

---

# An Overview of the Idaho Endowment Fund Investment Board

---

Interim Committee on Endowment Issues

August 28, 2014



---

# Outline

- Overview of the Investment Board
- The EFIB's approach to investing
- Investment results
- Managing the cost of investing
- How distributions are determined
- The outlook for fund returns
- Review of other states

---

# Mission

## Endowment Fund Investment Board

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

# Trust Assets Overseen by the Investment Board June 30, 2014

	<b>Assets (<u>\$millions</u>)</b>	<b>% of <u>Total</u></b>
Endowment Fund	1,744.8	72%
State Insurance Fund	630.2	26%
Bunker Hill Water Treatment*	52.0	2%
Parks & Rec Endowments	<u>3.3</u>	<u>0.1%</u>
 TOTAL	 <u><u>2,430.3</u></u>	 <u><u>100%</u></u>

\* EFIB began management July 11, 2014

*PERSI took responsibility for the \$75.1 million Judges' Retirement Fund July 1, 2014*

# Endowment Fund Investment Board

## Land Grant 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
- Select and direct staff
- Select investment consultant, auditor
- Submit a budget for legislative approval
- Determine distributions for the Capitol Endowment
- Oversee Credit Enhancement program (guarantees school bonds)

# Endowment Fund Investment Board

## Non-Land Grant Responsibilities

### ■ State Insurance Fund

- Reserves and surplus retained to ensure payment of worker's compensation claims
- EFIB is assigned by statute to manage under the direction of the Manager of the SIF

### ■ Other Funds

*Statute allows the EFIB to manage investments which are not general "state" funds as defined by Idaho Code*

#### □ Bunker Hill Endowment

- Funds contributed by Hecla Mining; Fund water treatment plant to remove heavy metals from Bunker Hill site
- Managed on behalf of the Dept. of Environmental Quality

- **Two Parks & Rec Endowments** which support operation of the Trail of Coeur d'Alenes, Ritter Island Unit of Thousand Springs State Park

---

# Board of Land Commissioners

## Endowment Fund responsibilities

- Oversee activities of the Endowment Fund Investment Board
- Determine the uses of undistributed earnings (Earnings Reserves)
  - Annual distribution to beneficiaries
  - Portion retained to protect future distributions
  - Portion added to the Permanent Fund to build corpus (and thereby increase distributions)

---

# 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

# Endowment Fund Investment Board members

## Gavin Gee

*EFIB Vice Chair*

Director, Dept. of  
Finance; attorney



## Neil Anderson

State Representative

Retired Investment  
Advisor



## Dean Buffington

*EFIB Chair*

Partner, investment firm;  
attorney

# Endowment Fund Investment Board members (page 2)

## Warren Bakes

U. of I.; former  
Superintendent Coeur  
d'Alene Schools



## Tom Kealey

Businessman;  
investor; former  
MK CFO

## Gary Mahn

Retired businessman;  
former head Dept.  
Commerce



# Endowment Fund Investment Board members (page 3)

**Sue Simmons**

Dept. of Labor  
Deputy Director; CPA



**Richelle Sugiyama**

Investment Officer, PERSI

**Chuck Winder**

State Senator  
Real estate broker



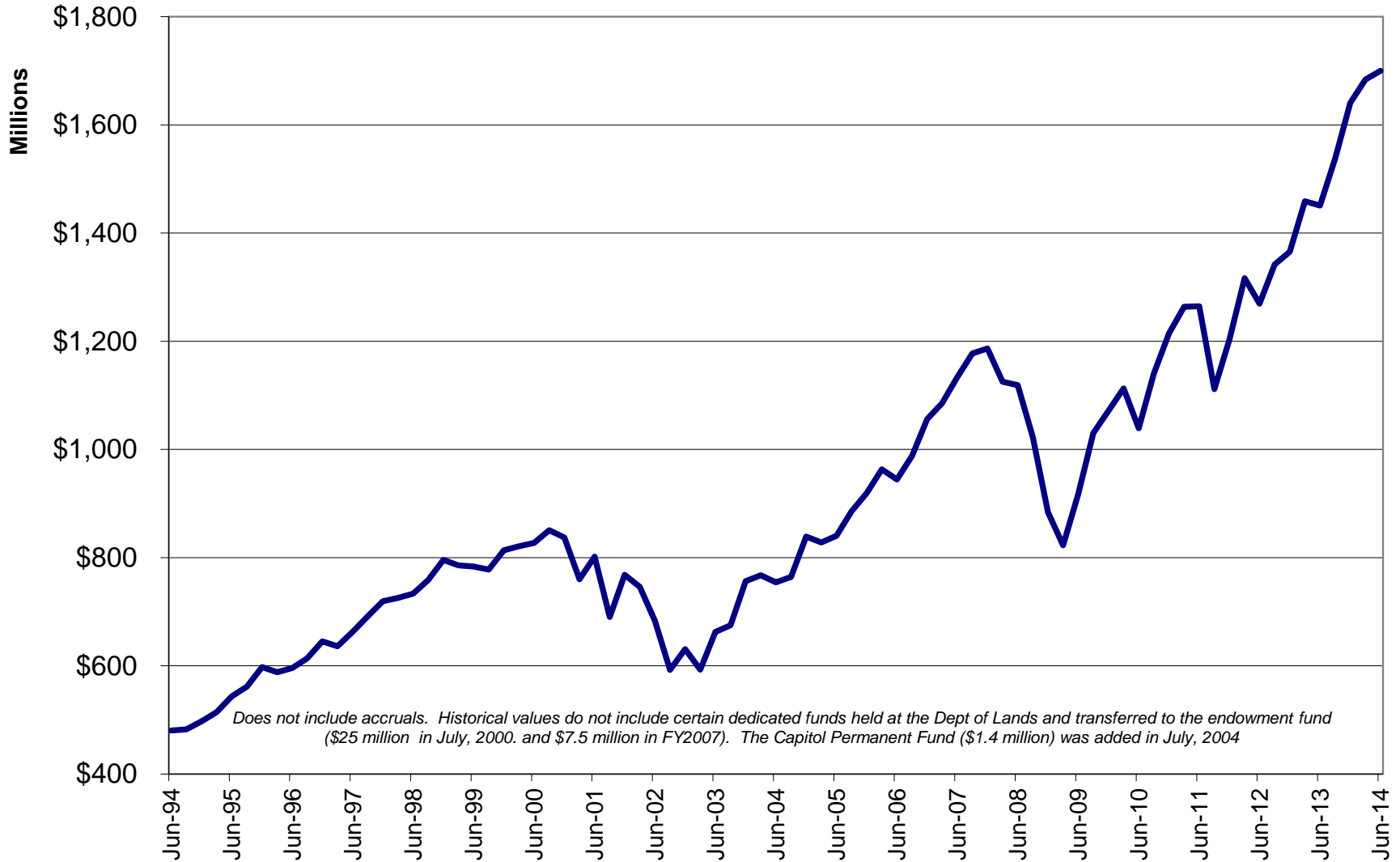
---

# EFIB Goals for Client Service

***We will provide good investment advice and the tools for implementing that advice***

- Develop a prudent long-term investment strategy
- Select the best portfolio managers and other agents to execute that strategy
- Diligently evaluate performance over time
- Develop an effective distribution policy (for the land grant endowments)
- Help the clients fulfill their fiduciary responsibilities and communicate with their stakeholders

## Total Endowment Fund Assets By Quarter -- June 1994 Thru June 2014



# History of the Endowment Fund Investment Strategy

- Until July 2000, investments were limited by law to fixed income, which was managed internally
- In 1998, a constitutional amendment authorized broader investment authority for the EFIB according to the State's Prudent Investor Rule
- A change in asset mix to 70% equities and 30% fixed income was implemented in the last half of the year 2000 thru the hiring of external investment managers
- Internal management of fixed income was discontinued in 2003
- There have been no substantial changes from the original 70/30 mix since 2000

---

# Investment Board philosophy

- Long-term investors
  - No attempt to time markets
  - Hold high proportion of equity in portfolios with an investment horizon of 20 years or more
- Hold a diversified portfolio
  - U.S. stocks
  - International stocks
  - Bonds (protection from equity downturns)
- Use index funds for bonds and small allocations to equity

# Five Elements of Fund Diversification

- 1. Risk of return: equity vs. fixed income**
  - *Endowment: 70% stocks, 30% bonds*
- 2. Region: U.S. vs. International**
  - *Endowment: 79% U.S., 21% International (Equity 70%/30%)*
- 3. Investment Style: Value vs. Growth**
  - *Endowment: Evenly balanced*
- 4. Size: Large, medium and small companies**
  - *Endowment: Slight overweight to mid-size*
- 5. Active vs. Passive security and industry selection**
  - *Endowment: Passive for 100% of bonds, 14% of equities*

---

*Elements 1 thru 5 correspond with the numbers in boxes on the fund map on the next page*

# Endowment Fund Asset Diversification Map

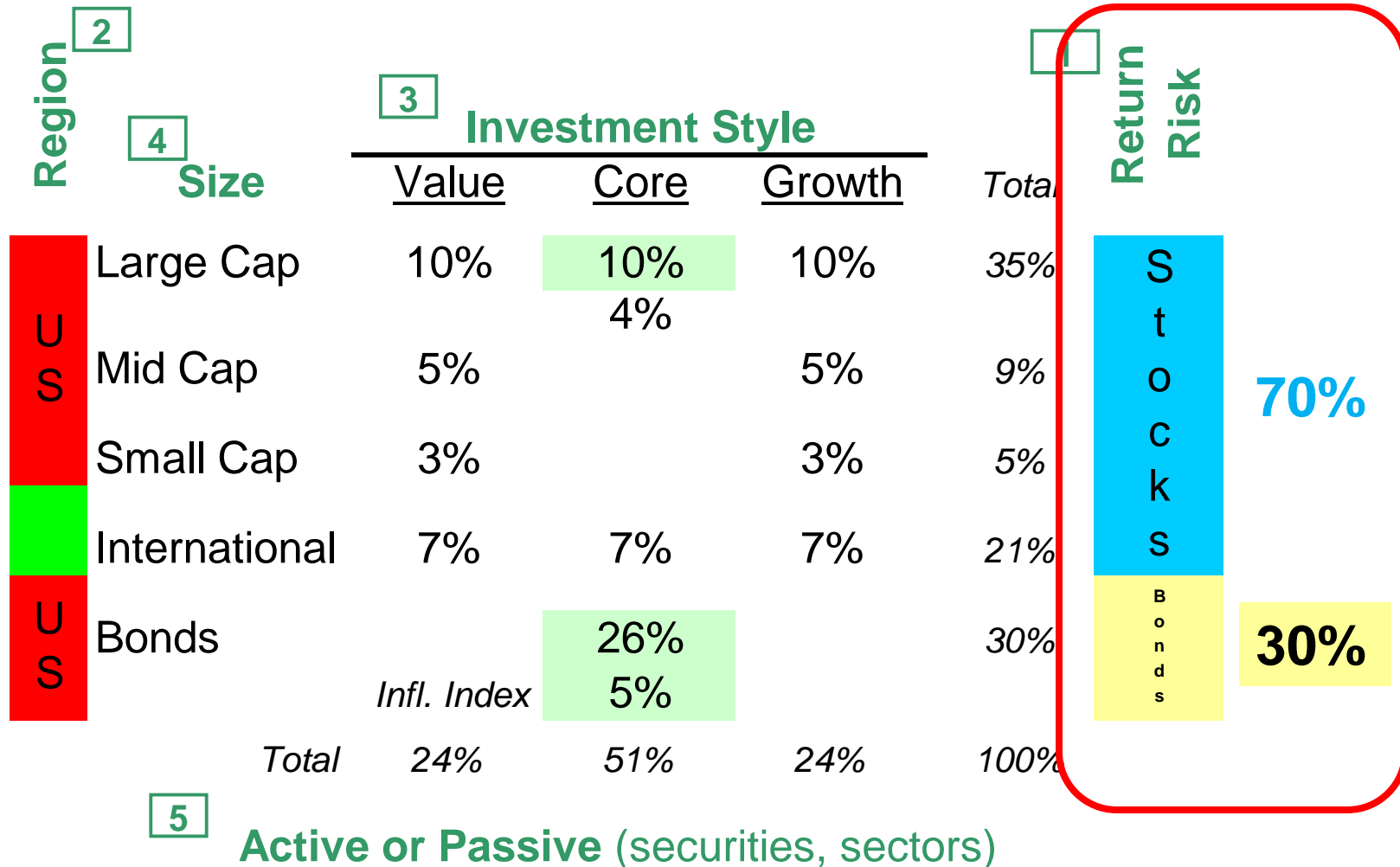
Region <sup>2</sup>	Size <sup>4</sup>	Investment Style <sup>3</sup>			Total	Return Risk <sup>1</sup>
		<u>Value</u>	<u>Core</u>	<u>Growth</u>		
S C	Large Cap	10%	10% 4%	10%	35%	S t o c k s
	Mid Cap	5%		5%	9%	
	Small Cap	3%		3%	5%	
	International	7%	7%	7%	21%	B o n d s
S C	Bonds		26% 5%		30%	
		<i>Infl. Index</i>				
	<i>Total</i>	24%	51%	24%	100%	

## <sup>5</sup> Active or Passive (securities, sectors)

Passive/index approach (remainder take an active approach to securities and sectors within their area of expertise)

*Totals may not add due to rounding*

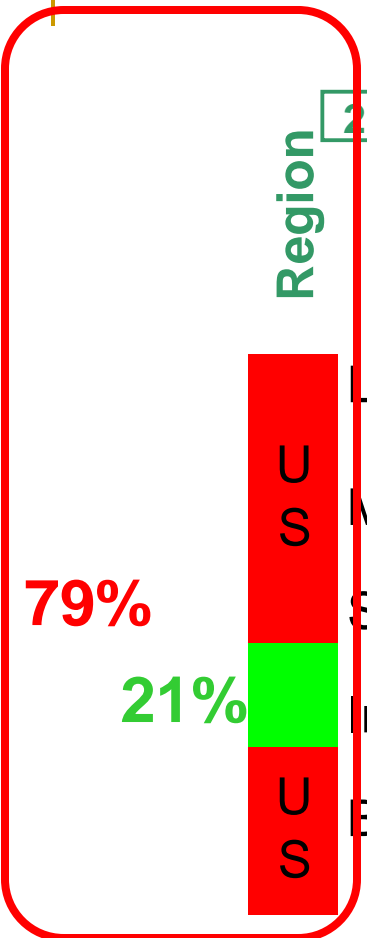
# Endowment Fund Asset Diversification Map



Passive/index approach (remainder take an active approach to securities and sectors within their area of expertise)

Totals may not add due to rounding

# Endowment Fund Asset Diversification Map



Region	Size	Investment Style			Total	Return Risk
		Value	Core	Growth		
US	Large Cap	10%	10% 4%	10%	35%	S t o c k s  B o n d s
	Mid Cap	5%		5%	9%	
	Small Cap	3%		3%	5%	
International	7%	7%	7%	21%		
US	Bonds		26% 5%		30%	
		<i>Infl. Index</i>				
<b>Total</b>		24%	51%	24%	100%	

**5 Active or Passive (securities, sectors)**

Passive/index approach (remainder take an active approach to securities and sectors within their area of expertise)

Totals may not add due to rounding

# Endowment Fund Asset Diversification Map

Region <sup>2</sup>	Size <sup>4</sup>	Investment Style <sup>3</sup>			Total	Return Risk <sup>1</sup>
		<u>Value</u>	<u>Core</u>	<u>Growth</u>		
S C	Large Cap	10%	10% 4%	10%	35%	S t o c k s
	Mid Cap	5%		5%	9%	
	Small Cap	3%		3%	5%	
I S	International	7%	7%	7%	21%	
S C	Bonds		26% 5%		30%	
		<i>Infl. Index</i>				
	<b>Total</b>	24%	51%	24%	100%	

<sup>5</sup> **Active or Passive (securities, sectors)**

Passive/index approach (remainder take an active approach to securities and sectors within their area of expertise)

Totals may not add due to rounding

# Endowment Fund Asset Diversification Map

Region	Size	Investment Style			Total	Return Risk
		Value	Core	Growth		
S C	Large Cap	10%	10% 4%	10%	35%	S t O C K S
	Mid Cap	5%		5%	9%	
	Small Cap	3%		3%	5%	
	International	7%	7%	7%	21%	
S C	Bonds		26% 5%		30%	B o n d s
		<i>Infl. Index</i>				
	<i>Total</i>	24%	51%	24%	100%	

## 5 Active or Passive (securities, sectors)

Passive/index approach (remainder take an active approach to securities and sectors within their area of expertise)

Totals may not add due to rounding

# Endowment Fund Asset Diversification Map

Region <sup>2</sup>	Size <sup>4</sup>	Investment Style <sup>3</sup>			Total	Return Risk <sup>1</sup>
		<u>Value</u>	<u>Core</u>	<u>Growth</u>		
S C	Large Cap	10%	10% 4%	10%	35%	S t o c k s
	Mid Cap	5%		5%	9%	
	Small Cap	3%		3%	5%	
	International	7%	7%	7%	21%	B o n d s
S C	Bonds		26% 5%		30%	
		<i>Infl. Index</i>				
	<i>Total</i>	24%	51%	24%	100%	

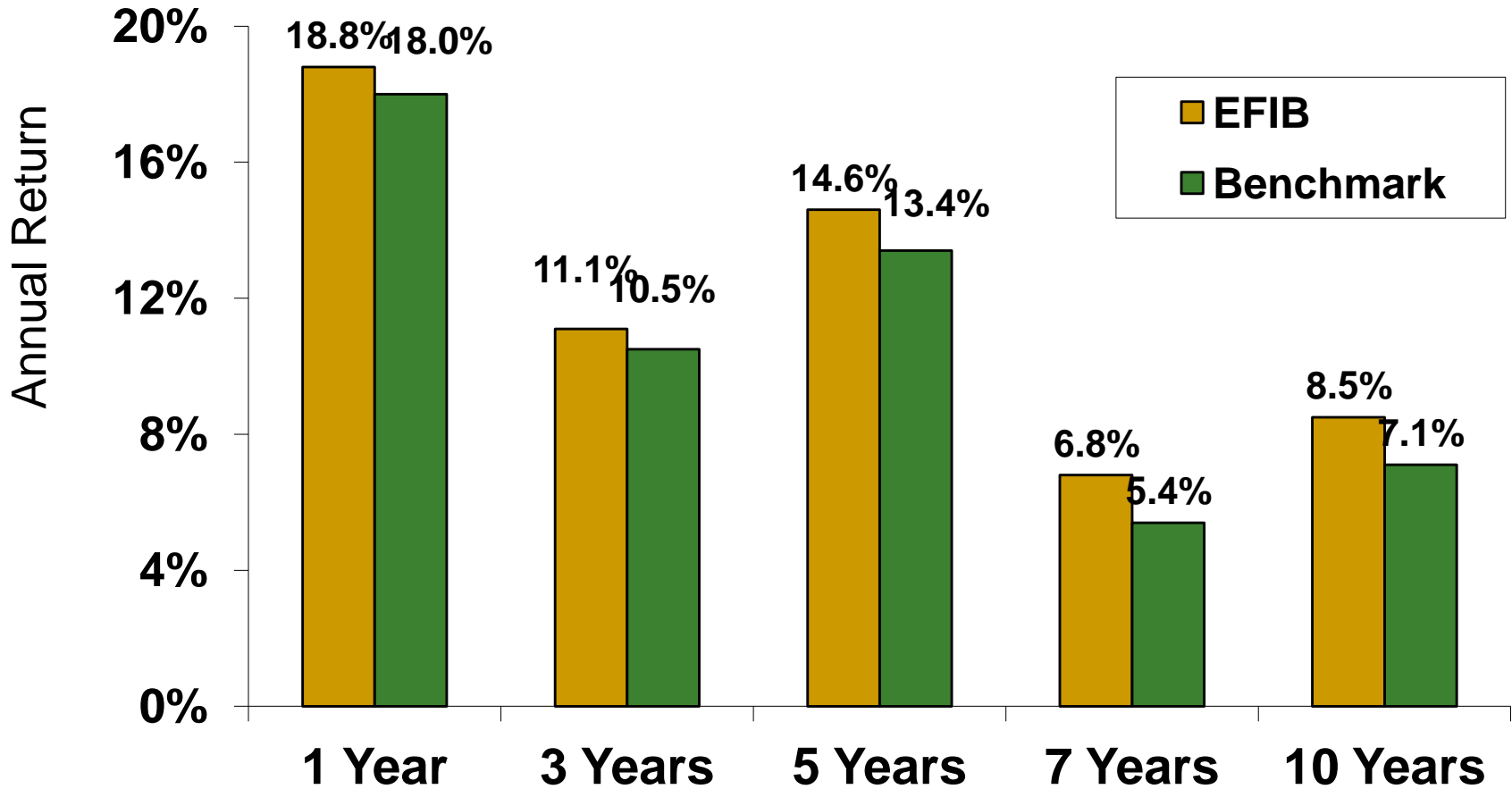
<sup>5</sup> **Active or Passive (securities, sectors)**

Passive/index approach (remainder take an active approach to securities and sectors within their area of expertise)

Totals may not add due to rounding

# Endowment Fund Performance

(For periods ended June, 2014)



# Performance vs. Peers (June, 2014)

## Idaho's "Rank in class"

Source: Callan Associates

### Comparison

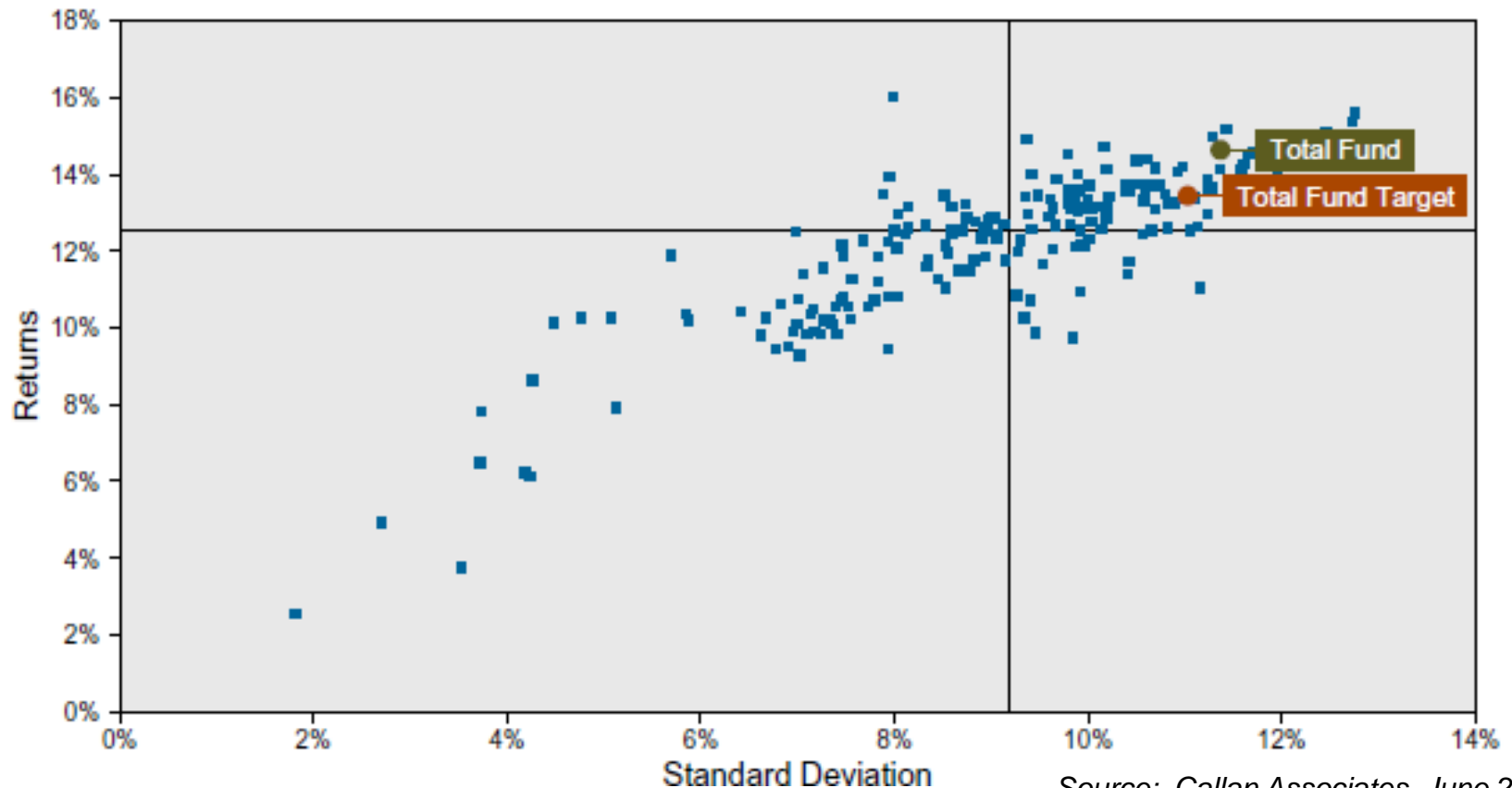
<u>Group</u>	<u>1 Year</u>	<u>2 Years</u>	<u>3 Years</u>	<u>5 Years</u>	<u>7 Years</u>	<u>10 Years</u>	<u>15 Years</u>
Public							
Pension Plans	8th	8th	11th	4th	4th	3rd	67th
Endowments & Foundations	7th	8th	8th	2nd	2nd	8th	n/a

Relative to both public pension plans and endowment & foundations, the Idaho Endowment Fund's returns rank generally rank in the top 10% over the last 10 years. Some of this high ranking is attributable to the Fund's high commitment to public stocks, especially U.S. stocks. Most other funds had investments in real estate and other alternatives and higher commitments to foreign equities, all of which did not do as well as U.S. equities.

15 year comparisons are weaker because the fund was almost 100% fixed income in the high equity return period of 1999 to mid-2000.

# Risk vs. Return

## Five Year Annualized Risk vs Return



Source: Callan Associates, June 2014

Compared to most pension plans, Idaho's Endowment Fund has had higher variation or deviation in return and, over the last five years, higher absolute returns. It has also outperformed its passive index benchmark (the Fund Target).

---

# Determining Distributions

---

---

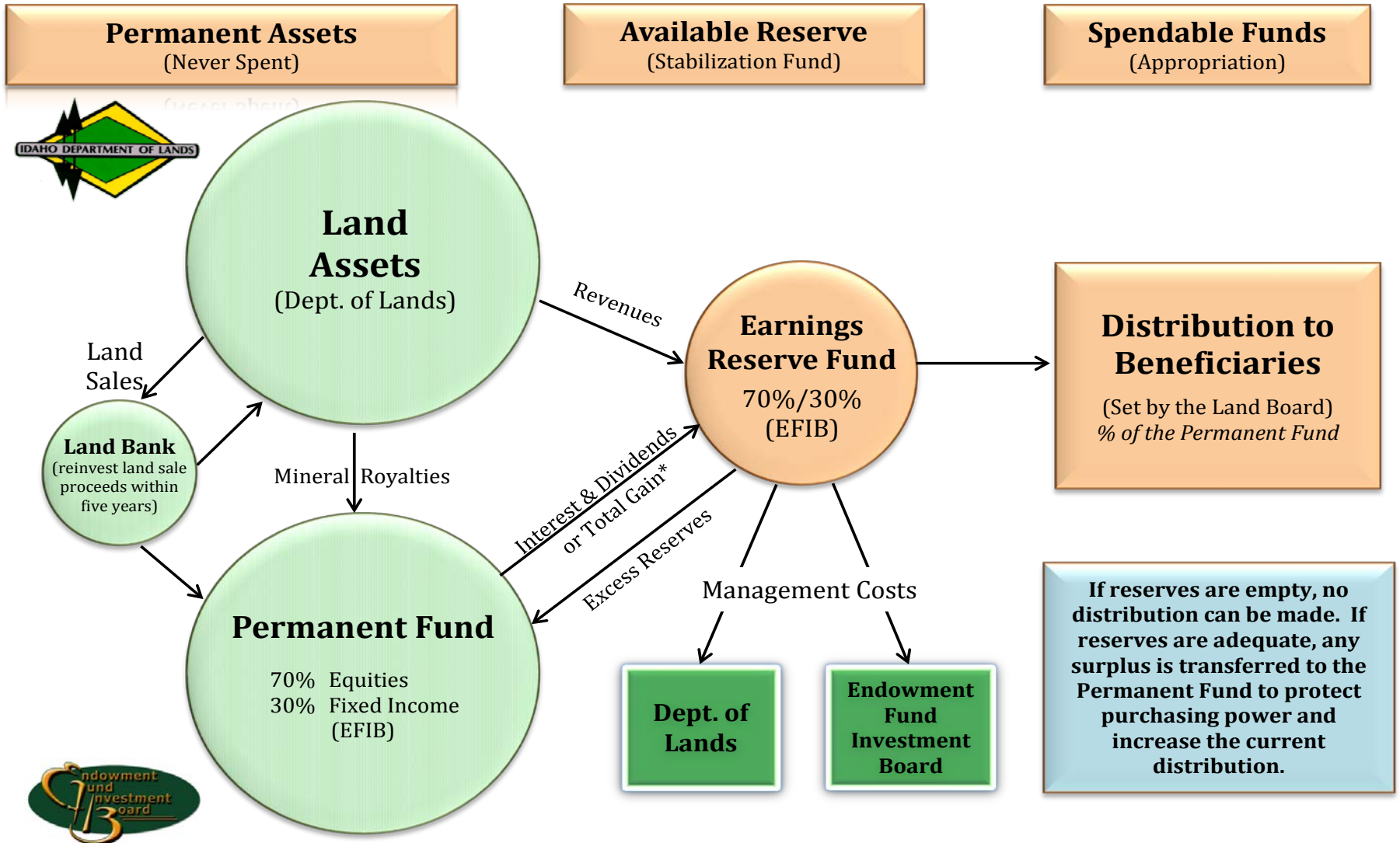
# Mission of Idaho Endowments

## Provide a Perpetual Stream of Income

To achieve this mission, Distribution Policy must balance three conflicting objectives:

- Maximize total return over time at a prudent level of risk
- Protect future generations' purchasing power
- Provide a relatively stable and increasing payout

# 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.

There are nine different land grant endowments

---

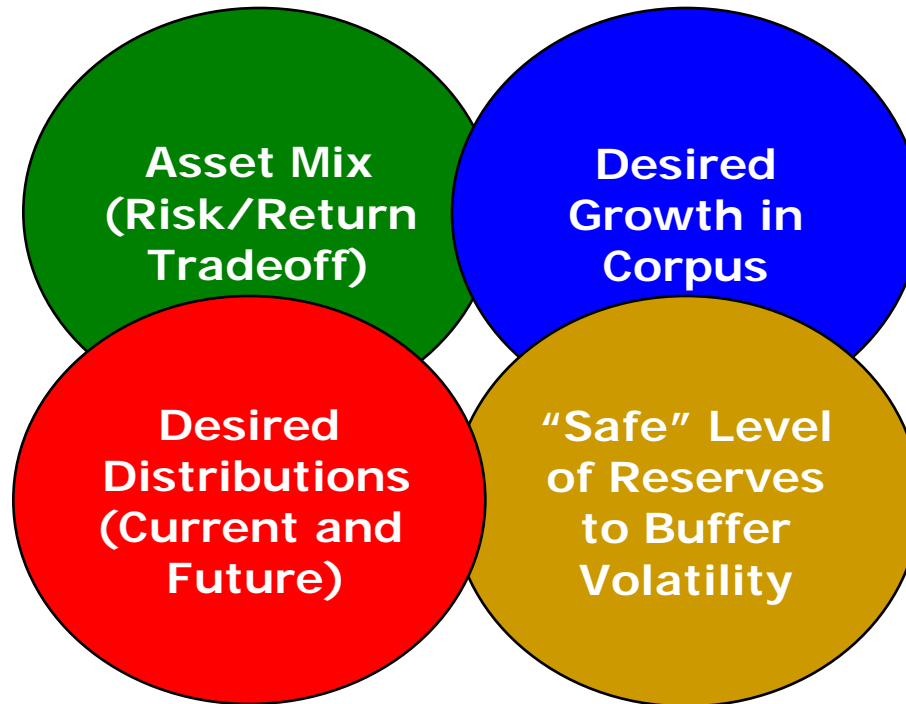
# Distribution Policy Management Principles

- Distribute expected long-term sustainable income every year
  - Buffer the highs and lows – save up income in a reserve when it exceeds expectations in order to maintain distributions when income temporarily falls
- Reinvest sufficient income back into principal so that distributions and permanent corpus grow at least as fast as inflation and population

# Fiduciary tradeoffs make defining and managing Distribution Policy challenging

Evaluate the interaction of four policy drivers in order to balance asset mix, current & future distributions, and levels of reserves

- Higher long-term return means more potential short-term volatility
- How much downside variation can the fund endure?



- How fast should the fund grow over time? With inflation? Faster than inflation?
- How much risk of a cut in distributions should beneficiaries face?

- What rate is sustainable?
- Spend a lot, save a little or spend little now and more later

*These tradeoffs must be determined by the Land Board within limits prescribed by state statute, the state constitution, and federal statutes*

# What Beneficiaries Prefer

- Beneficiaries clearly prefer that distributions be based on conservative income expectations
  - Distributions are used for ongoing spending, not one-time needs
- A reduction in distributions is much more difficult for them to adjust to than it is for them to temporarily forego an increase
  - It is impossible to eliminate the chance of a reduction, but the policy is designed to allow at least two years warning of a potential reduction, and avoid a catastrophic failure\*

\*Catastrophic failure: Insufficient reserves to pay appropriated distributions. Occurred in 2003 in Public School, 2005 in Ag College and Charitable

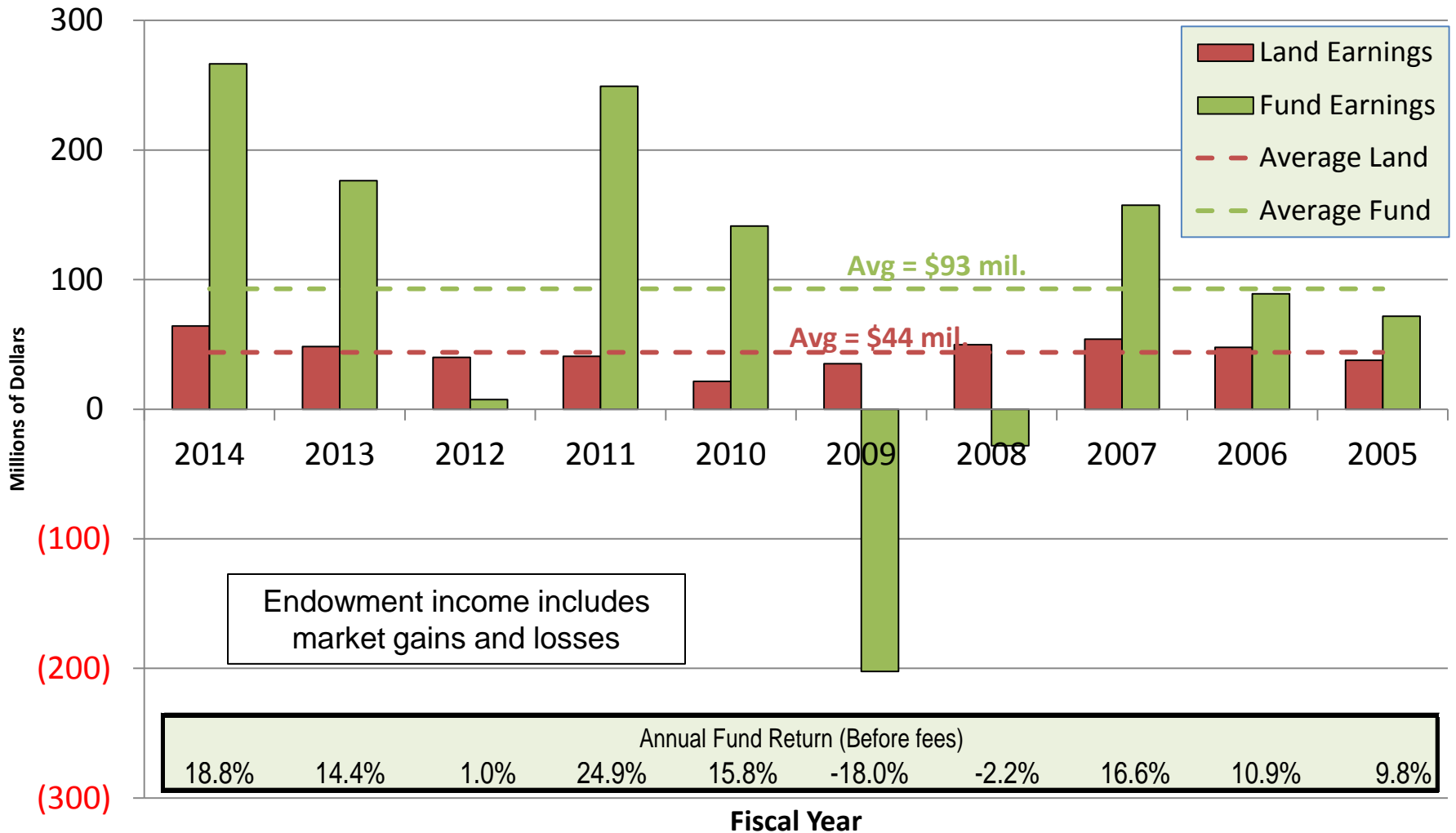
---

# Objectives for determining distributions (in priority order)

To balance the interests of current and future beneficiaries, the Land Board established the following priorities:

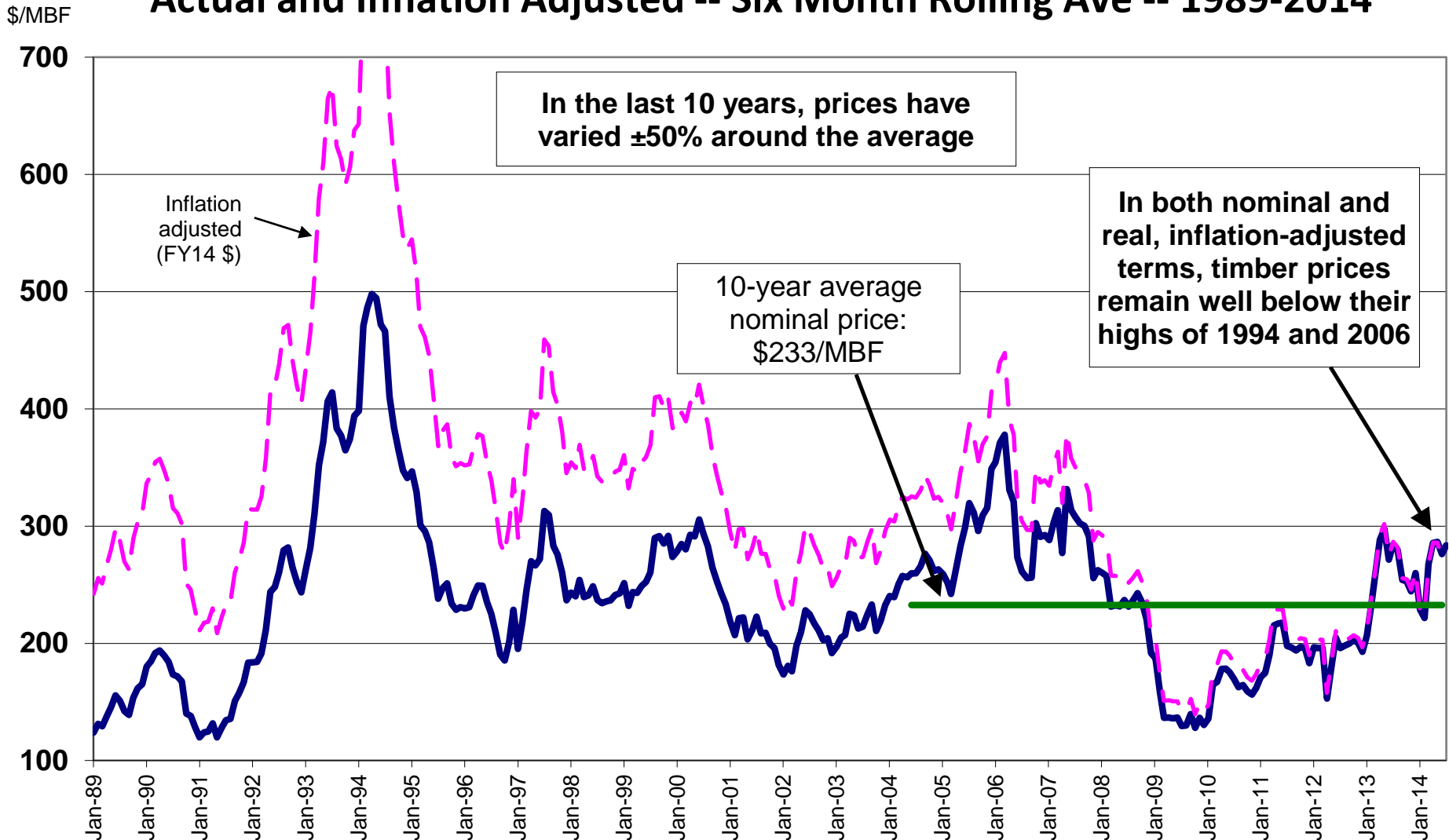
1. Avoid reductions in total endowment distributions
2. Maintain adequate Earnings Reserves to protect distributions from temporary income shortfalls
3. Grow distributions and permanent corpus faster than inflation and population growth

# Land and Fund Income History (Net of Expenses)

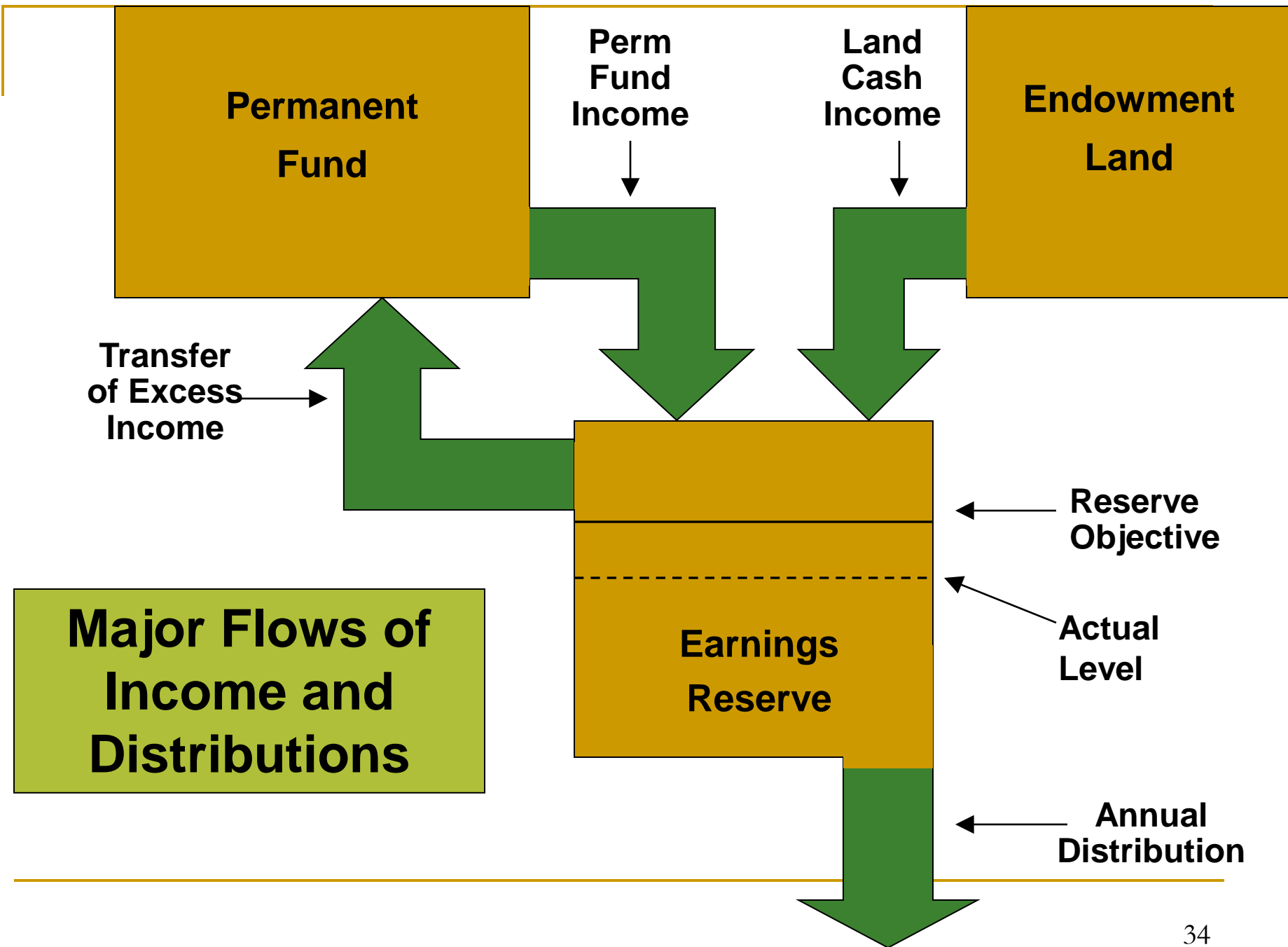


# Idaho Endowment Land Log Auction Price Trends

Actual and Inflation Adjusted -- Six Month Rolling Ave -- 1989-2014



***Besides volatility in financial markets, reserves are required to buffer the highs and lows of the timber market.***



# Determining Annual Distributions:

## Two main steps

**First:** Start with a policy calculation:

- (Policy rate) \* (Permanent Fund Balance)
  - E.g. 5% \* \$100 mill. = \$5 million distribution
  - Year-to-year increase/decrease driven by growth/shrinkage of the Permanent Fund

**Second:** If necessary, adjust the policy calculation up or down to reflect:

- The status of reserves
- The previous year's distribution level
- Any other relevant factor

---

The policy rate is currently 5% for all endowments except State Hospital (7%)

# FY 2015 Endowment Distribution Summary

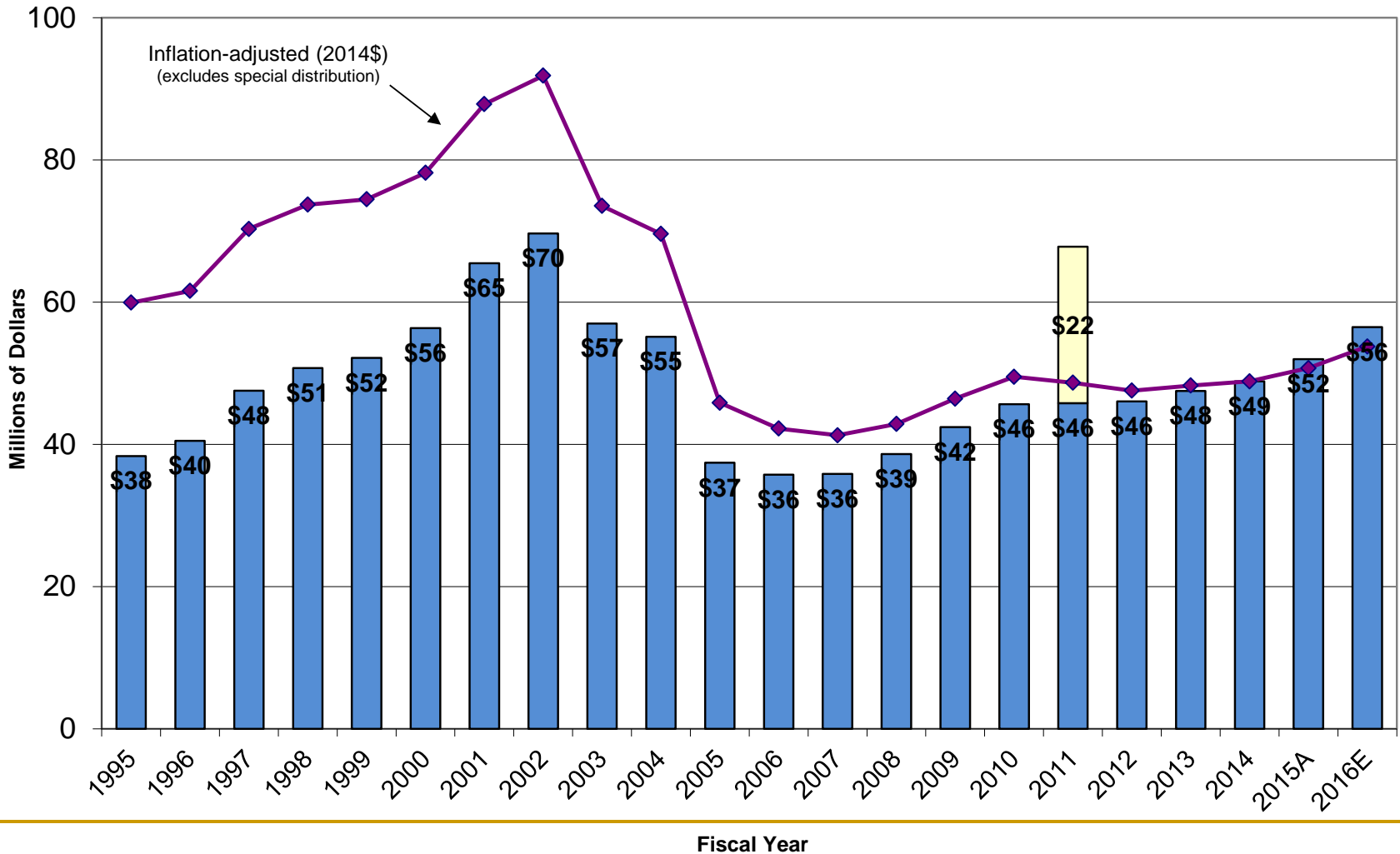
Endowment Beneficiary	FY 2014 Approp.	\$ Change	FY 2015 Approv. Dist.	% Change	% of Total
Public Schools	\$ 31,292	-	\$ 31,292	0.0%	60%
Universities	10,729	1,799	12,528	16.8%	24%
State Hospital South	2,946	679	3,625	23.1%	7%
Penitentiary	1,422	286	1,708	20.1%	3%
Juvenile Corrections	893	134	1,027	15.1%	2%
State Hospital North	893	134	1,027	15.1%	2%
Veterans Home	558	84	642	15.1%	1%
Deaf & Blind School	112	17	128	15.1%	0.2%
<b>Grand Total</b>	<b>48,845</b>	<b>3,133</b>	<b>51,978</b>	<b>6.4%</b>	<b>100%</b>

*All amounts in thousands of dollars*

*The Land Board will approve FY 2016 distributions in September, 2014. The EFIB is recommending an 8.7% increase to \$56.5 million.*

# Endowment Distributions To Beneficiaries 1995-2016 Actual/Estimated, Net of General Funds Nominal and Inflation-Adjusted

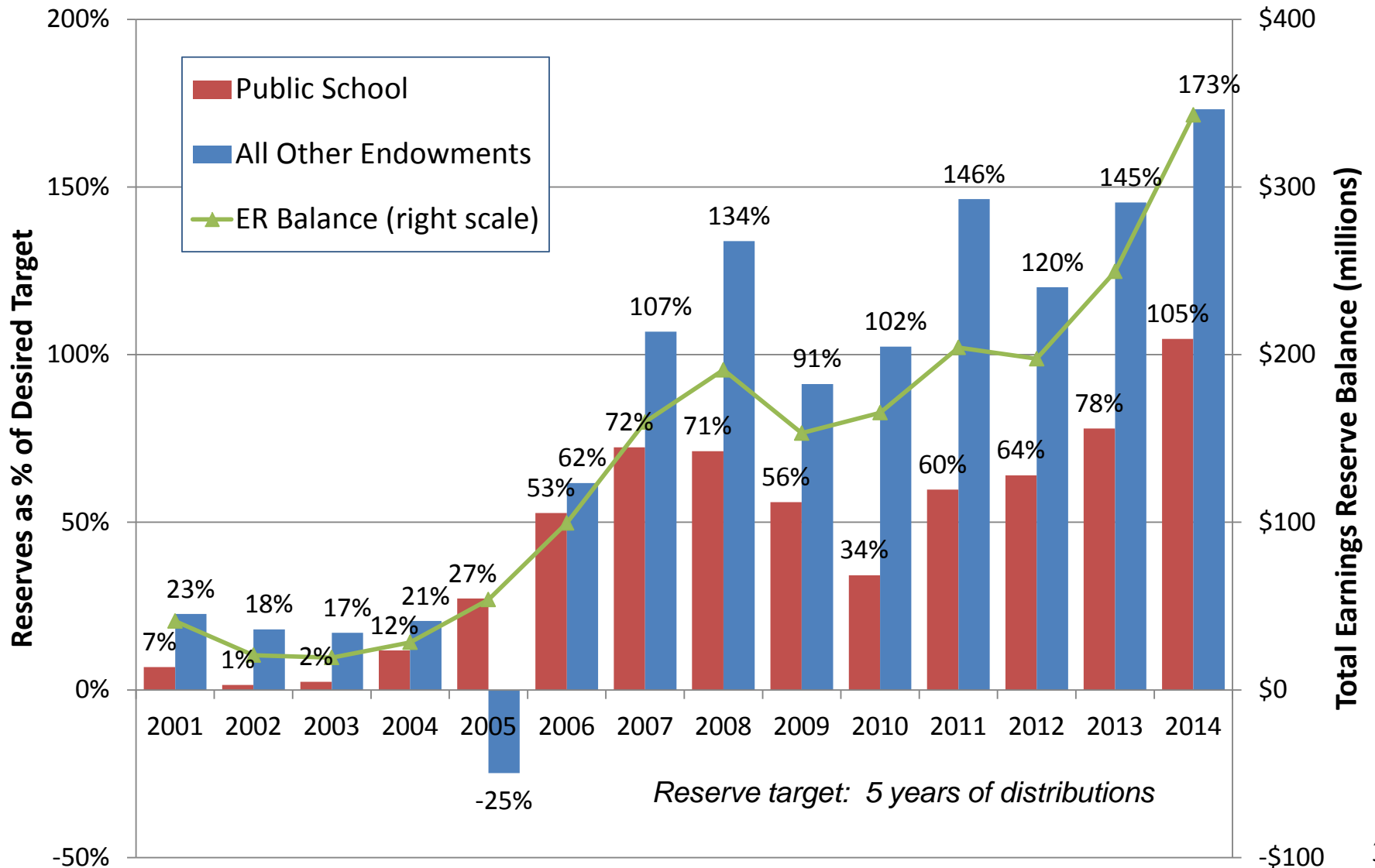
(Net of General Fund contributions 1995-2000, 2006; includes special Public School distribution in 2011 of \$22M)



Distributions had to be reduced in 2003-2006 as timber and fund income fell well below expectations

# Strong reserves permit distribution growth

## Earnings Reserves: % of Target, Total Balance



# Future Fund Returns

## Expected Return

	<u>Return</u>	<u>Mix</u>
Equities	7.6%	70%
Bonds	2.6%	30%
<b>Total</b>	<b>6.7%</b>	<b>100%</b>

Source: EFIB estimates, Callan Associates (1/13)

Current low interest rates and recent strong equity returns have dampened the outlook for fund returns over the next ten years.

## Expected Return Variation

<u>Probability</u>	<u>Annual Return Over</u>	
	<u>3 Years</u>	<u>7 Years</u>
	Of returns <b>greater</b> than:	
10%	17.8%	14.1%
25%	12.5%	10.5%
50%	6.9%	6.7%
	Of returns <b>less</b> than:	
25%	1.4%	3.2%
10%	-3.4%	0.0%

Returns are before investment management and EFIB oversight fees of approximately 0.4% and assume no gain or loss from active management vs. the index

Source: EFIB estimates, Callan Associates (1/14)

Also, due to natural variations in the market, there is a 25% chance returns could be less than 3.2% per year over the next 7 years.

---

# **The cost of EFIB investment management**

---

# Who pays for it?

- No General Funds are required to operate the EFIB
- All EFIB operating expenses are paid by its clients (i.e. taken from dedicated funds)
  - Endowment Earnings Reserve funds
  - State Insurance Fund
  - Bunker Hill Endowment
  - Parks & Recreation endowment funds
- Legislature approves the salary and administration budget, but historically has given the EFIB a continuous appropriation for investment management & consultant fees (which generally vary with asset balances)
- Governor approves salaries

# Endowment Fund Management Expense – FY 2014

		<i>% of Fund</i>
Endowment Fund Board and Staff*	\$ 408,767	0.02%
Consultant, Auditor, Custodian	681,878	0.04%
Investment Managers	6,196,879	0.36%
<b>Total</b>	<b>\$ 7,287,524</b>	<b>0.42%</b>

*Endowment Assets - June 2014 (\$MM)* \$1,744.8

\*Portion paid by land grant endowments. Excludes \$126,180 paid by other clients.

---

# Comparisons with Other States

---

# State Comparison – Who Oversees Land Grant Endowment Funds?

- Specialized Board **ID, NM, UT\***
  - Endowments are a main focus
- Treasurer **AZ, CO, NV, WY**
  - All except CO have an advisory board
- Centralized Board **MT, MN, NB, OR, SD, WA**
  - Invest essentially all state-related funds
    - Equivalent of PERSI, EFIB, and Treasurer combined
- Department of Lands **CA, ND, OK**
- State Board of Education **TX**

*\*This year, Utah transitioned from Treasurer oversight to a specialized board.*

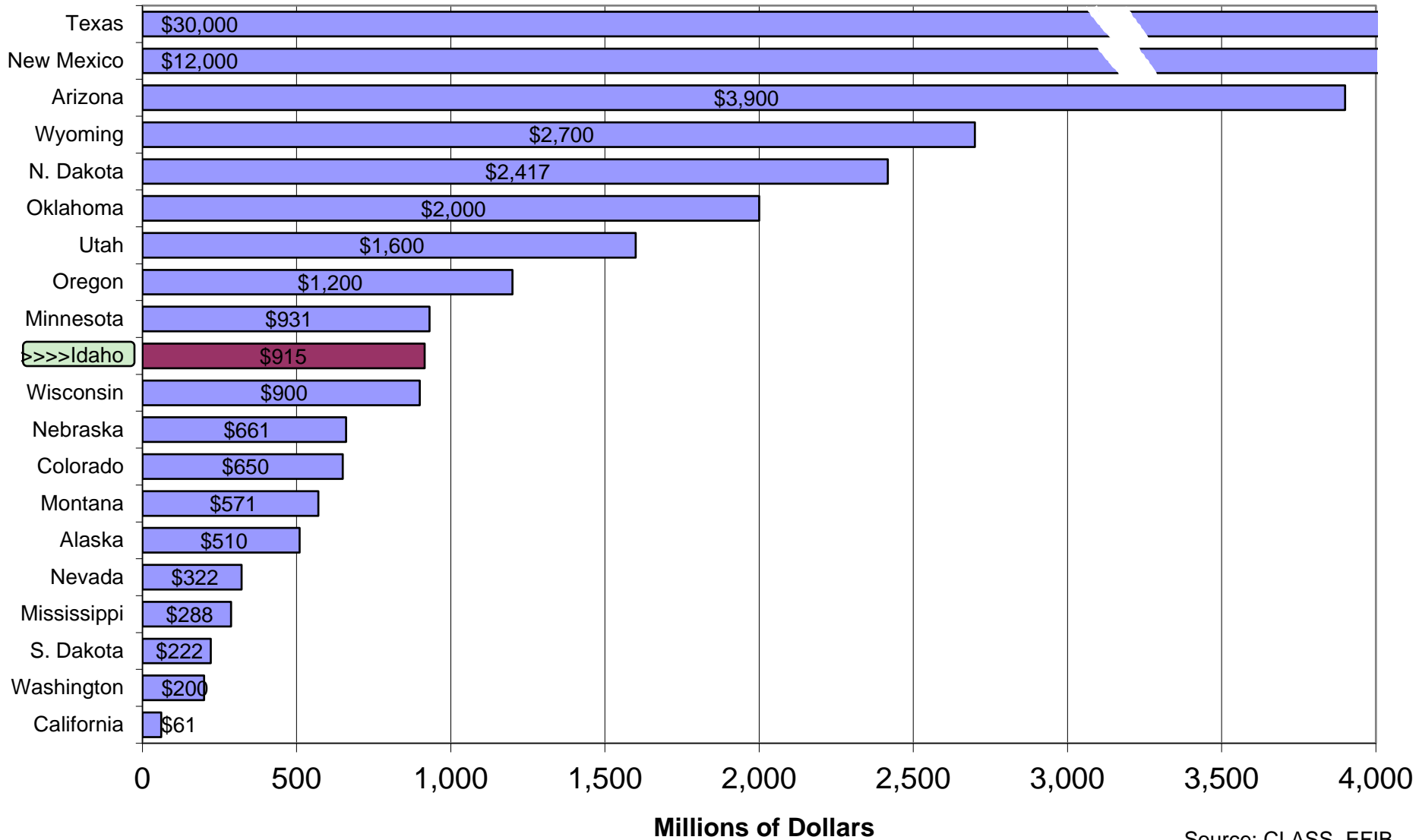
Source: EFIB staff. Note that almost every state has nuances in their governance structure which defy broad categorizations (like this one).

---

# Availability of Land Grant Endowment Fund Information

- Most states east of the Mississippi no longer have endowment land or an endowment fund
  - Information on **Public School Endowments** has been collected by the Children's Land Alliance to Support Schools (CLASS), and is the basis for most of the next three charts
    - Data is available on 19-20 states
  - Information on state's other land grant endowment funds (e.g. for higher education) is not readily available
-

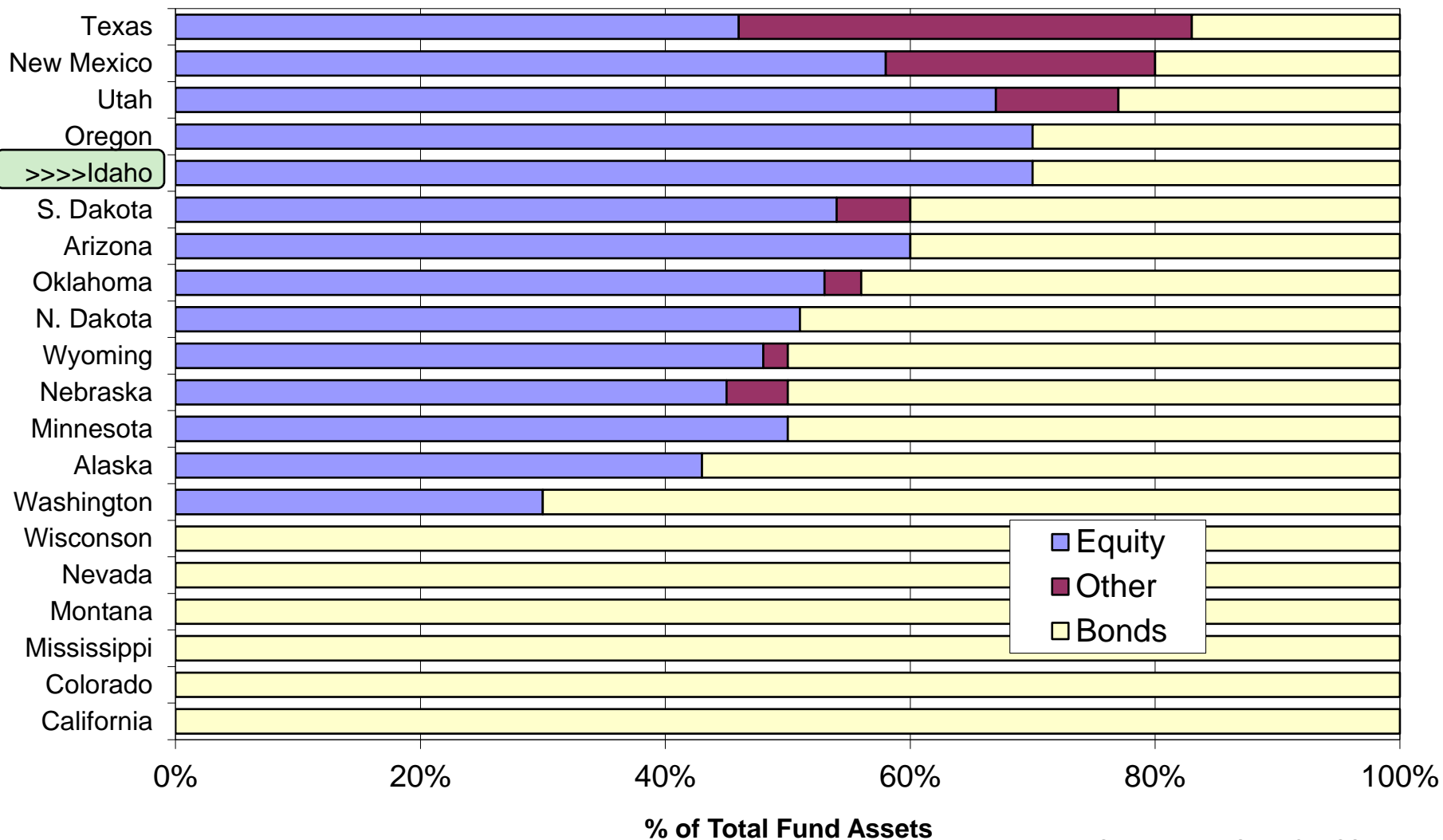
# Public School Endowment Assets By State - FY2013



Source: CLASS, EFIB

Idaho's balance ranks about median. The largest funds have oil & gas revenues.

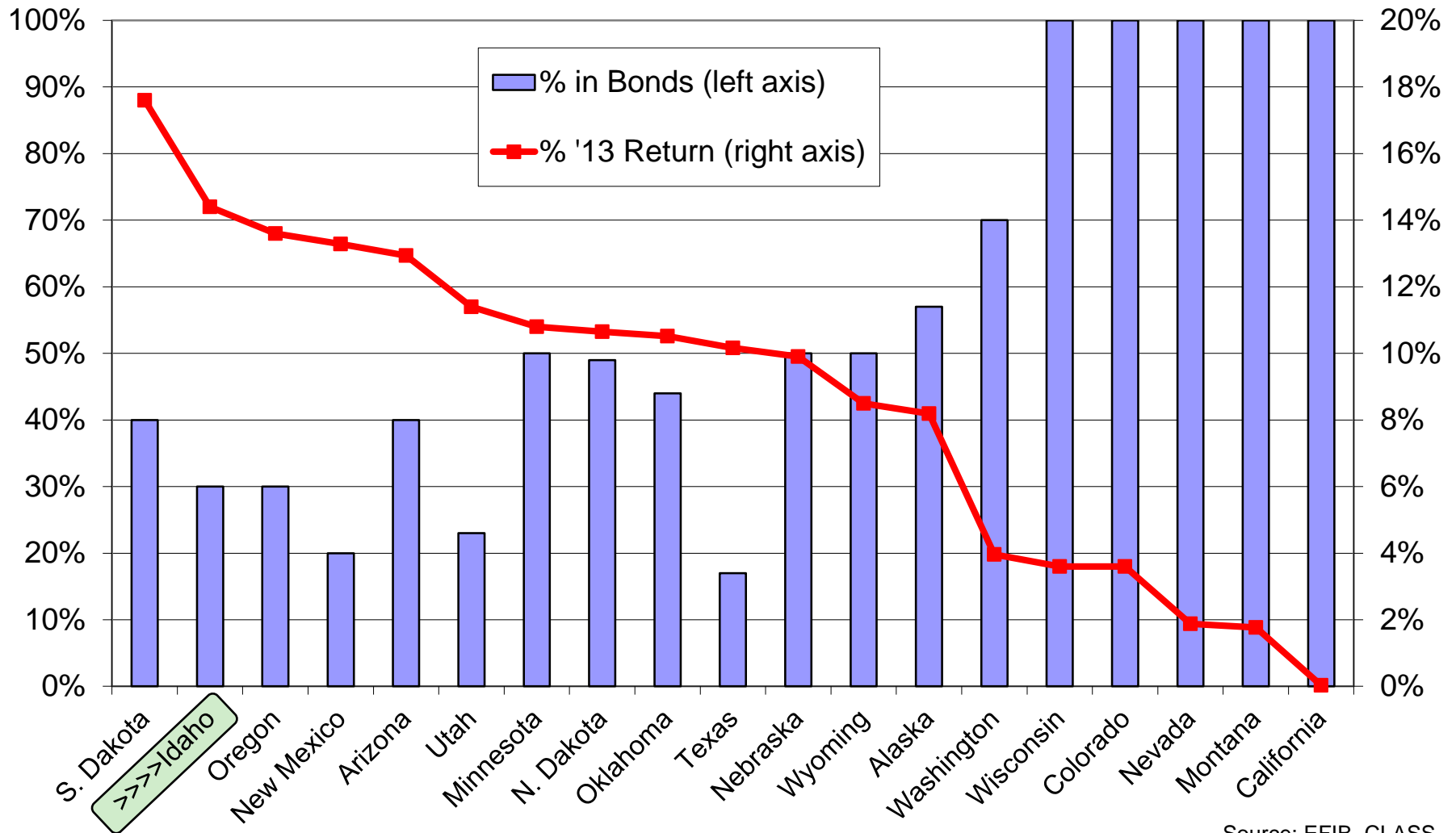
# Asset Mix - Public School Endowment Funds for Various States - FY2013



Source: EFIB Staff, CLASS

Idaho and Oregon have the highest allocation to publicly traded equities.

# Public School Endowments - 2013 Returns vs. Asset Mix



Source: EFIB, CLASS

Stocks outperformed bonds in FY13, so funds with fewer bonds generally performed better.

---

# Summary

- Idaho's endowment funds have performed well
- The governance structure is stable, robust, and cost-effective
- The outlook for fund returns is muted, but...
- With reserves having been built, distributions will continue to grow (barring a prolonged meltdown in equity markets or log prices)

---

# Appendix

---

Presentation to the Interim  
Committee on Endowment Issues

---

# Investment Board Staff

- Larry Johnson
  - Manager of Investments
- Chris Halvorson
  - Investment Officer
- Laurel Fritz
  - Fiscal Officer
- Judy Shock
  - Accounting & Administration

---

# Background of Larry Johnson

## EFIB Manager of Investments

- Idaho native
- Graduate of Boise State University in Economics and Accounting
- 25-year career in the forest products and utility industries in Idaho & Quebec
  - Managed \$2 billion retirement fund portfolio
- CFA charter, CPA, CMA
- Joined the EFIB nine years ago

# Investment Manager Lineup

## ■ Large Cap Equity

- Northern Trust (S&P index)
- **Sands**
- **INTECH**
- *Robeco Boston*
- *LSV*

## ■ Mid Cap Equity

- **TimesSquare**
- *Systematic*

## ■ Small Cap Equity

- **Eagle Asset Management**
- *Barrow, Hanley*

## ■ International Equity

- **WCM**
- *Allianz NFJ*

## ■ Global Equity

- Aberdeen
- Lazard

## ■ Emerging Markets Equity

- **Capital International**
- *GMO*

## ■ Fixed Income (all indexed)

- Northern Trust
- State Street

## ■ Daily Equitization/Rebalance

- Clearwater Associates

## ■ Index Funds (small mandates)

- Vanguard

**Growth style (bold)**

*Value style (italics)*

Core style (normal)

---

# It's a balancing act to achieve “Intergenerational equity”

- Future Beneficiary says:  
*“Don't deplete my principal.”*
- Current Beneficiary says:  
*“Don't hoard my income.”*

# Protecting the Principal from being depleted...

## Major temptation:

Deplete assets to satisfy the beneficiary's current needs at the expense of long-term needs

## Protections in place:

- Federal law and state Constitution: Generally prohibits spending ***original principal***
- State statute: Requires that principal be ***protected from inflation*** before any market appreciation of the Permanent Fund can be distributed
- Land Board policy objective: Requires that distributions be constrained to allow principal to grow faster than both inflation and ***population growth***

---

# Protection against hoarding income (thru miserly distributions)

To protect the current beneficiary from hoarding, Land Board policy:

- Places limits on the amount of income that can be accumulated in Earnings Reserve
- Requires distributions to grow if income is reinvested in the Permanent Fund

---

# Consulting and administrative support – Outside experts

- Custody, portfolio accounting
  - Northern Trust
- Asset mix advice, assist in manager monitoring
  - Callan Associates
- Performance measurement
  - Callan Associates
  - Northern Trust
- Independent financial audit
  - CliftonLarsonAllen

---

# The Prudent Investor Rule

## The fiduciary's standard of care

Managing the investments of others with the same care, skill, prudence and diligence that a prudent man, acting in a like capacity and familiar with such matters, would exercise in the management of their own affairs under the prevailing circumstances

---

# Principles of the Prudent Fiduciary

- Decisions made solely in the interest of participants
- Focus on risk/return
  - Broadly diversified portfolio
  - Prudence of a single investment is determined by its place in the portfolio
- Appropriate delegation to experts

Source: Rusty Olson, The Independent Fiduciary; EFIB