

STATE BOARD OF LAND COMMISSIONERS

July 17, 2008
Regular Agenda

SUBJECT

Asset management plan – endowment fund section

BACKGROUND

Over the past two years, the board has been developing a comprehensive set of workable guidelines to govern the administration of all endowment assets and ensure the fulfillment of the constitutional mandate to maximize the long-term revenue for the beneficiaries. The final land management sections were approved at the December, 2007 meeting. The only section that remains to be completed is the one that deals with management of the financial assets of the endowments.

DISCUSSION

Attachment 1 is the proposed section on endowment fund management for the Land Board's review and comment. It was initially drafted by the Endowment Fund Investment Board and incorporates additional edits by Land Board staff. Included in this financial asset section is the proposed policy on distributions to beneficiaries, including the level of reserves to be maintained and guidelines for making transfers from the Earnings Reserve Funds to the Permanent Funds.

Finally, as indicated by the Department of Lands at the December meeting, once the endowment fund section has been approved by the board, additional overarching text may be necessary to further delineate the form and frequency of total portfolio reporting, including the use of an asset optimization model to examine the desired future conditions regarding asset mix and attendant revenue streams.

RECOMMENDATION

Approve the endowment fund section of the Asset Management Plan

BOARD ACTION

BOARD ACTION: For discussion, Controller Jones moved that the endowment fund section of the Asset Management Plan be approved. She further moved that Mr. Johnson and the Land Board be tasked with reviewing the policy this year, with Superintendent Luna in full attendance. Attorney General Wasden seconded the motion.

Superintendent Luna offered a substitute motion that the Board accept what has been presented with his proposed changes: (1) third page, third paragraph, first sentence, "When Earnings Reserves exceed an adequate level, the Land Board may consider transferring the excess reserves to the Permanent Fund or increasing the distribution to beneficiaries"; (2) seventh page, third bullet, "The level of Earnings Reserves deemed adequate is three to five years of future distributions depending on the volatility of each endowment's total revenue stream and the presence of any other dedicated reserve funds." In addition Superintendent Luna's substitute motion was offered with the understanding that over the period of the coming year discussions and additional work would be completed before the policy would come before the Board again. Secretary of State Ysursa acknowledged Superintendent

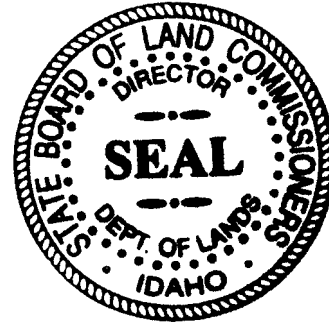
Luna's substitute motion and asked for a second. Hearing none, Secretary of State Ysursa noted that the substitute motion failed for lack of a second.

[Original Motion: Controller Jones moved that the endowment fund section of the Asset Management Plan be approved. She further moved that Mr. Johnson and the Land Board be tasked with reviewing the policy this year, with Superintendent Luna in full attendance. Attorney General Wasden seconded the motion.]

Secretary of State Ysursa stated the original motion, as brought forward by Controller Jones and seconded by Attorney General Wasden, is before the Board for a vote. The motion carried on a vote of 4-1, with Governor Otter, Secretary of State Ysursa, Attorney General Wasden and Controller Jones voting aye; Superintendent Luna voting nay.

ATTACHMENT

1. Asset Management Plan – Endowment Fund Section



Proposed endowment fund section of the Asset Management Plan

II. Financial Assets

A. History, Structure and Governance

1. History of the Endowment Funds

Since the original grants of land from the federal government, proceeds from the sale of land and income from the grant lands has been accumulated in endowment funds. These funds were managed first by the State Treasurer and later by the Department of Finance. By June 1966, the total endowment fund assets had grown to \$69 million. On March 25, 1969, the State Legislature created the "Endowment Investment Board", which held its first meeting on April 11, 1969. In later years, the name of the board was changed to the Endowment Fund Investment Board and oversight of other investment pools were added to its responsibilities, including the reserves and surplus of the State Insurance Fund, the assets of the Judges' Retirement Fund, and the Ritter Island Endowment Fund. The EFIB hired its first staff member in 1971.

Originally, the state Constitution only permitted endowment funds to be invested in fixed income securities and all interest income was distributed annually to the beneficiaries. From inception, most revenues from endowment lands, including timber harvest receipts, were deposited in the Permanent endowment funds. However, from the early 1970's to June 2000, the IDL retained 10% percent of the income it generated for capital spending necessary to preserve the asset base (e.g. replanting and road construction). The remaining lands receipts, such as annual grazing and cottage site lease revenue, along with interest on unharvested timber contracts were distributed directly to the beneficiaries. By June 2000, the endowment funds had grown to \$811 million, plus approximately \$25 million held by the IDL.

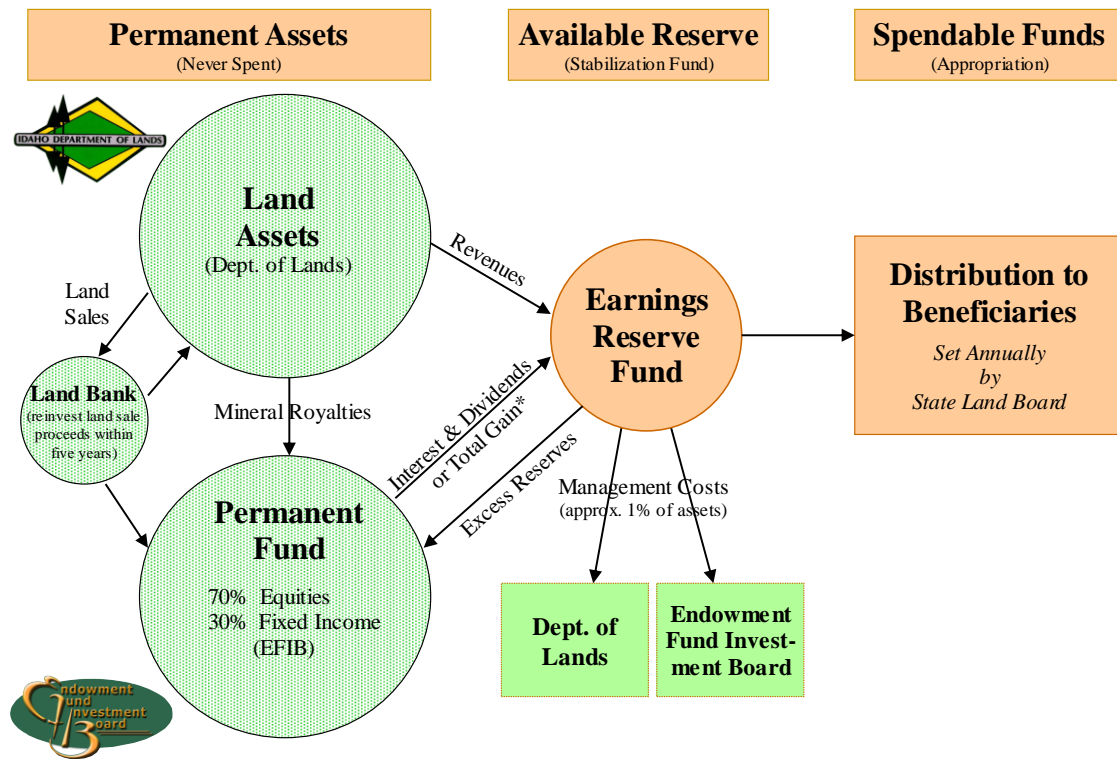
A major restructuring of the endowment funds was implemented in July 2000. The Land Board was given governance authority over the EFIB and all endowment funds, investment restrictions were made consistent with the Idaho Prudent Investor Act (Idaho Code title 68, chapter 5), and each endowment fund (except for the Capitol Permanent Fund) was split into a Permanent Fund and an Earnings Reserve Fund. In the second half of 2000, 70% of the assets of the endowment funds were shifted to the equity markets.

Information on endowment fund balances, distributions and asset mix is shown in Exhibit 1.

2. Structure of the Endowment Funds

Each endowment (with the exception of the Capitol Permanent Fund¹) has two types of assets: permanent assets, which can never be distributed, and a reserve or buffer fund, from which distributions can be made. As shown below, the permanent assets consist of endowment land and a Permanent Fund. Renewable revenues from the land (e.g. timber harvest and rental income) and income from the Permanent Fund flow into the Earnings Reserve fund. Payments of management expenses and beneficiary distributions are made from the Earnings Reserve Fund. If the Earnings Reserve Fund balance ever falls to zero, then distributions must stop because the principal of the Permanent Funds can never be distributed.

STRUCTURE OF IDAHO'S ENDOWMENT ASSETS



* When the Permanent Fund, adjusted for inflation, exceeds its June 2000 level, only total gain over inflation will be distributed to Earnings Reserve.

¹ The Capitol Permanent Endowment Fund has some unique characteristics. It is governed by the constitutional provisions that apply generally to the endowment funds, e.g. protect the endowments in a manner designed to secure the maximum long term financial return to the beneficiary. However, the statutes applicable to the Capitol Permanent Endowment differ from the other endowments. There is no earnings reserve fund and the Land Bank cannot be used for the sale and reinvestment of real property. Additionally, there is no strict statutory prohibition on spending the principal of the fund, but instead a requirement that distributions must take into account the preservation and growth of the fund over time. Lastly, Idaho Code 67-1610 states that distributions from the fund to the beneficiary, the Capitol Commission, are determined by the EFIB rather than the Land Board.

Currently, per Idaho Code 57-724A, interest and dividends from the Permanent Fund are added to the Earnings Reserve Fund each year. However, the flow of investment income to the Earnings Reserve Fund will change as each endowment's Permanent Fund passes its Gain Benchmark (essentially the June 2000 level adjusted for inflation and certain deposits). A year after the gain benchmark is achieved, the total gain (interest, dividends, and capital gains/losses) above inflation will flow to the Earnings Reserve Fund annually. While this will increase potential revenues due to the inclusion of capital gains, it will result in zero revenues flowing to reserves in years when there are capital losses in the stock market. Historically, capital losses in a 70% equity, 30% fixed income portfolio have occurred in one year out of three. Also, in each twenty-five-year period, there has been one period in which capital losses were severe enough that no income would have accrued to earnings reserve for five consecutive years.

This revised flow of income will help protect the inflation-adjusted corpus or principal in the Permanent Fund, since interest and dividends will be used to offset capital losses. However, that means interest and dividend income will no longer be available every year to help fund distributions.

When Earnings Reserves exceed an adequate level, the Land Board may consider transferring the excess reserves to the Permanent Fund. If the Permanent Fund is already at the Gain Benchmark, then the Land Board may designate any transfer as increasing the Gain Benchmark to preserve additional corpus for future beneficiaries. If the Permanent Fund is below the Gain Benchmark, the Land Board may choose not to apply the transfer toward increasing the Gain Benchmark. This will allow the Permanent Fund to recover any shortfall from the benchmark more quickly.

4. Governance of Endowment Funds

The Idaho constitution provides that the endowment funds are held in trust and administered by the Land Board as trustees. The constitution further provides that Idaho Legislature may establish a statutory structure for administration that is consistent with the nature of the trusts. Accordingly, the Idaho Legislature created a structure that established the EFIB and the appropriations process for the trust management expenses and the beneficiary distributions. The constitutional and statutory provisions, together with Land Board policy, establish the following responsibilities.

The Land Board is responsible for:

- Overseeing the activities of the EFIB.
- Reviewing appropriation requests of the IDL from Earnings Reserves for consideration by the legislature.
- Approving allocation of Earnings Reserve Funds, specifically how much is:
 - Distributed annually to beneficiaries (Distribution Policy);

- Retained for future distribution; and,
- Transferred to the Permanent Funds to build corpus.

The EFIB is responsible for:

- Establishing investment policy for the funds, including:
 - Setting asset mix; and,
 - Defining allowed and prohibited investments.
- Recommending Distribution Policy and transfers of Earnings Reserves to the Land Board.
- Establishing Distribution Policy for the Capitol Permanent Fund
- Selecting and monitoring investment managers, consultants, and custodians.
- Preparing audited financial statements for the funds and selecting an independent auditing firm.
- Selecting and directing staff.
- Approving an investment management expense budget from Earnings Reserve for consideration by legislative appropriation.

The Idaho Legislature is responsible for:

- Legislating methodology for restoring losses to the Public School and Agricultural College funds.
- Appropriating Earnings Reserve funds for operation of the IDL and the EFIB.
- Considering approved endowment distributions in setting beneficiary appropriations.

B. The Endowment Fund Investment Board

1. Mission of the EFIB

The mission of the EFIB is to provide professional investment management services to its stakeholders consistent with its constitutional and statutory mandates.

2. Structure of the EFIB

The EFIB, per Idaho Code 57-718, consists of nine members, appointed by the Governor and confirmed by the Senate. These members are:

- One State Senator, one State Representative;
- One professional educator; and,
- Six members of the public familiar with financial matters.

The EFIB must meet at least quarterly and currently has a staff of four persons.

As permitted in Idaho Code 57-720, the fund assets of all nine endowments, both Permanent Funds and Earnings Reserve Funds, are comingled in a single

investment pool for more efficient management oversight and to achieve economies of scale in fees.

The endowment funds are invested by professional investment firms. No funds are managed internally.

The EFIB also employs one or more outside consulting firms to provide specialized expertise and assist, among other things, in asset allocation, manager selection and monitoring, and performance measurement.

C. Fund Investment Management Philosophy

1. Investment Policy and Return Objectives

As perpetual funds, per state Constitution and statute, the endowment funds have a long-term investment horizon. All of the portfolios managed by the EFIB are subject to the variability of the financial markets and to the threat of eroding purchasing power due to inflation. The EFIB will mitigate some of the market risk by investing in diversified portfolios of assets so that the expected variation in the whole portfolio is less than the sum of the variations of each part.

With a citizen board and small staff, the EFIB will make strategic allocations and generally avoid making tactical calls, maintaining an asset mix that is expected to have reasonable performance over a market cycle. The asset mix of the fund takes into account the entire endowment portfolio – i.e. the fact that the revenues of the endowment lands, net of IDL expenses, will be contributed to the endowment funds.

The EFIB will maintain a detailed Investment Policy specifying responsibilities and containing guidelines for asset mix as well as allowed and prohibited investments. The current endowment fund asset mix of 70% equity and 30% fixed income is expected to earn 4.0% annually after inflation and investment expenses.

2. Performance Reporting to the Land Board

Each year the endowment funds will be audited by an independent public accounting firm. In addition, the EFIB will provide relevant, proactive reports on governance and performance to assure the Land Board that endowment fund assets are being prudently and profitably managed and to highlight any areas of concern.

Each month, EFIB staff will provide the Land Board with:

- Investment performance, both absolute and relative to benchmark.
- An evaluation of the sufficiency of earnings reserve balances (measured by coverage ratio: reserve balance divided by the distribution).

- A summary of any significant actions by the EFIB.
- Any compliance/legal issues, areas of concern, or upcoming events.

Part-way through the fiscal year, generally at the May meeting, the EFIB shall provide the Land Board with a brief financial summary of fiscal year-to-date activity.

After the end of the fiscal year, generally at the November meeting, the EFIB shall provide the Land Board with:

- A financial summary for the recently completed fiscal year.
- The report of the Audit Committee of the EFIB regarding control deficiencies identified by the independent auditor.
- An update on the EFIB's Strategic Plan.
- Investment performance for the fund versus strategic (longer-term) measures.
- A report on EFIB meetings; including number of meetings and attendance.

D. Distributions to Beneficiaries

1. Objectives

The ultimate purpose of Idaho's land grant endowments is to provide a perpetual stream of income to the beneficiaries. In determining distributions, the Land Board, with assistance from the EFIB, considers the following for each endowment:

- Actual and expected return on the fund and income from the land.
- Expected volatility of fund and land income.
- The adequacy of distributable reserves to compensate for volatility of income.
- The beneficiary's ability to tolerate declines in distributions.
- Need for inflation and purchasing power protection for future beneficiaries.
- Legal restrictions on spending principal.

To guide the determination of future distributions for Idaho endowments, the following objectives, in priority order, have been established by the Land Board:

1. Avoid reductions in total endowment distributions.
2. Maintain adequate Earnings Reserves to protect distributions from temporary income shortfalls.
3. Grow distributions and permanent corpus faster than inflation and population growth.
4. Define the Distribution Policy in simple, broad terms. Treat all endowments the same unless there is a compelling reason to differentiate.

2. Distribution Policy

Based on the above objectives and expected returns of the entire portfolio (lands and funds), the Land Board has established the following Distribution Policy²:

- Distributions are determined individually for each endowment.
- Current distributions are 5% of the three-year rolling average Permanent Fund balance for the most recently completed three fiscal years. The Land Board may adjust this amount, depending on the amount in the Earnings Reserve, transfers to the Permanent Fund, and other factors.
- The level of Earnings Reserves deemed adequate is five years of future distributions.
- The Land Board may transfer any balance in an Earnings Reserve Fund in excess of an adequate level to the corresponding Permanent Fund and designate whether the transfer will or will not increase the Gain Benchmark.

3. Role of the Endowment Fund Investment Board

Each year, the EFIB shall present the following recommendations to the Land Board for its consideration:

- Whether any change should be made to the Distribution Policy.
- The amount of distributions for the next fiscal year for each endowment.
- What is considered to be an adequate level of earnings reserves for each endowment.
- The amount, if any, to be transferred from each earnings reserve to the corresponding permanent fund and whether such transfer should increase the gain benchmark.

4. Role of the Department of Lands

As requested by the EFIB or the Land Board, the IDL shall prepare, for each endowment, a forecast of expected land revenues and expenses.

E. Restoring Losses in Endowment Funds

The state has a legal obligation to make up losses in contributed principal in two of the nine endowment funds³. Responsibility for making up these losses

² The Distribution Policy is different for the Capitol Permanent Fund. Idaho Code 67-1601 specifies that on July 1 of each fiscal year, the EFIB shall distribute a percentage of the value of the Capitol Permanent Fund. The percentage is approved by the EFIB and must be calculated to provide a stable source of funds while still preserving and increasing over time the value of the fund. The EFIB, after considering expected revenues from endowment land, has established that percentage as 5% of the three-year average value of the Capitol Permanent Fund.

³ Article 9, Section 3 of the state Constitution requires the state to make up any losses in the principal of the Public School Permanent Endowment Fund. Idaho Code 57-724 specifies that these losses must be made up after ten consecutive years of cumulative losses. Over time, expected transfers from Earnings Reserves to the Permanent Fund will significantly reduce the likelihood of the fund falling into a loss position.

ultimately rests with the state legislature. However, if the Land Board determines that a fund's Earnings Reserve is sufficient, the Land Board may chose to make up all or part of a loss by transferring funds from Earnings Reserve to the Permanent Fund.

7 U.S.C. section 304, a federal statute, requires the state to make up any losses in principal in the Agricultural College fund.

Exhibit 1

Endowment Fund Assets, Distributions and Asset Mix

Endowment Fund Assets

(Amounts in millions)

| | <i>Fiscal Year End</i> | | | | |
|-------------------------|------------------------|-------------------|----------------|-----------------------|-------------------------|
| | <u>1966</u> | <u>2000*</u> | <u>2007</u> | | |
| | | | <u>Total</u> | <u>Permanent Fund</u> | <u>Earnings Reserve</u> |
| Public School | 45.7 | 556.0 | 760.2 | 662.5 | 97.7 |
| Agricultural College | 2.6 | 14.8 | 21.0 | 17.7 | 3.3 |
| Charitable Institutions | 4.4 | 54.5 | 71.3 | 62.8 | 8.5 |
| Normal School | 4.2 | 47.3 | 65.6 | 56.4 | 9.3 |
| Penitentiary | 2.6 | 18.3 | 25.8 | 21.5 | 4.3 |
| School of Science | 4.3 | 54.8 | 73.3 | 63.2 | 10.1 |
| State Hospital South | 2.0 | 23.4 | 42.8 | 28.0 | 14.8 |
| University | 3.2 | 42.4 | 60.4 | 48.4 | 11.9 |
| | <u>69.0</u> | <u>811.5</u> | <u>1,120.3</u> | <u>960.5</u> | <u>159.8</u> |
| Capitol Permanent** | <i>not avail.</i> | <i>not avail.</i> | 17.7 | <i>not applicable</i> | |

* Excludes approximately \$25 million of endowment-related funds held by the IDL which were transferred to the EFIB in July 2000 to become the beginning balance of Earnings Reserves

** The Capitol Permanent Fund was managed separately from the other endowments until 2004.

Endowment Fund Distributions

(Amounts in millions)

| | <i>Fiscal Years</i> | | | | <i>Coverage Ratio*</i> |
|-------------------------|---------------------|-------------------|-------------|--------------|------------------------|
| | <u>1966</u> | <u>2000</u> | <u>2007</u> | <u>2009A</u> | |
| Public School | 3.0 | 42.8 | 24.6 | 29.7 | 3.3 |
| Agricultural College | 0.2 | 1.0 | 0.7 | 0.8 | 4.1 |
| Charitable Institutions | 0.3 | 3.8 | 2.4 | 2.8 | 3.0 |
| Normal School | 0.3 | 3.9 | 2.1 | 2.5 | 3.7 |
| Penitentiary | 0.2 | 1.3 | 0.8 | 0.8 | 5.4 |
| School of Science | 0.3 | 3.8 | 2.4 | 2.3 | 4.3 |
| State Hospital South | 0.1 | 2.5 | 1.1 | 1.3 | 11.8 |
| University | 0.2 | 3.1 | 1.8 | 2.2 | 5.5 |
| Total | <u>4.7</u> | <u>62.0</u> | <u>35.8</u> | <u>42.4</u> | <u>3.8</u> |
| Capitol Permanent** | <i>not avail.</i> | <i>not avail.</i> | - | 0.6 | <i>not applic.</i> |

* 2007 Earnings Reserves divided by 2009 Distributions

** The Capitol Permanent Fund was managed separately from the other endowments until 2004 and the beneficiary chose to forgo a distribution in 2007.

Endowment Fund Asset Mix

| | <i>Target % Of Assets Invested</i> | <i>Five-Year Expected Return*</i> | <i>Annual Absolute Risk</i> |
|--|--|---|-------------------------------------|
| <u>Equities</u> | | | |
| Developed markets | | | |
| U.S. | 56% | 9.0% | 17% |
| Foreign | 13% | 9.0% | 19% |
| Emerging markets | 1% | 9.4% | 28% |
| Private equity | 0% | 12.0% | 34% |
| High yield debt | 0% | 7.5% | 9% |
| Total Equities | 70% | 9.0% | 16% |
| <u>Fixed Income</u> | | | |
| Treasuries/Agencies | | | |
| T-Bills/Cash | 0% | 3.5% | 1% |
| Standard | 8% | 4.9% | 6% |
| Inflation-protected | 3% | 4.6% | 7% |
| Mortgages (agency) | 5% | 5.2% | 6% |
| Mortgages (non-agency) | 10% | 5.3% | 6% |
| Corporates, other | 4% | 5.6% | 6% |
| Foreign bonds | 0% | 5.2% | 10% |
| Total Fixed Income | 30% | 5.2% | 4% |
| Real Estate | 0% | 7.6% | 16% |
| Absolute Return | 0% | 6.5% | 10% |
| Total | 100% | 7.9% | 10% |
| Duration/Maturity of Fixed Income (in years) | | 4.7 | |

* Assumes annual inflation rate of 2.75%

Source: Callan Associates, EFIB staff. Return and risk assumptions as of March 2008.