NORTH DAKOTA LEGISLATIVE MANAGEMENT

Minutes of the

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD

Tuesday, October 28, 2014
Harvest Room, State Capitol
Bismarck, North Dakota

Senator Jerry Klein, Vice Chairman, called the meeting to order at 2:11 p.m.

Members present: Representative Keith Kempenich, Chairman, Representative Gary Kreidt; Senators Jerry Klein, Carolyn C. Nelson; Citizen Members Eric Hardmeyer, Ryan Rauschenberger, Sheila Peterson, Office of Management and Budget Designee

Others present: See Appendix A

It was moved by Representative Kreidt, seconded by Senator Nelson, and carried on a voice vote that the minutes of the June 16, 2014, meeting be approved as distributed.

STATUS OF THE BUDGET STABILIZATION FUND

At the request of Vice Chairman Klein, Mr. David J. Hunter, Executive Director and Chief Investment Officer, Retirement and Investment Office, provided information (Appendix B) regarding the status and asset allocation of the budget stabilization fund. Mr. Hunter said in August 2013, approximately $181 million was transferred from the general fund to the budget stabilization fund. He said since its inception, $567.4 million has been deposited into the budget stabilization fund; investment income has totaled $61 million; and distributions from the fund have totaled $41 million, resulting in net assets of $587.4 million as of August 31, 2014. He said because the budget stabilization fund is a reserve fund, assets are invested in short-term (1-year to 3-year) fixed income securities to protect the fund from long-term interest rate risk. He said the asset allocation of the fund is 100 percent short-term fixed income and Bank of North Dakota certificates of deposit (CDs).

Mr. Hunter provided information (Appendix C) regarding the market value of budget stabilization fund assets. He said market value of the fund as of August 31, 2014, was $587.7 million, of which $7.1 million (1.2 percent) is invested in cash equivalents, $105.1 million (17.9 percent) is invested in CDs at the Bank of North Dakota, and $475.5 million (80.9 percent) is invested in short-term fixed income securities with Babson Capital and JP Morgan. He said in addition to the $105.1 million invested in CDs at the Bank, another $94.9 million, for a total of $200 million, has been committed for a Match Loan CD Program at the Bank.

Mr. Hardmeyer said the budget stabilization fund investment in CDs at the Bank of North Dakota provide funding for the Bank's Match Loan CD Program. He said the Match Loan CD Program is an economic development program that finances the expansion of financially strong companies. He said the State Investment Board (SIB) and the Retirement and Investment Office (RIO) invest in CDs that are matched to the terms of the loans under the program. He said bank assets consist primarily of the state's funds on deposit at the Bank which are short term and not available for loans. He said the Match Loan CD Program allows the Bank to fix an interest rate for up to five years.

In response to a question from Representative Kreidt, Mr. Hardmeyer said the amount of the CD matches the loan in the Match Loan CD Program. He said because the Bank of North Dakota bears the loan risk, the fund assumes no credit risk and loan payments are scheduled to meet CD payments. He said the Bank has financed approximately $100 million in outstanding loans through the program.

Mr. Hunter provided information (Appendix D) regarding the returns of the budget stabilization fund. Since the fund's inception, he said, unaudited investment returns, net of fees, have averaged 2.39 percent compared to a policy benchmark of 1.64 percent. He said unaudited fund performance for one year as of June 30, 2014, net of fees, was 1.94 percent compared to a policy benchmark of .61 percent.

Mr. Hunter provided information (Appendix E) regarding investment management fees paid by the budget stabilization fund. He said investment management fees, as a percent of average assets under management, have remained stable at .13 and .12 percent in 2013 and 2014, respectively.

In response to a question from Senator Nelson, the Legislative Budget Analyst and Auditor said investment income in excess of the limit on the balance of the fund is transferred to the general fund.

STATUS OF THE LEGACY FUND

At the request of Chairman Kempenich, Mr. Hunter provided information (Appendix F) regarding the status of the legacy fund. He said from inception through August 31, 2014, $2.324 billion has been deposited into the legacy fund. He said income retained in the fund totaled $129.5 million, and net assets of the fund as of August 31, 2014, totaled $2.45 billion.

Mr. Hunter provided information (Appendix G) regarding monthly deposits to the fund from September 2011 through August 2014, the legacy fund strategic asset allocation, and the legacy fund transition plan. He said the legacy fund began receiving transfers from the strategic investment and improvements fund in August 2014. He said in August 2013, RIO began implementing a new policy allocation plan approved by SIB over an 18-month period using existing managers within the insurance trust. He said by January 31, 2015, the fund anticipates reaching the target policy allocation, which includes 30 percent broad United States equity, 20 percent broad international equity, 35 percent fixed income, 10 percent diversified real estate, and 5 percent core real estate. He said as of August 31, 2014, the asset allocation of the fund includes 15 percent short-term fixed income, 31 percent broad United States equity, 20 percent broad international equity, 24 percent fixed income, 6 percent diversified real estate, and 5 percent core real estate.

In response to a question from Mr. Hardmeyer, Mr. Hunter said as of August 31, 2014, the government securities index allocation was approximately $84 million; however, government securities are also a part of managed funds. He said the average maturity of the government securities is 5 to 10 years.

Mr. Hunter provided information (Appendix H) regarding the returns of the legacy fund. Since its inception, he said, unaudited investment returns on the legacy fund, net of fees, have averaged 3.22 percent compared to a policy benchmark of 2.12 percent. He said unaudited fund performance for one year as of June 30, 2014, net of fees, was 6.64 percent compared to a policy benchmark of 5.39 percent. He said the targeted return of the legacy fund with the new policy allocation fully implemented is 6.4 percent. He said the robust equity market has enabled the fund's return to exceed the targeted return before the full implementation of the new policy allocation.

Mr. Hunter provided information (Appendix I) regarding investment fees by asset class. He said from fiscal year 2013 to fiscal year 2014, investment management fees increased from 13 to 27 basis points, based on unaudited fund performance. He said the increase in investment fees is related to the transition from a short-term fixed income investment policy to the new asset allocation strategy and the increase in fees has been accompanied by increased returns.

Mr. Hunter said RIO has collaborated with Callan Associates Inc. to develop enhanced performance reporting for the SIB's five largest clients. He said as a result of enhanced reporting, net investment returns have been restated (Appendix J) to reflect intra-month cash flows during the last four years.

INVESTMENT POLICY STATEMENTS

Mr. Hunter reviewed the investment policy statements for the budget stabilization fund (Appendix K) and the legacy fund (Appendix L). He said the budget stabilization fund investment policy statement was approved in 2009 and the legacy fund investment policy statement was approved in 2013. He said it is appropriate to review and approve the policy statements annually. He suggested updating the section in the budget stabilization fund investment policy statement relating to standards of investment performance to change the reference from annual benchmarks to a minimum five-year evaluation. In addition, he said, both policy statements prohibit social investing and economically targeted investing unless it meets the Exclusive Benefit Rule.

In response to a question from Chairman Kempenich, Mr. Hunter said although the budget stabilization fund is a "stop gap" fund, it is invested long term and five-year benchmarks would be more meaningful.

ADVISORY BOARD DISCUSSION AND STAFF DIRECTIVES

Senator Klein said investment policy is the responsibility of the advisory board and suggested RIO bring copies of the proposed changes to each of the investment policies to a future meeting for consideration by the advisory board.

It was moved by Senator Klein, seconded by Representative Kreidt, and carried on a voice vote to request the Retirement and Investment Office prepare proposed changes to the budget stabilization fund investment policy for consideration by the advisory board.

In response to a question from Mr. Hardmeyer, Mr. Hunter said the Match Loan CD Program at the Bank of North Dakota has met expectations. He said because the current size of the budget stabilization fund's commitment to the Match Loan CD Program is not excessive and other more liquid investments amount to two-thirds of the fund's investments, there is currently no conflict with the fund's investment policy. However, he said, if RIO and SIB would increase the budget stabilization fund investment in the Match Loan CD Program to promote economic development, the action could be in conflict with current social and economically targeted investment policy statements.

Mr. Hardmeyer noted his positions as President of the Bank of North Dakota and a member of the advisory board present a conflict. He said the Bank has requested SIB increase the limit on the budget stabilization fund's investment in the Match Loan CD Program from $200 million to $300 million, or $195 million more than the current investment of $105 million. He said the request was made because the Bank anticipates demand for Match Loan CD Program loans will exceed $200 million in the near future. He said the Bank also requested an increase in the term of the fixed rate CDs from 5 to 10 years. He said the increase will provide more flexible financing to borrowers in the program.

Mr. Hunter said when interest rates were in decline, the investment in the Match Loan CD Program allowed the budget stabilization fund to receive higher rates in a declining market. He said benchmarks going forward will be higher and it may not be prudent for SIB to commit at the current low rates for longer periods of time. He expressed concern that increasing the limit of funds invested in the Match Loan CD Program and extending the CD terms from 5 to 10 years would represent social or economically targeted investing that may be contrary to the prudent investor rule in the investment policy statement.

Senator Klein said the Bank of North Dakota's purpose is to create investment.

Mr. Hardmeyer said marketing the Match Loan CD Program is difficult when the Bank of North Dakota is not certain funds will be available for loan. He said the budget stabilization fund receives a rate equal to the United States Treasury rate and program borrowers pay the United States Treasury rate plus a quarter percent on loans.

In response to a question from Senator Klein, Mr. Hardmeyer said the additional $100 million would be invested in the Match Loan CD Program over a period of six to nine months. In addition, he said, approximately $10 million in principle is returned to the fund each year and available for lending.

Chairman Kempenich said part of the mission of the Bank of North Dakota is to be responsive to the needs of the state.

Mr. Rauschenberger said the Match Loan CD Program is a quality program and increasing the investment in the program seems appropriate.

Mr. Hunter said if the limit on investment in the Match Loan CD Program were increased from $200 million to $300 million, the new limit would bring the fund's investment in the Match Loan CD Program to more than 50 percent of fund assets. He said the funding to increase the investment in the Match Loan CD Program would come from the fund's current investment in short-term fixed income and substantially change the fund with regard to liquidity and inherent interest rate risk. He said the average duration of short-term fixed income assets in the fund is less than two years compared to the average duration of investments in the Match Loan CD Program of three to four years.

Mr. Hardmeyer said loan requests are becoming larger. However, he said, a $50 million increase in the limit, for a total investment of $250 million in the Match Loan CD Program, would allow the Bank of North Dakota to finance additional projects.

It was moved by Senator Klein, seconded by Representative Kreidt, and carried on a roll call vote that the Legacy and Budget Stabilization Fund Advisory Board recommend the State Investment Board consider making available an additional $50 million, for a total of $250 million, from the budget stabilization fund for investments in certificates of deposit related to the Bank of North Dakota Match Loan CD Program. Representatives Kempenich and Kreidt, Senator Klein, and Mr. Rauschenberger, voted "aye." Senator Nelson and Ms. Peterson voted "nay." Mr. Hardmeyer, citing a conflict of interest, did not vote.

At the suggestion of the Legislative Budget Analyst and Auditor, Chairman Kempenich asked RIO to review the budget stabilization fund investment policy statement and identify any provision that may be in conflict with the board's recommendation. Mr. Hunter said RIO's counsel will review the statement and he will inform the board of any conflicts.

Representative Kreidt distributed copies of a bill draft [15.0057.03000] recommended to the Legislative Management by the Government Finance Committee related to the legacy fund.

At the request of Chairman Kempenich, the Legislative Budget Analyst and Auditor reviewed the provisions of the bill draft for the committee. He said the bill draft provides several definitions for constitutional provisions relating to the legacy fund and clarifies the process used to determine limitations on expenditures from the legacy fund. He said the bill draft also provides that earnings transferred from the legacy fund to the general fund at the end of a biennium are to be transferred back to the legacy fund and become principal unless certain criteria are met.

In response to a question from Ms. Peterson, the Legislative Budget Analyst and Auditor said language in the bill draft would preclude the Governor from recommending expenditures from the legacy fund as part of the Governor's budget.

It was moved by Senator Klein, seconded by Representative Kreidt, and carried on a voice vote that the meeting be adjourned, subject to the call of the chair.

No further business appearing, Chairman Kempenich adjourned the meeting at 4:03 p.m.

Sheila M. Sandness
Senior Fiscal Analyst

ATTACH:12