

**Legislative Permanent School Fund Commission**

**April 22, 2013**

# Permanent School Fund

*The Permanent School Fund is a trust fund created by the Minnesota State Constitution and designated as a long-term source of revenue for public schools. Proceeds from land sales, mining royalties, timber sales, lake shore and other leases are invested in the Fund. Income generated by the Fund's assets is appropriated directly to school districts. On June 30, 2012, the market value of the Fund was \$842 million.*

## Investment Objective

The State Board of Investment invests the Permanent School Fund to produce a growing level of spendable income, within the constraints of maintaining adequate portfolio quality and liquidity, that will assist school districts.

## Investment Constraints

The Fund's investment objectives are influenced by the legal provisions under which its investments must be managed. These provisions require that the Fund's principal remain inviolate. Any net realized capital gains from stock or bond investments must be added to the principal. Moreover, if the Fund realizes net capital losses, these losses must be offset against interest and dividend income before such income can be distributed. Finally, all interest and dividend income must be distributed in the year in which it is earned.

## Asset Allocation

In order to produce a growing level of spendable income, the Fund is invested to grow over time, and, therefore, has exposure to equities. The current asset allocation is 50% stock/48% fixed income/2% cash.

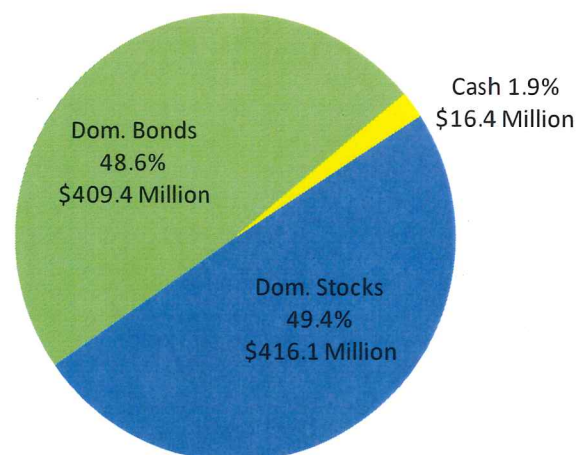
Prior to fiscal year 1998, the Permanent School Fund had been invested entirely in fixed income securities for more than a decade. While this asset allocation maximized current income, it limited the long term growth of the Fund and caused the income stream to lose value in inflation adjusted terms, over time.

To solve both issues, a proposal to introduce equities to the Fund's asset mix was presented during fiscal year 1997. Since this modification would reduce short term income and have budgetary implications for the state, the consent of the executive and legislative branches was necessary.

It was favorably received by the Legislature and incorporated into the K-12 education finance bill. As a result, the Fund allocation was shifted to a 50% stock/48% fixed income/2% cash allocation during July 1997.

Figure 34 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2012.

Figure 34. Permanent School Fund Asset Mix as of June 30, 2012



# Permanent School Fund

## Investment Management

SBI staff internally manages all assets of the Permanent School Fund. Given the unique constraints of the Fund, management by SBI staff is considered to be the most cost effective at this time.

### Stock Segment

The stock segment of the Fund is passively managed to track the performance of the S&P 500.

### Bond Segment

The bond segment is actively managed to add incremental value through sector, security and yield curve decisions, and its performance is measured against the Barclays Capital Aggregate Bond Index.

## Investment Performance

The *stock* segment of the Permanent School Fund had a positive tracking error of 0.1 percentage point for the year compared to its benchmark of the S&P 500.

The *bond* segment underperformed its benchmark by 1.0 percentage point during the current fiscal year, primarily due to a short duration position compared to the benchmark.

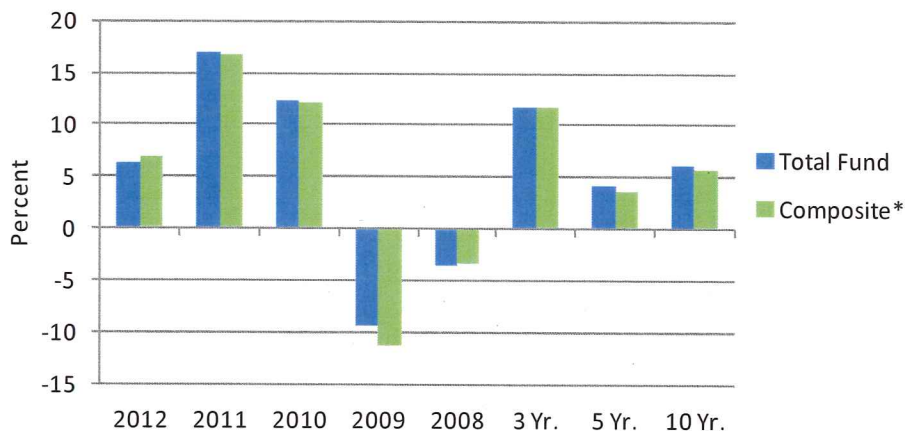
*Overall*, the Permanent School Fund provided a return of 6.4% for fiscal year 2012, underperforming its composite index by 0.4 percentage point. The Fund outperformed its composite index over the most recent five and ten year periods due to the incremental value added by both the stock and bond segments.

Total account results for the last three, five and ten years are shown in Figure 35.

Spendable income generated by the portfolio over the last five fiscal years is shown below:

Fiscal Year	Millions
2008	\$28
2009	\$27
2010	\$23
2011	\$23
2012	\$24

Figure 35. Permanent School Fund Performance for Period Ending June 30, 2012



	2012	2011	2010	2009	2008	3 Yr.	5 Yr.	10 Yr.
<b>Total Fund</b>	<b>6.4%</b>	<b>17.0%</b>	<b>12.3%</b>	<b>-9.3%</b>	<b>-3.6%</b>	<b>11.8%</b>	<b>4.1%</b>	<b>6.1%</b>
Composite*	6.8	16.8	12.1	-11.2	-3.3	11.8	3.7	5.7
<b>Stock Segment</b>	<b>5.5</b>	<b>30.8</b>	<b>14.2</b>	<b>-25.9</b>	<b>-13.1</b>	<b>16.4</b>	<b>0.3</b>	<b>5.4</b>
S&P 500	5.4	30.7	14.4	-26.2	-13.1	16.4	0.2	5.3
<b>Bond Segment</b>	<b>6.5</b>	<b>4.3</b>	<b>9.7</b>	<b>8.5</b>	<b>7.0</b>	<b>6.8</b>	<b>7.2</b>	<b>6.2</b>
Barclays Agg.	7.5	3.9	9.5	6.0	7.1	6.9	6.8	5.6

\* 50% S&P 500/ 48% Barclays Capital Aggregate/ 2% 3 Month T-Bills.

**PERMANENT SCHOOL FUND**

**Investment Objectives**

The investment objective of the Permanent School Fund is to produce a growing level of spendable income, within the constraints of maintaining adequate portfolio quality and liquidity. The income from the portfolio is used to offset expenditures on school aid payments to local school districts.

**Asset Mix**

Effective with FY98, the Permanent School Fund is invested in a balanced portfolio of common stocks and bonds. Common stocks provide the potential for significant capital appreciation, while bonds provide portfolio diversification and a more stable stream of current income.

Prior to FY98, the Fund was invested entirely in fixed income securities in order to maximize current income. It is understood that the change in asset mix will reduce portfolio income in the short term, but will enhance the value of the fund, over time.

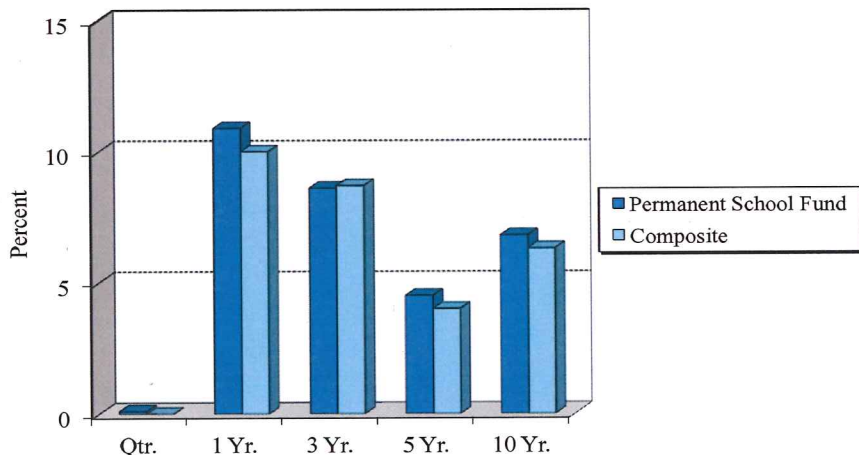
**Investment Management**

SBI staff manages all assets of the Permanent School Fund. The stock segment is passively managed to track the performance of the S&P 500. The bond segment is actively managed to add incremental value through sector, security and yield curve decisions.

**Market Value**

On December 31, 2012 the market value of the Permanent School Fund was \$874 million.

	12/31/2012 Target	12/31/2012 Actual
Stocks	50.0%	50.4%
Bond	48.0	47.7
Cash	2.0	1.9
Total	100.0%	100.0%



Period Ending 12/31/2012  
Annualized

Qtr.	1 Yr.	3 Yr.	5 Yr.	10 Yr.
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<b>Total Fund*</b>	0.1%	10.9%	8.6%	4.5%	6.8%
Composite	-0.1	10.0	8.7	4.0	6.3
<b>Equity Segment*</b>	-0.4	15.9	10.9	1.7	7.2
S&P 500	-0.4	16.0	10.9	1.7	7.1
<b>Bond Segment*</b>	0.6	5.8	5.9	6.5	5.8
Barclays Capital Agg.	0.2	4.2	6.2	5.9	5.2

\* Actual returns are calculated net of fees.

## Permanent School Fund

- Market value of assets on March 31, 2013 was \$ 931 million.
- Annual educational spending is limited by State Constitution to annual interest and dividend income only; none of the principal can be reduced to finance educational spending.
- The investment objective is to produce a growing level of spendable income within the constraints of maintaining adequate portfolio quality and liquidity needed to finance the periodic withdrawals for educational spending.

### Asset Allocation

50% stocks  
48% bonds  
2% cash

- Projected educational spending
  - FY 2013, based on 9 months of actual earnings, is \$ 26 million.
  - FY 2014 – 2016 is approximately \$26 million.