

NORTH DAKOTA LEGISLATIVE MANAGEMENT

Minutes of the

LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD

Tuesday, December 3, 2019
Harvest Room, State Capitol
Bismarck, North Dakota

Representative Keith Kempenich, Chairman, called the meeting to order at 2:00 p.m.

Members present: Representatives Keith Kempenich, Gary Kreidt; Senator Jerry Klein; Citizen Members Eric Hardmeyer, Jeff Larshus (Office of Management and Budget Director's designee), Ryan Rauschenberger

Member absent: Senator Jim Dotzenrod

Others present: See [Appendix A](#)

It was moved by Representative Kreidt, seconded by Mr. Hardmeyer, and carried on a voice vote that the minutes of the June 26, 2019, and July 26, 2019, meetings be approved as distributed.

STATUS OF THE BUDGET STABILIZATION FUND

At the request of Chairman Kempenich, Mr. David J. Hunter, Executive Director and Chief Investment Officer, Retirement and Investment Office, presented information ([Appendix B](#)) regarding the status of the budget stabilization fund, including fund balance, investment performance, and fund allocation. Mr. Hunter said the budget stabilization fund had a net return of 5.08 percent compared to a policy benchmark return of 4.60 percent for the 1-year period ended September 30, 2019. He said the fund had a net return of 2.02 percent compared to a policy benchmark return of 1.54 percent for the 5-year period ended September 30, 2019. He said as of September 30, 2019, the balance of the fund was \$669 million. He said the asset allocation of the budget stabilization fund is 98.8 percent short-term fixed income and 1.2 percent cash and equivalents. He said investment expenses were .16 percent of the average market value of assets under management in fiscal year 2019, the same percentage as fiscal year 2018.

In response to a question from Senator Klein, Mr. Larshus said based on state statute, the maximum balance allowed in the budget stabilization fund may not exceed \$726,534,475 during the 2019-21 biennium.

In response to a question from Mr. Hardmeyer, Chairman Kempenich said when the budget stabilization fund reaches the maximum balance, earnings of the fund are deposited into the general fund.

STATUS OF THE LEGACY FUND

At the request of Chairman Kempenich, Mr. Hunter presented information ([Appendix C](#)) regarding the status of the legacy fund, including investment allocation, fund balance, investment performance, and investment management fees. Mr. Hunter said the legacy fund had an overall net return of 3.79 percent compared to a policy benchmark return of 4.88 percent for the 1-year period ended September 30, 2019. He said the fund had a net return of 6.32 percent compared to a policy benchmark return of 5.68 percent for the 5-year period ended September 30, 2019. He said the market value of the fund was \$6.36 billion on September 30, 2019. He said asset allocations of the legacy fund are within 1 percent of target allocations reflecting the investment policy benchmark of 50 percent equity investments, 35 percent fixed income, and 15 percent real assets.

In response to a question from Mr. Hardmeyer regarding policy benchmark returns under 6 percent for the 5 years ended September 30, 2019, Mr. Hunter said the fund is a long-term investor and he is comfortable with the fund's long-term goals in the current market. He said the legacy fund is less aggressive than some of the other sovereign wealth funds seeking 7 to 8 percent returns.

Chairman Kempenich said during the 2019 legislative session there was uncertainty regarding legacy fund earnings to be transferred to the general fund. He said if earnings were defined as a percent of the average market value of assets of the fund, legacy fund distributions would be more predictable and less volatile.

In response to a question from Mr. Hardmeyer, Chairman Kempenich said the state constitution is silent with regard to how earnings are calculated, so the Legislative Assembly established the current method.

Mr. Rauschenberger said the percent of market value distribution method is more predictable; however, he expressed concern regarding the constitutionality of the method if the legacy fund's earnings do not meet or exceed the distribution percentage set in statute. He said a two-thirds vote may be required under such circumstances. He said using the percent of market value method may allow future legislatures to significantly increase the distribution percentage with a simple majority vote.

Chairman Kempenich suggested the committee explore the consequences of using percent of average market value to determine distributions from the legacy fund.

Mr. Hunter said most permanent funds establish a sustainable spending rate based on returns and inflation. He said most of the permanent funds surveyed use 5 percent of average market value. He said the percent of market value is based on trailing data and provides certainty during legislative sessions. He provided an example of how a percent of average market value calculation could be used to determine the earnings distribution during the 2021-23 biennium.

In response to a question from Mr. Hardmeyer, Mr. Hunter said cumulative earnings could be monitored and offset by distributions to determine undistributed earnings to prevent spending legacy fund principal when there is a downturn in investment earnings.

In response to a question from Representative Kreidt, Mr. Hunter said the percent of market value distribution rate provides transparency and consistency. He said the 4 percent distribution rate is based on the expectation the fund will yield a 6 percent investment return, which is offset by an estimated 2 percent inflation rate.

Mr. Hunter said investments managed by one investment manager have not been performing up to expectations; therefore, the manager has been placed on a "watch" list, but is improving. He said investment fees, as a percent of average assets under management, have increased from .33 percent in fiscal year 2018 to .39 percent in fiscal year 2019. He said overall, managers have outperformed policy benchmarks by .5 percent over the 5-year period ended September 30, 2019, and provided a positive return on fees paid.

In response to a question from Chairman Kempenich, Mr. Hunter said investment manager fees compare favorably to other United States sovereign wealth funds.

Mr. Hunter reviewed changes to the legacy fund investment policy statement approved by the State Investment Board (SIB) in August 2019. He said the changes increase the Bank of North Dakota (BND) certificate of deposit (CD) match program limit from \$200 million to \$300 million and provide the minimum return requirement of 1.75 percent be periodically reviewed for appropriateness to credit spreads of like term United States Treasury Bonds. He requested advisory board approval of the changes.

At the request of Chairman Kempenich, Mr. Hardmeyer provided information regarding the BND CD match program. Mr. Hardmeyer said interest in the program is a function of the economic development climate in the state and has been difficult to predict. However, he said, interest in the program has been increasing and the \$300 million limit may be reached soon. He said the legacy fund does not assume credit risk because the funds are deposited in CDs at the Bank and backed by the state.

Mr. Hunter said the CDs are at market rates which compare to rates of the SIB's three largest fixed income managers. He said investment in the BND CD match program complies with the criteria of Section 7 of the legacy fund investment policy statement.

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 approve the changes to the legacy fund investment policy statement approved by the State Investment Board in August 2019. Representatives Kempenich and Kreidt, Senator Klein, and Citizen Members Larshus and Rauschenberger voted "aye." No negative votes were cast.

Mr. Hunter said legacy fund earnings have totaled \$1.479 billion since inception. He said earnings, as defined in North Dakota Century Code Section 21-10-12, have totaled \$1.019 billion since inception and \$126.7 million for the months of June through September 2019.

Mr. Hunter provided an update ([Appendix D](#)) of SIB assets under management. He said the market value of assets under the management of the SIB as of September 30, 2019, totaled \$15.4 billion.

Chairman Kempenich suggested the Bank provide a report on the CD match program at a future meeting.

Chairman Kempenich requested a volunteer to attend SIB meetings beginning in 2020. Representative Kreidt will begin attending meetings in January 2020.

No further business appearing, Chairman Kempenich adjourned the meeting at 3:06 p.m.

Sheila M. Sandness
Senior Fiscal Analyst

ATTACH:4