



Board Members

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Manager of Investments

M. Dean Buffington, Chairman
Max C. Black
Vaughn Heinrich
Susan K. Simmons
R. John Taylor

Gavin M. Gee
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Monthly Report to the Board of Land Commissioners Since the April 20, 2010 Land Board Meeting thru May 11, 2010

Investment performance thru April 30, 2010 (preliminary)

Month: **1.8%** Fiscal year: **25.5%**

Status of endowment fund reserves

For all endowments, estimated reserves as of March were at least **3 times** the size of the approved FY2010 distributions.

When reserves in the Public School endowment are reduced by the approved \$22 million special distribution for FY2011, the coverage ratio for Public School drops to 2.5 times the regular distribution. This ratio will likely drop further in FY2011 as higher distributions kick in, but based on updated results thru April, the coverage ratio for **Public School is still expected to be around 2 times at the end of FY2012**, consistent with the “low” scenario presented to the Land Board last December.

Significant actions of the Endowment Fund Investment Board

Meetings: The EFIB had a special meeting April 27 to discuss Distribution Policy. No actions were taken.

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 attend the May Land Board meeting and give its regular semi-annual report. Per requests at the March meeting, the EFIB will also present **key rationale for Distribution Policy** related to establishing 5 years as the targeted level of reserves and transferring excess earnings reserves to the Permanent Fund.



INVESTMENT REPORT

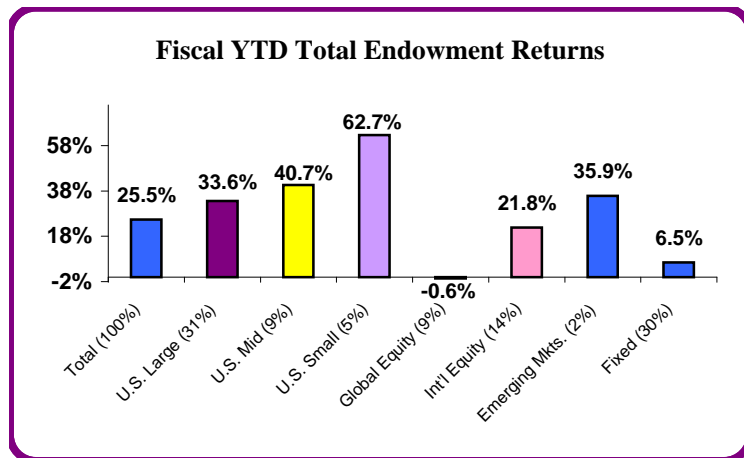
Preliminary Report (gross of fees & certain income accruals)

April 30, 2010

Current Value of the Fund	\$ 1,129,613,497
Investment Change in Market Value FYTD	\$ 232,924,478
Net Contributions FYTD	\$ (20,822,426)
Fiscal Year-to-Date Returns	25.5%
Month-to-Date Returns	1.8%

	<u>Apr-10</u>	<u>Fiscal Year to Date</u>	<u>Last Five Years</u>
Total Fund	1.8%	25.5%	6.3%
Benchmark	1.3%	24.1%	4.5%
Total Fixed	1.2%	6.5%	5.5%
Benchmark	1.0%	6.9%	5.4%
Total Equity	2.0%	33.7%	5.7%
Benchmark	1.6%	31.6%	3.6%
Domestic Equity	2.8%	37.9%	5.1%
Russell 3000	2.2%	33.3%	3.3%
Global Equity	-0.6%		
MSCI ACWI	0.2%		
Int'l. Equity	-0.3%	21.8%	8.1%
MSCI ACWI ex-US	-0.9%	25.0%	4.7%

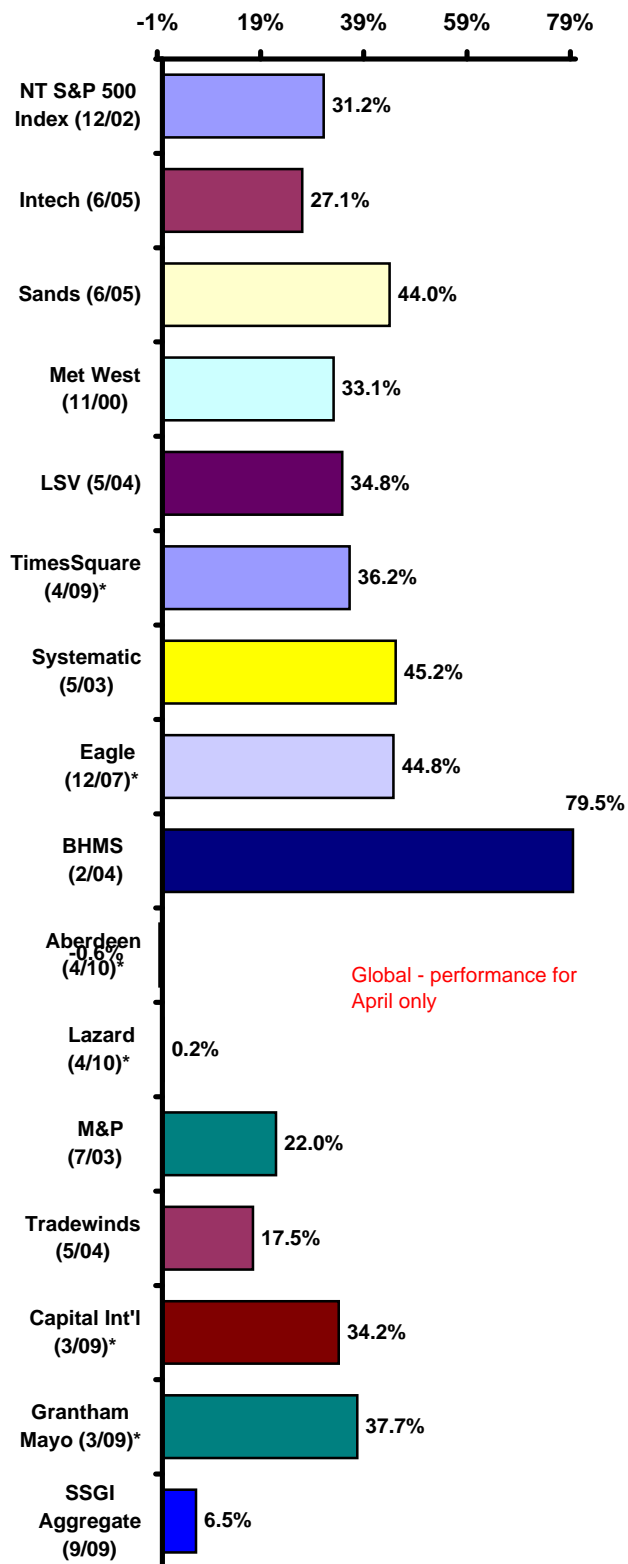
	<u>Mkt Value</u>	<u>% Alloc</u>
Domestic Equity	\$ 592.2	52.4%
Large Cap	\$ 401.9	35.6%
Mid Cap	\$ 125.2	11.1%
Small Cap	\$ 65.1	5.8%
Global Equity	\$ 50.0	4.4%
Int'l Equity	\$ 174.7	15.5%
Fixed Income	\$ 301.8	26.7%
Cash	\$ 10.9	1.0%
Total Fund	\$ 1,129.6	100.0%



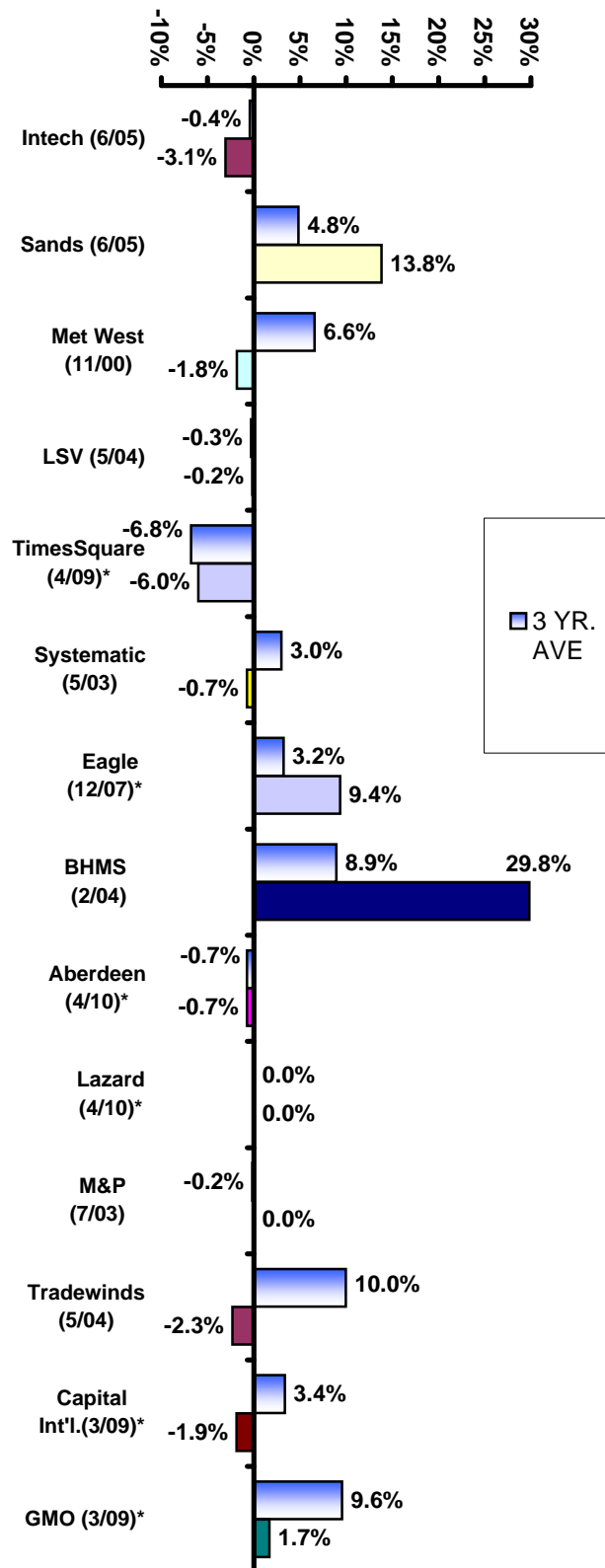
Endowment Fund Staff Comment:

The fund was up 1.8% for the month, 0.5% over benchmark. The Russell 3000 index was up 2.2%, Russell Midcap up 3.8%, and Russell 2000 (small cap) up 5.7%. International equities (MSCI ACWI ex-US) were down 0.9% for the month, and Emerging Markets up 1.2%. Value outperformed growth this month and international outperformed domestic equity. Bonds, as measured by the BC Aggregate index, were up 1% and TIPS up 2.4%. Six of 14 active managers beat their benchmark. On a Fiscal YTD basis the fund is up 25.5%, 1.4% over benchmark. Four 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.



Semi-Annual Report to the Board of Land Commissioners

From the Endowment Fund
Investment Board

May 18, 2010

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Mission

Endowment Fund Investment Board

**Provide professional investment
management services to our
stakeholders consistent with
our constitutional and statutory
mandates.**

Source: EFIB Strategic Plan

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Endowment Fund Investment Board Endowment responsibilities

- Determine investment policy
 - Asset mix
 - Allowed and prohibited investments
- Recommend allocation of Earnings Reserve (i.e. Distribution Policy) to the Land Board
- Select and monitor investment managers, consultants and custodian
- Select and direct staff

Source: Land Board Asset Management Plan ³

Who is the Endowment Fund Investment Board?

- Nine members, appointed by the Governor, confirmed by the Senate
 - One Senator, one representative
 - One professional educator
 - Six members of the public familiar with financial matters
- Meets at least quarterly
- Full-time staff of four

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Endowment Fund Investment Board members

Dean Buffington

Partner,
investment firm,
attorney



Gavin Gee

Director, Dept.
of Finance,
attorney

Max Black

Retired
insurance
agent,
legislator



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Endowment Fund Investment Board members (page 2)

Vaughn Heinrich

Retired Supt. Of
Vallivue School
District

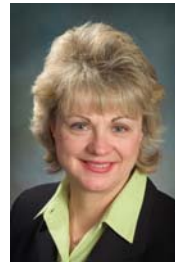


Tom Kealey

Business-
man, inves-
tor, former
MK CFO

Sue Simmons

Dept. of Labor
Project
Manager, CPA



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Endowment Fund Investment Board members (page 3)

**Richelle
Sugiyama**
Investment
Officer, PERSI



**John
Taylor**
Insurance
company
executive

**Chuck
Winder**
Senator, real
estate broker



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Financial Summary Nine Months Fiscal Year-to-Date 2010

Compared to the previous year end:

- Total fund balances increased \$193 million, or 21%, to \$1,114 million
- Earnings reserve balances increased \$24 million, or 15%, to \$177 million

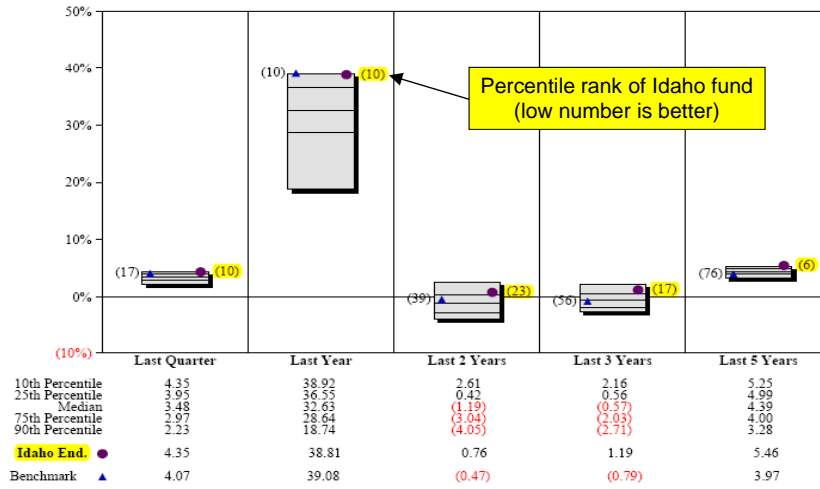
Receipts from endowment lands for the first nine months declined to \$35 million, a 36% decrease over the same period of FY2009

Total investment return, net of fees, was 23.3% for the first nine months and 5.5% annualized for the last five years. This is 120 basis points ahead of benchmark for the first nine months and 150 ahead for the last five years.

FY2010 financial statements of the endowment funds will be distributed to the Land Board in October and the results of the independent audit presented at the November meeting.

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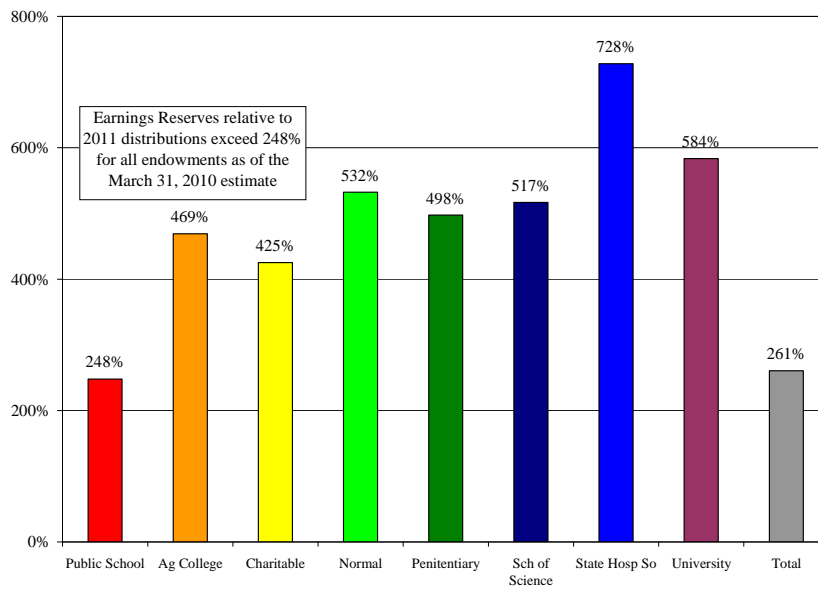
Idaho Endowment vs. Other Public Funds – March 2010



Source: Callan, EFIB staff

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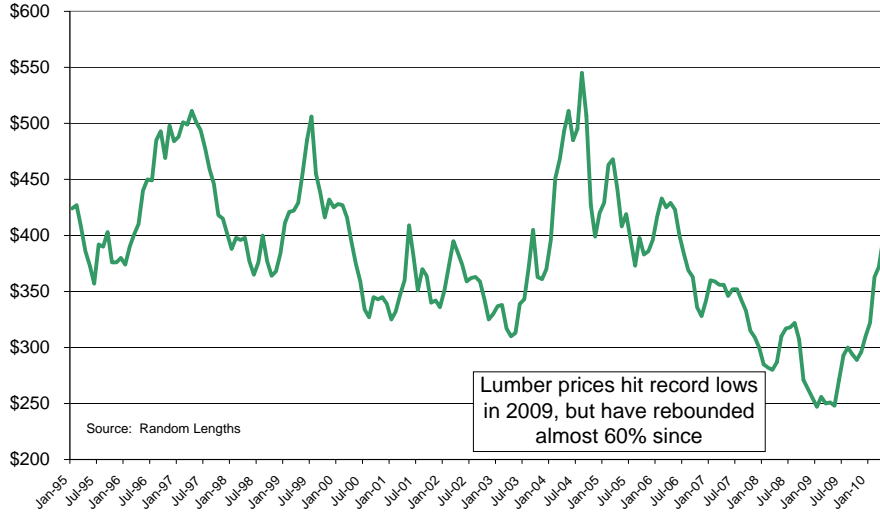
Coverage Ratio March 31, 2010



The Public School and Total ratios are adjusted for the one-time \$22 million distribution in FY2011

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Inland Lumber Price Monthly - 1995 Thru April 2010 (\$/MBF)



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Distribution Policy Discussion

Land Board

May 18, 2010



Objectives of today's Presentation

- **Describe rationale** behind current Distribution Policy, specifically:
 - Target level of earnings reserve (5 years)
 - Transferring excess reserves to the Permanent Fund
 - 5% distribution rate
- **Obtain feedback** on additional analysis or options the Land Board would like the EFIB to consider
 - Objective: Confirm or revise current policy by July 20 meeting (in preparation for setting the FY2012 distribution on August 17th)

Mission of Idaho Endowments: Provide a perpetual stream of income by:

- ❖ Maximizing total return over time at a prudent level of risk
- ❖ Protecting future generations' purchasing power
- ❖ Providing a relatively stable and predictable payout

Source: Land Board Asset Management Plan, EFIB comments

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Key Policies – Current Land Board Asset Management Plan

- 1) Mission statement for the endowments
- 2) Fund investment policy (70%/30%)
- 3) Criteria for determining distributions
- 4) Priorities for endowment distributions
- 5) Rate of annual distributions (5%)
- 6) Desired level of reserves (5 years)
- 7) Excess reserves may be transferred to the Permanent Fund

Each of these must be reexamined if excess reserves are used for special distributions

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Approved Land Board Distribution Policy (adopted July, 2008)

- Distribute approximately 5% of the value of the Permanent Fund each year
- Maintain an Earnings Reserve balance equal to five years of distributions
- Transfer excess reserves to the Permanent Fund each year

The EFIB recommends no changes to the current policy

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Land Board serves as independent trustees for fund beneficiaries

Why does a grantor place trust assets under the control of an independent trustee? It is often because the creator of the trust (in this case the U.S. Congress and the drafters of the Idaho Constitution*), has **concerns that the beneficiary will spend funds too quickly and neglect long-term needs**. Rather than hand control over to the beneficiary, the creator entrusts the assets to an independent fiduciary, who can **make decisions from an arms-length**; a trustee who has a sacred duty (and a personal legal liability) to **consider both current and future recipients**.

Trust and endowment beneficiaries seldom have enough current income to satisfy their desires. Therefore, the **current recipient is conflicted** in representing the needs of the future recipient. That is the reason individuals or entities create trusts – to have an independent third party be the **impartial gatekeeper** who can manage the funds to protect the interests of both current and future beneficiaries.

*Constitutional structure confirmed by Idaho Citizens in 1999 election

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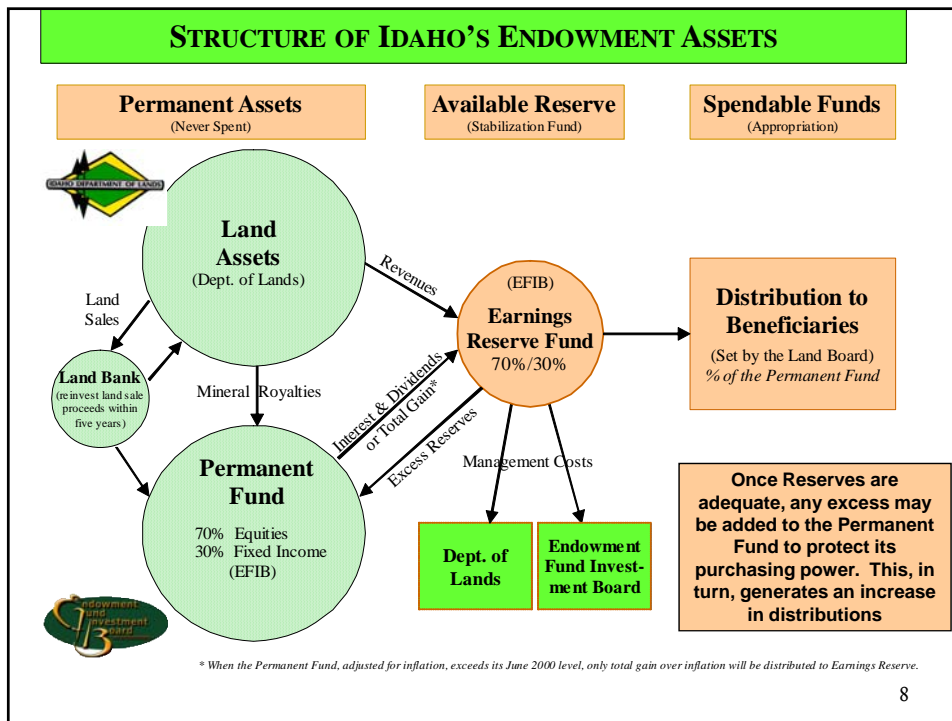
Land Board must consider multiple factors

A prudent trustee must consider both investment policy and distribution policy, taking a **multifaceted, integrated view**:

- Investing in markets that provide **growth** over many years
- Maintaining **liquidity** to make annual distributions
- Establishing a **method to allocate earnings** that:
 - **Does not starve current beneficiaries** to achieve unwarranted fund growth, while, at the same time,
 - **Retains sufficient income** to maintain future purchasing power

Before making a change in one factor, a prudent fiduciary must consider the **long-term impact on all other aspects** of their responsibilities, consistent with their role as an **impartial, third-party gatekeeper**.

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1st Topic: Level of Earnings Reserves

- Purpose of Earnings Reserves: A Shock Absorber
 - Mechanism to **allocate benefits** between current and future beneficiaries
 - **Stabilize distributions** to beneficiaries

Reserve levels are particularly important when the fund eventually exceeds its “Gain Benchmark”
Significantly **increases the volatility** of income, requiring **higher reserve levels** to buffer volatility

- We have **little control** over when a fund will achieve its gain benchmark – driven primarily by the market
- We have **no experience** managing the fund under these new conditions – unexpected problems could arise

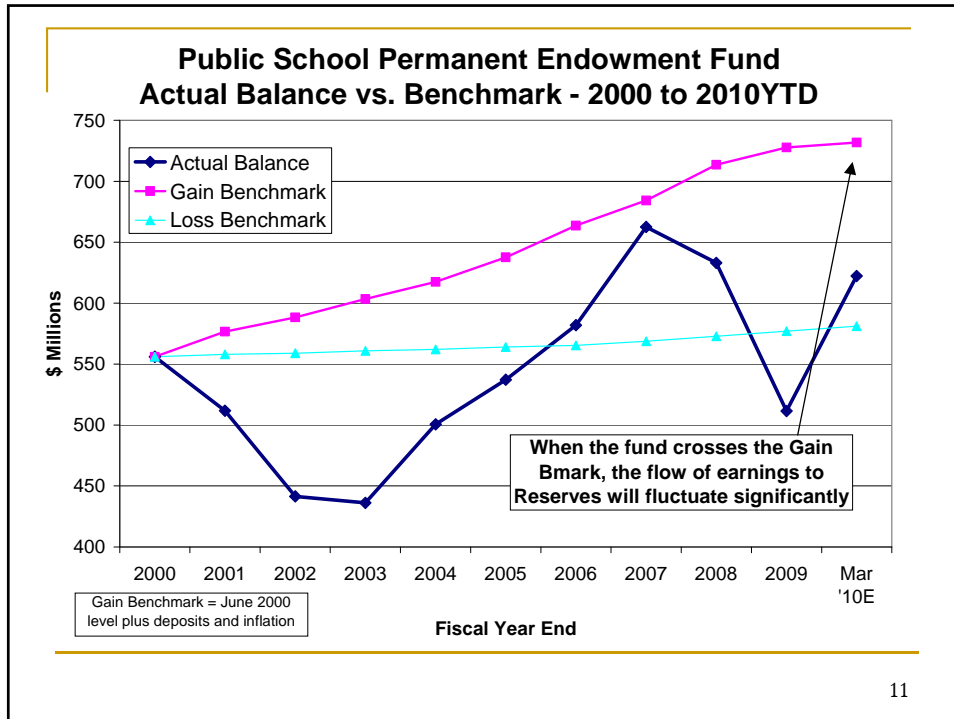
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Crossing the Gain Benchmark

- In 2003, a statute was enacted to further **protect Permanent Funds from losses**
 - Pub School fund loss must be made up after 10 years
- When the permanent fund reaches its June 2000 level (adjusted for inflation) interest and dividends no longer flow automatically to reserves each year
 - Instead, the total gain above inflation goes to the reserves
 - In loss years, any **cash income is retained by the permanent fund** to boost/protect long-term corpus
- Once every 25 years, we can expect **cumulative losses to extend for 5 years** or more
 - **No investment income** to reserves for 5 years
 - Requires a larger reserve
 - If a fund crosses the benchmark with only one year of reserves, the **chances of a catastrophic failure are significant**

State Hospital crossed the Gain Benchmark in FY2009 – no other endowments are expected to do so thru FY2010

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- ## Callan's recommendation on level of reserves
- Based on a 2008 simulation of variations in land revenue and fund returns, to prevent a reduction, Callan recommended the EFIB set reserves at:
 - 3 years for Normal Sch., State Hospital and Sch. Of Science
 - 4 years for the other 5 endowments
 - Forecast done with 95% certainty – a budgeted shortfall would only arise 1 year out of 20
 - Zero chance of a reduction in, or interruption of, an already approved distribution
 - Forecast assumed all endowments would soon exceed their Gain Benchmark – results in a need for additional reserves to protect distributions
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**Annual Cash Revenues
Public School Endowment Fund
2001 to 2010 (millions of dollars)**

	History										Forecast	
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010F		
Cash Revenues (net of management cost)												
From the land *	28	29	24	37	26	33	30	21	17	8		
From the fund **	20	10	8	10	11	13	17	19	16	10		
Total	48	39	32	47	37	46	47	40	33	18		

** Cash earnings from timber sales, leases, etc, less management expenses of the Dept. of Lands

** Interest and dividend income less the management expenses of the EFIB

Total cash revenues to the reserves have exceeded the current distribution of \$31.3 mill./year every year in the last 10 years except in 2010

However, if fund revenues had not been available (if the fund was above the Gain Benchmark), then land revenues alone would have exceeded the current distribution only twice in 10 years, hence Callan's recommendation for multiple years of reserves

EFIB modifications to Callan's recommendation

The EFIB recommended the Land Board adopt 5 years of reserves, recognizing:

- The weakness of statistical analysis to handle unusual negative events
- The desire to reduce the chance of a budgeted shortfall to 1 in 30 years (97% confidence)
- A desire to provide more advance warning of a potential reduction in distributions

Land Board Policy Recommendation re: Reserves

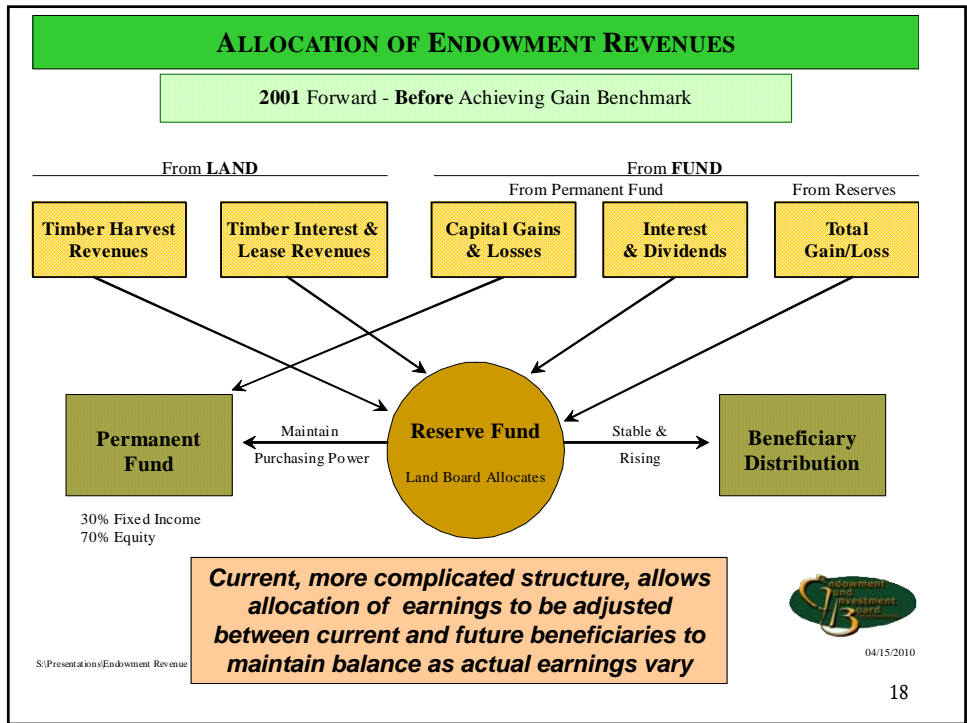
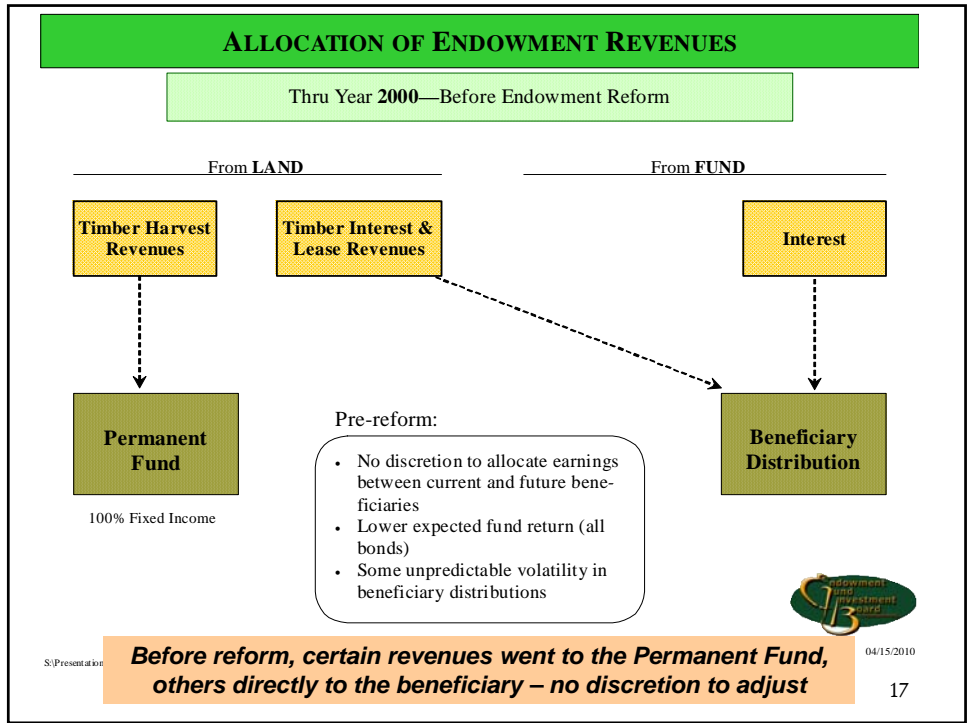
- The EFIB continues to recommend 5 years of reserves
 - Conservative and reasonable, given that the flow of income changes after the Gain Benchmark is reached
 - Provides a sufficient shock absorber to protect distributions from variations in revenues

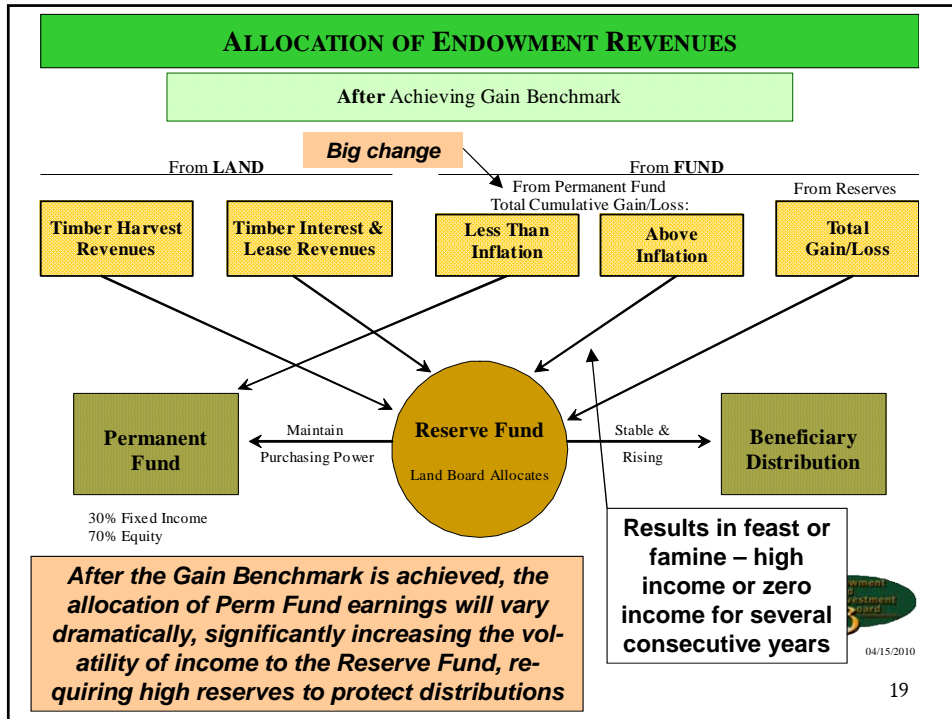
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2nd topic: Why excess reserves should be transferred to the Permanent Fund

- Who owns the reserves? They are shared by both current and future beneficiaries, serving to absorb shocks in actual revenues
 - If revenues fall below distributions (like in 2009), reserves go to the current beneficiary
 - If reserves are “full”, excess reserves go to the future beneficiary to make up losses and protect purchasing power once the current distribution is secure
 - Automatically drives an increase in the sustainable distribution to the current beneficiary
- Land Board has discretion to allocate reserves to ensure balance between current and future
 - A key component of endowment reform in year 2000

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If excess reserves aren't regularly transferred to the Permanent Fund...

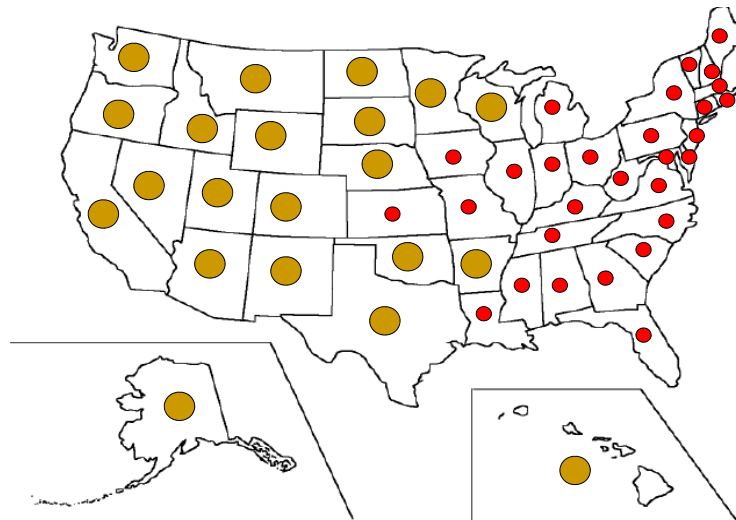
- The ability to grow future distributions and sustain purchasing power will be severely compromised
 - Some income must be reinvested in the Permanent Fund to make up for inflation and population growth
 - A stagnant Permanent Fund increases the likelihood that the Public School Fund will fall into a loss position that the legislature will be required to make up from the General Fund
 - Threatens the current/future balance by no longer tying higher distributions to increases in the Permanent Fund

Protecting Future Taxpayers (and future Land Boards)

- If excess reserves are not transferred, but allowed to accumulate, in 10 years endowments could have over 10 years of reserves
- In the next major downturn, faced with either a tax increase or a raid of excess reserves, citizens would put terrific pressure on the Land Board to trade short term relief for long term pain
- Many states no longer have endowment assets because there was past taxpayer pressure to draw down the asset, much to the detriment of today's taxpayer

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Only 21 states still have school endowment assets, and only about half of those have maintained the purchasing power of those assets



● Endowment Assets

● No Endowment Assets

Source: CLASS, EFIB staff

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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.

One-time distributions fundamentally change priorities – reductions become certain, future purchasing power becomes less certain

Source: Land Board Asset Management Plan, EFIB comments

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EFIB recommendations regarding transfers to the Permanent Fund

- Maintain the current practice of regularly transferring excess reserves
 - Ensures balance of current & future beneficiaries
- Avoid any policy or practice of retaining excess reserves for special distributions
 - If the possibility exists to use reserves for special distributions, that will:
 - Dramatically increase the complexity of the distribution process
 - Require that all current policies and management guidelines be reexamined and redesigned
 - Investment horizon shortens, liquidity needs increase

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3rd Topic: Distribution rate at 5% of the Permanent Fund

- The EFIB recommended the 5% rate based on:
 - The Land Board's approved objective of growing distributions and reserves faster than both inflation and population growth
 - Retaining income to allow both reserves and the permanent fund to grow to target
 - Not depending on both fund returns and land receipts to achieve expected levels

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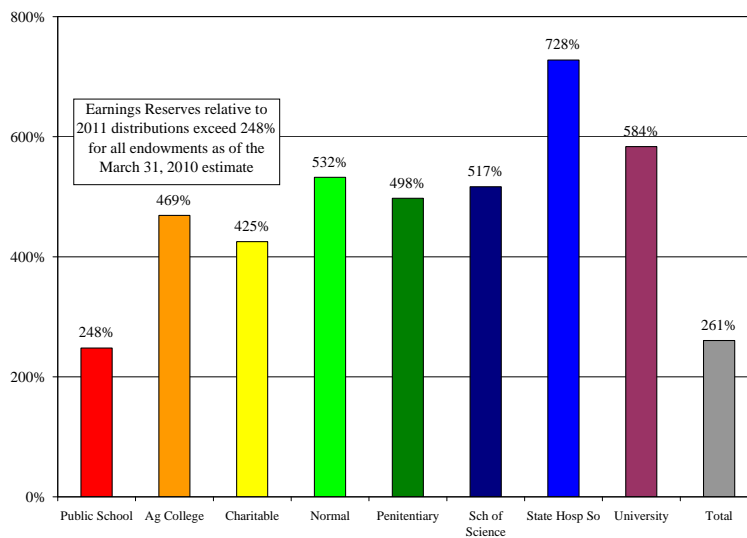
Summary EFIB Recommendations

- Maintain current approved priorities
 - 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
- Maintain current approved investment policy
 - Distribute approximately 5% of the Permanent Fund
 - Hold five years of reserves
 - Transfer excess reserves to the Permanent Fund

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Appendix

Coverage Ratio March 31, 2010



If coverage remains at March levels, four of eight endowments will transfer reserves to their Permanent Fund at fiscal year end

ESTIMATED ENDOWMENT DISTRIBUTIONS - FY2012

(\$ in millions)

	Total	Public School	Ag College	Charitable	Normal Schools	Penitentiary	School of Science	State Hospital South	University
Permanent Fund Value									
3-Year Average	869.4	589.0	16.5	55.3	50.1	20.4	55.9	37.3	44.9
Distribution % Per Policy	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
FY 2009 Distribution	42.4	29.7	0.8	2.8	2.5	0.8	2.3	1.3	2.2
FY 2010 Distribution	45.7	31.3	0.9	3.0	2.7	1.0	3.0	1.5	2.3
FY 2011 Normal Distribution*	45.8	31.3	0.9	3.0	2.7	1.0	3.0	1.7	2.3
2012 Distributions									
5% formula, no xfer to Perm Fund	43.5	29.5	0.8	2.8	2.5	1.0	2.8	1.9	2.2
No reduction, with xfer to Perm Fund	46.1	31.3	0.9	3.0	2.7	1.0	3.0	2.0	2.3
% Change vs. 2011 Distribution									
5% formula, no xfer to Perm Fund	-5.1%	-5.9%	-3.2%	-6.6%	-5.8%	-2.1%	-6.3%	12.0%	-3.5%
No reduction, with xfer to Perm Fund	0.7%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	18.7%	0.5%
Years of Reserve (3/10)									
Adequate Years of Reserve (policy)	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
5% formula, no xfer to Perm Fund	4.1	3.4	4.8	4.6	5.7	5.1	5.5	6.5	6.0
No reduction, with xfer to Perm Fund	3.7	3.2	4.7	4.3	5.0	5.0	5.0	5.0	5.0
Earnings Reserve Balance (3/10)									
	176.7	99.6	4.0	12.6	14.2	5.2	15.4	12.1	13.6
Transfers to Permanent Fund	5.5	0.0	0.0	0.0	0.9	0.0	0.5	2.2	1.9
% of Earnings Reserve	3%				6%		3%	18%	14%

* Excludes a \$22 million one-time distribution from Public School

If year end 2010 balances = March's, then FY2012 distributions will rise for two endowments and four will have transfers

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Distribution of Public School Endowment Earnings FY2001-FY2011 (est)

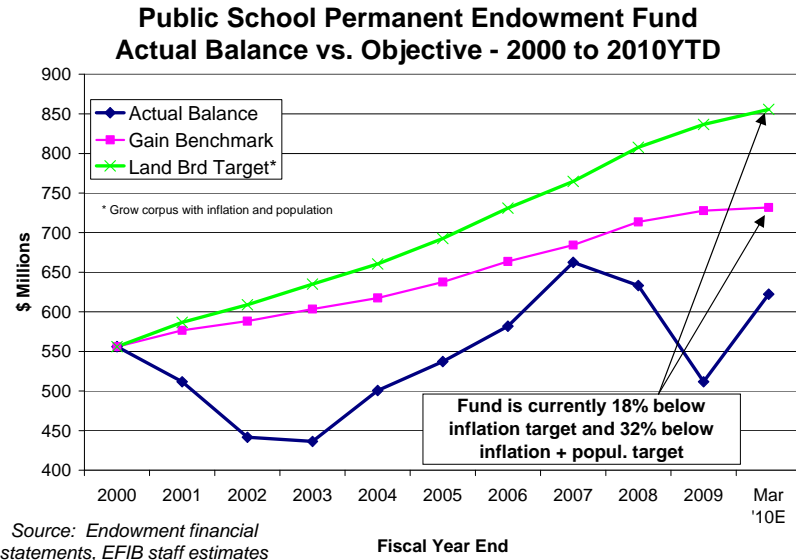
	With One-Time Distribution
(millions of dollars)	
Balance FY2000	555
Net Income 2001-2011	
Lands	268
Fund	249
Total	517
Distributions	(372)
Balance FY2011 (est)*	700
% Income Distributed	72%

* Based on "Low" income forecast for FY2010-'11 with fund balance @ 3/10.
Permanent Fund balance is \$622 million, Earnings Reserves are \$99 million

Current policy assumes roughly 50/50 split of long-term earnings between current and future beneficiaries. For the 11 years ending in FY2011, an estimated 72% of earnings will have gone to current beneficiaries.

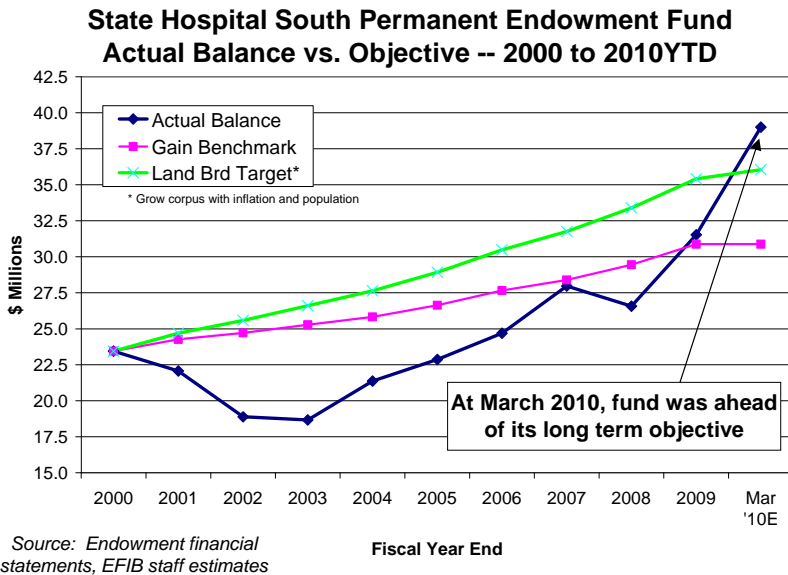
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Since 2000, the Pub School Perm. Fund has not kept up with long-term objectives



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Because high land income has been transferred, State Hosp. South has met its objectives



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Return expectations for the next 30 years...

Expected Long Term Income Endowment Fund Average

Gross fund return	7.8%
Less: management exp.	<u>-0.4%</u>
Net fund return	7.4%
Contributions from land	<u>2.6%</u>
Total Earnings	10.0%
Less: Distributions*	<u>-4.0%</u>
Available for reinvestment	6.0%
Expected inflation	<u>-2.8%</u>
Real growth in the fund	<u>3.2%</u>

* As a percent of the total fund; essentially equivalent to 5% of the Permanent Fund

Source: EFIB staff, Callan

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