

NORTH DAKOTA LEGISLATIVE MANAGEMENT

Minutes of the

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD

Thursday, August 23, 2012
Harvest Room, State Capitol
Bismarck, North Dakota

Senator Randel Christmann, Chairman, called the meeting to order at 9:00 a.m.

Members present: Senators Randel Christmann, Jim Dotzenrod; Representative Keith Kempenich; Bank of North Dakota President - Eric Hardmeyer; Office of Management and Budget Director - Pam Sharp; Tax Commissioner - Cory Fong

Member absent: Representative Dave Weiler

Others present: See [Appendix A](#)

It was moved by Representative Kempenich, seconded by Senator Dotzenrod, and carried on a voice vote that the minutes of the June 18, 2012, meeting be approved as distributed.

CHIEF INVESTMENT OFFICER POSITION - RETIREMENT AND INVESTMENT OFFICE

Chairman Christmann called on a representative of the State Investment Board (SIB) to provide a status update ([Appendix B](#)) regarding the recruitment of a new Chief Investment Officer. Mr. Darren Schulz, Interim Chief Investment Officer, State Investment Board, said the committee organized by the SIB is leading the search to fill the Chief Investment Officer and Executive Director positions. He said members of the search committee include:

- Lt. Governor Drew Wrigley (Chairman);
- State Treasurer Kelly Schmidt;
- Department of Trust Lands Commissioner Lance Gaebe;
- Public Employees Retirement System Trustee Mike Sandal; and
- Teachers' Fund for Retirement Trustee Bob Toso.

Mr. Schulz said the search committee has completed a request for proposal (RFP) to retain an executive search firm to assist in filling the position. He said the job duties of the position continue to be evaluated by the search committee. He said the search for a viable candidate continues, and a timetable has not yet been set for when the position will be filled.

Representative Kempenich asked for a copy of the RFP and a listing of the job duties under evaluation. Mr. Schulz said the RFP had no material changes from the prior RFP used to recruit the former Chief Investment Officer with the SIB and Executive Director of the Retirement and Investment Office, Mr. John Geissing. He said he would provide the information to the advisory board.

STATUS OF THE LEGACY FUND AND BUDGET STABILIZATION FUND

Mr. Schulz provided a status update ([Appendix C](#)) on the legacy and budget stabilization funds.

Mr. Schulz said the asset allocation for the legacy fund provides that 100 percent of assets be invested in bonds or fixed income instruments with preference that investment grade bonds be purchased to provide a range of laddered maturities not to exceed 10 years with an effective duration not to exceed 3.5 years. He said the June 2012 market value of the legacy fund was \$399 million. He said the investment policy statement notes that plans for including stocks and equities as part of the asset class mix will be finalized by the advisory board in the future. He said the legacy fund's net investment income, inception to date (nine months), is \$2.3 million or 1.02 percent which is above the policy benchmark of .17 percent.

Mr. Schulz said the asset allocation for the budget stabilization fund provides for a minimum of 90 percent of assets to be invested in short-term fixed income and Bank of North Dakota CDs, a maximum of 5 percent of assets to be invested in bank loans with floating yield, and a maximum of 5 percent of assets to be invested in absolute return strategies. He said the June 2012 market value of the budget stabilization fund was \$395.1 million. He said the budget stabilization fund has experienced an average annualized return of 2.47 percent during the most recent six and three-quarter years, which is above the policy benchmark of 1.99 percent. He provided the following asset return data by fiscal year:

Fiscal Yearend	Net Assets End of Period	Net Return
June 30, 2006 (initial funding - September 2005)	\$99,876,516	Not applicable, partial year
June 30, 2007	\$99,876,003	5.12%
June 30, 2008	\$198,837,270	0.01%
June 30, 2009	\$190,101,212	(4.23%)
June 30, 2010	\$325,116,846	7.38%
June 30, 2011	\$325,673,084	3.63%
June 30, 2012 - To date through April 2012	\$394,954,806	1.67%

Mr. Schulz said financial statements and performance reports for the legacy and budget stabilization funds are available on the Retirement and Investment Office website (legacy fund -

[Financial Statements](#) and [Performance Report](#)) and (budget stabilization fund - [Financial Statements](#) and [Performance Report](#)).

NORWAY'S GOVERNMENT PENSION FUND GLOBAL

Chairman Christmann called on Mr. Hardmeyer to present information ([Appendix D](#)) on the investment policy of Norway's Government Pension Fund Global (GPF). Mr. Hardmeyer reviewed information (on file in the Legislative Council office) on the fund which was trademarked, but which he had received permission to use. He said Norway's GPF is similar to the legacy fund, collecting revenue from oil taxes and established for the benefit of future generations. He highlighted the following points of the fund:

- As of July 2012, GPF was ranked by the Sovereign Wealth Institute as the second-largest sovereign wealth fund in terms of assets under management.
- GPF investment strategy focus is long-term with no specific liabilities earmarked or liquidity needs. The GPF investment strategy goal is to have diversified investments that will generate the highest possible return within moderate risk levels.
- GPF has produced returns using an asset class mix of 60 percent equities, 35 to 40 percent fixed income, and zero to 5 percent real estate.

Of the 60 percent invested in equities, 50 percent is invested in European equities (excluding Norway); 35 percent invested in the Americas, Africa, and the Middle East; and 15 percent invested in Asia and Oceania (tropical Pacific Island region). Europe is the primary equity investment due to favorable currency conversions.

As of July 2012, less than 1 percent of the 5 percent target allocation has been invested in real estate. Real estate investments focus on major European markets in larger cities either for key centers for offices or retail space in densely populated areas. These investments are primarily made with partners through joint ventures.

- Transfers from GPF can only be made to Norway's budget to cover the non-oil budget deficit as determined during preparation of the annual budget, withdrawals are limited to the anticipated long-term annualized real return of approximately 4 percent.
- Norway utilizes ownership rights to promote good corporate governance and high social and environmental standards at companies held in the GPF portfolio. Investments and activities of Norway's GPF are highly transparent to build public support and acceptance.

In response to a question from Representative Kempenich, Mr. Hardmeyer said the reason GPF does not invest within Norway is that the government could potentially manipulate the country's economy because of the size of the fund.

DORSEY WRIGHT MONEY MANAGEMENT

Chairman Christmann called on Mr. John Lewis, Portfolio Manager, Dorsey Wright Money Management, Pasadena, California, to present information ([Appendix E](#)) on tactical allocation as a potential investment strategy for the legacy fund. Mr. Lewis said tactical allocation actively changes portfolio allocations to capitalize on market anomalies, whereas strategic asset allocation uses a buy-and-hold strategy based on fixed portfolio allocations. He said in a tactical allocation investment strategy, an investment's relative strength rating is calculated on a regular basis by comparing the investment price to a base index of similar investment prices. He said equities are purchased and sold by identifying shifts in the markets--purchased after trends of strength have been established and sold after trends of weakness appear. He said an advantage of using the relative strength rating as an investment determination factor is that stronger performance is easier identified than in the traditional practices of financial statement and performance analysis.

In response to a question from Representative Kempenich, Mr. Lewis said an appropriate asset allocation percentage for equities should be based on the variables of the fund's future use and investment goals. He said if the investment is viewed as short term, a low percentage of acceptable risk is appropriate, and if the investment is viewed as long term, a higher percentage of acceptable risk is appropriate. He said he believes 60 percent equities and 40 percent fixed income is a standard asset class mix; however, 50 percent equities and 50 percent fixed income would be a more conservative approach. He said a risk of only holding low-risk investments with fixed income in a portfolio is that in an inflationary period the investments realize lower returns.

PROPOSED STUDY ON LEGACY FUND ASSET CLASS MIX

Chairman Christmann called on Mr. Schulz to provide information ([Appendix F](#)) on a proposed investment consultant study of the appropriate asset class mix for the legacy fund. Mr. Schulz said under authority provided in North Dakota Century Code Section 21-10-11, the staff of the Retirement and Investment Office suggests that the advisory board recommend that the SIB conduct an asset allocation and spending study for the legacy fund to assist in developing asset allocation and investment policies for the fund. He said components of the study may include the following:

- Major asset class performance projections:
Used to create asset mix alternatives.
Used to estimate the financial future of the fund.
- Creation of alternative asset mixes to compare to the existing target mix:
Focus on optimal mixes.
Review a range from conservative to aggressive.
- Simulation of future outcomes:
Review the range of possible future fund conditions.
Determination of the relative benefits of each of the asset mixes.
- Identification of a target asset mix:
Identify parameters most important to the fund.

Mr. Fong asked whether the advisory board should delay hiring an investment consultant to conduct an asset allocation and spending study for the legacy fund until the legacy fund's intended purpose is more clear.

Senator Christmann said the constitutional amendment does not define a specific purpose of the legacy fund. He said future Legislative Assemblies' use of the fund will change due to changing economic conditions over time. He said because the constitutional provisions allow up to 15 percent of the fund's principal balance to be utilized each biennium beginning in the 2017-19 biennium, the investment strategy will need to have a portion of the fund's assets available if the funds are needed.

Mr. Hardmeyer and Ms. Sharp also indicated the need for 15 percent of the principal and accumulated earnings of the legacy fund to be held in liquid investments.

In response to a question from Senator Christmann, Mr. Schulz said most investment consultants would likely recommend a strategic over tactical asset allocation investment strategy. He said a tactical asset allocation investment strategy is difficult to implement with consistency, adjustments may introduce risk undermining the integrity of strategic asset allocation decisions, and trading costs can exceed any perceived benefits. Senator Christmann said the study should address tactical allocation as a potential investment strategy.

In response to a question from Ms. Sharp, Mr. Schulz said Callan Associates Inc. has submitted a preliminary proposal to conduct an asset allocation and spending study for the legacy fund at an estimated cost of \$64,000. He suggested using an informal process exempt from regular procurement requirements to obtain a consultant to conduct the study. Ms. Connie Flanagan, Fiscal and Investment Officer, Retirement and Investment Office, said the SIB has specific statutory exemptions regarding contracting for investment consultants. She said consulting costs may be paid pursuant to the

continuing appropriation provided in Section 21-10-06.2.

In response to a question from Senator Christmann, Mr. Schulz said the Attorney General has issued an opinion letter that states an investment consultant costs are associated with management of the legacy fund and are an appropriate expense to be paid from money in the fund.

In response to a question from Senator Christmann, Mr. Schulz said the investment consultant study is expected to take eight weeks and would include meetings with advisory board members to determine the study's scope. He said a recommended asset class allocation would be the result of the investment consultant study.

In response to a question from Senator Christmann, Mr. Schulz said upon advisory board approval he would present the advisory board's recommendation to proceed with an investment consultant study to the SIB at its meeting on Friday, August 24, 2012. He said upon the SIB's approval, the Retirement and Investment Office would proceed with obtaining proposals from the following investment consultants to conduct the study--Callan Associates Inc., Cambridge Associates, Hewitt EnnisKnupp, R. V. Kuhns and Associates, and Strategic Investment Solutions.

Mr. Fong suggested the Retirement and Investment Office rank and select the top three investment consultants submitting proposals, provide the advisory board with details on the selection process and proposals, and allow the advisory board to review this information prior to selecting an investment consultant to conduct the study.

Mr. Hardmeyer also suggested that the advisory board members have an opportunity to review the investment consultant proposals prior to final selection of a consultant.

Senator Christmann asked that time to complete, cost, and inclusion of a review of the tactical asset allocation investment strategy be considerations in selecting the investment consultant.

It was moved by Representative Kempenich, seconded by Senator Dotzenrod, and carried on a roll call vote that the Legacy and Budget Stabilization Fund Advisory Board recommend that the State Investment Board arrange to contract with an investment consultant to conduct a study on the appropriate asset class mix for the legacy fund. Senators Christmann and Dotzenrod, Representative Kempenich, Ms. Sharp, Mr. Fong, and Mr. Hardmeyer voted "aye." No negative votes were cast.

ADVISORY BOARD DISCUSSION AND STAFF DIRECTIVES

Chairman Christmann said if the study is approved by the SIB, he anticipates that Mr. Schulz will contact prospective consultants and present recommendations on the consultant to select to the advisory

board. He said advisory board members will be notified when more information is available. He said the next meeting date will depend on when the prospective consultant information is available for review.

No further business appearing, Chairman Christmann adjourned the meeting at 12:10 p.m.

Sara E. Pahlke
Fiscal Analyst

Allen H. Knudson
Legislative Budget Analyst and Auditor

ATTACH:6