January 2015, assuming a legacy fund market value of $2.37 billion. Management fees under the current asset allocation policy have been approximately 35 basis points.

Based on the 2013 legislative forecast, $1.782 billion is estimated to be deposited into the legacy fund during the 2013-15 biennium, and the balance in the legacy fund on June 30, 2015, is estimated to total $3.1 billion.

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NORTH DAKOTA LEGACY FUND

INVESTMENT POLICY STATEMENT

1. PLAN CHARACTERISTICS AND FUND CONSTRAINTS

The North Dakota legacy fund was created in 2010 when the voters of North Dakota approved a constitutional amendment--now Article X, Section 26, of the Constitution of North Dakota--to provide that 30 percent of oil and gas gross production and oil extraction taxes on oil and gas produced after June 30, 2011, be transferred to the legacy fund. The principal and earnings of the legacy fund may not be spent until after June 30, 2017, and any expenditure of principal after that date requires a vote of at least two-thirds of the members elected to each house of the Legislative Assembly. Not more than 15 percent of the principal of the legacy fund may be spent during a biennium. The Legislative Assembly may transfer funds from any source to the legacy fund, and such transfers become part of the principal of the fund. The State Investment Board (SIB) is responsible for investment of the principal of the legacy fund. Interest earnings accruing after June 30, 2017, are transferred to the general fund at the end of each biennium. North Dakota Century Code Section 21-10-11 provides that the goal of investment for the legacy fund is principal preservation while maximizing total return.

2. FUND MISSION

The legacy fund was created, in part, due to the recognition that state revenue from the oil and gas industry will be derived over a finite timeframe. The legacy fund defers the recognition of 30 percent of this revenue for the benefit of future generations. The primary mission of the legacy fund is to preserve the real inflation-adjusted purchasing power of the money deposited into the fund while maximizing total return.

3. RESPONSIBILITIES AND DISCRETION OF THE STATE INVESTMENT BOARD

The Legacy and Budget Stabilization Fund Advisory Board (the board) is charged by law under Section 21-10-11 with the responsibility of recommending policies on investment goals and asset allocation of the legacy fund. The SIB is charged with implementing policies and asset allocation and investing the assets of the legacy fund in the manner provided in Section 21-10-07--the prudent institutional investor rule. The fiduciaries shall exercise the judgment and care, under the circumstances then prevailing, that an institutional investor of ordinary prudence, discretion, and intelligence exercises in the management of large investments entrusted to it, not in regard to speculation but in regard to the permanent disposition of funds, considering probable safety of capital as well as probable income.

Management responsibility for the investment program not assigned to the SIB in Chapter 21-10 is hereby delegated to the SIB, which must establish written policies for the operation of the investment program consistent with this investment policy.

The SIB may delegate investment responsibility to professional money managers, which are also required to employ investment strategies consistent with the investment policy. Where a money manager has been retained, the SIB's role in determining investment strategy and security selection is supervisory not advisory.

At the discretion of the SIB, the fund's assets may be pooled with other funds. In pooling funds, the SIB may establish whatever asset class pools it deems necessary with specific quality, diversification, restrictions, and performance objectives appropriate to the prudent investor rule and the objectives of the funds participating in the pool.

The SIB is responsible for establishing criteria, procedures, and making decisions with respect to hiring, retaining, and terminating money managers. The SIB investment responsibility also includes selecting performance measurement services, consultants, report formats, and frequency of meetings with managers.

The SIB shall notify the board within 30 days of any substantial or notable changes in money managers; performance measurement services; and consultants, including hiring or terminating a money manager, performance measurement service, or a consultant.

The SIB, after consultation with the board, will implement necessary changes to this policy in an efficient and prudent manner.

4. RISK TOLERANCE

The board's risk tolerance with respect to the primary aspect of the legacy fund's mission is low. The board is unwilling to undertake investment strategies that might jeopardize the ability of the legacy fund to maintain principal value over time. The board recognizes that the plan will evolve as the legacy fund matures and economic conditions and opportunities change.

5. INVESTMENT OBJECTIVES

The board's investment objectives are expressed in terms of reward and risk expectations relative to investable, passive benchmarks. The legacy fund's policy benchmark is comprised of policy mix weights of appropriate asset class benchmarks as set by the SIB:

a. The legacy fund's rate of return, net of fees and expenses, should at least match that of the policy benchmark over a minimum evaluation period of five years.

b. The legacy fund's risk, measured by the standard deviation of net returns, should not exceed 115 percent of the policy benchmark over a minimum evaluation period of five years.

c. The risk-adjusted performance of the legacy fund, net of fees and expenses, should at least match that of the policy benchmark over a minimum evaluation period of five years.

6. POLICY ASSET MIX

After consideration of all the inputs and a discussion of its own collective risk tolerance, the board approves the following policy asset mix for the legacy fund as of April 2, 2013:

Asset Class	**Policy Target Percentage**
Broad US Equity	**30%**
Broad International Equity	**20%**
Fixed Income	**35%**
Core Real Estate	**5%**
Diversified Real Assets	**10%**

Rebalancing of the fund to this target will be done in accordance with the SIB's rebalancing policy, but not less than annually.

7. RESTRICTIONS

While the SIB is responsible for establishing specific quality, diversification, restrictions, and performance objectives for the investment vehicles in which the legacy fund's assets will be invested, it is understood that:

a. Futures and options may be used to hedge or replicate underlying index exposure, but not for speculation.

b. Derivatives use will be monitored to ensure that undue risks are not taken by the money managers.

c. No transaction may be made that would threaten the tax-exempt status of the legacy fund.

d. All assets will be held in custody by the SIB's master custodian or such other custodians as are acceptable to the SIB.

e. No unhedged short sales or speculative margin purchases may be made.

f. Social investing is prohibited unless it meets the exclusive benefit rule, and it can be substantiated that the investment must provide an equivalent or superior rate of return for a similar investment with a similar time horizon and similar risk. For the purpose of this document, social investing is defined as the consideration of socially responsible criteria in the investment or commitment of public fund money for the purpose of obtaining an effect other than a maximized return to the Fund.

g. Economically targeted investing is prohibited unless the investment meets the exclusive benefit rule.

   For the purpose of this document, economically targeted investment is defined as an investment designed to produce a competitive rate of return commensurate with risk involved as well as to create collateral economic benefits for a targeted geographic area, group of people, or sector of the economy.

   Also, for the purpose of this document, the exclusive benefit rule is met if the following four conditions are satisfied:

   - The cost does not exceed the fair market value at the time of investment.
   - The investment provides the legacy fund with an equivalent or superior rate of return for a similar investment with a similar time horizon and similar risk.
   - Sufficient liquidity is maintained in the legacy fund to permit distributions in accordance with the terms of the plan.
   - The safeguards and diversity that a prudent investor would adhere to are present.

   Where investment characteristics, including yield, risk, and liquidity, are equivalent, the board's policy favors investments which will have a positive impact on the economy of North Dakota.

8. INTERNAL CONTROLS

A system of internal controls must be in place by the SIB to prevent losses of public funds arising from fraud or employee error. Such controls deemed most important are the separation of responsibilities for investment purchases from the recording of investment activity, custodial safekeeping, written confirmation of investment transactions, and established criteria for investment manager selection and monitoring. The annual financial audit must include a comprehensive review of the portfolio, accounting procedures for security transactions, and compliance with the investment policy.

9. EVALUATION AND REVIEW

Investment management of the legacy fund will be evaluated against the fund's investment objectives and investment performance standards. Emphasis will be placed on 5-year and 10-year results. Evaluation should include an assessment of the continued feasibility of achieving the investment objectives and the appropriateness of the investment policy statement for achieving those objectives.

Performance reports will be provided to the board periodically, but not less than quarterly. Such reports will include asset returns and allocation data. Additionally, not less than annually, reports will include information regarding all significant and/or material matters and changes pertaining to the investment of the legacy fund, including:

- Changes in asset class portfolio structures, tactical approaches, and market values.
- Loss of principal, if any.
- Management costs associated with various types of investments.
- All material legal or legislative proceedings affecting the SIB.
- Compliance with this investment policy statement.
- An evaluation of the national economic climate.
- A forecast of the expected economic opportunities and dangers.
- Management of risk by the SIB.

In addition to the quarterly and annual evaluation and review process, the SIB shall notify the board within 30 days of any substantial or notable deviation from the normal management of the legacy fund, including any anomalies, notable losses, gains, or liquidation of assets affecting the fund.

Approved by:

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD	**STATE INVESTMENT BOARD**
Rep. Keith Kempenich	Darren Schulz
Representative Keith Kempenich **Chairman**	**Darren Schulz, CFA** **Interim CIO**
Date: 5-3-13	**Date:** 30 April 13

Legacy Fund Manager Structure

	9/30/13 Market Value
TOTAL LEGACY FUND	**1,440,680,819**
LARGE CAP DOMESTIC EQUITY	
Los Angeles Capital	18,620,336
LSV	18,386,106
Los Angeles Capital	12,293,790
Clifton Group (moved from fixed 11/1/08)	12,135,858
TOTAL LARGE CAP DOMESTIC EQUITY	***61,436,091***
SMALL CAP DOMESTIC EQUITY	
Research Affiliates	11,526,412
Clifton	11,465,995
TOTAL SMALL CAP DOMESTIC EQUITY	***22,992,407***
INTERNATIONAL EQUITY	
Capital Guardian	23,169,380
LSV	23,495,000
DFA	5,859,750
Vanguard	5,715,676
TOTAL INTERNATIONAL EQUITY	***58,239,807***
FIXED INCOME	
Western Asset	
Prudential	
PIMCO (DiSCO)	
Declaration	
State Street	
Wells Capital (formerly Strong)	
TOTAL FIXED INCOME	

	9/30/13 Market Value
INFLATION PROTECTED ASSETS	
Western Global TIPS	
TIR - Eastern Timber Opps Fund	
JP Morgan (Infrastructure)	
Credit Suisse (Infrastructure)	
TOTAL INFLATION PROTECTED ASSETS	
REAL ESTATE	
JP Morgan	6,003,827
Invesco	4,079,660
TOTAL REAL ESTATE	***10,083,487***
CASH EQUIVALENTS	
Northern Trust	147,368,165
TOTAL CASH EQUIVALENTS	***147,368,165***
SHORT TERM FIXED INCOME	
Babson Capital - Short Term Bonds-Legacy Fund	572,418,022
JP Morgan-Legacy Fund	568,142,841
TOTAL SHORT TERM FIXED INCOME	***1,140,560,863***