

# **ENDOWMENT FUND REFORM PROGRESS REPORT**

By Robert Maynard

Member, Governor's Committee on Endowment Fund Investment Reform (1996)

December 6, 2013

## **INTRODUCTION AND SUMMARY**

Endowment Fund reform began seventeen years ago with the report and recommendations of the Governor's Committee on Endowment Fund Investment Reform. The ultimate goal was clearly laid out in the initial paragraph of the Committee report in December of 1996:

The state needs to shift its current policy from management of individual parts (the land trust separately from the financial assets) to management of the entire endowment. The entire integrated endowment needs to have its rules of overall operation clarified, reorganized, and reoriented towards providing a predictable and increasing stream of revenue to the beneficiaries while at least maintaining the purchasing power of the assets of the endowment. The endowment also needs to specifically set out its goals and investment policies, including the rules for setting the distribution and level of benefits to both the current beneficiaries and those of future generations.

Most of endowment fund reform has been accomplished to the great benefit of the state and the beneficiaries of the Trust. Some steps, however, remain. The next major step is to introduce more of the "prudent expert rule" mode of thinking and decision making when the Land Board considers Idaho Department of Land (IDL) issues that have substantial investment components. This would essentially require "Trust, but Verify" type procedures when considering issues such as land exchanges, disposition of Land Bank assets, and commercial property transactions.

Currently, for example, IDL staff is responsible for making substantive recommendations, often using outside resources. This report assumes they are expert. But modern public fund investment practice always double checks expert recommendations by additional, independent expert opinions and reviews, and independently monitors performance and maintenance of qualifications. In practice, then, the prudent expert approach requires two separate actions: first, that all investment decisions are done either by experts or upon the recommendations of experts; and second, that independent monitoring systems are in place to assure that the experts making the decisions or recommending the decisions are, in fact, maintaining their expertise and that the decisions (or recommendations) meet institutional investment expert standards. Current Land Board procedures do not contain the second of these two steps – that of independent verification.

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. If desired, outside agents could also be responsible for portions of the actual management of investment activities with oversight by the Land Board through IDL staff and other consultants. These outside experts could also assist the Land Board, with the involvement of both the EFIB and the IDL, in developing an asset allocation policy

from an investment perspective that would include all Land Trust assets, both lands and the financial assets.

The Land Board should request the EFIB to supervise the recommendation of consultants and other experts to independently review, oversee and as necessary opine on the investment activities of the IDL, and present recommended consultants and other experts for approval by the Land Board. The EFIB should subsequently assist the Land Board in monitoring those agents and review any recommendations for conformance with institutional investment practice prior to presentation to the Land Board. The EFIB should not, however, make any independent judgments about the substance of the recommendations and reports (either by IDL staff or the reviewing experts).

### **RECOMMENDATION FOR INDEPENDENT VERIFICATION IS PROCEDURAL, NOT SUBSTANTIVE**

This recommendation for a procedural addition to IDL and Land Board practices makes no judgment on any past or current investments or policies, and no review has been made of those investments, practices, procedures or policies. It could be that an independent review or a contemporaneous outside due diligence opinion would have verified those recommendations, but without that additional independent review one could not be comfortable with any final conclusion under modern investment practice.

Thus, for example, this recommendation does not address the current debate over whether the Land Board should invest in commercial property. It simply notes that under current procedures, one cannot tell if commercial property is an appropriate investment since no asset allocation study reviewed or produced by an independent consultant of the entire Trust assets has been performed. Until such a study has been done from an investment perspective in conjunction with independent experts and has been adopted by the Land Board, the desirability (if any) of commercial property (not to mention the issue of whether that property should be local or national) cannot be confidently asserted under a “prudent expert” framework.

Nor does this recommendation comment on the reasonableness of any particular land swap or any particular purchase of a commercial property proposed or entered into by the IDL. This recommendation assumes that the Idaho Department of Lands is an expert in commercial property management and valuation of land exchanges, and that all of its recommendations are expert recommendations. But the “prudent expert” rule has two parts: first, hire an expert, but second, independently monitor the activities of that expert to assure that that delegated trust is warranted and is maintained. Investment practice recognizes that experts can be wrong or can make mistakes. It is the second part of the requirement to verify decisions or recommendations that is lacking in current Land Board procedures,

Those independent verifications are now standard practices under the “prudent expert” rule used by large institutional portfolios (including the EFIB). Land Board investment decisions involving Idaho lands, however, currently primarily follow procedures developed for land management and regulatory frameworks: namely, the Land Board directly makes a substantive decision on the underlying merits of a proposed action acting solely on the recommendation and analysis of the IDL. Modern investment

practice, however, would ask for more procedural assurance and reduce the Land Board's need to make their own substantive judgment.

With this relatively small procedural addition, endowment fund reform will be very close to achieving all of the aims of an effort that began almost a generation ago.

### **BACKGROUND AND PROGRESS TO DATE**

The primary concept of endowment reform was that the state is managing one entire Land Trust, which for historic and some management reasons had been split into two entirely separate parts: state lands managed by the Department of Lands, and financial assets managed by an Endowment Fund Investment Board who could only invest in certain types of bonds. The central goal was to not only merge the two types of assets in overall policy, but also integrate the different disciplines of land management on the one hand, and modern investment practice on the other.

The main change of endowment reform was to merge what were then entirely separate state entities into one organization under the Land Board with modern investment capabilities. The Land Board became both the land manager and the investment manager of all of the Land Trust. Second, the investment and management options were updated to reflect the changes in investment and fiduciary management that had occurred since the original grants in the late 1800s (such as the recognition that a diversified portfolio of assets across many types could lead to higher returns with less risk or volatility than a portfolio of solely land assets and investment grade bonds).

The Land Board became the ultimate policy maker for both land management and for investment management. The Endowment Fund Investment Board became the tactical arm under the Land Board for the financial assets, with the ability to invest in a wide range of financial assets beyond simply bonds. The Idaho Department of Lands remained as the tactical arm for land management.

Since then, major advances have been made to reach the goals of the reform effort – advances that have rebounded to the clear benefit of the citizens of the state of Idaho. These advances include:

1. The expansion of the investments of the financial assets of the endowment to a professionally managed fully diversified portfolio that is one of the very top performing billion dollar plus investment organizations in the world. For example, in the last ten years (ending with the most recent fiscal year), through some of the most turbulent financial markets in a century, the EFIB has ranked in the top 5% of all public funds (Callan Plan Sponsor Data Base). Over the past 5 years (starting with the Great Collapse of 2008) it has ranked in the top 10% of all endowments and foundations (Bank of New York Mellon database, 191 funds reporting), handily outperforming such well known endowments as Harvard and Yale, and sovereign wealth funds such as Norway and the Alaska Permanent Fund.
2. The Department of Lands has shifted its orientation from a focus on biological management to one that incorporates return considerations in the management of timber and other lands. These return considerations take into account changes in milling technology and preferences for smaller, less defective timber; risk factors such as loss of timber due to fire, insect and disease;

local, national and global market conditions; alternative energy goals and other pecuniary and non-pecuniary factors. Since 1996, annual sustained timber yields have increased approximately 50%. The benefits of this shift include avoiding many of the predictions of precipitous and dwindling timber revenues that were common at the end of the 1990s.

3. Distributions and payments of revenues from the Trust are now largely in the hands of policymakers who can respond to ongoing circumstances (such as the financial crises of 2001-2003 and 2008-2009) rather than left solely to the vagaries of outmoded statutes that acted as a “dead hand” in the distribution of revenue from solely bond interest and interest on timber sales, and which automatically deposited all timber sale revenue in the “lockbox” of the permanent fund (then being managed by an entirely separate Endowment Fund Investment Board). Currently policy makers from the Land Board, the Endowment Fund Investment Board, and even the Legislature can be involved in setting the rules for current distribution and the fair division of assets between future and current generations.
4. The Land Board has adopted an Asset Management Plan, a written investment policy which codifies the principles and procedures by which the Trust operates. This has added significant transparency and consistency to the governance of Trust assets. It has also promoted dialogue between policy makers when reviewing matters such as distribution policy. [The recommendation of this report would have simply added an outside review or involvement by a qualified expert investment consultant both prior to adoption as well as periodically since].

These and other benefits (including focusing on the needs of the individual beneficiaries, rationalizing the management of other land based assets of the endowment, providing for guarantees for school bond issuances, formal reviews of distribution policies, the creation of a Land Bank to provide flexibility in the disposition and management of state lands, increasing the cash flows to beneficiaries, etc.) attest to the dedication of the entire state system, from legislatures through constitutional officers, including citizen appointed boards, and staff members of the Department of Lands, the Endowment Fund Investment Board, and the Office of the Attorney General. While the participants and the public might emotionally feel that on a day to day basis there is slippage, when one looks over the decade and a half of efforts, the change for the better has been most impressive.

### **REMAINING ISSUE AND CHALLENGES**

While great strides have been made, the full benefits of complete integration of the management of the land trust are yet to be achieved. If a football analogy can be used, the ball has been advanced from one’s own goal line to around the opponents’ 15 or 20 yard line. The “red zone” has been reached, but there is yardage still to be gained.

The problems still remaining now lay in the “grey area” between financial assets and land assets: namely, decisions involving land assets that have substantial investment considerations. These areas include decisions involving the investment and deployment of the Land Bank funds, procedures and considerations involving land swaps, the purchase and management of in-state commercial property, decisions concerning asset allocation and distribution policies that do not expressly include all Land Trust assets and cash flows in the same framework as the financial assets, and the lack of a performance

measurement and monitoring system that includes all of the Land Trust assets using currently well-established institutional investment principles.

Currently there are still areas where the options and institutions being considered by the Land Board are artificially constrained by structures, procedures, and approaches that result in “siloed” management of parts of the land trust from parts of the financial trust. Small changes can materially advance the goals of the reform, and might lead to the Land Board being able to consider a wider range of options for the management of the land and financial assets, assure that the best decisions are being made for the Trust as a whole, and potentially avoid some of the controversies that have arisen in the management and disposition of the assets and in the setting of the policies for the distribution of those assets.

For example, there is one clear attitude from the current structure that infects the Trust: that the physical assets of the Department of Lands are seen and treated as a separate “pool” of assets from the financial assets of the Endowment Fund Investment Board. Both parts of the Trust see themselves as separate entities only marginally connected. Further, each entity manages its portion of the Trust with a different mentality: the EFIB from an institutional investor with a “prudent expert” frame of mind, and the Department of Lands as a state land manager and regulator with a primarily operational frame of mind. Each looks at their particular assets from their own different perspectives, and has different values (and valuations) because of that difference. And, at least impliedly, each views “their” assets as being lost if, for some reason, those assets would go to other parts of the Trust.

It is true that there are parts of each section of the Trust that requires those different points of view. The EFIB has no need to be expert on how to manage a timber sale, while the IDL has no need for help in evaluating a potential emerging market investment or whether a stock manager is picking the right stocks. But, there are major points of intersection between the two divisions. When there is investment overlap, the attitude of “separate but equal” managements might cause distortions in policy recommendations and a relative narrow view of the range of potential policy choices.

At the moment there are four issues causing policy and other concerns that demonstrate that further integration of the Trust is needed – that if the goal line of complete integration is still some way away, it does not mean the ball shouldn’t be advanced another ten yards.

These issues are:

1. The interim investment and ultimate destination of Land Bank funds
2. The valuation and implementation of land-swaps (particularly involving cabin sites)
3. The role and management of in-state commercial real estate
4. The determination of distribution policy

The first example is in decisions on Land Bank investments and purchases. The Land Bank is the temporary depository for proceeds from the sales of state lands – otherwise, the monies would be deposited in the Permanent Fund that is managed by the Endowment Fund Investment Board. That deposit of Land Bank monies in the Permanent Fund is delayed for five years to allow for the efficient

management of Trust lands (for example, isolated parcels of grazing land could be more easily consolidated through a Land Bank mechanism).

But, because of the siloed practices, Land Bank proceeds are (or are currently expected to be) kept on deposit in Treasury (in increasingly non-productive cash). Further, because there is an implied view of “use it or lose it”, there is an artificial motivation to invest the monies in in-state commercial real estate because of the perceived need to stabilize land revenues and reduce single industry risk (timber) only within that “silo”. There is an implied view that once monies go to the EFIB and the Permanent Fund, that they can never come back into Idaho, and that the jewel of the state land base will eventually be wasted away.

But investment practices require more. Modern investment practice would have an overall plan, developed in conjunction with and reviewed by independent investment experts, for all of the assets of the Land Trust, and decisions about the destination of Land Bank proceeds would be made in the context of that overall plan (or asset allocation). It may be that in-state commercial real estate is an allowable use of that money, either for return purposes or for long-term policy reasons. However, it is impossible to tell without some overall plan for the entire Trust – one that looks at not only the land assets in IDL, but also the financial assets managed by the EFIB. The Land Bank sits “between” these two components. In-state commercial property should not be the only option under consideration simply because of the tendency to see the entire Trust as consisting of completely separate pools of assets that are not parts of a larger whole.

The second example is land-swaps, particularly concerning cabin sites. For various reasons, land exchanges are used instead of straight sales and purchases. Without commenting on the use of that particular procedure, one problem that remains is that these swaps are now solely for other in-state lands. This is, in large measure, an Admission Act and statutory result of thinking solely from the traditional IDL viewpoint – IDL only has authority to manage in-state properties. And, in-state properties managed by the IDL can only be subsequently disposed of by auction or by another land-swap. Further, while the land swap may put the existing state property on the tax rolls, the new property would be taken off the tax rolls, with a differential between in-state taxing jurisdictions (particularly counties and school districts). These considerations severely constrained the market for land swaps, and therefore the value that might be achieved through land swaps of existing state properties (including cabin sites).

This approach made sense before Endowment Reform, because at that point the Endowment Fund Investment Board was entirely separate from the Land Board and the Idaho Department of Lands. Department of Land properties had to be managed by IDL. But with Endowment Fund reform the Land Board became the responsible party for the management of those endowment assets, and the EFIB became the entity charged with tactical implementation of investments. The EFIB, under prudent diversification standards now available after Reform, can purchase and manage out of state properties and other financial assets without the disposal and other restrictions that exist on in-state properties held by the state of Idaho.

Thus, the valuation options being considered in land swaps are artificially constrained to only properties within the state of Idaho. And, the swap is constructed to be for properties that will be managed in the longer term by the IDL, and not with an eye to being able immediately sell the acquired property at auction for proceeds that would (or could) go to the Permanent Fund for investment by the EFIB. The investment options are much broader than simply in-state commercial property that will be held long term by the IDL, and those options can provide a broader perspective when investment values are part of the ultimate decision. There may be very valid policy reasons for only swapping for in-state land (maintaining the Land Trust's in-state land base, etc.), but the issue of the value of the swap should look at broader considerations. That comparison at least widens the range of possibilities and potentially increases the values of current in-state properties.

The third example is the current management of commercial real estate and cabin sites in the Idaho Department of Lands. These assets are comprised entirely of in-state real estate managed by in-house IDL staff (who make the purchase or sale recommendation and other major property decisions, and implement those decisions through outside property managers, using outside appraisers, etc.). The tradition and orientation of the IDL is to manage assets primarily in-house – the requirements of disposal of state lands (with auction and other standard public protection statutes) and the local nature of the interests to be managed made management by in-house staff the universally preferred alternative.

There are two issues at stake: (1) whether acquiring only in-state commercial property makes sense in the context of the overall assets of the Land Trust; and (2) using solely in-house (IDL) staff for the acquisition and management of the properties without outside independent expert review and monitoring. As noted previously, both occur, in large part, because of the view that the land assets are a separate and siloed part of the Land Trust and should be managed consistent with the land management and regulatory tradition of the Idaho Department of Lands. And, because of that tradition, there is no independent, outside expert review of the investment activities or procedures of the IDL or an independent performance measurement and monitoring system with regular reports to the Land Board.

This is consistent with both the traditional land management and also regulatory activities of the IDL. After all, for example, having an outside expert independently approve a state regulatory decision is nonsensical. But when investment activities are involved, very different considerations and frameworks are involved.

Almost all billion dollar or greater investment funds (such as the Land Trust) have private commercial real estate portfolios. That is also an option for the Land Board when looking at the portfolio of the entire Trust. If part of a reasonable and considered overall asset allocation of the entire assets of the Trust, commercial real estate, whether within or without the state, can be a very legitimate investment. But, most programs make comparisons of real estate purchases on a national (if not international) comparison. There is no reason to restrict the decisions on commercial real estate to solely in-state investments, or constrain the consideration of the merits of a decision to only in-state factors.

Similarly, there is no reason to artificially restrict the management of real estate to solely in-house staff because of historical practice for other IDL activities. The decision on the structuring and oversight of a commercial real estate program should not be artificially restricted or constrained because of a “separate and siloed” mentality. There are a number of options available. There are a number of professional, national firms with the needed expertise to not only assist in the management of the in-state properties, but also to make reasonable comparisons to the decisions and procedures for in-state properties.

In-house management is, of course, an option – larger investment operations (particularly in Canada) often use in-house management because of cost savings. In-house management, for example, is clearly preferred for the Trust’s timberland assets. That is still an option, in whole or in part, for the Trust’s commercial real estate operations. But, here an investment mentality would require an independent review of the in-house management and a separate and independent performance and monitoring system to assure the Land Board that it has hired an “expert” when it has hired itself as the manager.

The fourth example issue is the determination of distribution policy and the scope and review of the asset allocation policy of the entire Land Trust.

Great strides have been made in the determination of the distribution policy of the Land Trust. It is no longer mechanically determined by statutes and regulations laid out separately for the land assets and the financial assets that were set out decades ago in completely different financial and market circumstances. Nor is the division of benefits mechanistically allocated between current and future generations. The EFIB now recommends an annual distribution to the Land Board in accordance with a detailed policy following general principles set out by the Land Board. This policy takes into account expected market environments, projected cash flows from the Department of Lands, and a number of other articulated factors. That recommendation is reviewed and expressly adopted or modified by the Land Board annually.

This largely completes the vision of the original endowment reform that distribution policy should take into account current and future needs of the beneficiaries in a manner that recognizes the changing market and other environments, and should be ultimately in the hands of the elected constitutional officers that comprise the Land Board. Recent debates about alterations to recommended distributions show that those officers are cognizant of those ultimate responsibilities, and that a wide range of considerations are applied.

The only step remaining on the distribution policy is one more of form, and probably not substance. Currently the EFIB proposes a distribution policy that is expressed solely in reference to the financial assets of the Trust, although the development of that policy considers the cash flow projections of the IDL.

Similarly, and requiring more effort, the asset allocation policy is developed solely in terms of the financial assets, with the IDL having its own, and separate, asset allocation policy for the lands – one with a much different cast, focus, and basis. Finally, each part of the Trust has its own performance measurement, again with different formats, concepts, bases, and valuation measures.

All of these activities should be merged for a presentation to the Land Board into one common format, language, and objectives, that is, in turn, reviewed and (if needed) produced by a consultant or other independent investment organization. The measurement and inclusion of “real” assets, including timberland, agricultural land, and mineral lands, in an investment performance report by independent sources is now a common occurrence in the global investment community, and similar standards should apply to the entire Land Trust under the direction and supervision of the Land Board.

Indeed, it is difficult to see any ultimate resolution of the place and desired size of commercial property in the overall Land Trust until there is an express asset allocation that looks at all Land Trust assets on the same footing, which, in turn, would require an investment valuation of the land assets to be comparable to the financial assets. Then there would be an investment basis for allocating some proportion of overall assets (if any) to commercial property. After a decision about the size and benefits of commercial real estate, then there would be a framework for the subsequent determination of the merits on in-state properties as opposed to commercial properties located out of state. But this “top-down” resolution is difficult, if not impossible, as long as the two parts of the Trust are seen (and measured) as separate pools of assets.

#### **ADDITION OF INDEPENDENT OUTSIDE REVIEWS – THE PRUDENT EXPERT RULE**

Land Board decisions involving land transactions and programs with substantial investment components currently rely only on IDL staff recommendations and require the Land Board to make the substantive investment decisions directly. But in the world of investment management and the “prudent expert” rule, other approaches become as feasible (and, in most instances, preferable).

In the investment world, the rules are different – if one directly makes a decision, then one is held to the standards of an expert in the field. But there is another alternative – particularly for investment Boards with “lay” Board members. That is that a Board can hire an outside expert, and then the responsibility is delegated to that outside expert to either make that decision, or present an investment recommendation for action. If the Board makes a different decision than recommended, and it is not for overriding non-investment policy concerns, then that different decision is subject to higher scrutiny. But, if the expert makes the decision, or if the Board follows the recommendations of the expert, then the Board or hiring authority is then only responsible for independently verifying that expertise: namely, that that agent was reasonably considered an expert, and the performance is monitored to assure the expertise is maintained. In other words, the decisions or recommendations of the delegated expert, itself, needs to be independently reviewed and monitored by some other organization independent from that delegated expert.

The Land Board has delegated decision and recommendation authority to IDL staff, and considers IDL the delegated expert. It needs to add independent oversight of the IDL to separately monitor and report to the Land Board on the delegated activities.

Currently, then, Land Board decisions involving land assets with substantial investment considerations do not contain a standard component of most modern institutional investment processes – the inclusion of an independent expert review opinion of the proposed decision, and the regular independent expert

review and monitoring of the investment components of a program. Instead, the Land Board relies on the recommendation and analysis only from the perspective of IDL, who have performed the analysis in-house (although the staff does use outside sources of information, such as appraisals and broker opinions). Even granting that the IDL staff is expert in the area, this is not enough. Standard practice in the investment world requires more.

As an example from the purely institutional investment world, most large funds hire expert stock managers to manage their domestic, international, or global stock portfolios. Those expert stock managers then pick individual stocks, and those managers also use many outside sources of information. Even granted their expertise, relying only on those managers is not enough. There are independent, and often daily, reviews of performance by other outside experts or sources of information (custodial reports, monthly or quarterly consultant reports, separate staff monitoring and reports, to name a few). Outside consultant and independent staff reviews (including on-site reviews) are regularly performed and reported to the usually lay Boards. Comparisons of performance with similar managers as well as against benchmarks are routine. Qualitative judgments of processes and continued expertise of the manager, as well, are a normal part of the information received by the Board. All of these independent, outside reviews are done in addition to receiving the reports of the expert managers themselves on their own stock-picking activities.

Here the role of the expert stock manager in the context of the in-state commercial real estate is performed by the expert IDL staff for real estate and land-swap valuation. Simply relying on their reports of their activities and their recommendations is only a part of the information that needs to be presented to the Land Board if they are to act as an institutional investor under modern standards. Independent confirmations of expertise and continued maintenance of that expertise similar to that performed on hired stock managers needs to be added.

For example, independent outside opinions from an investment perspective of recommendations or options need to be included in the presentations to the Land Board when decisions are made on purchase of in-state commercial properties (including land swaps) or when the management and performance of those properties are reviewed. The Land Board has hired itself (IDL) as the manager of the properties. If it had hired an outside professional real estate manager, then there would be certain reviews by independent consultants and certain performance monitoring reports required under investment industry standards. No less is required when the Land Board essentially has hired itself instead of an outside professional.

These outside reviews might also uncover options or considerations not advanced in the underlying recommendations. These outside opinions might also suggest different or additional procedures or processes that enhance the program. At the very least, these outside reviews will assure a “lay” Land Board and other outside stakeholders that any recommendations are consistent with current institutional practice and meet prudent fiduciary standards.

Therefore the next step in the integration of the two parts of the Trust is to at least partially “meld” the investment approach, procedures, and safeguards common to institutional investing with the IDL land

management and regulatory mentality in those areas where investment issues are a significant consideration. While it is impractical to suggest that that melding of attitudes can be accomplished in one step, some major strides could currently be taken in that direction.

There are various options. But all would require some involvement of one silo with the other in either joint decision making, or independent outside oversight of investment actions involving land assets.

An example for discussion purposes would be if the current structure of IDL primary management is kept. If so, then the EFIB should be responsible for supporting the Land Board's hiring of independent consultants or outside professionals to review, report, and monitor investment related activities and decisions by the IDL. Outside reviewers' mandates would include activities such as quarterly performance reports on all land asset types along with annual reviews of the commercial real estate and other investment related operations and procedures by outside, nationally recognized real estate investment professionals – including recommendations for any changes in procedures or operations, and reviews of annual business plans for the real estate portfolio. Those reports would be presented for initial vetting by the EFIB, and then presented to the Land Board for their consideration, including decisions on any recommendations for changes in operations.

Similarly, an outside expert review of any land exchanges could be achieved by the Land Board through the hiring, with the assistance of the EFIB, of an independent, nationally recognized firm for an opinion of fairness or reasonableness (often called a “due diligence” opinion). Again, the report would be vetted by the EFIB and then passed on to the Land Board for its considerations when it makes the final decision.

One of the first tasks of an independent review would be to determine which IDL activities have substantial enough investment considerations to warrant independent review and monitoring, and perhaps setting some order of priority. Clearly the commercial property operations, the land-swap determinations, allocation of Land Bank monies, and overall Land Trust allocations would fall into “investment related activities” that would be at the head of any list. At the other extreme, the regulatory activities of the IDL, such as regulation of surface mining, forest practices, lake protection, and similar activities would not. These are regulatory activities, not investment activities, and are on the other side of the line between “investment” and “other” activities. Nor does this recommendation mean that all pieces of this puzzle have to be solved at once – the Land Board with the assistance of outside experts, the EFIB, and the IDL would probably need to set some order of priority.

These are just a few of the investment activities that would be involved if the current structure is maintained. Other activities would also be included under this approach.

The EFIB should be formally involved (although not solely responsible) in any recommendation for the use of Land Bank proceeds for potential acquisitions, either as a major actor in making recommendations, or as a formal commentator on any plan to use that money (unless, perhaps, if the Land Bank is being used for its original purpose of consolidating current holdings of state lands). This should be done in the context of an overall asset allocation policy for the entire trust developed in accordance with modern investment practice. In any event, the EFIB should be given its original

intended role of investing Land Bank proceeds, rather than leaving it within the purview of the IDL, whose only investment option is to deposit it as cash in Treasury.

Further, the Land Board with the assistance of the EFIB should formally contract with a nationally recognized firm to develop an independent valuation of the “real” assets of the Land Trust according to institutional investment standards on at least an annual basis and include those valuations and performance in a performance report on the entire Land Trust to be reported to the Land Board. That valuation would, of necessity, project expected cash flows and make some judgment on their riskiness (through the use of a discount rate). That valuation would serve three purposes. The first would be to allow a complete view of the Trust assets in setting distribution policy. The second would allow an annual performance review of the Land Trust assets. Third, that valuation would allow the development of an overall Land Trust asset allocation policy based on the same investment principles and valuations.

It should be emphasized that in this structure the EFIB would not be responsible for the management of the assets of the Land Trust, nor would they even be in the lead position for determining, in the first instance, the preferred policy. Instead, they would be supporting the Land Board in retaining and monitoring independent experts to review potential decisions or actions by the IDL when the IDL is engaged in investment activities. The EFIB would initially review the independent conclusions of outside experts for reasonableness and clarity, and then pass on those reviews to the Land Board prior to any decision being reached.

Another option under the prudent expert rule is to delegate some of the IDL investment activities to an outside nationally recognized organization with real asset expertise, and have IDL and EFIB jointly exercise supervisory and monitoring authority over that outside firm (which would include, as with stock managers, other outside independent reviews of that activity). That firm could be responsible for making recommendations or managing commercial properties or land exchanges, and the joint EFIB/IDL oversight would be responsible for assuring that any decision by the Land Board or report to the Land Board based on that outside group’s recommendation was reasonable and expert. That joint oversight by the IDL and EFIB could also be responsible for overseeing other investment related activities that involve delegation to outside experts.

Again, this recommendation to “verify” IDL activities and recommendations does not, in any way, imply any judgments about current procedures, structures, practices or recommendations of the Idaho Department of Lands. There has been no review here of any of those operations or any of the transactions of the Idaho Department of Lands. It could very well be that an independent review and monitoring would have supported all of the recommendations, or verified all of the practices of the IDL.

But that is not the point of the recommendation. This recommendation is simply an observation that the IDL is performing analyses and making investment recommendations to the Land Board with no independent oversight, review, or monitoring. Independent review and monitoring of experts by other experts is standard practice in the institutional investment industry. The Land Board needs to include such independent verifications of the decisions of the investment expert who has delegated authority

(currently the IDL) and independently monitor the activities of the expert to assure expertise is maintained.

As a side note, once these independent verification procedures are set up, the Land Board might consider delegating the actual substantive decisions down to either IDL staff or another delegated expert. The EFIB board members do not pick individual stocks, and public pensions with commercial property portfolios usually do not have their Board members decide on individual properties. Because, under the prudent expert rule, if a lay Board member makes a specific investment decision, that decision is reviewed under the standards of an expert in the area – and most lay Board members do not meet that criteria. Once the Land Board is convinced of the expertise of its delegated agent (currently the IDL staff) and that expertise is continually confirmed by outside professionals both in general (such as by performance monitoring and structural reviews) and specifically (independent due diligence on major property decisions), it can choose to delegate the investment decision itself (such as whether a land swap is reasonable investment) and only retain approval authority for particular non-investment policy reasons.

In summary, this recommendation assumes that the Department of Lands is an expert. But there are two parts of the “prudent expert” rule. One is to hire an expert. The second is to independently monitor and verify the activities of that expert to assure that the judgment of expertise is warranted and maintained. It is the second of these two requirements – the oversight of the expert – that is lacking in the current procedures and should be added.

In either case, the EFIB is the appropriate entity to assist the Land Board in retaining outside experts, supervise the independent reviews, and monitor the agents to generate those reviews. First, the EFIB is the part of the overall Land Trust operation that is familiar with modern institutional investment practice, and the frame of mind that is needed to implement those practices. Second, the EFIB’s stellar investment record over the past decade is at least proof that it is a professional and well-qualified entity whose judgment and skill have withstood some of the most difficult financial markets in generations. Third, the entity reviewed (here the IDL staff) should not be the ones helping determine who watches them, and who recommends the hiring or firing of those reviewers. That should be the EFIB.

The suggestions set out in this report are only examples of possible approaches. The actual options and recommended courses of actions should be part of the process of the outside reviews facilitated by the EFIB. The EFIB should consult with and recommend to the Land Board, in the first instance, which types of consultants and tasks should be undertaken. For example, there are a number of fiduciary and governance consultants who do reviews of large investment programs and recommend structures and steps to achieve those structures. That may very well be the first type of expert to be hired by the Land Board with the assistance of the EFIB, and the recommendations of that review could set the template for future actions.

In any event, the EFIB should be tasked by the Land Board to

- arrange for the review of IDL activities by an outside expert(s) to be hired by and to report to the Land Board to
  - determine which activities need additional investment oversight
  - recommend experts to be hired by the Land Board to independently review those areas
  - report to the Land Board on options for oversight, review, and monitoring of the investment activities of the IDL
- help implement the preferred option(s) by arranging for the hiring of the experts by the Land Board
- review any reports or recommendations prepared by outside experts for completeness prior to presentation to the Land Board.