

TO: Legacy and Budget Stabilization Fund Advisory Board (“Advisory Board”)
FROM: Dave Hunter, Executive Director/CIO, Retirement and Investment Office (“RIO”)
DATE: December 1, 2014
SUBJECT: State Investment Board (“SIB”) Investment Policy Statement Update

SIB Update:

On November 21, 2014, RIO provided an Advisory Board update to the SIB. This update included a discussion of proposed changes to the investment policy statements of the Legacy and Budget Stabilization Funds along with the Advisory Boards recommendation to increase the Bank of North Dakota Match Loan Certificates of Deposit Program (“BND CD”) to \$250 million from \$200 million.

RIO Recommendation:

Based on SIB and Advisory Board discussion, RIO recommends the Investment Policy Statement for the Budget Stabilization Fund (“BSF” or “Fund”) should be revised to include a specific asset allocation percentage for the BND CD program. RIO recommends a 35% allocation to the BND CD program which is consistent with a \$250 million funding level after incorporating OMB’s forecasted \$134 million increase to the BSF (i.e. Fund assets > \$580 million plus OMB forecasted increase of \$134 million = \$714 million of which a 35% allocation would approximate \$250 million). The “Preliminary Budget Outlook – 2015-17 Biennium” is attached for reference.

Rationale:

Asset allocation recommendations within an investment policy statement are generally stated in percentage terms, rather than absolute dollar limits, in order to accommodate changes in future funding levels. RIO notes that this practice has been consistently followed within the investment policy statements of the Legacy and Budget Stabilization Funds in the past.

Review of Century Code Summary Statements:

Century Code 21-10-02 states that “The board (SIB) is charged with the investment of the funds enumerated in section 21-10-06.”

Century Code 21-10-06 specifically lists the “Budget stabilization fund” and the “Legacy fund”.

Century Code 21-10-07 further states that “The state investment board shall apply the prudent investor rule when investing for funds under its supervision.” The TFFR and PERS plans are specifically cited as being subject to the “exclusive benefit rule”.

Century Code 21-10-11 states that “The legacy and budget stabilization advisory board is created to develop recommendations for the investment of funds in the legacy fund and the budget stabilization fund to present to the state investment board”.

CIO Observations:

Based on Century Code 21-10-11, the Advisory Board may submit investment recommendations to the SIB for consideration and/or approval.

The CIO believes these Advisory Board recommendations can be presented to the SIB in the form of an investment policy statement which outlines the permitted investments and stated allocation percentage.

Summary of RIO's Investment Policy Statement Recommendations December 1, 2014

Budget Stabilization Fund

Section 1 – Fund Characteristics and Constraints: The first paragraph was refreshed to incorporate recent contributions into the Budget Stabilization Fund.

Section 4 – Standards of Investment Performance: The first paragraph was refreshed to incorporate current performance standards and restated to be consistent with current terminology.

Section 5 – Policy and Guidelines: The first paragraph was refreshed to replace the Officer of Management and Budget with the Legacy and Budget Stabilization Advisory Board. A new statement was added to specify a 35% asset allocation for the BND CD program. The guidelines were also refreshed to incorporate current investment restrictions and restated to be consistent with current terminology.

Legacy Fund

Section 6 – Policy Asset Mix: One sentence was added to make it clear that the SIB approved an 18 month implementation strategy for the asset allocation policy.

BUDGET STABILIZATION FUND
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INVESTMENT POLICY STATEMENT

1. FUND CHARACTERISTICS AND CONSTRAINTS.

The Budget Stabilization Fund (Fund) is a special fund created in 1987 under Chapter 54-27.2 of the North Dakota Century Code used to deposit general fund moneys in excess of appropriations. Notwithstanding the provisions of sections 54-27.2-01 and 54-27.2-02, \$124,936,548 was required to be transferred by the state treasurer to the budget stabilization fund from the general fund on July 1, 2009 along with \$61,414,562 on July 1, 2011 and \$181,060,584 on July 1, 2013. ~~These~~This transfers ~~will provide for a total of \$324,936,548 over \$580 million in the budget stabilization fund for the biennium beginning July 1, 2009 and ending June 30, 2011~~as of July 1, 2014. The state investment board shall supervise investment of the budget stabilization fund in accordance with chapter 21-10.

Any interest or other budget stabilization fund earnings must be deposited in the fund. Any amounts provided by law for deposit in the fund and any interest or earnings of the fund which would bring the balance in the fund to an amount greater than five percent of the current biennial state general fund budget, as finally approved by the most recently adjourned special or regular session of the legislative assembly, may not be deposited or retained in the fund but must be deposited instead in the state general fund.

If the director of the office of management and budget projects that general fund revenues for the biennium will be at least two and one-half percent less than estimated by the most recently adjourned special or regular session of the legislative assembly, and if the governor orders a transfer, the state treasurer shall transfer the appropriate funds from the budget stabilization fund to the state general fund to offset the decrease in general fund revenues. The amount transferred from the budget stabilization fund upon order of the governor may not exceed the difference between an amount two and one-half percent below the general fund revenue projections for the biennium and the general fund revenue projections for the biennium by the director of the office of management and budget.

2. RESPONSIBILITIES AND DISCRETION OF THE STATE INVESTMENT BOARD (SIB).

The Fund is charged by law under NDCC 21-10-02.1 with the responsibility of establishing policies on investment goals and asset allocation of the Fund. The SIB is charged with implementing these policies and asset allocation and investing the assets of the Fund in a manner consistent with the prudent investor rule as provided in NDCC 21-10-07.

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 objectives of the funds participating in the pools.

The SIB may delegate investment responsibility to professional money managers. When a money manager has been retained, the SIB's role in determining investment strategy and security selection is supervisory, not advisory. In accordance with this Investment Policy Statement, the Fund's assets may be invested directly or through collective investment vehicles.

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

The SIB will implement changes to this policy as promptly as is prudent.

3. INVESTMENT OBJECTIVES.

The investment objectives of the Fund reflect the relatively unknown life-span and the moderate risk tolerance of the Fund. Operating and statutory considerations shape the Fund's policies and priorities as outlined below:

Objective: Sufficient liquidity is to be maintained to meet known or anticipated financial obligations and preserve the value of the surplus. Cash equivalent investments will be used to achieve this objective.

4. STANDARDS OF INVESTMENT PERFORMANCE.

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

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

~~The Fund's investment objectives and liquidity constraints give rise to an asset allocation that is considered the most likely to achieve the results desired. For evaluation purposes, the following performance targets will apply:~~

~~a. The Fund should produce a rate of return that meets or exceeds the portfolio policy index.~~

~~b. The annual standard deviation of total returns for the Fund should not exceed that of the policy portfolio.~~

5. POLICY AND GUIDELINES.

The asset allocation of the Budget Stabilization Fund is established by the SIB, with input from the ~~Office of Management and Budget~~ Legacy and Budget Stabilization Advisory Board. Asset allocation is based upon the appraisal of projected liquidity and income requirements, and estimates of the investment returns likely to be achieved by the various asset classes over the next five years.

In recognition of these factors, the following allocation is deemed appropriate for the fund:

Short-term Fixed Income & BND CDs	Minimum of 90%
Bank Loans w/floating yield	Maximum of 5%
Absolute Return Strategies	Maximum of 5%

Bank of North Dakota Match Loan Certificates of Deposit Program ("BND CD") limit of 35%.

Rebalancing of the Fund to this target will be done in accordance with the SIB's rebalancing policy.

While the SIB is responsible for establishing specific quality, diversification, restrictions, and performance objectives for the investment vehicles in which the 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. Derivative use will be monitored to ensure that undue risks are not taken by the money managers.
- c. All assets will be held in custody by the State Investment Board's master custodian or such other custodians as are acceptable to the State Investment Board.
- d. No funds shall be borrowed.
- e. No unhedged short sales or speculative margin purchases shall 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 investment or commitment of public pension fund money for the purpose of obtaining an effect other than a maximized return to the intended beneficiaries."*

g.e.—Economically targeted investing is prohibited unless the investment meets the Exclusive Benefit Rule or is specifically recommended by the Advisory Board, approved by the SIB and relating to investment in the State of North Dakota. ~~prohibited unless the investment meets the Exclusive Benefit Rule.~~

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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:

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

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

6. EVALUATION AND REVIEW.

Investment management of the Fund will be evaluated against the Fund's investment objectives and investment performance standards. Evaluation will be conducted quarterly by the SIB through its review of funds participating in the Insurance Trust.

Money managers will be evaluated by the SIB quarterly. In-state meetings will be held with the money managers at least annually.

Approved by:

LEGACY AND BUDGET STABILIZATION
FUND ADVISORY BOARD
OFFICE OF MANAGEMENT AND BUDGET

STATE INVESTMENT BOARD

Representative Keith Kempenich
Chairman
Pam Sharp
Director of OMB

Steve Cochrane
David Hunter
Executive Director/CIO, RIO

Date: _____

Date: _____