

**NORTH DAKOTA
BOARD OF UNIVERSITY AND SCHOOL LANDS**

INVESTMENT PERFORMANCE REPORT

For periods ended September 30, 2013



PERMANENT EDUCATIONAL TRUST ASSETS

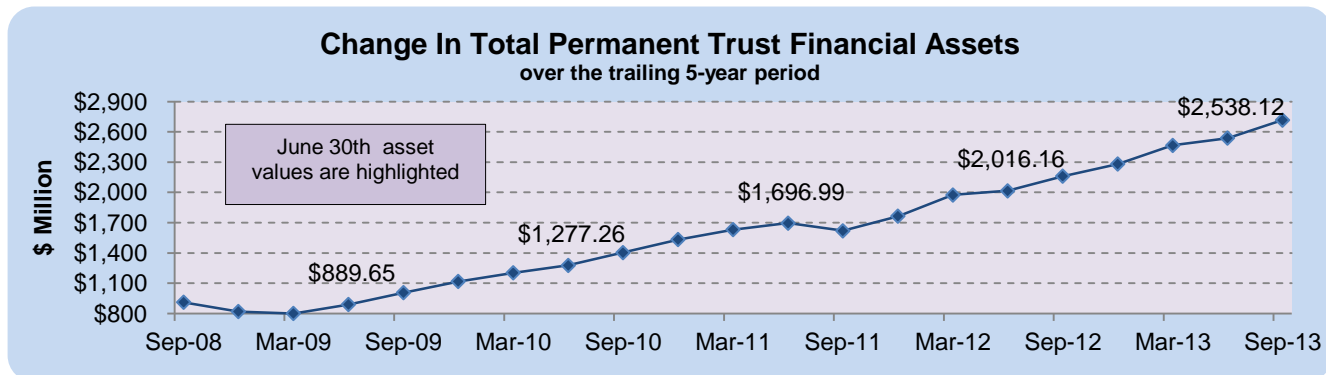
TOTAL TRUST ASSETS

The first section of this report shows combined data for the 13 permanent educational trust funds and the Indian Cultural Education Trust managed by the Board. Most assets of the trusts are invested in a pool. Each trust owns a share of the investments in the pool and each trust shares proportionately in the profits, losses and income generated by those investments.

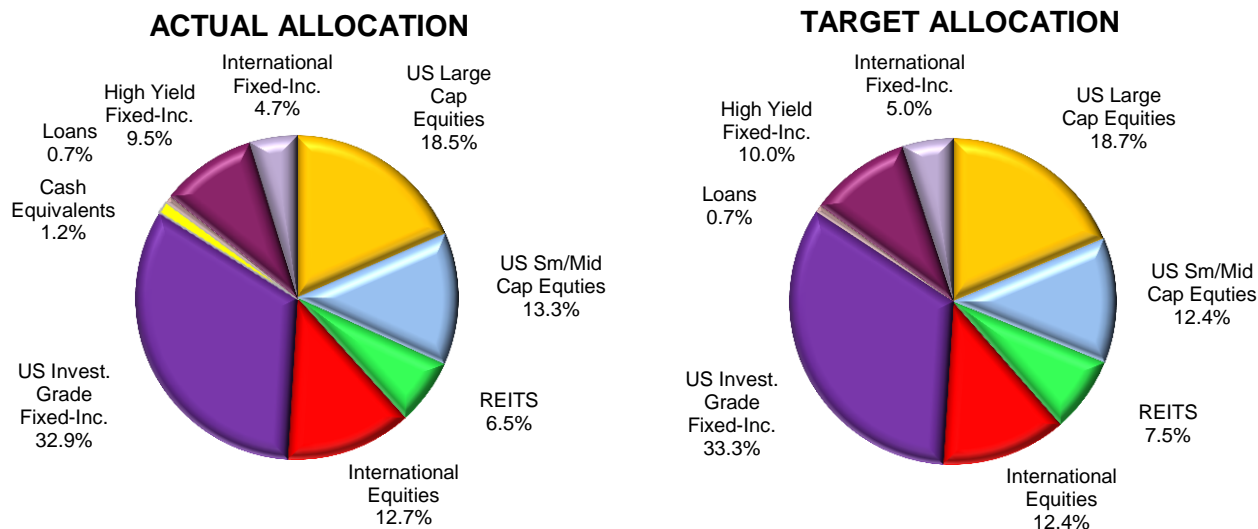
For the schedule below and for all other schedules, tables and charts that follow in this report, all loans, warrants, loan portfolios and certificates of deposit are valued at cost. All other investments in marketable securities, such as stocks, bonds, mutual funds and cash equivalents are valued at market value.

COMPARATIVE ASSET ALLOCATION SCHEDULE						
Date	Total Assets	Large Cap Equities	Sm/Mid Cap Equities	REITS	International Equities	Fixed Income
6/30/13 Rebalanced	\$2,538,122,000	\$474,629,000 18.7%	\$314,727,000 12.4%	\$190,359,000 7.5%	\$314,727,000 12.4%	\$1,243,680,000 49.0%
9/30/13 Actual	\$2,717,090,000	\$502,971,000 18.5%	\$360,112,000 13.3%	\$177,853,000 6.5%	\$343,609,000 12.7%	\$1,332,545,000 49.0%
9/30/13 Target	\$2,717,090,000	\$508,096,000 18.7%	\$336,919,000 12.4%	\$203,782,000 7.5%	\$336,919,000 12.4%	\$1,331,374,000 49.0%

- ◆ Total permanent trust assets grew by \$178.97 million during the quarter ended September 30, 2013, ending the quarter at \$2.72 billion.
- ◆ The investment portfolio earned a total return of 3.92% during the quarter; which was responsible for almost \$100 million of the above noted quarterly trust growth. Oil and gas royalties (\$56.85 million) and oil extraction tax collections (\$36.94 million) were the other large contributors to trust growth during the quarter.
- ◆ A total of \$12.00 million was distributed from the Common Schools Trust Fund to K-12 education in North Dakota during the quarter; a total of \$65.16 million will be distributed to K-12 education during fiscal year 2014. An additional \$4.18 million will be distributed to the beneficiaries of the other 12 permanent trust funds during the fiscal year.
- ◆ As total trust assets continue to grow at a steady pace, so will trust distributions. Projections now indicate that total permanent trust distributions will climb to more than \$200 million during the 2015-17 biennium and could reach more than \$500 million by the 2021-23 biennium.



ACTUAL ALLOCATION VS. TARGET ALLOCATION AS OF SEPTEMBER 30, 2013



Asset Class	Actual \$ million	Actual %	Target \$ million	Target %	Difference \$ million	% Diff.
US Large Cap Equities	\$ 502.97	18.5%	\$ 508.10	18.7%	(\$ 5.13)	(0.2%)
US Sm/Mid Cap Equities	360.11	13.3%	336.92	12.4%	23.19	0.9%
REITS	177.85	6.5%	203.78	7.5%	(25.93)	(1.0%)
International Equities	343.61	12.7%	336.92	12.4%	6.69	0.3%
Total Equities	\$ 1,384.54	51.0%	\$ 1,385.72	51.0%	(\$ 1.18)	(0.0%)
US Invest. Grade Fixed-Income	893.96	32.9%	903.98	33.3%	(10.02)	(0.4%)
Cash Equivalents	32.33	1.2%	0.00	0.0%	32.33	1.2%
Loans	19.83	0.7%	19.83	0.7%	0.0	0.0%
High Yield Fixed-Income	258.83	9.5%	271.71	10.0%	(12.88)	(0.5%)
International Fixed-Income	127.60	4.7%	135.85	5.0%	(8.25)	(0.3%)
Total Fixed-Income	\$ 1,332.55	49.0%	\$ 1,331.37	49.0%	\$ 1.18	0.0%
Total Portfolio	\$ 2,717.09	100.0%	\$ 2,717.09	100.0%		

- ◆ The actual asset allocations to equities and fixed income securities on September 30, 2013 essentially matched the target allocations on that date. The fixed income portfolio was overweight by \$1.18 million, while equities were underweight by the same amount.
- ◆ Within equities, domestic small/mid cap allocation was overweight by approximately 0.9%, while the allocation to REITs was underweight by 1%. This difference is due primarily to the strong performance of small/mid cap domestic stocks (31.55%) versus REITs (5.85%) over the trailing-year. Because the R.V. Kuhns investment study is close to complete, no rebalancing was done between equity portfolios.
- ◆ The overweight position to cash equivalents was used to rebalance the portfolio in late-October, when \$29.0 million was added to the Payden & Rygel Low Duration Fund. Over the past 3 months, all monies that have been allocated to fixed income assets have been invested in Payden & Rygel's Low Duration Fund in anticipation of the completion of the investment study and the implementation of a new asset allocation during 2014.
- ◆ Work continued on the R.V. Kuhns investment study during the quarter. In late-September the Land Board adopted a new, broad asset allocation for the permanent trusts that includes 17% U.S. equities, 15% international equities, 23% fixed income, 15% real estate, 20% absolute return strategies and 10% real assets. The actual structure of the investment portfolios, the hiring of managers and the funding of new mandates will occur over the next 6 to 12 months.

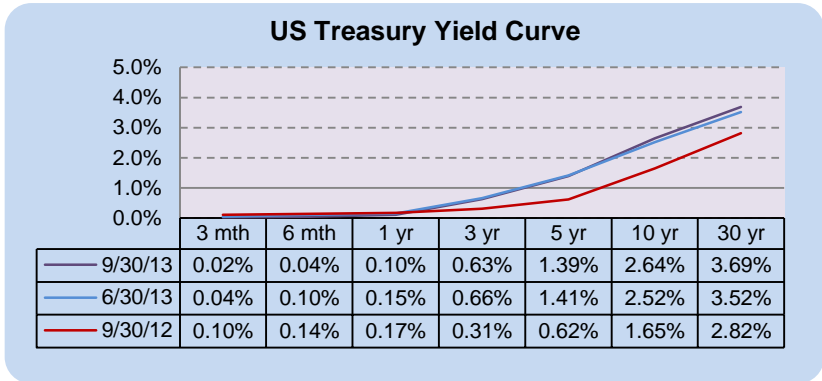
FINANACIAL MARKET OVERVIEW

FIXED INCOME MARKETS

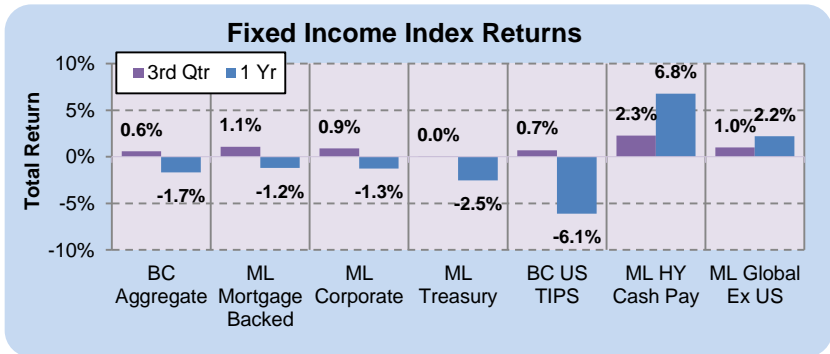
◆ Over the past 3 months the Treasury yield curve steepened as short rates fell slightly and longer-term rates rose slightly. The curve is substantially steeper than it was a year ago.

◆ On September 30, 2013 10-year Treasury rates stood at 2.64%, almost 1% higher than a year earlier; while 30-year rates were at 3.69%, 87 basis points higher than a year earlier. The sharp rise in longer-term rates has been driven by the expectation that the Fed will tighten monetary policy by reducing the purchase of government bonds sooner than later.

◆ Most fixed income asset classes in the permanent trusts' portfolio posted positive returns for the quarter ended September 30, 2013. Only domestic high yield bonds and international investment grade bonds posted positive returns for the trailing-year there ended September 30, 2013



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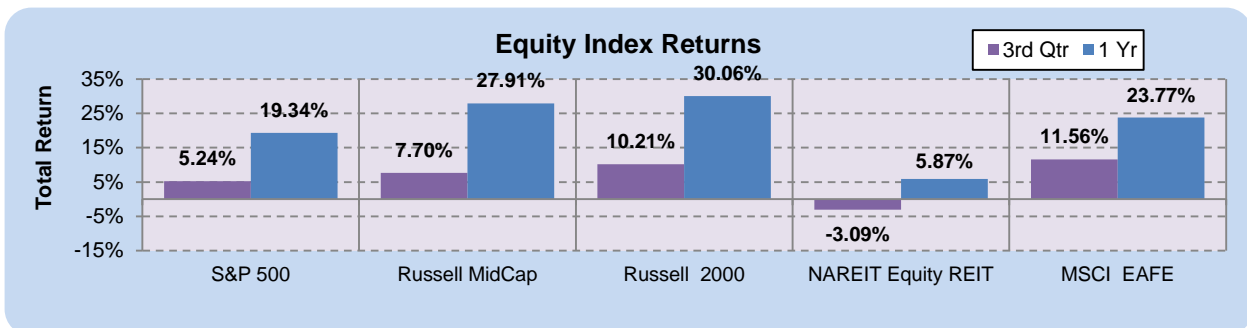


EQUITY MARKETS

◆ Most of the equity asset classes in the portfolio posted strong positive returns for both the quarter and trailing-year ended September 30, 2013; the only exception being REITs, which were down 3.1% for the quarter just ended and up only 5.87% over the trailing-year.

◆ The relatively weak returns posted by REITs for both the quarter and trailing-year can be attributed directly to the Fed's May announcement related to the cutting back on stimulus programs.

◆ Equity indexes were near their all-time highs on September 30, 2013. This is quite a change from only 4.5 years ago in the midst of the financial crisis, when equity markets bottomed out in March of 2009. Since that time the S&P 500 Index has returned 132.0%, the Russell 2000 Index (small cap) has earned 143.4% and the MECI EAFE Index has gained 97.5%. REITs, which were hit very hard during the 2008/2009 recession, have returned 217.2% over the past 4.5 years.



MANAGER AND PORTFOLIO RETURNS

RETURNS FOR PERIODS ENDED SEPTEMBER 30, 2013							
<u>Asset Class</u> MANAGER Benchmark/Index	9/30/13 Allocation (\$ mil.)	% of Total Portfolio	Last Qtr.	Last 1 Year	Last 3 Years	Last 5 Years	Last 10 Years
Large Cap US Equity							
STATE STREET - S&P 500 Index	\$502.97	18.5%	5.23	19.30	16.24	10.02	-
S&P 500 Index			5.24	19.34	16.26	10.02	7.56
Small/Mid Cap US Equities	\$360.11	13.3%	10.28	30.87	18.01	-	-
NORTHERN TRUST	\$139.65	5.2%	9.72	30.06	17.41	11.82	9.20
STATE STREET - Small/Mid Index	\$220.46	8.1%	10.64	31.50	18.67	-	-
60% Russell 2000/40% Russell Mid Cap			9.20	29.21	18.03	11.98	10.17
Russell Completeness Index			10.70	31.53	18.59	13.23	10.55
Real Estate Investment Trusts (REITS)							
DELAWARE INVESTMENT ADVISORS	\$177.85	6.5%	(2.94)	4.95	12.29	5.79	-
NAREIT Equity REIT Index			(3.09)	5.87	12.34	5.75	9.54
TOTAL DOMESTIC EQUITIES	\$1,040.93	38.3%	5.39	20.34	14.48	-	-
International Equities							
STATE STREET - International Alpha	\$343.61	12.7%	11.98	27.98	7.69	-	-
NORTHERN TRUST - EAFE Index	\$277.66	10.2%	12.10	28.28	7.87	5.37	-
MSCI EAFE Index	\$65.95	2.5%	11.57	-	-	-	-
			11.56	23.77	8.47	6.35	8.01
TOTAL EQUITIES	\$1,384.54	51.0%	6.95	21.92	13.22	8.47	7.17
US Investment Grade Fixed Income							
PAYDEN & RYGEL - Aggregate	\$926.29	34.1%	0.57	(1.94)	3.36	-	-
JP MORGAN - Intermediate	\$263.76	9.7%	0.87	(1.35)	3.87	6.84	5.27
BND - Project Notes	\$265.31	9.8%	0.39	(0.80)	-	-	-
PAYDEN & RYGEL - Low Duration	\$2.21	0.1%	0.07	1.29	2.52	5.14	4.89
NORTHERN TRUST - TIPS	\$194.15	7.1%	0.30	0.68	3.25	4.67	4.06
PAYDEN & RYGEL - Cash	\$168.53	6.2%	0.77	(6.09)	4.03	5.57	-
Barclay's Capital US Aggregate Index	\$32.33	1.2%	(0.01)	0.03	0.02	0.11	1.73
Barclay's Intermediate Govt./Corp.			0.58	(1.67)	2.88	5.42	4.60
Barclay's Capital TIPS			0.62	(0.50)	-	-	-
6 Month T-Bill			0.71	(6.09)	4.02	5.31	-
			0.01	0.12	0.14	0.33	1.80
Loans	\$19.83	0.7%	1.62	5.30	5.90	-	-
BND - Farm Loan Pool	\$18.36	0.7%	1.65	5.31	5.89	6.27	6.94
BND - Energy Construction Loans	\$1.47	0.0%	1.26	5.20	-	-	-
US High Yield Fixed Income							
LAZARD ASSET MANAGEMENT	\$258.83	9.5%	1.91	5.26	7.41	9.91	-
Merrill Lynch US High Yield Cash Pay Index			2.27	6.79	8.75	13.17	-
Merrill Lynch BB/B Index			2.07	6.04	8.42	11.92	-
TOTAL DOMESTIC FIXED INCOME	\$1,204.95	44.3%	0.88	(0.17)	4.38	-	-
International Invest. Grade Fixed Income							
FIRST INT'L ADVISORS	\$127.60	4.7%	(0.01)	0.23	2.75	5.48	-
Merrill Lynch Broad Global (Ex-US) Index - Hedged			1.00	2.19	3.15	4.78	-
TOTAL FIXED INCOME	\$1,332.55	49.0%	0.80	(0.13)	4.21	6.40	5.29
TOTAL PORTFOLIO	\$2,717.09	100.0%	3.92	10.82	9.02	8.07	6.62

All return figures for periods of 1 year or greater have been annualized. All returns are net of fees.

EQUITY PORTFOLIO REVIEW

- ◆ During the quarter ended September 30, 2013, the combined equity portfolio posted a total return of 6.95%; it earned 21.82% for the year there ended.
- ◆ All three of the permanent trusts' active equity managers (Northern Trust Small/Mid, Delaware REIT and State Street - International Alpha) outperformed their benchmarks for the quarter ended September 30, 2013. Both the NTGA and State Street portfolios also outperformed for the trailing-year there ended.
- ◆ All new money being added to equities continues to be added to one of the portfolio's index funds when possible. Doing so will help reduce the cost of transitioning to the new asset allocation that was recently adopted by the Land Board.
- ◆ It is important to note that although the amount of assets managed for the Land Board by State Street has grown to close to \$1 billion over the past few years; "manager risk" is not a concern as the vast majority of the assets managed are in passive index accounts.

Northern Trust – Small/Mid Cap

- ◆ Northern Trust outperformed the custom benchmark for this account for both the quarter and trailing-year ended September 30, 2013. Northern underperformed for the three, five and ten-year periods shown in the table on page 4, but have posted a return of 10.07%, and beat the benchmark for this account by 89 basis points, since inception of this account back in April 1996.
- ◆ This portfolio is invested in Northern's "manager of managers" program; it currently consists of 5 small cap managers and 3 mid cap managers. The benchmark for the account is a custom index made up of 60% of the return of the Russell 2000 (small cap) Index and 40% of the return of the Russell Mid Cap Index.
- ◆ Six out of the eight managers that make up this portfolio outperformed their benchmarks during the quarter. The portfolio's overweight to industrial and technology sectors, and underweight to the financial sector added the most to relative performance during the quarter.

Delaware Investment Advisors

- ◆ Delaware outperformed versus the benchmark for this portfolio by a small margin for the quarter ended September 30, 2013, but underperformed by 89 basis points for the trailing one-year period there ended. Delaware has essentially matched the benchmark for all longer periods of time shown in the table on page 4, and since inception of the account almost 10 years ago.
- ◆ An overweight position in the industrial sector had a positive impact on relative performance as did the underweighting of the healthcare sector. An underweight position and poor stock selection in the lodging sector hurt performance.
- ◆ According to Delaware, the recent selloff in the REIT sector has led to opportunities to buy attractive companies that are selling at discounts to net asset value. Delaware feels this bodes well for performance going forward.

State Street Global Advisors (SSGA) – International Alpha

- ◆ State Street outperformed the benchmark for this account by 54 basis points for the quarter ended September 30, 2013 and 450 basis points for the trailing-year there ended. This portfolio has underperformed for all other periods shown in the table on page 4.
- ◆ Although the portfolio has performed exceptionally well since the dynamic component was added to SSGA's quantitative model in early 2012, the Commissioner intends to work with R.V. Kuhns to evaluate whether or not it makes sense to continue using this investment strategy going forward.

FIXED INCOME PORTFOLIO REVIEW

- ◆ The combined fixed income portfolio earned a total return loss of 0.80% during the quarter ended September 30, 2013. The portfolio posted a negative return of -0.13% for the trailing-year there ended, as rising interest caused valuation decreases that more than offset the interest income earned by the portfolio.
- ◆ Almost every fixed income manager posted a positive return for the quarter, but the permanent trusts' loan and high yield bond portfolios were the biggest drivers of fixed income returns. For the trailing-year the performance of TIPS had the biggest negative impact on performance while the performance of loans and high yield bonds had the biggest positive impact.
- ◆ Of the active fixed income managers in the portfolio, only Payden & Rygel (Aggregate) was able to outperform over both the quarter and trailing-year ended September 30, 2013. J.P. Morgan, Lazard and First International all underperformed for both the quarter and trailing-year.

Payden & Rygel – Aggregate

- ◆ Payden outperformed the benchmark for the quarter ended September 30, 2013, and for all other periods shown in the table on page 4.
- ◆ The portfolio's overweight exposure to corporate bonds helped relative performance during the quarter as did the portfolio's underweight to Treasury securities. The portfolio's large position in mortgage backed securities was neutral to the portfolio's overall return.

J.P. Morgan

- ◆ The J.P. Morgan intermediate portfolio has underperformed the Barclays Capital Gov./Corp. Intermediate Index by a small margin for all periods shown in the table on page 4.

Payden & Rygel – Low Duration Fund

- ◆ Since August of 2013, all cash flows that need to be allocated to fixed income have been invested in Payden & Rygel's Low Duration Bond Fund (previously known as Short Bond Fund). During the quarter a total of \$55.5 million was added to the Low Duration Fund.
- ◆ This is being done in anticipation that many fixed income assets will be redeployed to other asset classes when the permanent trust's new asset allocation is implemented in early 2014.

Bank of North Dakota (BND) – Farm Loan Pool

- ◆ No new loans have been funded since April 2012, when it was decided that it wouldn't be prudent for the Board to lock up funds long-term at historic low interest rates. Longer-term rates will not have to rise a whole lot more for the Board to once again begin funding new farm loans.

Lazard

- ◆ Lazard has underperformed both the broad Cash Pay index and the higher quality BB/B index for the quarter ended September 30, 2013, and for all other periods shown in the table on page 4.
- ◆ The strong performance of lower quality CCC bonds (3.4%) versus higher quality B (2.2%) and BB (1.9%) bonds was the primary cause of underperformance for the quarter.

First International Advisors

- ◆ Although First International underperformed versus the benchmarks for the quarter and trailing 1 and 3-year periods ended September 30, 2013, they have outperformed both benchmarks over the past 5 years and since inception of the account in April 2004.
- ◆ The cost of fully hedging the portfolio (-88 basis points) and poor security selection (-1.56 basis points) were the driving force of the portfolio's 226 basis points of gross underperformance during the first nine months of 2013.

OTHER TRUSTS MANAGED BY THE LAND BOARD

The **Strategic Investment and Improvements Fund (SIIF)** was created effective July 1, 2011, by legislative action, through the merging of the former Budget Stabilization and Lands and Minerals funds. It holds the assets and collects the revenues earned from 758,000 sovereign mineral acres, including those formerly owned by the Bank of North Dakota and State Treasurer and minerals located under navigable rivers and lakes. The SIIF also receives a substantial portion (more than \$712 million during the 2011-13 bi.) of the oil and gas production and extraction taxes collected by the State.

	9/30/13 Asset Balances	Current Yield
Strategic Investment and Improvements Fund		
Medical Facility Loan Fund	\$ 50,000,000	0.05%
School Construction Loans	\$ 28,492,000	1.19%
Treasury Securities	<u>\$ 891,365,000</u>	0.18%
Total	\$ 969,857,000	

- ◆ During the quarter ended September 30, 2013, \$50 million was transferred to the medical facilities infrastructure loan program at BND, \$28.49 million of new school construction loans were funded and \$9.6 million was transferred to the Attorney General's Office to provide grants to law enforcement agencies for crime related needs.
- ◆ Because this fund is fully expendable and an additional \$680 million will be transferred out of the SIIF or committed to school loans or loan guarantees before the end of the current biennium, it is currently invested in short-term Treasury securities that mature before June 30, 2015.
- ◆ The investment study currently being performed by R.V. Kuhns will explore whether this fund could be invested in a way that better balances the SIIF's liquidity needs with the desire to earn income.
- ◆ The unobligated balance of the SIIF was \$75.75 million on September 30, 2013. The unobligated fund balance is the amount of the fund balance that has not been set aside until potential title disputes to certain riverbed leases are resolved and has not been committed to future distribution or dedicated to various loan programs. Once the unobligated balance reaches \$300 million, 25% of all revenues that go into this fund will instead be deposited into the Legacy Fund.

The **Capitol Building Trust** was created for the construction and maintenance of "public buildings at the capital". It generates revenues from the almost 10,000 surface and 27,700 mineral acres it owns. Because the entire balance of this trust can be appropriated by the legislature each biennium, it is invested in conservative, short-term fixed income securities which tend to have maturities of two years or less.

	9/30/13 Asset Balances	Current Yield
Capitol Building Trust		
Treasury Securities	\$ 2,957,000	0.28%

- ◆ A total of \$1.2 million was appropriated from this trust for the 2011-13 biennium. The bulk of that appropriation authority relates to capitol grounds' projects that began during the 2011-13 biennium but were not completed; further work on these projects will not be performed until the summer of 2014.
- ◆ The yield of the portfolio climbed during the quarter as lower yielding bonds matured, and the proceeds were reinvested in higher yielding Treasury securities. The part of this trust that will be spent during the biennium is invested out to the date Facilities Management has informed us they will need the money. The balance of these assets are invested to the end of the biennium.

The **Coal Development Trust Fund** is a permanent fund from which the Land Board issues loans to energy impacted counties, cities and school districts as provided in NDCC Section 57-62-03, and loans to school districts pursuant to NDCC Chapter 15-60. The Land Board is responsible for investing all funds that have not been loaned to political subdivisions. Because these funds can be loaned at any time, they are invested in a conservative short-term fixed income portfolio managed by Payden & Rygel. The income earned by this fund is transferred to the General Fund each year.

	9/30/13 Asset Balances	Current Yield
Coal Development Trust Fund		
Coal Warrants	\$ 7,846,000	3.84%
School Construction Loans	\$ 32,010,000	2.08%
Marketable Securities	<u>\$ 25,481,000</u>	N/A - see returns below
Total	\$ 65,337,000	

- ◆ The Commissioner expects that the school construction loan balance will reach the statutory cap of \$50 million during the current biennium; this would be the first time the cap has ever been reached. Funding for any new loans will come out of the marketable securities portfolio managed by Payden & Rygel.

Payden and Rygel – Coal

- ◆ Payden & Rygel essentially matched the performance of the benchmark Merrill Lynch 1-3 Year Treasury Index for the quarter ended September 30, 2013; they underperformed the benchmark by 85 basis points during the trailing-year there ended. The portfolio’s exposure to both credit and mortgage backed securities had a negative impact on performance during the past year.
- ◆ Long-term performance, for both the past 10-years and since inception in 1995, is now just slightly below the benchmark for this portfolio.

	9/30/13 Asset Balance	Last Qtr.	Last 1 Year	Last 3 Years	Last 5 Years	Last 10 Years
Payden & Rygel Coal Dev.	\$25.41	0.26	0.51	1.21	2.27	2.56
ML 1-3 Year Treasury Index		0.30	1.35	1.04	1.81	2.67
All return figures for periods of 1 year or greater have been annualized. Returns are net of fees						