

NORTH DAKOTA LEGISLATIVE MANAGEMENT

Minutes of the

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD

Thursday, October 27, 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; Tax Commissioner - Cory Fong

Members absent: Senator Jim Dotzenrod; Bank of North Dakota President - Eric Hardmeyer

Others present: See [Appendix A](#)

It was moved by Representative Weiler, seconded by Mr. Fong, and carried on a voice vote that the minutes of the September 6, 2011, meeting be approved as distributed.

CALLAN ASSOCIATES INC.

Chairman Christmann called on Mr. Paul Erlendson, Senior Vice President, Callan Associates Inc., to provide information ([Appendix B](#)) regarding investment policy statement development for the legacy fund and investment policy statement revision for the budget stabilization fund, including:

- Investment process and the utilization of investment managers.
- Analysis of costs incurred in the investment process.
- An assessment of budget stabilization fund investment managers' performance.
- Callan's role in evaluation and review of fund performance.
- Potential risks and returns of investment options.
- Suggested risk tolerance level and asset mix to comply with the legacy fund mission of principal preservation while maximizing total return.

Mr. Erlendson said also present with him was Mr. Bill Howard, Vice President, Callan Associates Inc. Mr. Erlendson said historically Callan has been retained by the state of North Dakota as an investment consultant in the investment process of other state funds. In this role, he said, Callan has assisted in the performance measurement of investment managers, assisted in investment manager research and selection, provided education to the State Investment Board, and completed special projects upon request. He said Callan assists in investment manager research and selection by finding candidates with required attributes, such as Securities

Exchange Commission-registered managers or firms with ownership by key individuals. He said Callan assists in monitoring performance through total pooled funds performance analysis, as well as analysis of each of the components. He said Callan researches developments in the market and emerging markets and educates the State Investment Board of investment opportunities through research publications.

In response to a question from Senator Christmann, Mr. Erlendson said Callan provides advisory services to the State Investment Board for investment manager selection based on a background check of candidates. He said for most clients, Callan performs the entire investment manager research process.

In response to a question from Senator Christmann, Mr. Erlendson said Callan monitors investment manager performance quarterly which includes a review of the composition of investments and periodically meeting with investment managers.

Mr. Erlendson said investment results are important; however, the process used by fiduciaries in evaluating and adopting policies defines prudence, not just the investment results. He said prudence is defined by the process of evaluating and adopting policies. He provided the following recommended fiduciary process:

Step 1 - Analyze current position

Conduct fiduciary review:

- Current position
- Regulatory environment
- Mission and objectives
- Risk tolerance
- Performance objectives
- Cashflow considerations
- Liabilities

Step 2 - Design optimal portfolio

Develop investment policy guidelines

Set asset allocation policy

Determine rational manager structure

Identify appropriate performance benchmarks

Step 3 - Formalize investment policy*

Prepare a written investment policy statement

Step 4 - Implement policy

Hire investment managers

Negotiate investment manager fees

Review custody and recordkeeping arrangements

Review securities lending program

Establish brokerage policies

Step 5 - Monitor and supervise*

Review performance measurement and reporting procedures
 Monitor trading costs
 Monitor ongoing manager performance
 Make program refinements as required

*Results from monitoring and supervision may lead to a rebalance of the formalized investment policy.

Mr. Erlendson said in developing an investment policy statement consideration should be given to the interaction of three key policies that govern the fund:

Investment policy

How will the assets supporting the spending be invested?
 What are the risk and return objectives?
 How are cashflows to be managed?

Funding policy

What is the revenue expectation?
 What are the near-term policies?
 Is there consistency of policy and amounts derived thereof?

Spending policy

What are the objectives of the distribution policy?
 What is the expected level of spending?
 What are expectations regarding fees?

Mr. Erlendson said a crucial first step in establishing investment policy is to define the investment goals. He said once investment goals have been established, decision variables and risk tolerance to adhere to the investment goals should be identified and defined, and finally an asset mix should be selected based upon all three elements. He said a broad asset allocation target should be identified that is appropriate for the parameters of the risk and return objectives. He said key considerations include the purpose of assets, short-term and long-term objectives, liquidity needs, diversification, and tolerance for downside risk. He said another potential risk to any investment is inflation. He said the three key policies of spending, funding, and investment should coordinate and work together with inflation protection strategies to ensure real returns keep pace with inflation.

Mr. Erlendson said there is no single "best" structure. He said factors to consider in the design of an investment program structure are financial theory as found in academic literature; empirical evidence through capital market observations; and the established risk tolerance in terms of time, liquidity considerations, total portfolio versus individual manager focus, an understanding and support for specific styles of management, and time and professional resources available to monitor the program. He said the following issues affect investment structure:

Use of index funds

Market subsectors that are most efficient and the percentages that passive allocations are made

Types (styles) of managers

Specialists, such as growth and value managers, or generalists, such as a core manager

Number of managers

Driven by a fund's size and the use of index funds and types of managers

Types of vehicles

Separately managed portfolio
 Commingled or mutual fund
 Managers of managers

Cost-effectiveness

There is little or no value in building a "theoretical" structure that is too expensive to implement. Consider cost-effectiveness of transition costs, monitoring costs, management fees, and legal costs of contract review for desired investment structure.

In response to a question from Senator Christmann, Mr. Erlendson said Callan consulting service assists in determining the number of managers that work most effectively to attain investment goals. He said some funds have a limit of not more than 20 percent of a fund's assets to one manager.

Mr. Erlendson provided the committee observations from the Callan Investments Institute--the educational division of Callan--2009 "Cost of Doing Business" survey. He said the survey results are based on responses from 55 funds and trusts, including endowments, foundations, and pension funds from across the United States. He said that on average, the surveyed funds and trusts spend over 0.47 percent annually of total assets to operate and manage funds. He said 87.5 percent of total fund expenses relate to external investment manager fees, 5.8 percent to noninvestment manager external adviser fees, 3.4 percent to total investment-related staff compensation, 2.9 percent to custodial expenses, 0.2 percent to board and staff travel and education, and 0.2 percent to other investment operational expenses.

Mr. Erlendson provided a table of investment returns ([Appendix C](#)) that provide annual returns for key indices from 1991 to 2010 ranked in order of performance to illustrate changes in investment returns for key indices from one year to the next. He said the table illustrates the need for diversification across investment styles (growth versus value), capitalization (large versus small), and regions (United States versus international). He said the most appropriate investment strategy will be guided by priority and nature of spending goals and risk objectives. He provided a chart showing the variety of asset classes that 134 endowments and foundation funds were invested in as of June 30, 2011. He said the most common investments were domestic broad equities, domestic fixed, and international equity. He said the less-utilized investments were cash equivalents, real estate, and international fixed income assets.

Ms. Connie Flanagan, Fiscal and Investment Officer, Retirement and Investment Office, provided the committee a copy ([Appendix D](#)) of the budget stabilization fund investment performance report as of September 30, 2011. She said for the month of September 2011 the budget stabilization fund had a net return of 0.11 percent and a fiscal year to date net return of (0.17) percent. She said the three years ended June 30, 2011, net return was 2.15 percent,

and the five years ended June 30, 2011, net return was 2.30 percent. Mr. John Geissinger, Chief Investment Officer, Retirement and Investment Office, said that in late August 2011 the State Investment Board approved a motion to transition from the short-term bond management of Prudential to Babson Capital and JP Morgan and, therefore, historical investment performance information on these money managers is not available.

LEGACY FUND INVESTMENT POLICY STATEMENT DISCUSSION

Chairman Christmann said the State Treasurer's office has deposited approximately \$66.9 million into the legacy fund to date in the 2011-13 biennium, approximately \$34.3 million in September 2011 and \$32.6 million in October 2011. Mr. Geissinger said due to a capacity limit with the Bank of North Dakota, \$48.2 million is in an account with the Bank, and \$18.7 million is invested in a AAA-rated institutional money market fund managed by JP Morgan. He said due to the capacity limitation, until an investment policy statement is in place, all future deposits will be invested in the JP Morgan institutional money market fund.

Chairman Christmann distributed a document ([Appendix E](#)) to facilitate discussion regarding the investment plan for the budget stabilization fund and the legacy fund. He said the investment plan would create three funds--budget stabilization "income" fund, legacy "income" fund, and legacy "growth" fund. He said under the investment plan, deposits into the budget stabilization and legacy fund would not be pooled with other funds. He said the budget stabilization "income" fund and legacy "income" fund would consist of fixed maturity corporate bonds and cash equivalents, and North Dakota offices of qualified brokers and dealers would be solicited to bid on fund purchases. He said the legacy "growth" fund investment plan would be finalized by the advisory board in the coming months, and the "growth" fund would receive a set percentage of revenues.

Representative Weiler asked whether the asset mix selection is the responsibility of the advisory board. Ms. Sharp distributed a copy of North Dakota Century Code Section 21-10-02.1 ([Appendix F](#)). She said pursuant to this section, the asset allocation must be approved by the governing body of each fund and the State Investment Board by January 1 of each year.

In response to a question from Mr. Fong, Mr. Geissinger said the investment policy statement developed by the advisory board should include an asset allocation target and establish benchmarks by which performance is to be measured.

Chairman Christmann said because of the advisory board's fiduciary responsibility to the people of the state, he believes the board should provide more detailed oversight of the investment of funds in the budget stabilization fund and legacy fund. Representative Weiler said the advisory board's fiduciary responsibility is to establish the investment policy statement and not micromanage the State Investment Board. Mr. Geissinger said statutory provisions require the advisory board to develop recommendations for the investment of funds in the legacy fund and the budget stabilization fund to present to the State Investment Board, and the State Investment Board is responsible for making the investment decisions.

Mr. Fong suggested that for the next meeting, advisory board members be prepared to discuss acceptable risk tolerance, future utilization of the legacy fund, and investment goals to use in the development of an investment policy statement for the legacy fund.

ADVISORY BOARD DISCUSSION AND STAFF DIRECTIVES

Chairman Christmann asked the advisory board members to consider discussions from this meeting regarding the investment policy development for the legacy fund and changes to the current budget stabilization fund investment policy for discussion at the next meeting. He said the next meeting would be in November 2011.

No further business appearing, Chairman Christmann adjourned the meeting at 12:35 p.m.

Sara E. Pahlke
Fiscal Analyst

Allen H. Knudson
Legislative Budget Analyst and Auditor

ATTACH:6