

NORTH DAKOTA LEGISLATIVE MANAGEMENT

Minutes of the

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD

Thursday, August 11, 2011
Harvest Room, State Capitol
Bismarck, North Dakota

Senator Randel Christmann, Chairman, called the meeting to order at 8:30 a.m.

Members present: Senator Randel Christmann; Representatives Keith Kempenich, Dave Weiler; Office of Management and Budget Director - Pam Sharp; Bank of North Dakota President - Eric Hardmeyer; Tax Commissioner - Cory Fong

Member absent: Senator Jim Dotzenrod

Others present: See [Appendix A](#)

It was moved by Ms. Sharp, seconded by Representative Kempenich, and carried on a voice vote that the minutes of the June 28, 2011, meeting be approved as distributed.

INVESTMENT POLICY OF OTHER STATES' PERMANENT FUNDS

At the request of Chairman Christmann, the Legislative Council staff presented a memorandum entitled [Investment Policy of Other States' Permanent Funds](#). The Legislative Council staff said the memorandum provides information on the investment policy statements of Alaska's permanent fund, New Mexico's severance tax permanent fund, and Wyoming's permanent mineral trust fund. The Legislative Council staff provided information on the different state funds, including source of revenue, use of funds, the state's managing entity, investment goal, and the fund's investment performance summary as of March 31, 2011. The performance summary included the asset allocation of the other states' funds and return information fiscal year to date, for the last three years, and last five years.

Chairman Christmann requested that Mr. John Geissing, Chief Investment Officer, Retirement and Investment Office, provide a comparison at the next meeting of the asset allocation of the other states' funds to the asset allocation of the budget stabilization fund.

NORTH DAKOTA POLITICAL SUBDIVISIONS BONDED INDEBTEDNESS

At the request of Chairman Christmann, the Legislative Council staff presented a memorandum entitled [North Dakota Political Subdivisions Bonded Indebtedness](#). The Legislative Council staff said the memorandum includes information reported by political subdivisions in response to a Legislative Council survey. The survey was distributed to all

cities and counties, of which 22 cities and 31 counties have responded. Of the 22 cities, 17 reported indebtedness, and of the 31 counties, 13 reported indebtedness. The Legislative Council staff provided information by city and county, including the year debt was issued, purpose, type of bond, initial amount, outstanding balance, source of payment, average annual principal and interest payment amount, and the final maturity date of the reported debt. The Legislative Council staff provided information on participants' future anticipated indebtedness. The Legislative Council staff said 12 cities and 11 counties reported anticipated indebtedness in the next 24 months. The Legislative Council staff also reviewed the interest rates on bonds issued since 2001. Interest rates ranged from 2 percent to 6 percent during this period.

In response to a question from Senator Christmann, the Legislative Council staff said the survey included a question on whether any city or county had defaulted on debt issuances in the past, and of the survey respondents, there were no defaults reported.

INVESTMENT POLICY

Chairman Christmann called on Mr. Geissing to provide information regarding:

- Options for investing in North Dakota political subdivision debt instruments.
- Details of the history of budget stabilization fund investments and investment returns and on the current asset allocation for the budget stabilization fund.
- Suggested changes to the investment policy statement for the budget stabilization fund.

Options for Investing in North Dakota Political Subdivision Debt Instruments

Mr. Geissing said the current budget stabilization fund asset allocation does not include investments in political subdivision debt instruments. He said the interest rates on municipal bonds are often lower than other investment options because of the tax-exempt interest advantage for investors purchasing municipal bonds. He said municipal bonds are not risk-free, and when compared to other investment options of comparable risk, rates of return are generally lower.

Budget Stabilization Fund Investments

Mr. Geissinger provided a listing of budget stabilization fund investments held as of May 31, 2011 ([Appendix B](#)). He provided an analysis of the budget stabilization fund portfolio by credit quality, showing that 98.3 percent of the portfolio is invested in AAA to BBB rated investments considered investment grade by Standard & Poor's, 0.4 percent is invested in BB to B rated investments considered speculative grade by Standard & Poor's, and 1.3 percent of investments are invested in assets not rated. He also provided information on the maturity of investments held in the budget stabilization fund portfolio as follows:

Maturity	Percentage of Portfolio
< 90 days	18.2%
90 to 180 days	1.8%
181 to 360 days	5.2%
1 to 2 years	26.0%
2 to 3 years	27.8%
3+ years	21.0%

Mr. Geissinger provided an analysis of the budget stabilization fund using historical market data to measure performance under various asset allocation scenarios ([Appendix C](#)). He said the current asset allocation of the budget stabilization fund includes:

Investment	Percentage
Short-term investments	20%
Enhanced cash	30%
Short-term bonds	40%
Bank loans	10%

Mr. Geissinger said the analysis indicated that overall, the current asset allocation of the budget stabilization fund (Scenario F) outperformed other asset allocation scenarios both in rolling one-year returns and rolling two-year returns in terms of rate of return per unit of risk.

Chairman Christmann asked Mr. Geissinger to provide an assessment of the budget stabilization fund portfolio credit quality and its correlation to the perceived level of risk as provided in the budget stabilization fund investment policy statement to be presented at the next meeting.

Suggested Changes to the Budget Stabilization Fund Investment Policy Statement

Mr. Geissinger provided suggested changes to the current budget stabilization fund investment policy statement ([Appendix D](#)). The suggested changes include adding statements relating to the fund mission, risk tolerance, and internal controls. Language is added to clarify investment objectives and evaluation and review procedures. Other changes incorporate appropriate changes for the 2011-13 biennium, including updating transfer and balance amounts, biennium dates, and naming the Legacy and Budget Stabilization Fund Advisory Board

as the advisory board for the fund. He also suggested the following change to the current asset allocation:

Current Asset Allocation		Suggested Changes		
		Asset Class	Policy Target Percentage	Rebalancing Range Percentage
Short-term fixed income and Bank of North Dakota certificates of deposit	Minimum 90%	Short-term bonds and Bank of North Dakota certificates of deposit	70%	65% to 75%
		Cash and cash equivalents	20%	15% to 25%
Bank loans with floating yield	Maximum of 5%	Bank loans	10%	7.5% to 12.5%
Absolute return strategies	Maximum of 5%			

In response to a question from Mr. Hardmeyer, Mr. Geissinger said the investment objective to limit the fund's risk, measured by the standard deviation of net returns, to 115 percent of the policy benchmark over a minimum period of five years is a standard industry policy.

STATE INVESTMENT BOARD PROCESS

Mr. Geissinger provided an overview of the investment process of the State Investment Board ([Appendix E](#)). He said pursuant to North Dakota Century Code Section 21-10-02.1, the governing body of each fund, including the Legacy and Budget Stabilization Fund Advisory Board, is to establish policies on investment goals and objectives and an asset allocation that must include long-range asset allocation goals and acceptable rates of return, liquidity, and levels of risk. Pursuant to Chapter 21-10, he said, the State Investment Board is responsible for implementing asset allocations established by the governing body of each fund, application of the prudent investor rule ([Appendix F](#)), approval of types of securities for investment, establishment of policies and procedures regulating securities transactions, selection of an asset custodian servicer, and selection of investment director and investment consulting services as well as creating investment pools. He said the role of the Retirement and Investment Office on behalf of the State Investment Board is to administer the overall investment strategy; advise the State Investment Board on methods to manage risk and maximize return opportunities within each asset class; serve as a liaison between the State Investment Board and the custodian bank, investment managers, and investment consultants; monitor each fund's investment guidelines and asset allocations; and maintain separate accounting for funds.

Mr. Geissinger said investment consultants are utilized in the selection of investment managers, performance measurement of investment managers, providing education to the State Investment Board, and for special projects. Once selected, he said, investment managers are responsible for buy and sell decisions based on investment guidelines, the implementation of specific mandates or investment missions, regular reporting to the Retirement and Investment Office, and for providing education to the State Investment Board.

In response to a question from Representative Kempenich, Mr. Geissinger said investment managers are selected through a due diligence process considering quantitative and qualitative factors, and decisions are based on capabilities of the investment manager to manage the desired asset allocation and produce the desired return. He said the compensation of investment managers varies based on investment type and may be a percentage fee on assets under management or paid based on performance.

In response to a question from Senator Christmann, Mr. Geissinger said a major consideration in selecting investment managers is determining whether historical performance will continue in the future. He said investment managers possessing an institutionalized investment process with investment teams in existence at least five years or longer are the preferred types of managers.

In response to a question from Mr. Fong, Mr. Geissinger said the State Investment Board currently has contracts with 38 different investment managers who manage from 80 to 100 different investment strategies.

Ms. Connie Flanagan, Fiscal and Investment Officer, Retirement and Investment Office, provided information regarding custodian bank responsibilities in the State Investment Board process. She said custodian banks are responsible for the safekeeping of assets, settling trades, and recordkeeping functions of the investment process. She said Northern Trust in Chicago, Illinois, is the primary custodian bank used by the State Investment Board. She said the custodian bank electronically transfers funds as directed by the investment managers and the Retirement and Investment Office accounts for transfers monthly. She said ad hoc reporting for commingled funds is difficult where assets of different funds have been pooled together, because assets must first be separated by fund and then assigned current market values. She said investment consultants, such as Callan Associates Incorporated, utilize Northern Trust when measuring performance of investment managers. She provided an example of the budget stabilization fund and Workforce Safety and Insurance investment performance reports as of May 31, 2011 ([Appendix G](#)).

LEGACY FUND TEMPORARY INTERIM INVESTMENT POLICY STATEMENT

Chairman Christmann said that the Legacy and Budget Stabilization Fund Advisory Board was created to provide recommendations to the State Investment Board regarding the investment policy for the legacy and budget stabilization fund. He said the board is responsible for establishing policies on investment goals and objectives and developing an asset allocation for the funds to provide to the State Investment Board.

Chairman Christmann said that within the investment policy statement the advisory board may define risks and areas of concern regarding the investment of fund assets. He suggested that utilizing North Dakota money managers may be an option to consider and may result in improved rates of return. Ms. Sharp said the State Investment Board has been selecting investment managers, and she does not believe limiting the selection of investment managers only to those in North Dakota would be an appropriate investment policy. Mr. Hardmeyer said a broader pool of expert investment managers would be available if not limited to only those in North Dakota. Representative Weiler said the advisory board's responsibility is to determine an investment policy statement for the fund and give direction to the State Investment Board regarding risk tolerance. He said directing the State Investment Board to utilize only certain investment managers may not be appropriate. Mr. Fong suggested addressing accountability as part of the investment policy statement. Mr. Geissinger explained the roles of the entities involved in the investment process. He said the advisory boards define risks to develop asset allocation through an investment policy statement, the Retirement and Investment Office administers investment policy statements of advisory boards and provides advice to the State Investment Board, the State Investment Board selects investment managers based on advice from the Retirement and Investment Office and performance evaluations of investment managers' policy implementation, and investment managers are held accountable to produce investment returns established in the investment policy statement. He said ultimately the State Investment Board is responsible for investment manager selections--good or bad.

Mr. Geissinger distributed a template for the creation of an investment policy statement for the legacy fund ([Appendix H](#)). He said the fund mission included in an investment policy statement is the fund's goal measured over many years; whereas, investment objectives are defined actionable steps to implement an immediate plan. In response to a question from Mr. Fong, he said the template assumes the legacy fund will accept more risk in investments than the budget stabilization fund where the fund mission is to preserve principal and ensure liquidity for unknown risks. Ms. Sharp said the goal of

the legacy fund stated within Chapter 21-10 is principal preservation while maximizing total return.

Representative Kempenich suggested that Mr. Geissinger provide a comparison highlighting the key differences of the budget stabilization fund investment policy statement, with his proposed changes incorporated, and the template of the legacy fund investment policy statement to be presented at the next meeting.

The Legislative Council staff informed board members that the first deposit into the legacy fund is expected on September 21, 2011.

In response to a question from Representative Kempenich, Mr. Geissinger said that the timing of establishing an investment manager for the legacy fund would depend on the investment strategy. If an investment plan similar to other fund investment strategies is employed, legacy fund assets could be included in current pooled assets. He said an advantage of pooling assets for investment is to reduce management fees. He said some asset managers operate on a declining fee schedule, where the more assets managed results in a smaller fee schedule.

BOARD DISCUSSION AND STAFF DIRECTIVES

Chairman Christmann suggested inviting representatives of Callan Associates Incorporated, and potentially other investment consultants, to the next meeting to provide information regarding revision of the current budget stabilization fund investment

policy statement and creation of the legacy fund investment policy statement.

Chairman Christmann asked that the board members review and consider changes to the current budget stabilization fund investment policy suggested by Mr. Geissinger for discussion at the next meeting.

For the development of the temporary interim investment policy statement for the legacy fund, Chairman Christmann asked board members to provide input on the key items to include in a temporary interim investment policy statement for the legacy fund. He said the Legislative Council staff, after considering board member input and in consultation with the chairman, will prepare a draft of a temporary interim investment policy statement for the legacy fund for the board to review and discuss at its next meeting.

No further business appearing, Chairman Christmann adjourned the meeting at 11:50 a.m.

Sara E. Chamberlin
Fiscal Analyst

Allen H. Knudson
Legislative Budget Analyst and Auditor

ATTACH:8