



Board Members

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Monthly Report to the Board of Land Commissioners
Since the June 15, 2010 Land Board Meeting thru July 13, 2010

Investment performance thru June 30, 2010 (preliminary)

Month: -2.2% Fiscal year: 16.0%

Status of endowment fund reserves

For all endowments, estimated reserves as of May were at least 4 times the size of the approved FY2011 distributions, except for Public School, which is at 2.3 times the regular distribution after current reserves are reduced by the approved \$22 million special distribution for FY2011.

Starting with the actual May balance and projecting forward using the December 2009 land revenue forecast and assuming no fund gain or loss, the coverage ratio for Public School is expected to be around 2 times at the end of FY2012.

Significant actions of the Endowment Fund Investment Board

Meetings: None.

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 EFIB will meet August 11 to develop a recommendation for the Land Board regarding FY2012 endowment fund distributions and transfers from the earnings reserve funds to the permanent funds. Based on the information available today, EFIB staff would recommend that distributions be maintained at FY2010/2011 levels, except for a 12% increase in State Hospital South and discontinuation of the special \$22 million distribution from Public School. The final recommendation to the Land Board will consider investment results thru the end of June and an updated forecast of land revenues provided by the Department of Lands.

At the May Land Board meeting, the Superintendent asked the EFIB to evaluate whether adjustments should be made to statute which requires that deposits to the earnings reserve funds from the permanent funds should eventually switch from cash income (interest and dividends) to cumulative total return above inflation (i.e. include capital gains). An analysis of that statute by EFIB staff is included in this report in support of the EFIB's formal recommendation that no change be made to the statute.





INVESTMENT REPORT

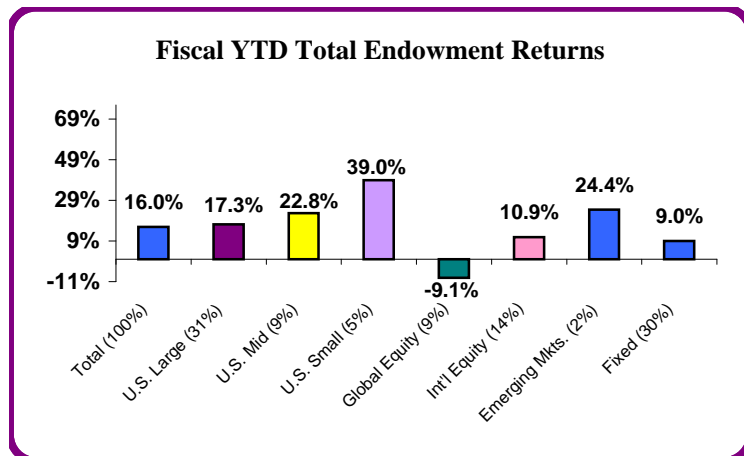
Preliminary Report (gross of fees & certain income accruals)

June 30, 2010

Current Value of the Fund	\$	1,039,746,805
Investment Change in Market Value FYTD	\$	148,237,741
Net Contributions FYTD	\$	(26,002,381)
Fiscal Year-to-Date Returns		16.0%
Month-to-Date Returns		-2.2%

<u>Jun-10</u>		<u>Fiscal Year to Date</u>		<u>Last Five Years</u>	
Total Fund	-2.2%	Total Fund	16.0%	Total Fund	3.8%
Benchmark	-2.8%	Benchmark	13.4%	Benchmark	2.0%
Total Fixed	1.6%	Total Fixed	9.0%	Total Fixed	5.6%
Benchmark	1.6%	Benchmark	9.5%	Benchmark	5.5%
Total Equity	-3.8%	Total Equity	18.4%	Total Equity	2.2%
Benchmark	-4.9%	Benchmark	14.7%	Benchmark	0.0%
Domestic Equity	-5.5%	Domestic Equity	20.5%	Domestic Equity	1.4%
Russell 3000	-5.7%	Russell 3000	15.7%	Russell 3000	-0.5%
Global Equity	0.1%	Global Equity		Global Equity	
MSCI ACWI	-3.1%	MSCI ACWI		MSCI ACWI	
Int'l. Equity	-0.1%	Int'l. Equity	10.9%	Int'l. Equity	5.3%
MSCI ACWI ex-US	-1.3%	MSCI ACWI ex-US	10.4%	MSCI ACWI ex-US	1.8%

	<u>Mkt Value</u>	<u>% Alloc</u>
Domestic Equity	\$ 500.8	48.2%
Large Cap	\$ 352.3	33.9%
Mid Cap	\$ 98.0	9.4%
Small Cap	\$ 50.4	4.8%
Global Equity	\$ 45.6	4.4%
Int'l Equity	\$ 172.9	16.6%
Fixed Income	\$ 307.6	29.6%
Cash	\$ 13.0	1.2%
Total Fund	\$ 1,039.7	100.0%

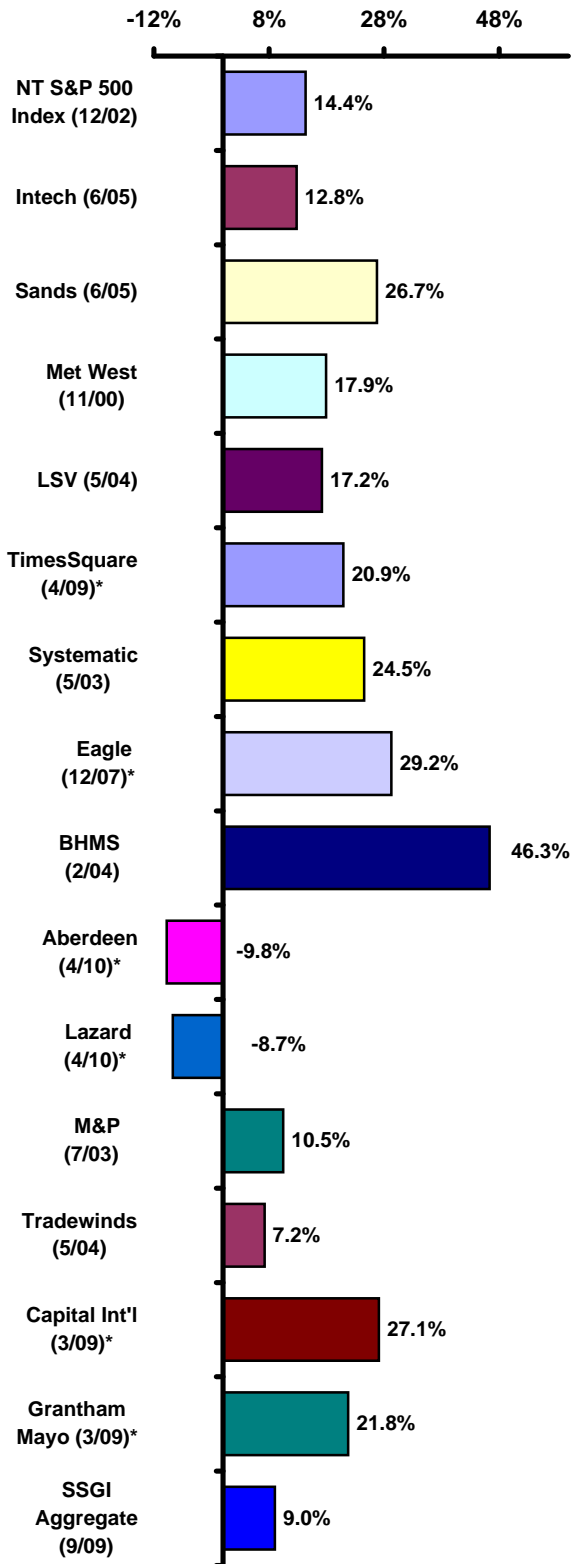


Endowment Fund Staff Comment:

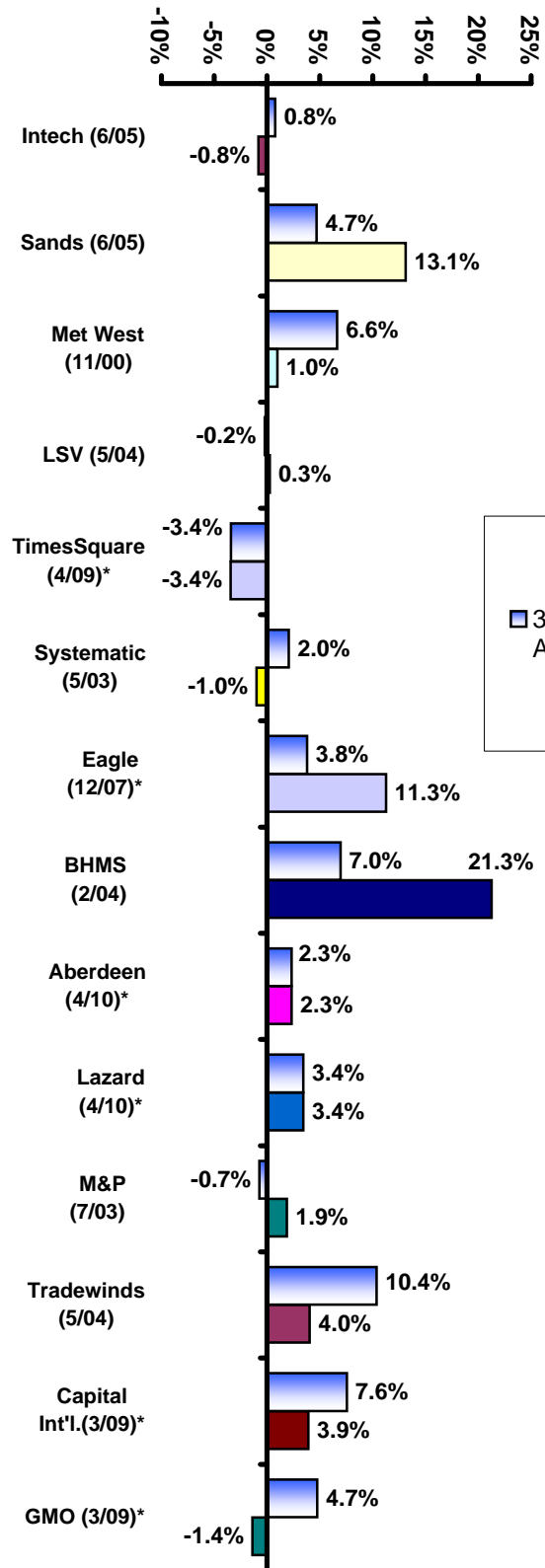
The fund was down 2.2% for the month, 0.6% better than benchmark. The Russell 3000 index was down 5.8%, Russell Midcap down 6.3%, and Russell 2000 (small cap) down 7.8%. International equities (MSCI ACWI ex-US) were down 1.3% for the month, and Emerging Markets down 0.8%. Growth outperformed value this month and international outperformed domestic equity. Bonds, as measured by the BC Aggregate index, were up 1.6% and TIPS were up 1.4%. Twelve of 14 active managers beat their benchmark. On a Fiscal YTD basis the fund is up 16%, 2.6% over benchmark. Ten of 14 active managers are ahead of their benchmark.



FYTD Manager Returns



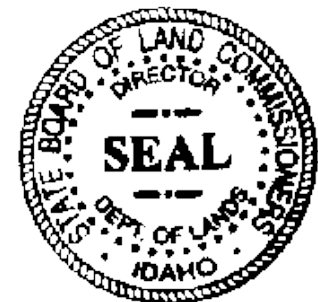
FYTD Active Manager Relative Returns and 3-Yr. Annualized Relative Returns*



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

Analysis of Fund Income Flow As Defined by Statute

Land Board
July 20, 2010

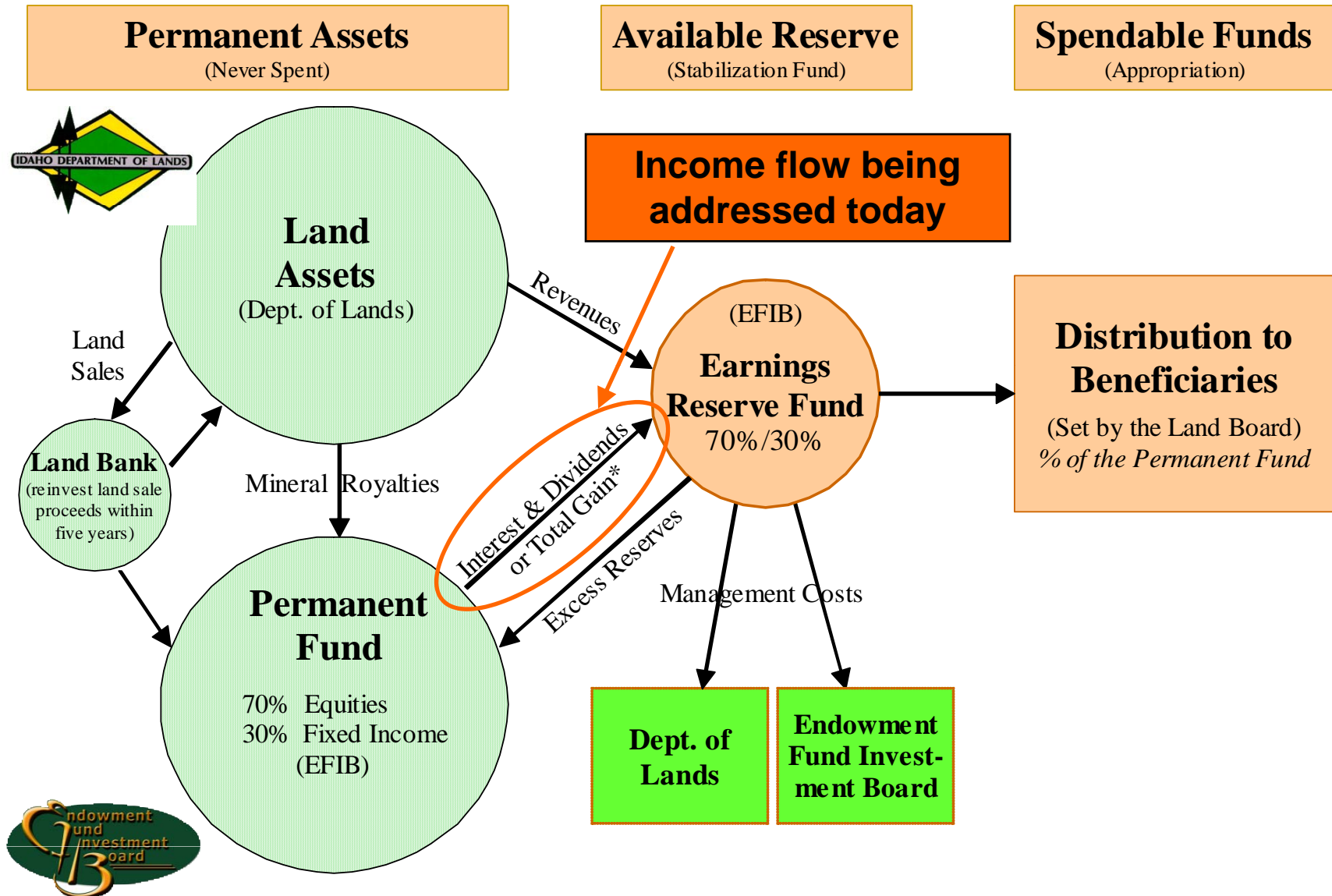


NO ACTION WAS TAKEN ON THIS AGENDA ITEM - 7/20/10

Objectives of today's Presentation

- **Address question from May Land Board meeting regarding the statutory allocation of Permanent Fund income**
 - Should a change in statute be considered?
- **EFIB recommendation – retain the current statutory language, which provides that:**
 - Initially: cash income allocated to reserves, market appreciation/depreciation allocated to the Permanent Fund
 - After a Permanent Fund achieves year 2000 balance plus inflation: from then on, income = total appreciation in value greater than inflation

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.

Defining Income and Principal

- Conceptually, the objective of a permanent, perpetual endowment is to:
 - Distribute “income” to current beneficiaries, while, at the same time,
 - Retain “principal” for the benefit of future generations
- Specifically defining “income” and “principal” is essential for proper endowment management
 - There is discretion in these definitions
 - For the Idaho endowments, “income” goes to the reserve fund, “principal” remains in the Permanent Fund

An institutional investor defines “income” as total return

- Normal practice in managing endowments is to focus on total return – cash income (interest & dividends) plus market appreciation or depreciation
 - A prudent investor is generally ambivalent whether a dollar of return comes in the form of cash or capital gains
 - Note that the EFIB reports total fund return to the Land Board, without distinguishing between cash and market appreciation/depreciation
- A focus on generating either cash income or capital gains would reduce investment flexibility and result in lower total return over time

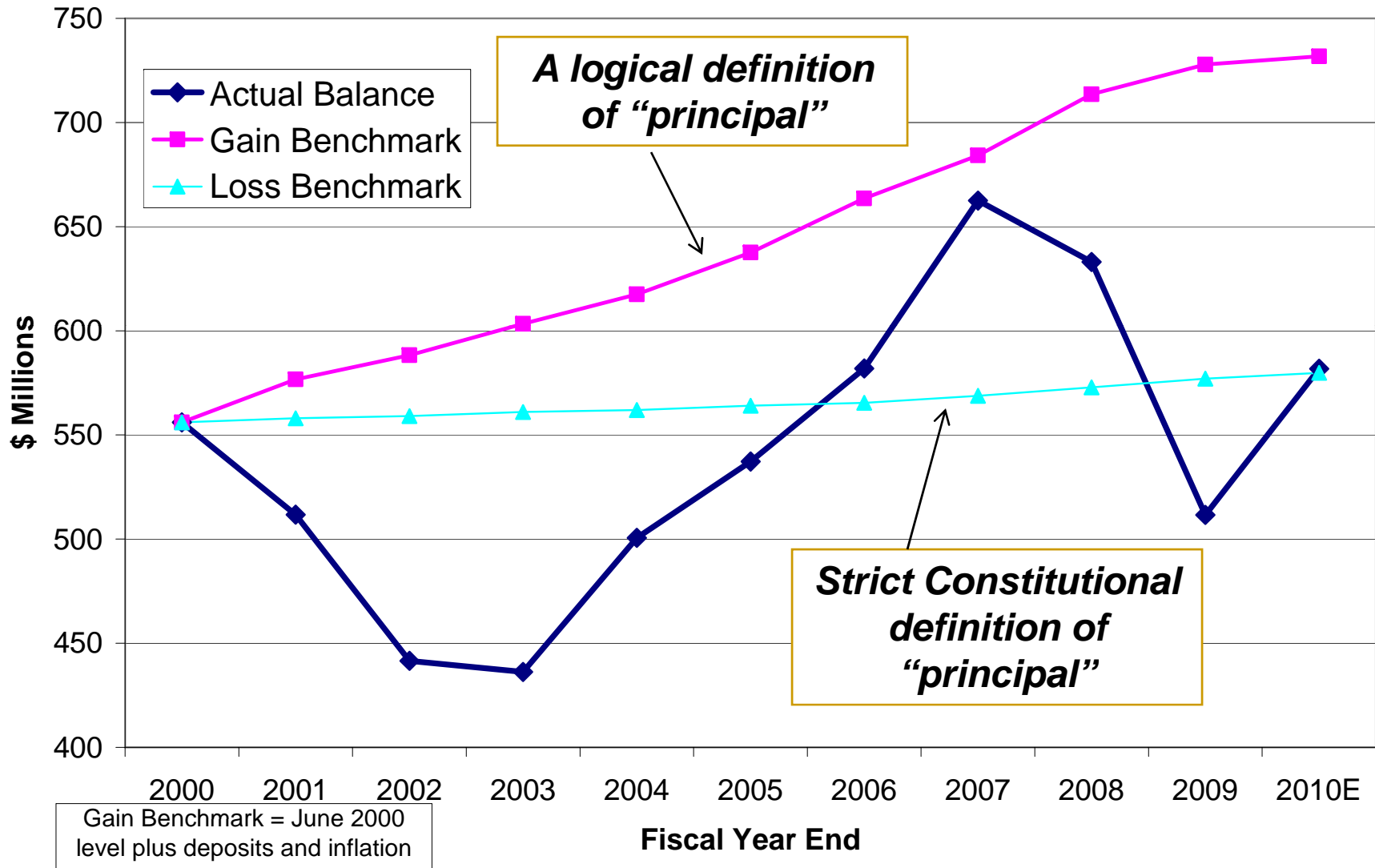
Current statutory definition of “income”

- Statute currently makes a distinction between cash income and market appreciation, directing cash income to the reserve fund while retaining market appreciation/ depreciation in the Permanent Fund
- When the current structure was first established in 2000, reserves were at very low levels, so this distinction was a reasonable way to ensure a steady flow of income to the reserves until they could be built up
- However, the long term objective would be to define income as “total return”, to be consistent with the way the endowment fund is are managed

“Principal” is purchasing power

- Normal practice in managing permanent endowments is to define “principal” as the initial contribution, adjusted for inflation over time
 - This ensures future generations have the same purchasing power as current beneficiaries
- Per the Constitution, the Land Board is strictly prohibited from distributing any original principal
 - However, there is no strict requirement that income be retained to offset inflation – the current statute adds this requirement
 - The legislature must make up a “loss” in original principal of the Public School fund after 10 years

Public School Permanent Endowment Fund Actual Balance vs. Benchmarks - 2000 to 2010



Long-term solution (as contained in the current statute)

- Once a Permanent Fund balance achieves year 2000 levels plus inflation, the definition of income changes to a “total return” concept
 - Cash income is no longer treated differently than market appreciation/depreciation
- Total return is allocated, in priority order to:
 1. Recover any investment losses in the Permanent Fund
 2. Offset inflation in the Permanent Fund
 3. Increase Earnings Reserves with the remainder
 - Guarantee the current distribution
 - If reserves are adequate, then excess income is transferred to the Permanent Fund and distributions rise

Advantages of the switch in definition of income

- Aligns the definition of “income” and “principal” with prudent investment practice, long-term objectives
 - Manages for total return
 - Explicitly protects the original principal from inflation
- Helps ensure sufficient margin is maintained so normal market depreciation does not result in a loss of original principal of Public School that must be repaid by the legislature

Implication of the planned switch: Higher reserves needed

- In years of market depreciation, any cash income is retained by the Permanent Fund to increase the long-term principal
 - Statistically, once every 25 years, we can expect cumulative losses to extend for 5 years or more
 - No Permanent Fund income would be allocated to reserves during the cumulative loss period
 - Requires a larger reserve to sustain distributions
 - Every additional dollar held in reserves (instead of being transferred to the Permanent Fund) reduces current distributions by 5 cents
 - Distributions = 5% of Permanent Fund
-

Conclusion: Retain the current statute

- The definition of “income” and “principal” contained in the current statute is reasonable
 - Aligns the statutory definitions with long-term objectives
 - Makes the process of allocating income to offset inflation more transparent, less subjective

Appendix

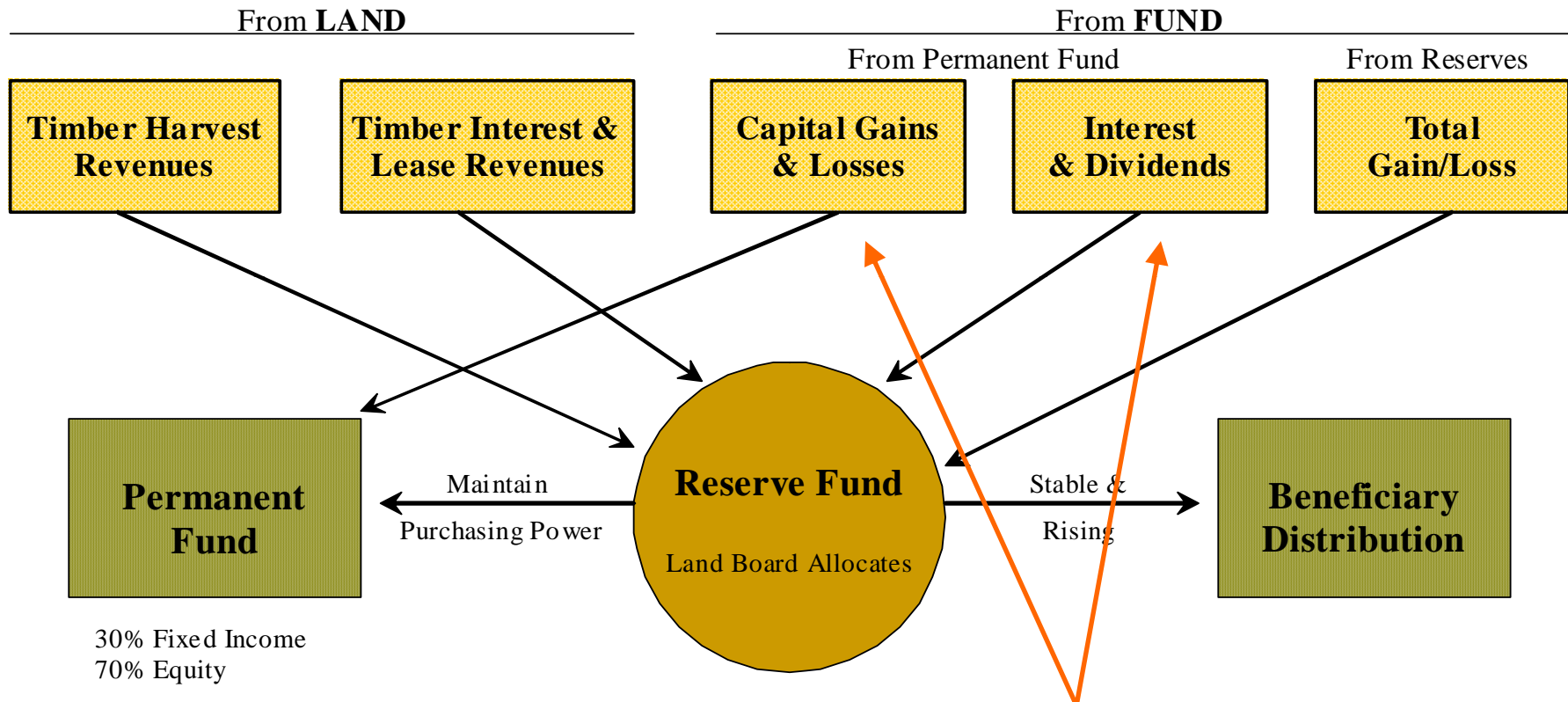
Land Board's Approved Priorities for Allocation of Endowment Income

- 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.

The statute's shift in income flow (once the fund achieves its inflation objective) further supports these priorities

ALLOCATION OF ENDOWMENT REVENUES

2001 Forward - Before Achieving Gain Benchmark



30% Fixed Income
70% Equity

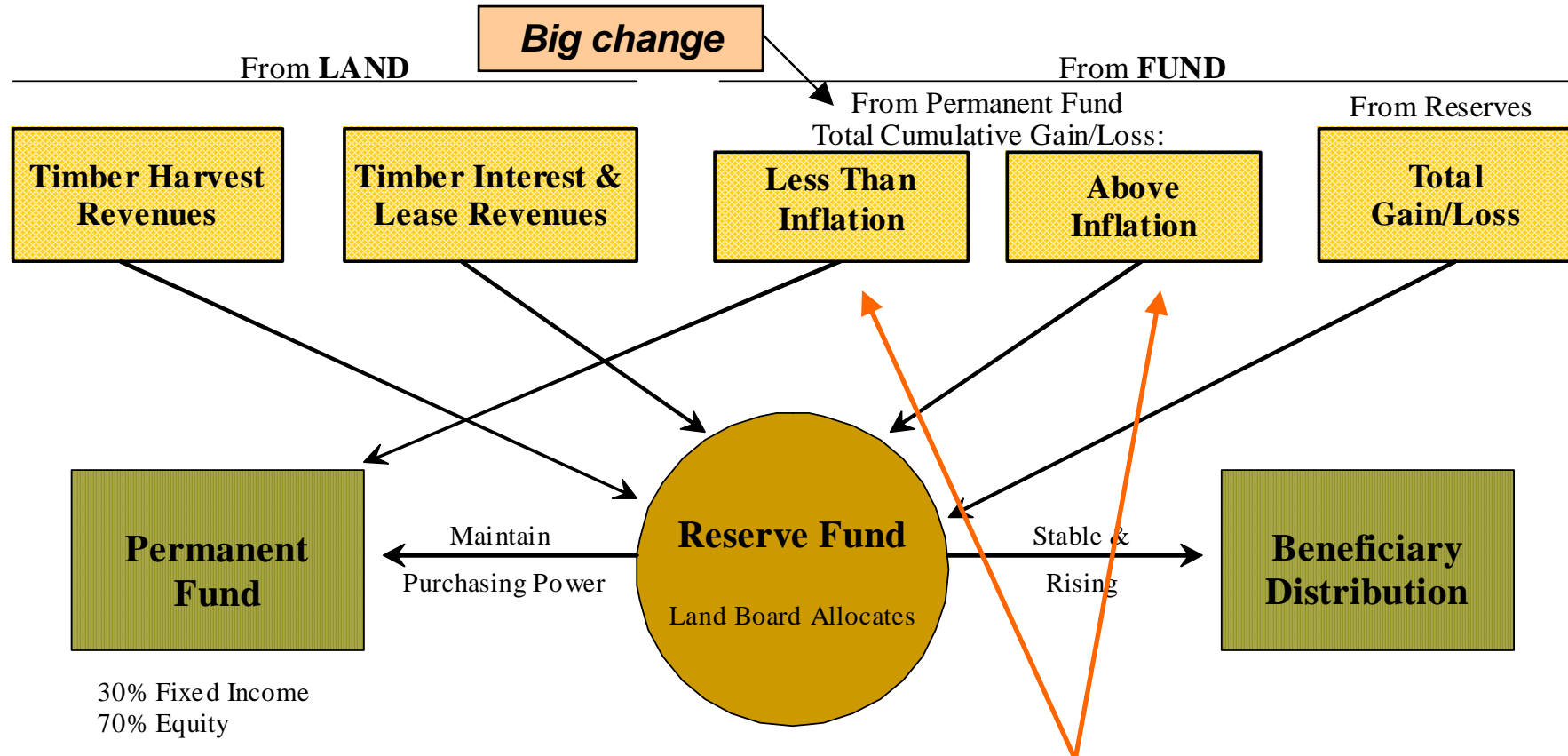
In the current structure, cash income from the Permanent Fund always flows to the reserves while capital gains/losses remain in the Permanent Fund



04/15/2010

ALLOCATION OF ENDOWMENT REVENUES

After Achieving Gain Benchmark



After the Gain Benchmark is achieved, the flow of Perm Fund earnings will be based on total return and automatically directed to either reserves or the Perm Fund depending on whether the Perm Fund has kept up with inflation or not



04/15/2010

Purpose of Earnings Reserves

- A “shock absorber” mechanism to:
 - **Allocate benefits** between current and future beneficiaries
 - **Stabilize distributions** to beneficiaries
- Determines when we have sufficient reserves so income can safely be transferred to the Permanent Fund, both increasing distributions to current beneficiaries and increasing the amounts set locked up for future generations
- In bad economic times, reserves are drawn down to preserve the current distribution
- In good economic times, the additional income flows first to build reserves before distributions are increased