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## LEGACY AND BUDGET STABILIZATION FUND ADVISORY BOARD

Thursday, November 12, 2020  
Roughrider Room, State Capitol  
Bismarck, North Dakota

Representative Keith Kempenich, Chairman, called the meeting to order at 1:00 p.m.

**Members present:** Representatives Keith Kempenich, Gary Kreidt; Senator Jerry Klein; Citizen Members Kelvin Hullet (Bank of North Dakota President's designee), Joe Morrisette, Ryan Rauschenberger

**Member absent:** Senator Jim Dotzenrod

**Others present:** Representative Jeff Magrum, Hazelton  
See [Appendix A](#) for additional persons present.

**It was moved by Representative Kreidt, seconded by Senator Klein, and carried on a voice vote that the minutes of the October 23, 2020, meeting 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 as of September 30, 2020, the balance of the fund was \$739 million and the asset allocation of the budget stabilization fund was 99 percent short-term fixed income and 1 percent cash and equivalents. He said the budget stabilization fund had a net gain of 1.63 percent compared to a policy benchmark gain of 0.23 percent for the quarter ended September 30, 2020. He said the fund had a net gain of 2.22 percent compared to a policy benchmark gain of 2.06 percent for the 5-year period ended September 30, 2020. He said a market downturn related to the Coronavirus (COVID-19) pandemic resulted in net returns of 3.06 percent, 0.65 percent less than the policy benchmark gain of 3.70 percent, for the year ended September 30, 2020.

Mr. Hunter said even though investment expenses increased from \$185,812 in fiscal year 2019 to \$882,938 in fiscal year 2020, investment basis points declined from 0.16 percent in fiscal year 2019 to 0.13 percent in fiscal year 2020. He said the decline in basis points related to the significant increase in the average balance in the budget stabilization fund.

Mr. Hunter provided a copy ([Appendix C](#)) of the budget stabilization fund investment policy statement. He said the Retirement and Investment Office (RIO) suggests the 2019-21 biennium statutory maximum budget stabilization fund balance of \$726,534,475 be added to the budget stabilization fund investment policy statement.

In response to a question from Senator Klein, Mr. Hunter said the budget stabilization fund is a long-term investor in short-term investments. He said the fund has performed well while maintaining a high degree of liquidity.

In response to a question from Senator Klein, Mr. Morrisette said because the budget stabilization fund balance exceeded the statutory maximum as of June 30, 2020, approximately \$390,000 of excess funding was transferred from the budget stabilization fund to the general fund in September 2020. He said if the balance in the budget stabilization fund continues to exceed the statutory maximum during fiscal year 2021, a similar transfer of any excess balance in the fund as of June 30, 2021, would be made in 2021.

**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 a change to the budget stabilization fund investment policy statement to establish a maximum budget stabilization fund balance of**

**\$726,534,475.** Representatives Kempenich and Kreidt, Senator Klein, and Citizen Members Hullet, Morrissette, and Rauschenberger voted "aye." No negative votes were cast.

### STATUS OF THE LEGACY FUND

At the request of Chairman Kempenich, Mr. Hunter presented information ([Appendix D](#)) regarding the status of the legacy fund, including investment allocation, fund balance, investment performance, and investment management fees. Mr. Hunter said the market value of the legacy fund was \$7.4 billion as of September 30, 2020. He said asset allocations of the legacy fund were within 2 percent of target allocations reflecting the investment policy benchmark of 50 percent equity investments, 35 percent fixed income, and 15 percent real assets. He said the legacy fund gained 4.93 percent compared to a policy benchmark gain of 3.95 percent for the quarter ended September 30, 2020. He said the fund had a net gain of 7.91 percent compared to a policy benchmark gain of 7.25 percent for the 5-year period ended September 30, 2020. He said in spite of a market downturn related to the COVID-19 pandemic, the legacy fund gained 8.27 percent compared to a policy benchmark gain of 7.46 percent for the year ended September 30, 2020. He said the State Investment Board's (SIB's) use of active management has generated approximately \$125 million of incremental income over the last 5 years. He said legacy fund earnings have totaled \$2.035 billion since inception. He said earnings, as defined in North Dakota Century Code Section 21-10-12, have totaled \$1.297 billion since inception, of which \$436.8 million was added to the principal of the fund. He said from June 2019 through September 2020, earnings, as defined in Section 21-10-12, have totaled \$405 million.

In response to a question from Senator Klein, Chairman Kempenich said the 2019 Legislative Assembly used \$164 million of the anticipated \$405 million of legacy fund investment earnings in the 2019-21 budget.

Mr. Hunter reviewed a bill draft, recommended by the Legacy Fund Earnings Committee, to establish a legacy earnings fund. He said the draft legislation creates a legacy earnings fund to be invested by the SIB and provides 6 percent of the average legacy fund asset balance at the end of each fiscal year for the 5-year period ending with the most recently completed even-numbered fiscal year is available for appropriation. Based on the bill draft's provisions, he said, the prior average balance and distribution amount would be known before each legislative session. He said the 5-year average ending market value of the legacy fund through June 30, 2020, was approximately \$5.5 billion and the 6 percent distribution rate for a biennium is the equivalent of 3 percent per year.

Mr. Hunter said although investment fees increased from \$23 million during fiscal year 2019 to \$24.6 million during fiscal year 2020, as a percent of average market value, fees decreased slightly from 0.38 percent in 2019 to 0.37 percent in 2020. He said actual investment performance, net of fees, lagged the policy benchmark by 1.14 percent and 0.15 percent in fiscal years 2019 and 2020 respectively. He said, however, active management has been positive for the 1- and 5-year periods ended September 30, 2020.

Mr. Hunter reviewed suggested changes to the legacy fund investment policy statement ([Appendix E](#)). He said on September 25, 2020, the SIB approved a \$100 million increase in the Bank of North Dakota certificate of deposit (CD) match program limit from \$300 million to \$400 million. He said the Bank in-state investment program is a sector allocation within fixed income investments and represents just over 5 percent of total legacy fund assets.

In response to a question from Chairman Kempenich, Mr. Hullet said a number of large scale economic development projects has increased the need for available CD match program funding.

Mr. Hunter said as of September 30, 2020, the legacy fund has invested \$86.7 million in the Bank of North Dakota CD match program and an additional \$26.5 million was in cash deposits for a total of \$113.2 million at the Bank.

In response to a question from Senator Klein, Mr. Hunter said until it is needed by the Bank of North Dakota CD match program, funding allocated to the program is part of the 35 percent allocation invested by fixed income managers. He said the legacy fund continues to receive monthly tax deposits which also are available to fund the Bank CD match program when needed.

In response to a question from Chairman Kempenich, Mr. Hullet said the CD match program allows companies with an investment rating to access funding without the cost associated with bonding. He said the SIB requires a market rate on legacy fund CD investments. He said when funds are loaned, the Bank of North Dakota assumes the credit risk and receives 0.25 percent over the market rate paid on the CDs. He said the lead bank initiating the loan also receives a 0.10 to 0.15 percent management fee. He said the Bank is receiving larger requests for funding and is working with RIO to make the CD match program competitive.

**It was moved by Representative Kreidt, seconded by Senator Klein, and carried on a roll call vote that the Legacy and Budget Stabilization Fund Advisory Board approve changes to the legacy fund investment policy statement, approved by the SIB in September 2020, to increase funding available to the Bank of North Dakota CD match program to \$400 million.** Representatives Kempenich and Kreidt, Senator Klein, and Citizen Members Hullet, Morrissette, and Rauschenberger voted "aye." No negative votes were cast.

At the request of Chairman Kempenich, Mr. Hunter presented a copy of a memorandum ([Appendix F](#)) prepared by Mr. Dean DePountis, Assistant Attorney General, Attorney General's office, and other information regarding investment governance. He said the memorandum indicates the SIB may invest a portion of the legacy fund in economic development provided any such investment is accomplished in accordance with recommendations from the Legacy and Budget Stabilization Fund Advisory Board and the prudent investor rule. He said Mr. DePountis concluded that although there is no legal obligation to do so, the SIB may invest a portion of the legacy fund in economic development if, however ultimately defined, economic development can return a profit on the investment commensurate with its risk and the amount of the total portfolio allocated to that magnitude of risk is consistent with the prudent investor rule.

Mr. Hunter said the prudent investor rule, defined in Section 21-10-07, provides that in making investments the fiduciaries shall exercise the judgment and care, under the circumstances then prevailing, that an institutional investor of ordinary prudence, discretion, and intelligence exercises in the management of large investments entrusted to it, not in regard to speculation, but in regard to the permanent disposition of funds, considering probable safety of capital as well as probable income. He said to accomplish this the SIB does not make individual investments and all client portfolios are externally managed by approved investment firms. He said the investment policy statement provides economically targeted investing is prohibited unless the investment meets the "exclusive benefit rule" and the following four conditions are satisfied:

1. The cost does not exceed the fair market value at time of investment;
2. The investment provides the fund with an equivalent or superior rate of return for a similar investment with a similar time horizon and expected risk;
3. Sufficient liquidity is maintained in the fund to permit distributions in accordance with plan terms; and
4. The safeguards or diversity that a prudent investor would adhere to are present.

In response to a question from Senator Klein, Mr. Hunter said the prudent investor rule applies similarly to the legacy fund and to pension funds.

Ms. Kelly L. Schmidt, State Treasurer and member of the SIB, said due diligence after an investment is made, including consultant analysis and the monitoring of investments, is as important as the decision to make the initial investment.

Mr. Hunter reviewed the policies of the Alaska Permanent Fund Corporation (APFC) regarding in-state investment. He said objectives and considerations of the Alaska in-state investment policy require:

- The APFC invest in-state to the extent in-state investments have a risk level and expected return comparable to alternate investment opportunities and otherwise meet the fund's investment standards, such as the prudent investor rule;
- Compelling risk-adjusted returns;
- Fund diversification; and
- The APFC seek participation by another institutional investor.

He noted the APFC has invested \$22 million, or 0.04 percent of total assets under management, in Alaskan businesses and assets, less than the current legacy fund commitment to the Bank of North Dakota CD match program.

In response to a question from Mr. Morrissette, Mr. Hunter said RIO would provide information regarding the asset allocation strategy for the APFC to the advisory board members.

Chairman Kempenich said it is difficult to quantify the impacts of in-state investment.

At the request of Chairman Kempenich, Mr. Paul Erlendson, Senior Vice President, Callan LLC (Callan), provided information ([Appendix G](#)) regarding a research approach to evaluate a potential in-state investing program. Mr. Erlendson said the proposal provides the SIB with a prudent investment process to evaluate and

implement an in-state program consistent with sound fiduciary practice. He said the proposal consists of five steps completed in three phases. He said the steps include:

1. Conduct fiduciary review;
2. Design optimal portfolio;
3. Formalize investment policy;
4. Implement program; and
5. Monitor and supervise.

He said step 1 is the first phase of the process, while steps 2 and 3 are considered Phase 2 and steps 4 and 5 make up Phase 3.

Mr. Alex Browning, Senior Vice President, Callan LLC, said primary objectives include providing the SIB with background education regarding the history of in-state investment programs implemented in other states; outlining alternative investment program designs for consideration by the SIB, including investment objectives, measurement standards, and types of investments and assets to be included; and assisting the SIB with policy development, selection of third-party managers, and implementation of the program. He said education is Phase 1 of the study because it is important to learn from other in-state investment programs. He said Phase 2 is program structure, including asset class, breadth of the program, program statistics, objectives for a North Dakota program, potential pitfalls, and a summary of the program structure. He said Phase 3 is implementation, including manager searches, governance model, evaluating key terms, resources, documentation of investment policy, and a summary of how the program will be implemented. He said implementation should include objectives, benchmarks, program design, and a governance system to ensure success for a long-term commitment and a sustainable program for the state.

In response to a question from Chairman Kempenich, Mr. Browning said parameters and program design are determined by the SIB and the advisory board; however, managers could provide input.

Chairman Kempenich said given the upfront cost, the commitment to an in-state investment program would need to be significant.

Mr. Pete Keliuotis, Executive Vice President, Alternative Consulting, Callan LLC, said many states have implemented in-state investing programs of varying sizes over the last 20 years. He said there is interest in economic development; however, programs should be structured to provide returns competitive with other investments. He said it is early in the study; however, lessons learned include keeping politics out of program execution, establishing clear objectives and accountability, driving a competitive selection process, allocating capital gradually, sizing the program appropriately, and having a long-term commitment to the program in advance.

In response to a question from Mr. Morrissette, Mr. Erlendson said this study proposal was submitted to and approved by the SIB at their last meeting. He said it is now being presented to the advisory board for consideration.

Chairman Kempenich said the advisory board was created to develop recommendations for the investment of funds in the legacy fund and the budget stabilization fund to present to the SIB and is a client of the SIB.

Ms. Schmidt said the SIB approved a motion to work with consultants and the advisory board to establish an in-state investment program and any discussion regarding investment amounts or percentages would be premature. She suggested the advisory board, RIO, and the SIB work through the process with Callan. She said the state should first determine a partner to assist the state in establishing investment criteria. She said the SIB and advisory board should allow the partner to make decisions based on the criteria. She said politics should not play a role in program policy. She said the prudent investor rule in North Dakota is no different than other states and to change it would be counterproductive.

Lieutenant Governor Brent Sanford, Chairman, State Investment Board, said after receiving presentations from investment managers with in-state investment program experience, the SIB was encouraged to learn these types of programs can be successful and determined the advisory board also should receive the information. He said the advisory board has approved the current asset allocation. He said with input from the advisory board, Callan could design a program to allocate a portion of the fixed income allocation to infrastructure financing or a portion of the domestic equity allocation to investment in North Dakota companies.

Mr. Morrissette said the advisory board needs more information. He suggested Phase 1, the education phase, of the Callan study should include both the SIB and the advisory board.

Mr. Erlendson said Callan will provide study information to the SIB over the next 4 to 5 months.

**It was moved by Representative Kreidt, seconded by Mr. Rauschenberger, and carried on a roll call vote that the Legacy and Budget Stabilization Fund Advisory Board approve the SIB's continued engagement of Callan to conduct the proposed three-phase research approach to evaluate a potential in-state investing program and to provide updates to the Legacy and Budget Stabilization Fund Advisory Board regarding the research study and any investment policy updates identified in Phase 2 of the research.** Representatives Kempenich and Kreidt, Senator Klein, and Citizen Members Hullet, Morrissette, and Rauschenberger voted "aye." No negative votes were cast.

Chairman Kempenich said advisory board members should plan to attend the next SIB meeting and should receive updated information from the SIB and Callan regarding the study's progress as it proceeds.

No further business appearing, Chairman Kempenich adjourned the meeting at 3:07 p.m.

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Sheila M. Sandness  
Senior Fiscal Analyst

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