MEMORANDUM

OFFICE OF THE ATTORNEY GENERAL

To:	Idaho State Board of Land Commissioners
From:	Lawrence Wasden, Attorney General
cc:	Irving Littman, Reinvestment Subcommittee Member
Date:	Monday, May 11, 2020
Re:	Minority Report of Attorney General Wasden, Member, Land Board Reinvestment Subcommittee

The following Minority Report is prepared to summarize the history of the Board's decisions concerning investment policy and the discussions of the Reinvestment Subcommittee; analyze the recommendation of the Majority Report and make an alternative recommendation and motion to the Idaho State Board of Land Commissioners. This is a lengthy report because I have attempted to coalesce the testimony presented to the Board and the Subcommittee in one place. Accordingly, I will begin with a summary of the report and my alternative recommendation.

SUMMARY AND RECOMMENDATION

The purpose of the Reinvestment Subcommittee was to examine whether the analysis and recommendations of the 2016 Strategic Reinvestment Plan as reaffirmed by the Land Board at its July 2018 meeting remained valid, or whether changes in market conditions required a different reinvestment strategy. During the course of five separate meetings of the Reinvestment Subcommittee over the course of eleven months, no testimony from Callan & Associates (Callan), EFIB director Chris Anton, or any other expert, reflected any change in the underlying rationales or analysis that supported the 2016 or 2018 decisions of the Land Board. Indeed at the March 12, 2020 meeting both Callan and EFIB Director Anton reaffirmed that the analysis and recommendations of 2016 and 2018 remained valid.

Despite the lack of any expert testimony or information to suggest a change in the investment strategy, a majority of the Reinvestment Subcommittee voted on April 10, 2020 to recommend to the Land Board that $50,000,000.00 of the funds currently held in the Land Bank be invested in the Permanent Fund. Notably, at no time did any expert recommend this to the Subcommittee either as to the amount, nor as to whether doing so was in the best long term financial interests of the endowments as compared to purchasing land assets. In fact, the only testimony presented during these proceeding concerning the future performance of the permanent fund was that Callan's market expectations were either lower for the permanent fund than in past years or would remain unchanged.

> **Ms. Becker-Wold**: Right. And as I mentioned earlier, and I think this is an important thing for us to consider, is that we do an asset allocation update for the Endowment Fund Investment Board annually, to sort of re-benchmark what our current forward ten-year look is. So that is probably up for adjustment, because as the capital markets have outperformed so dramatically, our expectation now going forward is going to be lower for the endowment fund, which means that the hurdle rates should also be adjusted at some point as well. We haven't done that work, and we haven't even completed our expectations for this year yet, but I'm thinking that given the fact that the capital markets have done so well, the equity returns could come down a little bit. We try to do that every year on the endowment fund, so we can make adjustments if we need to. We don't generally make big adjustments, but that's possible, yes.

Minutes of October 10, 2019, Reinvestment Subcommittee Meeting at pg. 11 (emphasis supplied). (TAB 1); See also Minutes of March 12, 2020, Reinvestment Subcommittee Meeting at pg. 7. (TAB 2).

No testimony or analysis presented over the course of the meetings supports the Majority Recommendation. And, indeed, the Majority Recommendation is actually counter to the testimony of Chris Anton to the Reinvestment Subcommittee.

> **Mr. Anton**: As I look at the Callan study that was published in 2018, it really provided the Land Board with a framework to evaluate land acquisition opportunities that were presented from the Department of Lands. Essentially it said that if the opportunity presents a real return of less than 3.5%, it makes sense to put it in the financial assets. If it presented a return between 3.5 and 4.5%, it is somewhat indifferent, although it recommended that if we increased our reserves, as you're closer to the 3.5% end of that range, the financial assets are probably preferable; because we have higher reserves we can withstand a little more volatility. As you move out closer to 4.5%, or above 4.5%, the study recommended considering timberland investments. Again, looking at it from a whole trust perspective, the idea is that if we have opportunities that provide solid returns that are more stable from timber that makes sense from a whole trust perspective. I think the analysis that they did still makes a lot of sense, that we have to be disciplined, that the Land Board would evaluate any opportunities that were brought forward; we would also have to look at any synergies. I look at us as a strategic buyer. We're in the timber business. We have substantial holdings that if a land acquisition also enhances the returns from our other property it can provide other benefits. We feel at EFIB that we should give the Department of Lands that opportunity that the Land Bank provides to look at opportunities. I think there was always an understanding that if the Department of Lands said there weren't opportunities, or there weren't complete opportunities that spend all of that money, we could certainly transfer the money sooner into the financial portfolio. I think that the model Callan developed, from my perspective, made a lot of sense.

Minutes of March 12, 2020, Reinvestment Subcommittee Meeting at pg. 3 (emphasis added).

The Majority Recommendation thus ignores a fundamental premise of endowment fund reform and the policy of the Land Board to seek out and rely upon expert opinion rather than ad hoc decisions by elected officials. In these uncertain times, it is more important than ever that we adhere to this principal. As our world faces a global pandemic which as of May 7, 2020 has killed approximately 263,268 people worldwide and wreaked havoc on the world economy, we should be ever more cautious about how we make investment decisions.

At the April 10, 2020 meeting, I made and continue to support, an alternative recommendation to the Land Board which comports with Land Board policy to seek out and rely upon the expert advice of professional advisors. To wit:

> At its July 2018 meeting, the Land Board adopted what is known as Option A. Essentially, Option A provided that the Board, consistent with the reinvestment plan, identify transactions that meet the established hurdle rates and set aside sufficient funds over an appropriate time horizon, and in fulfillment of the scope and purpose of this subcommittee to examine that decision and make recommendations to the full Board, I make a four-part motion:
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> > 1) That the full Board stay the course on Option A in order to maintain the Board's flexibility in applying funds to either land or financial investments;
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> > 2) The full Board request Callan to review the efficacy of the hurdle rates;
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> > 3) Recognizing that our normal processes for investment require our seeking advice from our retained experts, that the full Board also request Callan and EFIB to review current market conditions and report to the full Board at its next monthly meeting and make any recommendations concerning investments in current financial markets;
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> > 4) That the Department of Lands prepare a letter of transmittal to the full Board outlining the subcommittee's recommendations, and I offer Darrell Early to assist the Department in preparing that letter .

See Meeting Minutes of April 10, 2020 Reinvestment Subcommittee (TAB 3).

This recommendation adheres to the adopted decisions of the Land Board as recommended and supported by our retained consultants in 2016 and 2018 because there has been no change in the information or analysis which supported those decisions. Importantly, however, it does not rule out the possibility of transferring Land Bank funds to the Permanent Fund, but instead allows for IDL to retain the flexibility to acquire land assets that will meet or exceed the established and validated hurdle rates <u>or</u> to transfer money to the permanent fund if our expert consultants identify that it will be in the long term best financial interests of the endowments. Until such a decision is endorsed by our investment advisors, however, the funds should remain available for land acquisition.

I encourage my fellow Land Board members to consider this minority report and recommendation.

DISCUSSION OF CONSTITUTIONAL & LEGAL OBLIGATIONS OF THE LAND BOARD

At the October 10, 2019 and November 13, 2019 meetings of the Reinvestment Subcommittee, the Office of the Attorney General submitted testimony concerning the fiduciary responsibility of the Land Board and other legal constraints upon the Board's actions. (TABS 4 & 5).

The Land Board is the "epitomic public trustee" bound by a fiduciary duty to fulfill the constitutional purpose of the trust to maximize long term returns to the beneficiaries. The fiduciary duty of the Board consists of two principals: Undivided loyalty and prudent business judgment.

Undivided loyalty requires the Board to reject any considerations other than those of the stated purposes of the trust which is the maximum long term return to the endowments. This principal is embodied both in the general law of trusteeship and reflected in the *Idaho Watersheds* decisions.

Prudent business judgment requires the Board to exercise the degree of skill and care that an ordinary prudent investor would in the course of their private affairs. A concomitant feature of this rule, as reflected in Land Board policy is, that in making decisions, the Board should seek out and rely upon the advice of experts. Known as the "prudent expert rule" the policy requires:

> This additional step would engage outside consultants and experts hired directly by the Land Board with the assistance of the Endowment Fund Investment Board to provide an independent review and confirmation of information and recommendations to the Land Board prior to any major investment decisions. These additional agents would also be responsible for measuring, monitoring, and reporting on those IDL investment activities to assure progress toward the investment goals and maintenance of procedures and standards at the expert level in investment management.

See R. Maynard, Endowment Fund Reform Progress Report, December 6, 2013 at 2-3 (TAB 6); Minutes of the December 17, 2013, Land Board Meeting at 4-5 (TAB 7).

<u>CHRONOLOGY OF REINVESTMENT DECISIONS AND DOCUMENTS:</u>[1]

Decisions concerning investments are, first and foremost, governed by the Board's adopted "Statement of Investment Policy" which states that the goals of investment are:

- Maximize long-term financial return at a prudent level of risk.
- Provide relatively stable and predictable distributions to the beneficiaries.
- Constrain distributions to protect future generations' purchasing power.
- Maintain sufficient liquidity for anticipated expenditures.

July 17, 2018, Statement of Investment Policy pg. 3. (TAB 8)

In 2014 Callan was retained by the Land Board to (among other things) conduct an asset allocation study incorporating the IDL-managed land assets with the financial assets. *Minutes of May 22, 2014, Land Board Meeting at 5 (TAB 9).*

The report was submitted to and approved by the Land Board in November 2014. *Minutes of November 18, 2014, Land Board Meeting at 4 (TAB 10).*

As part of the Asset Allocation study, Callan recommended a range of investment split between the financial assets and the land assets. Callan recommended a range for timber between 30% and 50%. At the time in 2014, timber was approximately 39% of the total portfolio. *2014 Asset Allocation and Governance Review: Pg. 27 (TAB 11).*

Callan concluded in 2014 that investment in timberland could be increased if IDL could obtain parcels that performed at least as well as the existing inventory.

> Timberland is a desirable investment across the range of asset mixes reviewed. Timberland has an attractive forecast return for the anticipated level of risk and diversifies other asset classes well. Consequently, the unconstrained computer model specified an allocation to timberland at or above its current level for all asset mixes evaluated. The model suggest that timberland investment could be expanded if the acquired properties are expect to perform at least as well as the existing timberland.

2014 Asset Allocation and Governance Review: Pg. 4

> In all asset mixes IDL timberland has an allocation at least as large as its existing allocation. Consequently, we would not recommend reducing the overall timber portfolio. Unconstrained, allocations to timberland are higher suggesting the allocation could be expanded. It is important to recognize that this is only the case if new investments are expected to perform at least as well as the existing

[1] This chronology starts in 2014, but the issue of managing the land assets as part of a "whole trust" concept started long prior. For a detailed chronology of this, see "Overview of Land Board Endowment Reform" by Clive Strong.

> timberland. Expanding timberland for the sole purpose of meeting an unconstrained allocation is not recommended.

2014 Asset Allocation and Governance Review: Pg. 31

At the December 15, 2014 Land Board meeting the Board voted to establish an Investment Subcommittee. The members of the subcommittee are one EFIB Board Member, the EFIB Manager, and the Director of the Idaho Department of Lands. *Minutes of December 15, 2014, Land Board Meeting* at 6. The subcommittee was directed to "to develop a draft policy (consistent with Idaho Code Section 58-1333) regarding proceeds from the disposal of assets (e.g. cabin sites, commercial real estate, grazing land) utilizing the Land Bank Fund to hold a portion of the proceeds to be used for land acquisition (excluding commercial buildings), and to purchase access to currently owned endowment lands and to block up ownership of endowment lands." *Id*.

The Investment Subcommittee met several times and at the May, 2016 Land Board meeting IDL recommended adoption of the "Strategic Reinvestment Plan" that had been developed by Callan and the Investment Subcommittee: *Minutes of May, 17, 2016 Land Board Meeting at pg. 7 (TAB 12).*

At the time of the 2016 Strategic Reinvestment Plan, Timberland remained at 39% of the total endowment portfolio. The Strategic Reinvestment Plan had the following conclusions.

- Callan recommends pursuing additional investment in timberland in Idaho provided investment can be sourced with appropriate net returns.
- Additional investment is supported by the asset allocation study which indicates portfolio risk/return will be maintained with additional investment in timberland provided new investments have a net projected returns at or above the returns of the existing portfolio with a similar level of risk. In Callan's study, the existing timberland portfolio had an expected net 10 year composed return of 5.70 (3.45% net real return). The recommend Hurdle Rate for Timberland is a minimum net real return of 3.5% which equates to 5.75% net nominal return, assuming 2.25% inflation. The risk profile of each transaction and market dynamics will dictate the return that will be require, such that some transaction may have returns above the hurdle Rate.
- Callan does not recommend setting a hard target for the amount of dollars to be invested, but rather allowing the investment decision to be driven by the opportunities. The range for timberland is 30-50% of the total endowment portfolio if attractive opportunities are found, all of the projected proceeds in the Land could be invested in timberland and timberland would remain in the target 30-50% range, assuming the total portfolio remains at or above the current value.
- Investment in additional timberland is a way to replace lost income from the sales of cabin sites and commercial real estate.
- Market dynamics in the Timberland industry included increasing transaction flow. There have been several large intuitional portfolios of timberland brought to the market in the U.S. Several closed–end commingled funds are nearing their expiration, which will result

in timberland for sale. Additional multiple timberland investment organizations are undergoing changes which could result in additional deal flow from manager disruption and terminated vehicles. The environment with substantial availability of properties for sale and projected to be for sale may help to moderate pricing. The availability of transactions is in marked contrast to prior years and the Land Board should take advantage of the increased transaction flow.

- This is an unusual time for the Endowment due to the amount of disposition activity taking place. Based on the current Asset Management Plan, it does not appear that after FY 2020, there will again be the level of proceeds to invest in land. Therefore, the Land Board should consider using Land Bank proceeds to invest in Timberland and Farmland, provide the targeted Hurdle Rates can be met or exceeded and an institutional investment process is used.

Strategic Investment Plan p.g 6-7 (TAB 13). Callan further recommend that a detailed business plan be developed for the acquisition strategy. The Land Board approved and adopted the Strategic Reinvestment Plan. *Minutes of May 17, 2016 Land Board Meeting at pg. 6.*

In the summer of 2017 the Land Board directed Callan to further analyze the reinvestment of Land Bank funds as related to the smaller endowments based on a concern that perhaps the smaller endowments should be treated differently than the public school endowment. *See Minutes of July 5, 2017 Land Board Meeting at pg. 4-5 (TAB 14).*

In April 2018 Callan submitted its analysis which also included a review of the overall strategic reinvestment plan. By this time Timberland was approximately 34% of the Endowment Assett mix by class due to the growth of the financial investment. See *April 17, 2018 Asset Allocation and Distribution Study pg. 4 (TAB 15).* The 2018 study looked at several factors including the level of funding retained in Earnings Reserve and the reinvestment of land sale proceeds. The study recommended increasing Earnings Reserve to protect against financial market volatility due in part to the sale of residential cottage sites and commercial properties.

> "Focusing on cumulative real distributions, a financial investment results in greater distributions in the expected and better-case outcomes while land reinvestment protects in poor capital market environments. Land reinvestment generally provides equal or better protection relative to the financial assets in terms of preventing declines in distributions."

April 17, 2018 Asset Allocation and Distribution Study pg. 6.

The summary findings concluded:

- Depositing land sale proceeds into the financial asset portfolio is preferable under <u>recommended</u> (i.e. increased) reserve levels.
- Reinvesting land sale proceeds back into the lands is preferable <u>at current</u> earnings reserve levels.

The study further noted the "important role in dampening the volatility of the total Endowment over long time periods. *See April 17, 2018 Asset Allocation and Distribution Study pg. 30.*

If, however, the expected return on land investments increased toward 4.5% net real, land reinvestment becomes more compelling relative to the financial assets. *Id. at 31.*

At the May 2018 Land Board meeting, the Land Board approved the recommendation of the EFIB Board to increase earnings reserve levels for the endowments.

> Attorney General Wasden stated his understanding that the basis for this recommendation is two-fold: an analysis of the market by Callan, and the new asset mix that is a result of cottage site auction sales. Attorney General Wasden commented that the Board is contemplating potential risks and the ability to maintain constant payout to the beneficiaries. Mr. Anton agreed; given the expected decline in revenue from both investments and lands, in order to keep the same level of confidence in distributions it is appropriate to have larger reserve levels. Attorney General Wasden noted that the purpose of maintaining constancy in terms of distributions is to best serve the beneficiaries; they can count on that money rather than having some level of volatility which would cause them difficulty. Mr. Anton concurred; the beneficiaries rely on the annual distributions as a significant portion of their budgets, and the Land Board and Investment Board take seriously their roles in keeping distributions stable each year, if not increasing modestly.

See Minutes of May 15, 2018 Land Board Meeting pg. 6-7 (TAB 16).

At the July 2018 Land Board Meeting Callan and the IDL presented the final results of the Strategic Reinvestment Plan Update and the recommendation of the Investment Subcommittee. Consistent with the April Study, the Department and Callan presented three (3) options to the Land Board.

A. Option A "Consistent with the Reinvestment Plan, identify transactions that meet established hurdle rates and set aside sufficient funds over an appropriate time horizon (immediately move money that will either mature prior to the transaction or exceeds what is required).
B. Option B – Move land sale proceeds that are set to expire in calendar years 2020-2021 (approximately $58 million) into the Permanent Fund with the remainder contingent on IDL identifying land acquisitions consistent with the Strategic Reinvestment Plan.
C. Option C – Immediately transfer all Land Bank funds to the financial asset portfolio.

Minutes of July 17, 2018 Land Board Meeting pg. 3 (TAB 17).

Following presentation of the options, there was a robust discussion of the issue by members of the Land Board.

> Attorney General Wasden requested verification and assurance from the Department, from EFIB, and from Callan that the recommendation of Option A accomplishes two things simultaneously and that is—recognizing that the future cannot be predicted; there is no crystal ball—to the best of all parties' ability Option A is intended to accomplish reducing volatility in the endowments' overall investment portfolio at the same time as increasing returns, or the potential for reducing volatility and the potential for increasing returns. Ms. Kostka stated that is exactly the goal of the Department. Ms. Kostka mentioned another component intended to counter any volatility is the increase in reserve levels which was approved by the Board and is already being implemented. Regarding the financial portfolio, Mr. Anton remarked that during the February meeting Callan presented their capital markets assumptions and indicated that over the next ten years they expect gross returns of about 6.3%, net returns of 4.05%. In their study Callan said timberland investment is a good diversifier. If the Department gets similar real returns, because timber has lower volatility, it helps reduce overall volatility. It also provides similar and potentially greater returns if the Department finds opportunities above that hurdle rate. <u>EFIB's perspective is that the Board should preserve its flexibility during this five year period and allow the Department to find and identify opportunities as long as they meet or exceed the hurdle rate.</u> Governor Otter wondered what the motivation was for even considering Options B and C. Mr. Anton commented that the recommendation for B and C is they could potentially get similar returns on the financial assets but would likely have more volatility. Neither of those are bad options, the financial assets have been performing well; however, the Department has this unique opportunity to reinvest the money in timberland and it makes sense to preserve flexibility and look for transactions that provide substantial returns. Governor Otter suggested a cautious eye would look at Options B and C and conclude they were only included to validate Option A. Mr. Anton noted that Callan believes investing Land Bank money in financial assets is not a bad decision either. Generating 6.3% gross returns, 4% real returns, is a good option. Right now there is another option and that is to look at timber opportunities. Mr. Anton said Callan and EFIB agree that the Department should have the opportunity to look for reinvestment opportunities in timber and agricultural land. If the Department finds opportunities that meet the hurdle rate it will reduce overall volatility and enhance returns for the beneficiaries.

Minutes of July 17, 2018 Land Board Meeting pg. 5 (emphasis added). There was further discussion by Acting Director Groeschl concerning the effects on sustained yield for the total timber portfolio of additional timberland acquisitions.

> In addition to providing a stable revenue source, new timberland will increase the Department's sustained yield—not only is there sustained yield off the land base that is acquired, it also then increases the sustained yield off the existing land base because now it is looking at entire ownership. For example, one area has a sustained yield calculation of roughly 85 million board feet (MMBF) a year; if 20,000 or 30,000 acres is acquired with 15 MMBF on those acres, add those numbers and the sustained yield is 100 MMBF. But in running the model again, a third time, the sustained yield is actually 115 MMBF because what it does is now look at the entire land base and age/size class distribution

> and it gives an uplift on sustained yield across the entire land base. However, returns for acquisitions are only calculated on that acquisition, on what that land can produce, so it is conservative. Director Groeschl stated that the existing timberland base from the southern border of Idaho to the northern border of Idaho is returning about 3.9% net revenue. The Department is looking to acquire timberland in the strongest wood basket areas—good transportation, strong markets, competition—the return expectations for those acquisitions are higher.

Id. at 6. The Land Board voted unanimously to approve Option A. *Id. at 8.*

PROCEEDINGS OF THE REINVESMENT SUBCOMMITTEE:

The concept of the "Reinvestment Subcommittee" first came up at the April 2019 Land Board meeting after a presentation by Stimson Lumber regarding its concerns about the Strategic Reinvestment Plan and the "Packers 1" (Molpus) acquisition. Governor Little raised it as follows:

> For the record, Governor Little commented that he was not a member of the Land Board at the time the policy was put in place and proposed that a subcommittee of the Land Board review the current situation. Governor Little noted that EFIB reported earlier in the meeting that a request for proposal for an investment consultant is being advertised, and also noted that $200 million is a large sum of cash to be spending in a significant manner. Governor Little asked for volunteers to serve on a subcommittee of the Land Board to review the asset management plan [strategic reinvestment] going forward. Attorney General Wasden and Secretary of State Denney volunteered to serve on the subcommittee; Governor Little so ordered.

Minutes of April 16, 2019, Land Board Meeting at 8 (TAB 18).

The Committee was formally created at the May 2019 Land Board meeting:

> Land Board Subcommittee: Study of Reinvestment Strategy Discussion: Governor Little reported that following the last Land Board meeting, Attorney General Wasden and EFIB board member Irv Littman agreed to join the subcommittee to look at the current asset investment. Governor Little stated that given the magnitude of $240 million to reinvest, there is a need for absolute certainty in the plan going forward: that the net-net to beneficiaries is what the Board wants it to be in the long term, and that the Board complies with its obligation to maximize returns to the endowments in the long-term. Governor Little mentioned that Mr. Littman was a former chief financial officer of Boise Cascade who knows about timberland investment and is very capable in the securities and investment field.
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> Attorney General Wasden commented that he is pleased to serve on this subcommittee and that it will be beneficial to the entire Land Board. Attorney General Wasden shared some ideas to consider in terms of how the subcommittee's discussion is focused: what

are the Constitutional provisions and the legal aspects; what is the history–how did the Board arrive at its current strategic reinvestment plan; and what are the options going forward. Governor Little duly noted the Attorney General's suggestions.

Minutes of May 21, 2019, Land Board Meeting at 7 (TAB 19).

<u>JULY 10, 2019 MEETING</u>: In July 2019, the Reinvestment subcommittee held its first meeting which was largely formative in nature. No testimony was taken. Governor Little explained his purpose in asking for the Committee is "to have a higher comfort level in the strategy the Land Board is using to reinvest the enormous sum of money that will be available in the coming years, and what the Land Board is doing with that sacred trust." The Governor further indicated that his view was that perhaps "things have changed since the asset allocation study done by Callan in 2014: standards for investment have changed; opportunities for investment have changed; the Endowment Fund did not have a real estate portfolio at that time; 2 1/4% was the acknowledged standard for inflation then." The Committee agreed to meet again where it would hear from legal counsel and its retained experts, Callan and EFIB on these and other issues.

Minutes of July 19, 2019, Reinvestment Subcommittee Meeting (TAB 20).

<u>OCTOBER 10, 2019 MEETING</u>: At its next meeting in October the Subcommittee heard testimony on the following topics:

1. Legal framework governing the Land Board's reinvestment decisions by Darrell Early, Deputy Attorney General. (See TAB 4)
2. A summary of Callan's work in 2014, 2016 and 2018 concerning investment strategy by Janet Becker-Wold. (TAB 21)
3. A summary of performance of the Endowment Fund from Chris Anton (TAB 22)
4. A summary of the land acquisition process and acquisitions to date from former Deputy Director David Groeschl. IDL also provided written answers to questions raised during the July meeting (TAB 23).

Key take-aways from Callan's presentation at the October meeting were as follows:

- Callan is comfortable with the current target asset allocation

- Lands and financial assets fall within the prescribed bands, while cash is clearly over its 1% target

- We recognize that as the financial assets have outperformed lands, they have grown in percent relative to the lands portfolio

- The 2018 study re-visited the asset allocation and concluded that preference for financial assets versus land assets differs based on the assumed return from lands, the earnings reserve levels and primary objectives (e.g., growing real distributions; protection against a decline in distributions)

– The study concluded that moving to a more or less aggressive asset allocation has very little impact on the prevention of a decline in distributions

– Focusing on cumulative real distributions, a financial investment results in greater distributions in the expected and better-case outcomes while land reinvestment protects in poor capital market environments

– Land reinvestment generally provides equal or better protection relative to the financial assets in terms of preventing a decline in distributions

Minutes of October 10, 2019, Reinvestment Subcommittee Meeting (See TAB 1); Powerpoint presentation of Janet Becker-Wold (see TAB 21).

During questioning Ms. Becker-Wold further explained how the timber asset portfolio works to dampen volatility in the Endowment portfolio because even while it moves in response to economic conditions its movements are delayed. *Minutes of October 10, 2019, Reinvestment Subcommittee Meeting at pg. 5 and 9-10.*

In discussing the 3.5% hurdle rate Ms. Becker-Wold explained these were set to assure that any land asset purchase was “accretive” to the over-all endowment. In other words a purchase would add equal or greater value to the endowment than would purchasing a financial asset. She next explained how the hurdle rates were revisited annually or anytime there was a significant change in market conditions. Importantly, Ms. Becker-Wold, explained that in light of how well the equity markets had performed in recent years, it was likely that the return on investment expectations for the financial assets going forward would be lower, and thus the hurdle rate adjusted downward.

> **Mr. Littman**: That says that given the capital market assumptions that Callan was using for us and other clients, that 3.5%, given the perceived risk and the alternatives, that's kind of a point of indifference.
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> **Ms. Becker-Wold**: Right. And as I mentioned earlier, and I think this is an important thing for us to consider, is that <u>we do an asset allocation update for the Endowment Fund Investment Board annually, to sort of re-benchmark what our current forward ten-year look is. So that is probably up for adjustment, because as the capital markets have outperformed so dramatically, our expectation now going forward is going to be lower for the endowment fund, which means that the hurdle rates should also be adjusted at some point as well.</u> We haven't done that work, and we haven't even completed our expectations for this year yet, but I'm thinking that given the fact that the capital markets have done so well, the equity returns could come down a little bit. We try to do that every year on the endowment fund, so we can make adjustments if we need to. We don't generally make big adjustments, but that's possible, yes.

Minutes of October 10, 2019, Reinvestment Subcommittee Meeting at pg. 11 (emphasis added).

Mr. Anton, then explained the view of EFIB on how timberland assets help to balance the financial portfolio and allow for more aggressive investment in the financial markets by providing a stream of income for payment of distributions. The synergy created by this has allowed Idaho's permanent fund grow and outperform other similar funds in the U.S.

> **Mr. Anton**: Governor, Mr. Attorney General, yes, I think our structure is very well thought out, and I say that in a couple respects. First of all, as we've looked at other land grant structures, the thought that went in during endowment reform of setting up this structure is pretty remarkable. And I say that for a couple of reasons: first, each year we have to grow the permanent fund at least at the rate of inflation. If we have years when that doesn't happen, we make it up. We then move earnings above inflation into the reserve funds to make sure we have adequate and sufficient reserves to manage volatility and keep distributions to beneficiaries consistent. And if the levels in the reserve funds exceed those target reserve levels, we move that money back into the permanent fund, and that's allowed the permanent fund to grow not only at the rate of inflation and population growth, we've exceeded both of those numbers historically as a result of these. In terms of the integration of lands and the endowment fund, it works very effectively because the revenue from lands allows us to pay some of those beneficiary distributions. If you look at the ratios at the bottom of that schedule, you see that in many years, the revenue generated by lands covered all of the distributions, which allowed us to preserve our investment returns, grow the fund, grow distributions. So they all work together cohesively as a nice systematic cycle. So, since we have those reserves, since we have the extra revenue coming in from lands, to your question, we are able to invest fairly aggressively. We have looked at the asset allocation of other land grant institutions and we are on the more aggressive side with 68% equities, so we are going to have more volatility, we are going to have down years, but what we've seen is it's allowed us to generate greater returns than most of our competitors, other land grant institutions. In fact, we've been in the top 10% when compared to all of those institutions, and it's because we have those reserves, because we have money coming in from lands, that we're allowed to invest more aggressively. I don't know if that answers your question.

Minutes of October 10, 2019, Reinvestment Subcommittee Meeting at pg. 15

Finally, Deputy Director Groeschl explained the process used for making timberland acquisitions including how the Discounted Cash Flow analysis is performed and evaluated by third party experts to assure that the established hurdle rates are met or exceeded. With respect to acquisitions made recently, he explained those transactions exceeded the hurdle rates without accounting for increases in the Forest Asset Management Plan sustained yield.

> **Mr. Groeschl**: . . . So with that, the expected return rate well-exceeded … it was in that 4-6% range that I mentioned earlier. The other thing, the immediate benefit of that property as well … we don't look just because of the adjacency, we look at the market conditions of where that property is located. That property also resulted in an increase in

> our forest asset on our sustained yield, on our existing land base, of about 10 million board feet a year because of the sustained yield effect by bringing 32,000 acres of young growing stock into the model and into our existing land base. It allowed us to address the large older size classes quicker because we had that younger growing stock in place. That bumped our sustained yield by 10 million board feet, which should generate an addition $3 million a year just from that increase or that sustained yield effect – so that is an immediate benefit of bringing that property into the portfolio.
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> **Mr. Groeschl**: The 3.5% net real is the hurdle rate that we are expected to meet and when we do those evaluations and models, then those models are evaluated by outside experts. They actually develop the models and we have them review each other's models to see if they make sense, as well as internally, but they have to stand alone to meet the 3.5%. When I say that those investments all are expected to yield 4-6%, those were as stand-alone properties, but they will likely yield more than that because of the additional benefit that they provide to the existing endowment land base.

Minutes of October 10, 2019, Reinvestment Subcommittee Meeting at pg. 18-19.

<u>NOVEMBER 13, 2019 MEETING</u>: At the next meeting of the Reinvestment Subcommittee in November, 2019 the Subcommittee asked additional questions of Callan concerning the way hurdle rates were established and the validity of the 2018 recommendations. Ms. Haskins explained that hurdle rates are set so that any land acquisition is "accretive" to the over-all portfolio.

> **Ms. Haskins**: Well, if you remember from our 2018 report, part of what you decide to do depends on where you want to be with regard to the downside scenario, in the worst worse case scenarios – if you want to protect against that, and it was clear that you want to do that, was where land really came into account. So I think part of it is where you want to be on that risk spectrum. I have maintained all along that this is … if you can find transactions … I come at it from more of a bottom up perspective, if you can find transactions that are truly accretive to what you already have; and it sounds like the last couple that have been done not only stood on their own, but have made the rest of the portfolio better, then that's the way to go about it. I think that's what we've tried to stress too.
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> **Mr. Littman**: Sally, correct me if I misspeak here. I think what Sally is saying is that's where the hurdle rate comes in. That as you consider adding individual investments, they have to be accretive, they have to be better than what you've got. That is why the hurdle rate was designed. Sally describes that the hurdle rate … this is a criteria, a threshold, she's saying it has to be done in such a way to include all costs including the fire costs and projected inflation. So if the investment is good enough and high enough, then it adds to the overall return and health of the portfolio. If it's marginal or below the hurdle rate, then it will hurt the portfolio and we should not do it. So the question really becomes of

the $150 million, how much is there within the time that we have prescribed that we can execute transactions that are individually accretive and I would ask, not barely accretive, but have enough cushion so that you know you're really adding to the portfolio. Did I say that right?
Ms. Haskins: Way better than I could ever say it, thank you.

Minutes of November 13, 2019 Reinvestment Subcommittee at pg. 7-8 (TAB 24).

Attorney General Wasden then clarified earlier remarks addressing how changes to the overall endowment risk portfolio were addressed by acquiring lands.

> **Attorney General Wasden**: Sally this is Lawrence Wasden. We step back for a moment in time: the state owned a number of parcels of land, they happen to be around Priest Lake and Payette Lake. We've sold land, and that's actually the genesis of that $150 million is that our land portfolio went down. As a consequence of that, our risk factors went up. To accommodate for those risk factors, we increased the size of our reserves. By doing that we were leveling the playing field. The question now is what do we do with this $150 million and in order for us to maintain that balance, we need to do something. That is, we can purchase securities, but that is more volatile marketplace than is the land which is the whole issue I was trying to raise earlier. That it's the working of the entire portfolio together so if we were to acquire land, it may be that we could reduce the size of our reserves based upon what the relative risks were. Isn't it the entire workings of that together that we're trying to accomplish the maximum long-term return?
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> **Ms. Haskins**: That's correct, and you point out that there are trade-offs to anything that you do.

Minutes of November 13, 2019 Reinvestment Subcommittee at pg. 8-9.

Governor Little then asked EFIB Director Anton a hypothetical about whether the endowments would have been better off if land bank money had been invested in the equity markets and if issues of risk could be better addressed through reserve levels.

> **Governor Little**: The most widely scribed to index is the Vanguard index, what, 8 basis points?
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> **Mr. Anton**: The S& P 500 is 3 basis points now.
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> **Governor Little**: I just looked this afternoon. Three, five and ten years it's almost 300 basis point premium over the incredible work that you've done. But it's in a different area. So if you take $2.3 billion times 3%, that's $60 million bucks a year; we would have an additional return if we would have just plowed it all in there. I am not, just like the Towne Square Mall, I am not advocating for that; but what I am saying are there a number of years of earnings reserve that we could put aside to compensate for just plowing it all into the SPDR, the Vanguard SPDR.

> **Mr. Anton**: Governor, members of the subcommittee, we do have a substantial portion of the portfolio of the S&P 500 index. But we don't have it all invested in that because we believe diversification of non-correlated or partially correlated assets reduces the overall risk. To your point, yes if we happen to be all in the US equity market, we would have earned more over the last 10 years. But if you look at the prior 10 years we would have earned less because the S&P 500 was flat for 10 years.
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> **Governor Little**: Vanguard's 11% over the life of the programs.
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> **Mr. Anton**: Okay, different assets perform well different periods and that's why we're diversified.
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> **Governor Little**: But my question is can you make up for that diversity just by having more earnings reserve.
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> **Mr. Anton**: If you compare our portfolio to other land grant institutions, we're fairly equity intensive with 66% and we're able to do that because we have the earnings reserves. We're able to take more equity risk in the portfolio and still meet our objective of stable distributions for the beneficiaries because we have 6 or 7 years of reserves and because we have revenue coming into the reserves from the Department of Lands through timber sales. That structure is well thought out and it allows us to be fairly aggressive. Many of our peers are investing in other non-equity related investments to try to reduce volatility. They are investing in other alternatives, infrastructure and other things. So to your question to Sally, yes, we could consider other types of investments that have low risks, but we're able to take a fair amount of risk to try to maximize the returns for the beneficiaries given our structure.

Minutes of November 13, 2019 Reinvestment Subcommittee at pg. 8-9.

<u>MARCH 12, 2020 MEETING</u>: The next meeting of the Committee occurred on March 12, 2020 at that meeting, the Subcommittee once again heard from its experts.

> **Attorney General Wasden**: I'd like to read some minutes of our May 15, 2018 Land Board meeting. It's a fairly lengthy paragraph, but I'd like to read it because it sets out part of our discussion. Callan made a presentation, and then it was actually your discussion. The minutes reflect:
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> > In their study, Callan said timberland investment is a good diversifier. If the Department gets similar real returns, because timber has lower volatility, it helps reduce overall volatility. It also provides similar and potentially greater returns if the Department finds opportunities above that hurdle rate. EFIB's perspective is that the Board should preserve its flexibility during this five-year period and allow the Department to find and identify opportunities as long as they meet or exceed the hurdle rate. Governor Otter wondered what the motivation was for even

considering options B and C. Mr. Anton commented that the recommendation for B and C is that they potentially get similar returns on the financial assets but would likely have more volatility. Neither of those are bad options. The financial assets have been performing well, however the Department has this unique opportunity to reinvest the money in timberland and it makes sense to preserve flexibility and look for transactions that provide substantial returns … Mr. Anton said Callan and EFIB agree that the Department should have the opportunity to look for reinvestment opportunities in timber and agricultural land. If the Department finds opportunities that meet the hurdle rate, it will reduce overall volatility and enhance returns to the beneficiaries.

Here's my question, do you still feel the same way based upon changes that have taken place in the marketplace, that having the flexibility with these monies while we have this unique opportunity is a recommended option. We chose option A and I am asking you are we still there?

Mr. Anton: As I look at the Callan study that was published in 2018, it really provided the Land Board with a framework to evaluate land acquisition opportunities that were presented from the Department of Lands. Essentially it said that if the opportunity presents a real return of less than 3.5%, it makes sense to put it in the financial assets. If it presented a return between 3.5 and 4.5%, it is somewhat indifferent, although it recommended that if we increased our reserves, as you're closer to the 3.5% end of that range, the financial assets are probably preferable; because we have higher reserves we can withstand a little more volatility. As you move out closer to 4.5%, or above 4.5%, the study recommended considering timberland investments. <u>Again, looking at it from a whole trust perspective, the idea is that if we have opportunities that provide solid returns that are more stable from timber, that makes sense from a whole trust perspective. I think the analysis that they did still makes a lot of sense, that we have to be disciplined, that the Land Board would evaluate any opportunities that were brought forward; we would also have to look at any synergies. I look at us as a strategic buyer. We're in the timber business. We have substantial holdings that if a land acquisition also enhances the returns from our other property it can provide other benefits.</u> <u>We feel at EFIB that we should give the Department of Lands that opportunity that the Land Bank provides to look at opportunities.</u> I think there was always an understanding that if the Department of Lands said there weren't opportunities, or there weren't complete opportunities that spend all of that money, we could certainly transfer the money sooner into the financial portfolio. I think that the model Callan developed, from my perspective, made a lot of sense.

Minutes of March 12, 2020 Reinvestment Subcommittee at pg. 2-3 (emphasis added) (See TAB 2).

Mr. Anton later explained the effects of land revenue on earnings reserve and distributions.

Mr. Anton: One thing that I think is important to highlight as well, is that the revenue generated from the Department of Lands goes into the earnings reserve fund. For many

> years, that level of revenue was enough to basically make the beneficiary payment so that all of the growth and financial assets allowed the fund to grow more rapidly. Over time as the financial assets have grown and the land revenue has come down somewhat, that revenue coming from the lands generates only about 50-60% of the annual distribution. That's another type of volatility or risk that we have, that we're less able to look to that steady source of revenue, and why under certain scenarios having more land revenue is beneficial because it does come into that reserve. It helps make some of those beneficiary distributions.

Minutes of March 12, 2020 Reinvestment Subcommittee at pg. 4. The committee then further discussed how hurdle rates were established and whether they should be annually reviewed.

This was the conclusion of the substantive discussions and testimony to the Reinvestment Subcommittee.

CONCLUSION:

In 2016 and again in 2018, the State Board of Land Commissioners heard from its experts concerning how to reinvest the proceeds held in the land bank resulting from the sale of cottage and commercial properties. While investment in financial assets was always an option, the Board's experts advised that investment in timberland that met or exceeded a specific hurdle rate was also a prudent decision because it provided protection against the risks of down markets and cash revenue to the earnings reserve that in some years paid for distributions and in others allowed for more aggressive investment by the EFIB. Similarly, because of the delayed response of timber prices, it dampened volatility. This Board made an informed decision to be conservative in its investment strategy to protect distributions against market volatility and replace the lost cash revenue by allowing IDL to look for land acquisitions that would be accretive to the endowments and also create additional value to the endowments in the form of increased sustained yield.

During the entire course of proceedings before the Reinvestment Subcommittee not a single expert offered a different view. Despite lengthy questions, both Callan and EFIB have said that nothing has changed between the decisions in 2016, 2018 and today and that the same risk balancing reasons for investing in timberland present in 2016 and 2018 remain true. Both Callan and EFIB continue to support their prior work and recommendations to the Board.

While a worthwhile effort, the proceedings of the Reinvestment Subcommittee have offered no new information that should change the course this Board previously charted for IDL. And, most importantly, no experts have advised that investing in the financial markets today is a better course than continuing to look for timber investment. I encourage my fellow land board members to listen to our experts and affirm the actions already taken by this Board to stay the course as outlined in my alternative motion. IDL should be directed to proceed with the approved strategy from the July 2018 Land Board meeting keeping in mind that as new information, or new ideas for investment of Land Bank monies come forward, those ideas should be evaluated as potential "strategic" investments. Likewise, the IDL should continue to monitor the Land Bank aging report and look at the "pipeline" of possible investments making sure to consult with EFIB and expeditiously move money into the Permanent Fund that will not be useable for acquisitions.

In an uncertain world, it is more imperative than ever that this Board choose wisely and rely upon its investment advisors when it comes to making investment decisions. Taking action to invest tens of millions of dollars in the financial markets when neither of our investment consultants have recommended such course reflects a lack of prudence that should be avoided.