

Legacy and Budget Stabilization Fund Advisory Board Update

June 15, 2016

Dave Hunter, Executive Director/CIO
Darren Schulz, Deputy Chief Investment Officer
ND Retirement & Investment Office (RIO)
State Investment Board (SIB)

Agenda

- ▷ Budget Stabilization Fund Update
 - ▷ Status - Contributions, Income and Distributions
 - ▷ Asset Allocation – Actual versus Target
 - ▷ Investment Performance
 - ▷ Investment Policy Statement
 - ▷ Bank of North Dakota Match Loan Certificate of Deposit Program Update
- ▷ Legacy Fund Update
 - ▷ Status - Contributions, Income and Distributions
 - ▷ Asset Allocation – Actual versus Target (and transition history)
 - ▷ Investment Performance
 - ▷ Investment Manager Allocations and Watch List
 - ▷ Investment Policy Statement
- ▷ Appendix

Budget Stabilization Fund - Status

Funding, Income and Disbursement History

Budget Stabilization Fund

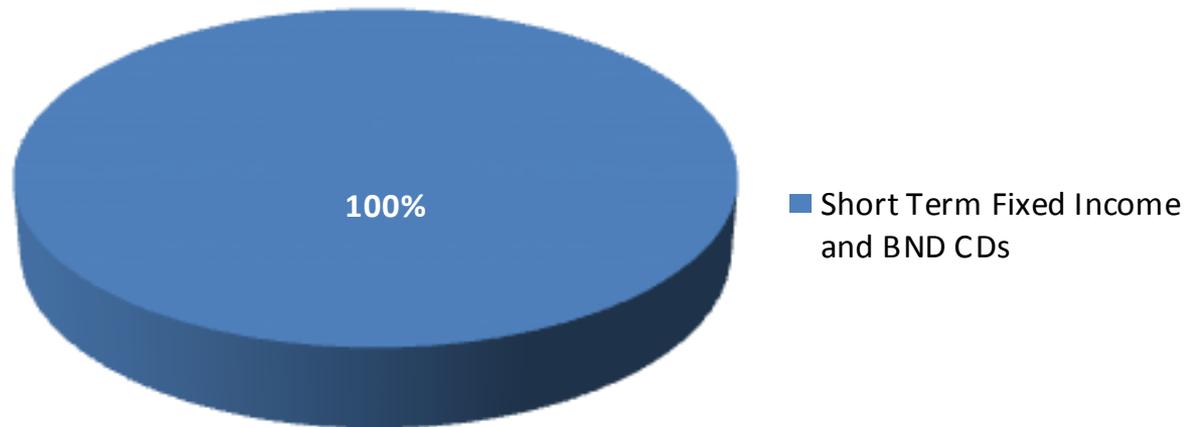
Through April 30, 2016

	Contributions	Income	Income Distributions	Net Assets
	New Money In	Net Increase	Out	End of Period
FY2006 (Initial Funding - Sept. 2005)	99,472,631	3,611,730	(3,207,845)	99,876,516
FY2007	-	4,980,987	(4,981,500)	99,876,003
FY2008	100,527,369	122,430	(1,688,532)	198,837,270
FY2009	-	(8,736,058)	-	190,101,212
FY2010	124,936,548	21,464,258	(11,385,172)	325,116,846
FY2011	-	12,031,101	(11,474,863)	325,673,084
FY2012	61,414,562	7,867,160	-	394,954,806
FY2013	-	7,239,388	(1,036,797)	401,157,397
FY2014	181,060,584	10,966,393	(7,183,404)	586,000,970
FY2015	-	10,992,146	(23,332,755)	573,636,701
FY2016	-	7,210,164	-	580,846,865
	<u>567,411,694</u>	<u>70,539,535</u>	<u>(64,290,868)</u>	
Net Increase - Inception to Date		70,539,535		
Income Distributions Taken			<u>(64,290,868)</u>	
Income Retained in Fund		6,248,667		

Note: Amounts are preliminary, unaudited and subject to change.

Budget Stabilization Fund - Asset Allocation

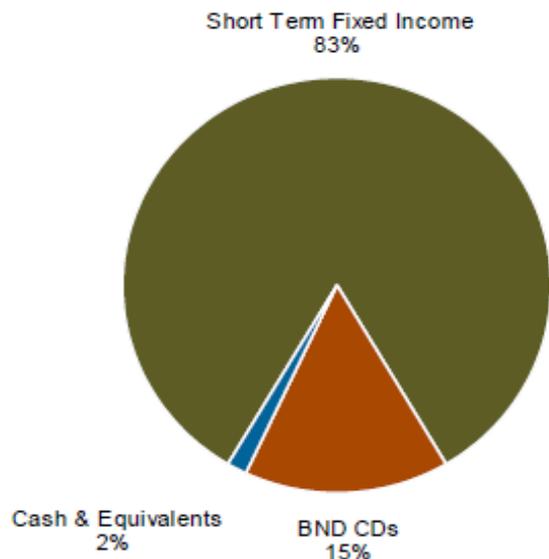
Policy Allocation



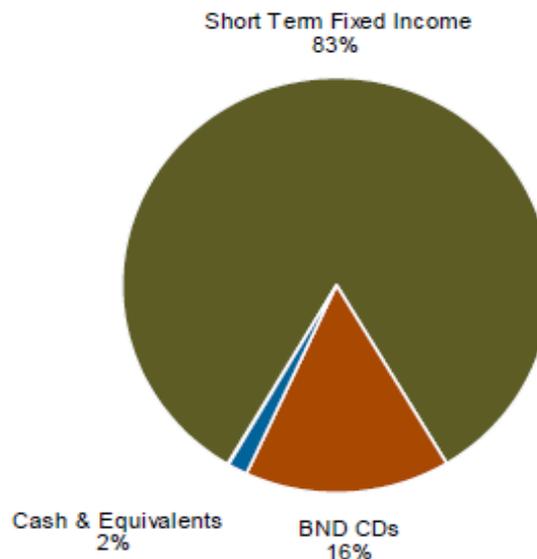
Budget Stabilization Fund Allocation

As of March 31, 2016

Actual Asset Allocation



Target Asset Allocation



Asset Class	\$000s Actual	Weight Actual	Target	Percent Difference	\$000s Difference
Short Term Fixed Income	481,120	83.0%	83.0%	0.0%	168
BND CDs	89,814	15.5%	15.5%	0.0%	(230)
Cash & Equivalents	8,875	1.5%	1.5%	0.0%	62
Total	579,810	100.0%	100.0%		

Budget Stabilization Fund Performance Exceeds Policy Benchmarks for 1-, 3- and 5-years ended March 31, 2016

Current FYTD 3/31/2016	1 Yr Ended 3/31/2016	3 Yrs Ended 3/31/2016	5 Yrs Ended 3/31/2016	Risk 5 Yrs Ended 3/31/2016	Risk Adj Excess Return 5 Yrs Ended 3/31/2016
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BUDGET STABILIZATION FUND

\$	579,947,916					
Total Fund Return - Net	1.02%	1.37%	1.62%	1.83%	0.71%	0.57%
Policy Benchmark Return	0.98%	1.08%	0.75%	0.59%	0.44%	
Excess Return	0.04%	0.29%	0.87%	1.23%		

Investment Summary:

Given the current low interest rate environment, investment returns for the Budget Stabilization Fund's fixed income portfolio has been declining in recent years. **The Fund generated a net investment return of 1.37% over the last year versus 1.83% for the last 5-years.**

Despite this challenging environment, the fund's investment managers have generally outperformed their respective benchmark indices (by **0.29%** in the last year and **1.23%** for the 5-years ended March 31, 2016). Given the nature of this "rainy day fund", capital preservation is valued more highly than income generation as evidenced by the low level of observed risk (as measured by standard deviation) of **0.71%** for the portfolio for the last 5-years.

Budget Stabilization Fund

Current Fiscal Year To Date Returns – March 31, 2016

	March-16	Current FYTD		Prior Year FY15		3 Years Ended 6/30/2015		5 Years Ended 6/30/2015	
	Market Value	Returns		Returns		Gross	Net	Gross	Net
		Gross	Net	Gross	Net				
TOTAL BUDGET STABILIZATION FUND	579,947,916	1.13%	1.02%	1.95%	1.86%	1.98%	1.89%	2.36%	2.28%
<i>POLICY TARGET BENCHMARK</i>		<i>0.98%</i>	<i>0.98%</i>	<i>0.75%</i>	<i>0.75%</i>	<i>0.55%</i>	<i>0.55%</i>	<i>0.42%</i>	<i>0.42%</i>
Bank of ND CD'S	89,952,365	2.12%	2.12%	2.68%	2.68%	3.05%	3.05%	3.59%	3.59%
CASH EQUIVALENTS									
Northern Trust (1)	8,875,391	0.06%	0.06%	0.01%	0.01%	N/A	N/A	N/A	N/A
TOTAL CASH EQUIVALENTS	8,875,391	0.06%	0.06%	0.01%	0.01%	0.10%	0.10%	0.17%	0.17%
<i>90 Day T-Bill</i>		<i>0.12%</i>	<i>0.12%</i>	<i>0.02%</i>	<i>0.02%</i>	<i>0.06%</i>	<i>0.06%</i>	<i>0.08%</i>	<i>0.08%</i>
SHORT TERM FIXED INCOME									
Babson Capital	240,129,059	0.85%	0.68%	2.55%	2.43%	2.28%	2.15%	N/A	N/A
<i>BC 1-3 Year US Gov't Index</i>		<i>0.78%</i>	<i>0.78%</i>	<i>0.91%</i>	<i>0.91%</i>	<i>0.68%</i>	<i>0.68%</i>		
JP Morgan	240,991,100	1.08%	0.97%	1.11%	1.01%	1.08%	0.97%	N/A	N/A
<i>BC 1-3 Year Gov/Credit Index</i>		<i>0.91%</i>	<i>0.91%</i>	<i>1.62%</i>	<i>1.62%</i>	<i>1.17%</i>	<i>1.17%</i>		
TOTAL SHORT TERM FIXED INCOME	481,120,159	0.96%	0.82%	1.83%	1.72%	1.71%	1.60%	2.05%	1.94%
<i>BC 1-3 Year US Gov't Index (1)</i>		<i>0.78%</i>	<i>0.78%</i>	<i>0.91%</i>	<i>0.91%</i>	<i>0.68%</i>	<i>0.68%</i>	<i>0.52%</i>	<i>0.52%</i>

NOTE: Monthly returns and market values are preliminary and subject to change.

Effective July 1, 2013, net of fee returns are calculated on a cash basis in the month paid. Prior years were accrual based and

(1) Prior to October 1, 2011, the benchmark was 90 Day T-bills.

Budget Stabilization Fund - Investment Fees:

Excess Return from Active Management Exceeds Investment Fees

RIO will refresh this slide for the fiscal year ended June 30, 2016, when our audited financial statements are issued later this year.

Budget Stabilization Fund Schedule of Investment Expenses

	FY 2015				FY 2014			
	Average Market Value	Fees in \$	Fees in %	Contribution to Total Fees	Average Market Value	Fees in \$	Fees in %	Contribution to Total Fees
Investment managers' fees:								
Short-term fixed income managers	478,363,794	660,665	0.14%	0.14%	466,375,734	507,502	0.11%	0.11%
Cash & equivalents managers	7,565,653	9,835	0.13%	0.00%	16,402,731	21,324	0.13%	0.00%
Total investment managers' fees	485,929,447	670,500	0.14%		482,778,465	528,824	0.11%	
Custodian fees		40,150	0.01%	0.01%		49,602	0.01%	0.01%
Investment consultant fees		26,509	0.01%	0.01%		17,623	0.00%	0.00%
Total investment expenses		737,159	0.15%			596,049	0.12%	
Actual Investment Performance (Net of Fees)			1.86%				1.94%	
Policy Benchmark			0.75%				0.61%	
Outperformance			1.11%				1.33%	

➤ During each of the last two fiscal years ended June 30, 2015, the Budget Stabilization Fund generated over \$5 million of incremental income from active management while paying less than \$1 million in fees each year.

➤ Investment fees for the Budget Stabilization Fund remain reasonable at less than 20 bps per annum particularly when comparing the annual excess return of \$5 million ($\$480 \text{ million} \times 1.1\% = \5 million) to the incremental cost of less than \$1 million per year.

Note: All amounts are deemed to be materially accurate, but are unaudited and subject to change.

Bank of North Dakota Match Loan Certificate of Deposit Program

RIO intends to transfer the existing Bank of North Dakota (BND) Match Loan CD Program from the Budget Stabilization Fund (BSF) to the Legacy Fund prior to a material portion of this “rainy day fund” being used to offset expected budget shortfalls. RIO’s recommendation is contingent upon BND guaranteeing a minimum 1.75% return noting that current 5-year Treasury rates (upon which the CD rates are based) were 1.21% as of June 9, 2016. The minimum return requirement will be reviewed periodically to ensure the Legacy Fund will be able to maintain its’ long-term expected rate of return of approximately 6.4% per annum. **The BSF investment policy statement will be revised to exclude the BND CD Program.**

The Legacy Funds’ current asset allocation is 50% equity, 35% fixed income and 15% real assets. **RIO can incorporate the BND CD program within the fixed income allocation of the Legacy Fund without materially impacting its’ overall return (6.4%) and risk profile as long the CD Program size is limited to the lesser of \$200 million or 5% (of the Legacy Fund) and a minimum 1.75% return requirement is maintained for this AA rated investment. These relevant terms will be incorporated into the revised investment policy statement for the Legacy Fund.** RIO discussed this action with the SIB on May 27, 2016, which confirmed SIB Governance Policy E-12 which states “The source of funding for CD’s shall be determined by the Investment Director”. If the Advisory Board has any questions with regards to this proposed action, RIO invites a discussion at our meeting on June 15, 2016.

BND Match Loan CD Program Background:

BND has a strong desire to maintain the CD Program which provides reduced cost financing to companies seeking to develop new businesses in North Dakota. RIO notes this economic development program has been in place for over 20 years although the funding source has migrated among various funds overseen by the SIB. **Given the nature and size of the \$3.7 billion Legacy Fund, RIO views the Legacy Fund as a better funding alternative given that one can make a case that both programs are intended to create or preserve intergenerational wealth for North Dakota's citizens.** In contrast, the BSF serves as a reserve fund with a greater demand for increased liquidity during periods of economic stress.

BND has issued 25 CD's over the past 20 years in connection with nearly \$1 billion of "Total Project" developments. Although the rates and terms have varied considerably since inception, BND has generally issued 5-year fixed rate CD's post 2008 with the average interest rate declining materially during this time period. **There are \$84 million of CD's outstanding within the \$580 million BSF as of May 20, 2016.**

Advisory Board Background:

The Legacy and Budget Stabilization Funds Advisory Board (Advisory 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 and budget stabilization funds. The SIB is charged with implementing policies and asset allocation and investing the assets of both funds.

BUDGET STABILIZATION FUND 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 transfers provide over \$580 million in the budget stabilization fund as of July 1, 2014. The statutory cap for the 2015-17 biennium is \$572,485,454. 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.



5. POLICY AND GUIDELINES.

The asset allocation of the Budget Stabilization Fund is established by the SIB, with input from the 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 excluding a SIB approved securities lending program.
- 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. 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:

- (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.

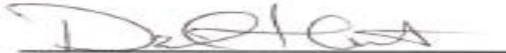
Approved by:

**LEGACY AND BUDGET STABILIZATION
FUND ADVISORY BOARD
STATE INVESTMENT BOARD**


Representative Keith Kempenich
Chairman

Date: 9-3-15

**NORTH DAKOTA
STATE INVESTMENT BOARD**


David Hunter
Executive Director/CIO, RIO

Date: 8/28/15

Approved by the NDSIB: 8/28/2015
Approved by the LBSFAB: 12/1/2014