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**Larry Johnson, CFA, CPA**  
Manager of Investments

**Monthly Report to the Board of Land Commissioners**  
Since the November 16, 2010 Land Board Meeting thru December 12, 2010

**Investment performance thru November 30, 2010** (preliminary)

Month: **0.0%**                      Fiscal year: **13.5%**

**Status of endowment fund reserves**

For all endowments, estimated reserves as of September 2010 were at least **4.7 times** the size of the approved FY2011 distributions, except for **Public School**, which is at **2.6 times** the regular distribution (after current reserves are reduced by the special distribution in FY2011).

**Significant actions of the Endowment Fund Investment Board**

*Meetings:* The Investment Board met November 16 and **finalized responses to recent questions** and requests from the Superintendent of Public Instruction (see attached).

**Compliance/legal issues, areas of concern**

*Material deviations from Investment Policy or compliance guidelines for investment managers:* **None.**

*Material legal issues:* **None.**

*Changes in board membership or agency staffing:* **None.**

**Upcoming issues/events**

The Department of Lands is updating its term forecast of land revenues thru 2013, which will allow EFIB staff to provide a **new forecast of earnings reserves thru 2012** for presentation at the January Land Board meeting. This will allow the Land Board to see to what degree expectations have changed since distributions for 2012 were approved last August.

As explained in the attached, the Department of Lands is also developing a long term (10 years +) forecast of net land revenues for the State Hospital South endowment. Based on the results of this work, the EFIB will, in February, develop a **recommendation to the Land Board on whether or not to raise the distribution rate for State Hospital.**



# INVESTMENT REPORT

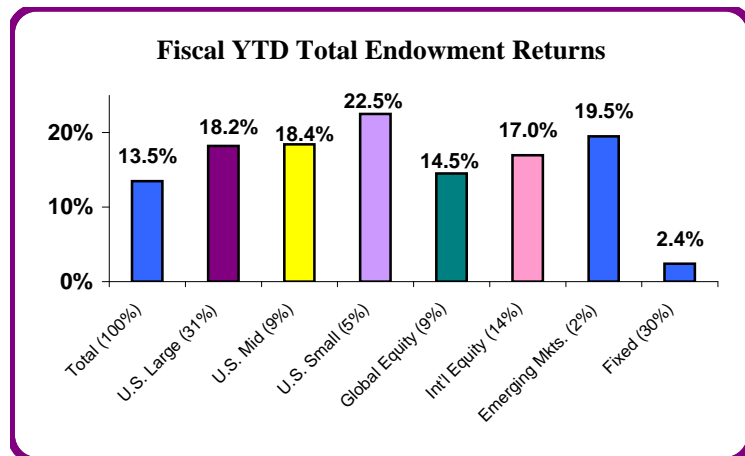
Preliminary Report (gross of fees & certain income accruals)

November 30, 2010

<b>Current Value of the Fund</b>	\$	<b>1,163,419,832</b>
<b>Investment Change in Market Value FYTD</b>	\$	<b>128,356,086</b>
<b>Net Contributions FYTD</b>	\$	<b>(3,966,530)</b>
<b>Fiscal Year-to-Date Returns</b>		<b>13.5%</b>
<b>Month-to-Date Returns</b>		<b>0.0%</b>

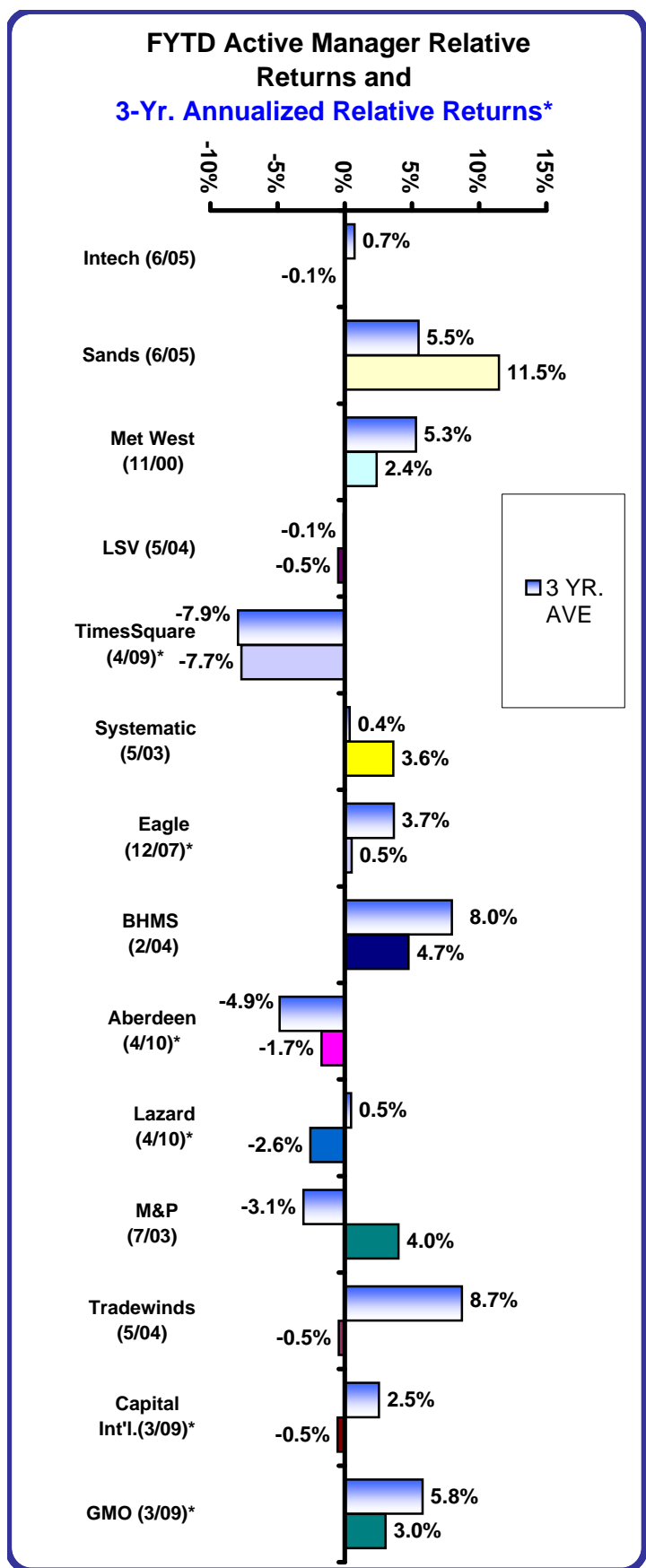
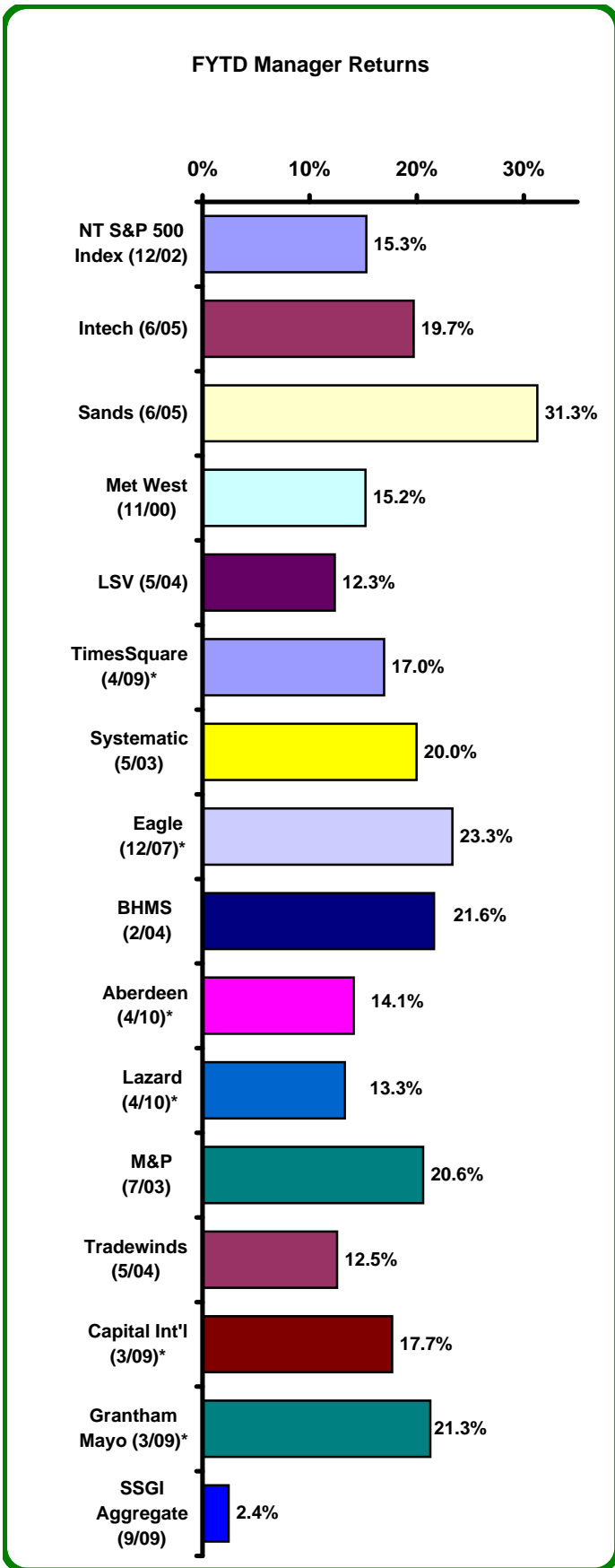
<u>Nov-10</u>		<u>Fiscal Year to Date</u>		<u>Last Five Years</u>	
<b>Total Fund</b>	<b>0.0%</b>	<b>Total Fund</b>	<b>13.5%</b>	<b>Total Fund</b>	<b>5.2%</b>
Benchmark	-0.5%	Benchmark	12.2%	Benchmark	3.5%
<b>Total Fixed</b>	<b>-0.7%</b>	<b>Total Fixed</b>	<b>2.4%</b>	<b>Total Fixed</b>	<b>6.3%</b>
Benchmark	-0.6%	Benchmark	2.3%	Benchmark	6.2%
<b>Total Equity</b>	<b>0.2%</b>	<b>Total Equity</b>	<b>18.0%</b>	<b>Total Equity</b>	<b>3.8%</b>
Benchmark	-0.3%	Benchmark	16.5%	Benchmark	1.8%
<b>Domestic Equity</b>	<b>1.3%</b>	<b>Domestic Equity</b>	<b>18.7%</b>	<b>Domestic Equity</b>	<b>3.2%</b>
Russell 3000	0.6%	Russell 3000	16.6%	Russell 3000	1.4%
<b>Global Equity</b>	<b>-2.4%</b>	<b>Global Equity</b>	<b>14.5%</b>	<b>Global Equity</b>	
MSCI ACWI	-2.2%	MSCI ACWI	15.8%	MSCI ACWI	
<b>Int'l. Equity</b>	<b>-2.4%</b>	<b>Int'l. Equity</b>	<b>17.0%</b>	<b>Int'l. Equity</b>	<b>6.3%</b>
MSCI ACWI ex-US	-3.9%	MSCI ACWI ex-US	15.9%	MSCI ACWI ex-US	3.0%

	<u>Mkt Value</u>	<u>% Alloc</u>
<b>Domestic Equity</b>	<b>\$ 593.6</b>	<b>51.0%</b>
Large Cap	\$ 415.7	35.7%
Mid Cap	\$ 116.1	10.0%
Small Cap	\$ 61.7	5.3%
<b>Global Equity</b>	<b>\$ 51.4</b>	<b>4.4%</b>
<b>Int'l Equity</b>	<b>\$ 201.9</b>	<b>17.4%</b>
<b>Fixed Income</b>	<b>\$ 310.1</b>	<b>26.7%</b>
Cash	\$ 6.0	0.5%
<b>Total Fund</b>	<b>\$ 1,163.0</b>	<b>100.0%</b>



## Endowment Fund Staff Comment:

The fund was flat for the month, 0.5% over benchmark. The Russell 3000 index was up 0.6%, Russell Midcap up 1.8%, and Russell 2000 (small cap) up 3.5%. International equities (MSCI ACWI ex-US) were down 3.9% for the month, and Emerging Markets down 2.6%. Growth outperformed value and domestic outperformed international equity. Bonds, as measured by the BC Aggregate index, were down 0.6% and TIPS were off 1.7%. Ten of 14 active managers beat their benchmark. On a Fiscal Y-T-D basis, the fund is up 13.5%, 1.3% over benchmark. Seven of 14 active managers are ahead of their benchmark.



\* ITD return used when manager has less than 3 years with EFIB.

# Superintendent's Inquiries Related to Distribution Policy

Land Board Meeting  
December 21, 2010



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## Background for this presentation

- The Superintendent of Public Instruction asked the EFIB to look at several issues related to Distribution Policy and investment management
- The EFIB committed to address most of these requests at the December 21 Land Board meeting
  - A response to the request to consider changing the statutory definition of income was presented at the July Land Board meeting
    - The EFIB recommended no change in the statute and the Land Board took no formal action

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## Summary: *Superintendent's Inquiries* and **EFIB Recommendations**

(page one of two)

1. *Once an endowment fills its reserves, ensure that we weight equally the interests of current and future beneficiaries*
  - Done. The methodology for calculating distributions was changed to ensure current/future balance when reserves are transferred to the Permanent Fund
2. *Consider investing Reserves more conservatively than the Permanent Fund*
  - Continue to invest Reserves the same as the Permanent Fund, unless they fall to critical levels
3. *Quantify, since 2000, the split of benefits between current and future beneficiaries. Which group has done better/worse?*
  - Since 2000, the balance of benefits between current and future beneficiaries has been reasonable for all endowments except Public School, and to a lesser extent, Charitable, both of which have favored current beneficiaries

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## Summary: *Superintendent's Inquiries* and **EFIB Recommendations**

(page two of two)

4. *Reexamine distribution amounts to consider a more comprehensive approach that looks at the performance of the whole endowment, including the land*
  - Continue with the 5% distribution rate for all endowments pending further work on a land revenue forecast for State Hospital
5. *Look at each of the endowments individually and make an individual recommendation for the level of reserve needed*
  - For now, maintain the same 5-year reserve target for all endowments, but assess annually
6. *Consider using different population growth targets for different endowments*
  - Defer recommendation until June, 2011 to better determine implications for SHS under new definition of income

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## Superintendent inquiry #2: Consider investing the Earnings Reserve funds conservatively

- Objective: Reduce the volatility of the return of the reserves, leading to a reduction in required reserves
- EFIB Recommendation:
  - Continue to invest reserves in same mix as Permanent Fund
    - Moving to 100% fixed income would modestly reduce long-term fund returns and not significantly reduce required reserves
    - Implement a new management policy to consider moving to a more conservative mix when reserves fall to a “critical” level (about a year for Public Schools)
      - Downside: may lock in losses

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## Rationale for recommendation to continue investing reserves in current mix

- Moving to 100% fixed income would only reduce required reserves by about ½ of a year
  - Most of the reserve exists to buffer volatility in land revenues and market gains/losses in the Permanent Fund, volatility which would not change if reserves were invested differently
  - Releasing ½ year of reserves would only boost annual distributions by, at most, 2.5% (if reserves are at 5 years now)
- We expect to invest a healthy level of reserves into perpetuity – this long investment horizon justifies a higher risk, higher return asset mix
  - Moving to 100% bonds would drop overall fund return by 0.5% (assuming 4.5 years of reserves at a 3% lower return than the current 70% equity/30% bonds mix)
- Investing reserves in a different mix would marginally increase management costs and modestly complicate fund administration and communication

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### **Superintendent inquiry #3: Quantify historical current/future beneficiary balance**

Objective: Measure how well past management of distributions and retained earnings has met fiduciary objectives since the year 2000

EFIB Conclusion:

- Based on the Land Board objective of keeping up with both inflation and population growth, only one endowment (State Hospital) has balanced current and future
  - This was an unusually difficult goal to reach given actual land revenue and fund returns of the past ten years and an increased emphasis on avoiding reductions in distributions,
- Based on the statutory objective of keeping up with only inflation, for the other seven endowments:
  - Five endowments have had a reasonable balance between current and future (i.e. their balance has kept up with inflation)
  - Two endowments, Public School and Charitable, have tilted toward current beneficiaries (their balance has fallen materially behind inflation)

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### **Measuring Current /Future Balance: Achieving “Intergenerational Equity”**

- Current beneficiaries should be neither advantaged or disadvantaged relative to future beneficiaries
- To achieve this balance, the endowment must in real terms (i.e. adj. for inflation) maintain its value over time
  - Land Board policy dictates that it should also grow with population, to maintain real per capita value
- To measure the balance since reform was implemented in 2000, we looked at:
  - Distributions as a % of real (after inflation) income
  - Growth in fund balances (with and without inflation adjustment)
- Caveat to the analysis: Land Board and fiduciary objectives are best measured over the long term, and 10 years is not long-term

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**To maintain current/future balance,  
endowments cannot distribute more than  
their income (after inflation)**

**Distributions as a % of Real Income\***

	<i><u>Six Years</u></i> <i><u>2001-2006</u></i>	<i><u>Four Years</u></i> <i><u>2007-2010</u></i>	<i><u>Total</u></i> <i><u>2001-2010</u></i>
State Hosp. South	69%	31%	53%
Ag College	79%	103%	90%
Penitentiary	112%	63%	93%
University	103%	79%	94%
Normal School	102%	96%	100%
School of Science	123%	80%	106%
Charitable Instit.	115%	136%	123%
Public School	105%	244%	131%
Weighted Average	104%	146%	115%

\* Net Land Revenue and Net Fund Return after inflation (Gain Benchmark)

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## Implications of fund balance growth since year 2000

- The current/future balance has been reasonable for 6 endowments
  - Total fund (see Appendix) has kept up with inflation
    - Only 1 kept up with population growth, but shortfall is expected given: weak returns, emphasis on maintaining distributions
- Future beneficiaries have fallen behind in Public School, and to a lesser extent, Charitable
  - To achieve balance in the long-term for these endowments:
    - As income recovers, distributions may need to be increased slower than average to allow balances to recharge
    - A reduction in distribution rate may be necessary if future income does not improve modestly
- State Hospital's current beneficiaries may fall behind **if** future income continues at the high level experienced in the past

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## Superintendent inquiry #4: Consider both land and fund income

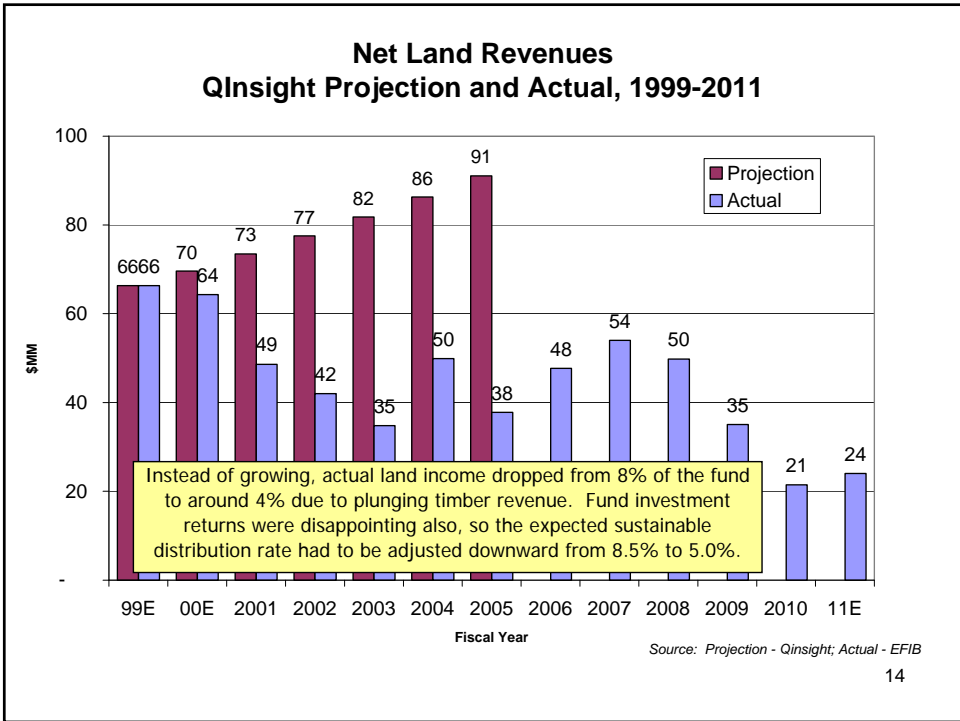
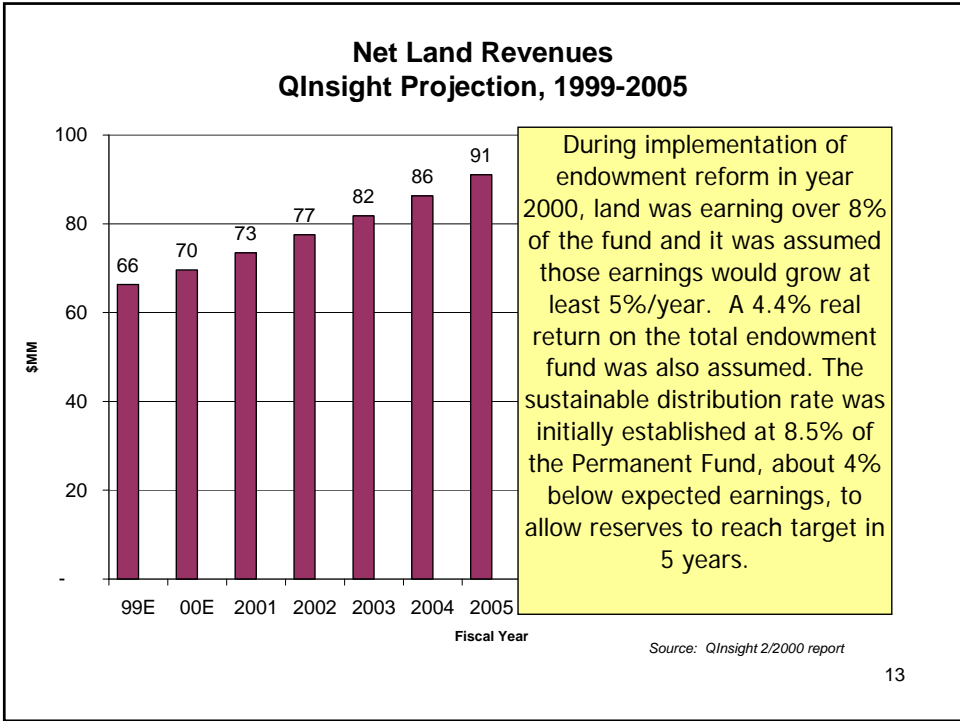
- Objective: Raise the 5% annual distribution rate based on reasonable expectations of land revenues
- EFIB Recommendation: Maintain the 5% distribution rate
  - 7 of 8 endowments need to retain income to just to reach their statutory fund balance objective (Perm Fund at inflation), so an increase in distribution rate is not warranted
  - For the smaller endowments, future timber income is too unpredictable to serve as a basis for a higher distribution rate
  - For the Public School endowment, future timber income will likely be more stable than the other endowments, but its earnings outlook remains weak due to the proportion of Public School lands located outside of strong timber market areas
  - Historically, beneficiaries have requested a conservative bias in setting the distribution rate to avoid future reductions
  - A conservative distribution rate does not have a material negative effect over the long term because of the current policy mechanism drives distributions higher as excess retained earnings are transferred to the Permanent Fund
  - Exception: Reconsider State Hospital South in February

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## Past experience leads to caution

- The endowments began the decade with very low reserves and a high, 8.5% distribution rate
- Unfortunately, expected fund returns and forecasted timber income proved too optimistic, requiring significant reductions in distributions, eventually reaching today's 5% level by 2005
- At the time, beneficiaries and other stakeholders expressed a strong preference to set distributions at levels which are sustainable in almost all market environments
  - The pain of being too optimistic, and having to make cuts, far outweighs missed opportunities to spend additional funds if expectations prove too conservative
  - To reflect this strong preference for "pain avoidance", the EFIB recommends the Land Board stick with a spending rate that can be sustained if either fund returns or land revenues prove severely disappointing – 5% fits this criteria

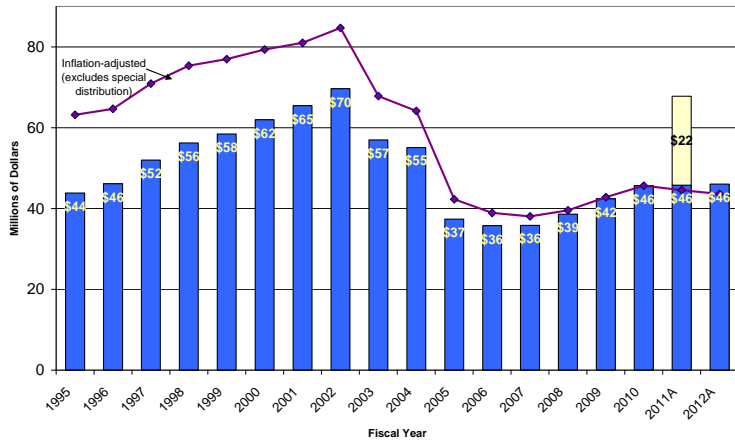
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**Disappointing income and low reserves led to a 49% reduction in distributions between 2002 and 2005**

**Total Endowment Distributions To Beneficiaries  
1995-2012 Actual and Approved  
Nominal and Inflation-Adjusted (in 2010\$)**

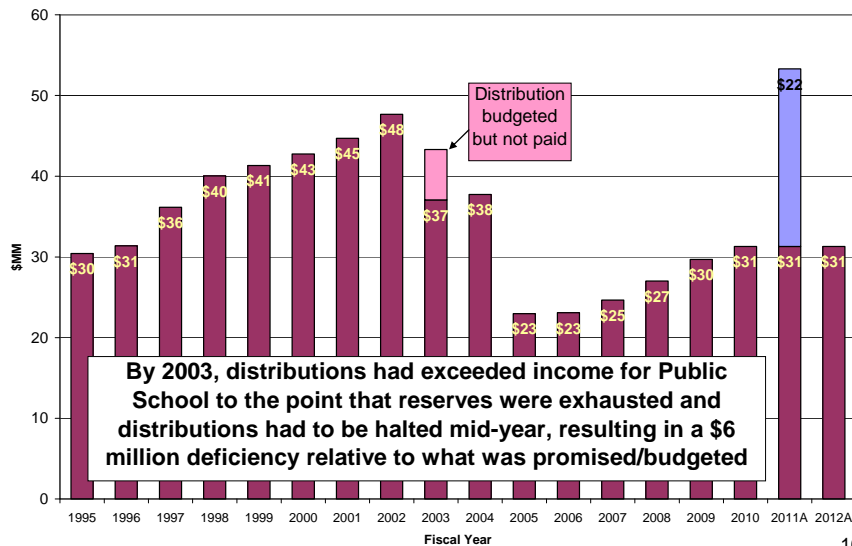
*(Net of General Fund contribution in 2006 of \$4.6MM, includes special Public School distribution in 2011 of \$22MM)*



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**Total Endowment Distributions To Pub Schools 1996 to 2012  
Actual and Approved**

*(Includes special distribution in 2011 of \$22MM)*



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**Endowment Income/Returns  
As a % of the Fund  
Ten Years -- 2001 thru 2010**

	<u>All Endowments</u>	<u>Public School</u>	<u>Other Endowments</u>
Land	3.5%	3.0%	4.5%
Fund	2.5%	2.5%	2.5%
<b>Total Income</b>	<b>6.0%</b>	<b>5.5%</b>	<b>7.0%</b>
Distributions	4.5%	4.5%	4.0%
Retained	1.5%	1.0%	3.0%
Inflation	(2.5%)	(2.5%)	(2.5%)
<b>Retained Income Sufficient (Insufficient) to Offset Inflation</b>	<b>(1.0%)</b>	<b>(1.5%)</b>	<b>0.5%</b>
<b>Real Income</b>	<b>3.5%</b>	<b>3.0%</b>	<b>4.5%</b>

*Rough estimates -- impact of the timing of  
specific cash flows was not precisely calculated*

- Over the last 10 years, endowments earned about 6% nominal income, or about 3.5% after inflation
- For some endowments, distributions exceeded real income

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## Implications if the distribution proves to be conservative...

- If actual income significantly exceeds distributions and inflation, the reserves will fill up quickly, resulting in higher transfers to the Permanent Fund, automatically increasing distributions to near the same level than if the distribution rate were set at a higher rate today
  - Distributions at 5% lag a 6% rate by only 1-3 years
- Therefore, there is no compelling fiduciary reason for the Land Board to increase the distribution rate
  - 5% provides a stable payout that should also rise over the long-term at least at the rate of inflation
    - Caveat: State Hospital requires further examination

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**Superintendent inquiry #5:  
Set target reserve levels individually  
for each endowment**

- Objective: Lower reserves for endowments with more stable land cash flows, use excess to boost Permanent Fund and distributions
- EFIB Recommendation: Maintain the same reserve target for all endowments for now, but continue to regularly assess
  - Dept. of Lands warns that land revenues for small endowments could be more volatile than history
  - Benefits of lower reserves are not significant
    - 5% increase in distributions for every year the target is reduced

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# Appendix

## Superintendent's Inquiries December 21 Land Board Meeting

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### **Superintendent inquiry #1: Ensure equal treatment when reserve level is achieved**

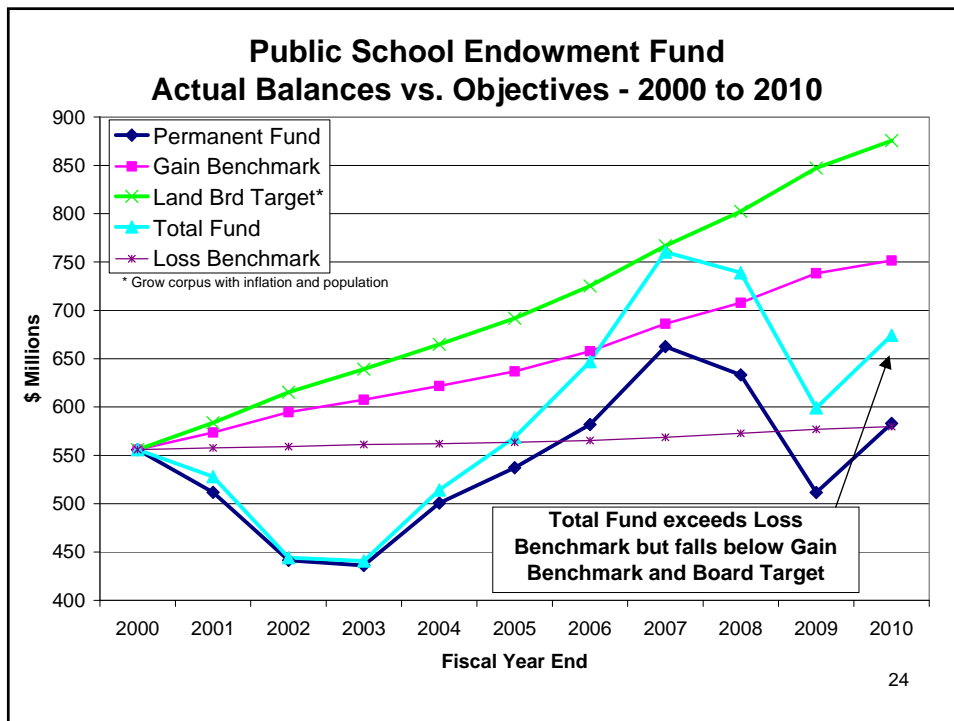
- Done. In May, the methodology used to adjust distributions for transfers was changed so that the next year's distributions immediately increase 5% for each \$1 transferred to the Permanent Fund
  - Better balances current and future beneficiary interests
  - Before, the increase in distributions resulting from the transfer was phased in over three years

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## Measuring “intergenerational equity” using fund balances

- To measure the balance since reform was implemented in 2000, we compared both the Permanent Fund and the Total Fund (Permanent plus Reserve) to the:
  - Loss Benchmark (original contributed principal, no inflation adjustment)
  - Gain Benchmark (original contributed principal plus inflation)
- Four measures for every endowment

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## Growth Above Orig. Principal, 2000-2010

- Total Fund: all endowments have grown
- Permanent Fund: 4 have grown materially

Total Fund in Excess of Loss Benchmark		
	<u>\$MM</u>	<u>% of Total Fund</u>
State Hosp. South	24.7	51.2%
Penitentiary	6.5	26.3%
Ag College	5.1	25.7%
University	14.7	25.7%
Normal School	14.6	23.1%
School of Science	14.9	21.4%
Charitable Instit.	11.8	17.7%
Public School	94.3	14.0%
<b>Total</b>	<b>186.6</b>	<b>18.2%</b>

Permanent Fund in Excess of Loss Benchmark		
	<u>\$MM</u>	<u>% of Total Fund</u>
State Hosp. South	15.1	39.0%
Penitentiary	1.7	8.4%
Ag College	1.3	8.3%
University	3.0	6.7%
Normal School	1.2	2.5%
School of Science	1.1	2.0%
Public School	3.2	0.6%
Charitable Instit.	(0.4)	(0.7%)
<b>Total</b>	<b>26.3</b>	<b>3.1%</b>

Essentially no growth since Year 2000

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## Growth Above Inflation, 2000-2010

- Total Fund: 6 endowments have grown
- Permanent Fund: 1 endowment has grown

Total Fund in Excess of Gain Benchmark		
	<u>\$MM</u>	<u>% of Total Fund</u>
State Hosp. South	14.7	30.5%
Penitentiary	1.0	3.9%
Ag College	0.6	3.1%
University	1.8	3.1%
Normal School	0.0	0.1%
School of Science	(1.8)	(2.5%)
Charitable Instit.	(4.9)	(7.3%)
Public School	(77.3)	(11.5%)
<b>Total</b>	<b>(65.9)</b>	<b>(6.4%)</b>

Permanent Fund in Excess of Gain Benchmark		
	<u>\$MM</u>	<u>% of Perm. Fund</u>
<i>Including recent transfers</i>		
State Hosp. South	5.1	13.3%
Penitentiary	(3.9)	(19.5%)
Ag College	(3.2)	(19.6%)
University	(9.9)	(21.7%)
Normal School	(13.3)	(26.7%)
School of Science	(15.6)	(27.8%)
Public School	(168.5)	(28.9%)
Charitable Instit.	(17.0)	(31.4%)
<b>Total</b>	<b>(226.2)</b>	<b>(26.2%)</b>

Future beneficiary disadvantaged

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## Adjusting distribution rates based on expected land income

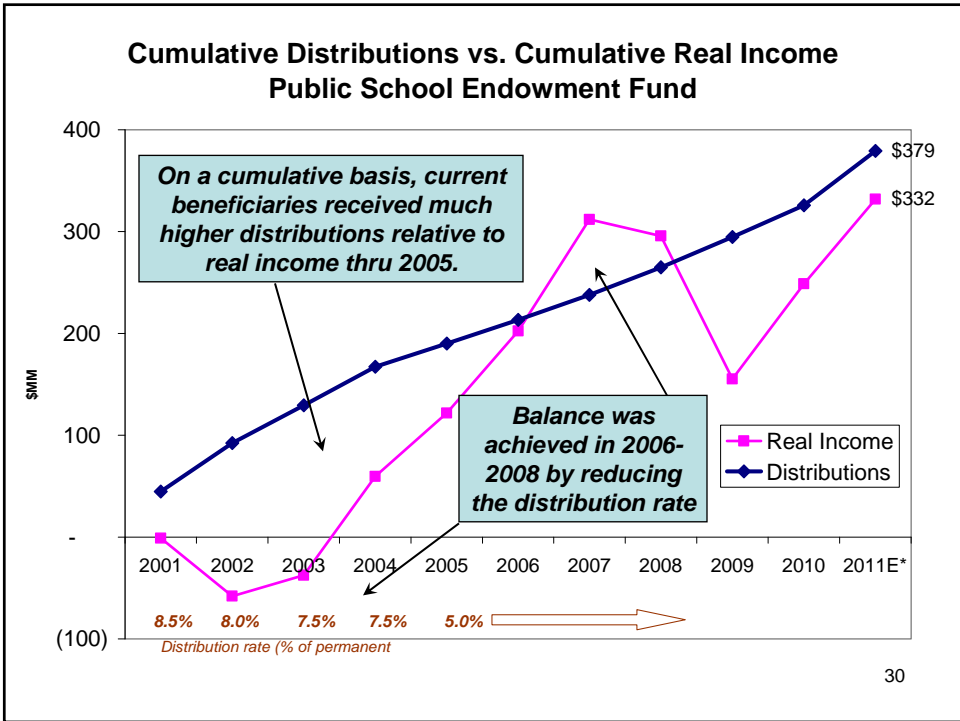
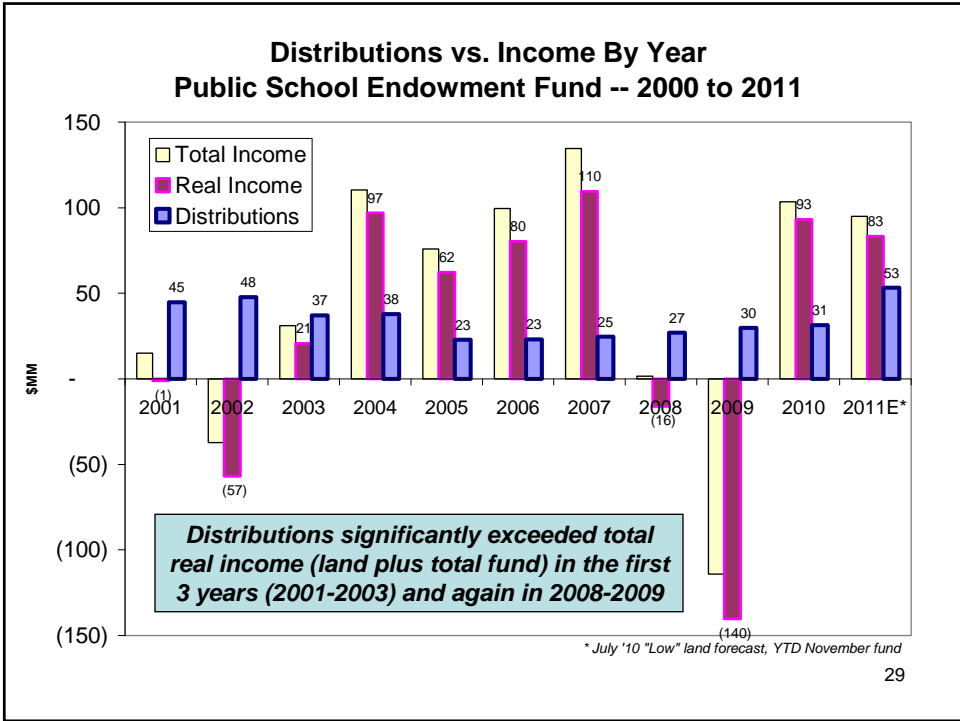
- The EFIB believes it prudent to consider adjusting the 5% distribution rate for endowments which:
  - Have reached target levels in their reserve fund (5 years) and permanent fund (inflation + population growth since year 2000)
    - Only State Hospital South currently meets this criteria
  - Have above average expected land revenues
    - Proper consideration of this criteria requires a reliable long-term land revenue forecast
- The Dept. of Lands has concluded that, for the smaller endowments, harvest levels are too unpredictable to develop a reasonably reliable long-term forecast of timber income
  - Harvests levels can go into a decade-long dearth relative to expectations due to emerging natural conditions in the forest (insects, disease, fire, droughts, etc.) or legal rulings (ESA, CWA, etc.)
  - The difficulty of forecasting is further compounded by the same type of pricing/economic uncertainty that equity markets face
- However, State Hospital South has significant residential and commercial real estate earnings, which are more stable than timber. Therefore, the Dept. of Lands is developing a long-term forecast of SHS earnings, with results expected to be ready by mid-January
  - If results are positive, the EFIB will consider whether to recommend an increase in the State Hospital distribution rate

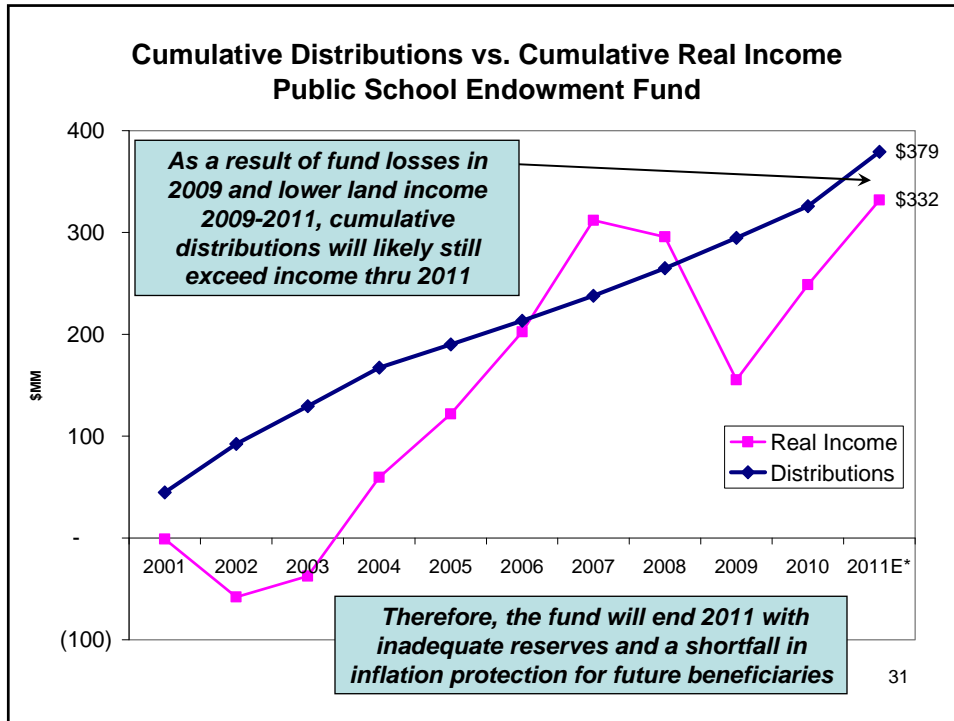
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## Public School Land Revenue Forecast

- Public School has by far the largest timber base, so the Dept. of Lands could develop a forecast of timber harvests and associated income that could be used to adjust the 5% distribution rate
  - It would still be subject to significant economic uncertainty related to future pricing and customer demand
- However, the EFIB believes that such a forecast would not be relevant today because it would not be prudent to boost the distribution rate of the endowment with the lowest level of reserves and that is furthest behind in keeping up with inflation
- In addition, Lands has concern that Public School's timber revenues, in the foreseeable future, will likely be lower than history, which supports a conservative distribution rate

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## Original expectations for Public School Endowment Earnings

- When endowment reform was implemented in FY2001, the expectation was that the Public School endowment would earn over \$1 billion over the decade, which would allow:
  - Reserves to build to more than five years
  - The Permanent Fund to retain enough income to offset inflation
  - Distributions to total about \$500 million

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## What if we'd had perfect foresight on income, inflation?

- Actual income, 2001-2010, was \$420 million and inflation took away \$170 million of the Permanent Fund's (future beneficiaries') purchasing power
  - A proper current/future balance would have been achieved if distributions and growth in reserves, would have totaled \$250 million (\$420 minus \$170)
  - Instead, distributions actually totaled \$417 million, leaving only \$3 million of the \$420 million to protect the future beneficiary from \$170 million of inflation
  - As shown in the next slide, bringing current/future back into balance over the next decade (i.e. achieving the Gain Benchmark) may require a reduction in the 5% distribution rate depending on income levels

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### Achieving Current/Future Balance Over the Next Ten Years -- Public School Fund

Land Income	Fund Investment Return			Performance Criteria
	High	Low	Poor	
<b>High</b>	Quickly	Slowly	Never	<i>Perm Fund achieves Gain Bmark</i>
	Quickly	Moderately	Slowly	<i>Reserve achieves 5-year target</i>
	Faster than inflation	At inflation	Below inflation	<i>Growth of distributions at current 5% rate*</i>
	None	Slow Growth	Reduce	<b>Adjustment to achieve balance</b>
<b>Low</b>	Quickly	Never	Never	<i>Perm Fund achieves Gain Bmark</i>
	Moderately	Never	Never	<i>Reserve achieves 5-yr target</i>
	Faster than inflation	Below inflation	None	<i>Growth of distributions at current 5% rate*</i>
	None	Hold flat	Reduce	<b>Adjustment to achieve balance</b>

\* Based on FY2011 starting point, excluding the special distribution

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## Growth in Distributions vs. Fund Balances – Public School

Distribution Policy ties growth in distributions directly to growth in the Permanent Fund. 10% growth in the 3-yr average of the Permanent Fund will automatically drive a 10% increase in the Distribution Rate. Therefore, the current beneficiary cannot be disadvantaged relative to the future beneficiary. (Two exceptions: distributions may not be reduced when the fund balance falls IF reserves are sufficient and distributions may be reduced even if the fund balance grows IF reserves are inadequate.)

For example, the 3-yr average of the Perm Fund for 2008 grew 6.2% vs. the average for 2003. As a result, distributions for 2010 compared to 2005 grew about the same rate (6.4%). Alternatively, the average for 2009 grew only 4.5% compared to 2005, but the distribution for 2011 (excluding the special) was held even, resulting in higher growth vs. 2005 (5.3%) than the fund experienced.

Due to the use of the 3-yr average (with a 2-year lag), there will be a mismatch in growth rates using annual numbers. As shown in the chart below, since the adoption of the 5% distribution rate in 2005, distributions grew 6.4% over 5 years compared to 1.7% for the Permanent Fund and 3.5% for the Total Fund.

Over 6 years (thru 2011), distributions (excl. the special) will grow 5.3% compared to an estimated 3.2% for the Perm Fund and 4.5% for the Total Fund.

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