

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

**INVESTMENT PERFORMANCE REPORT**

**For periods ended March 31, 2014**



## PERMANENT EDUCATIONAL TRUST ASSETS

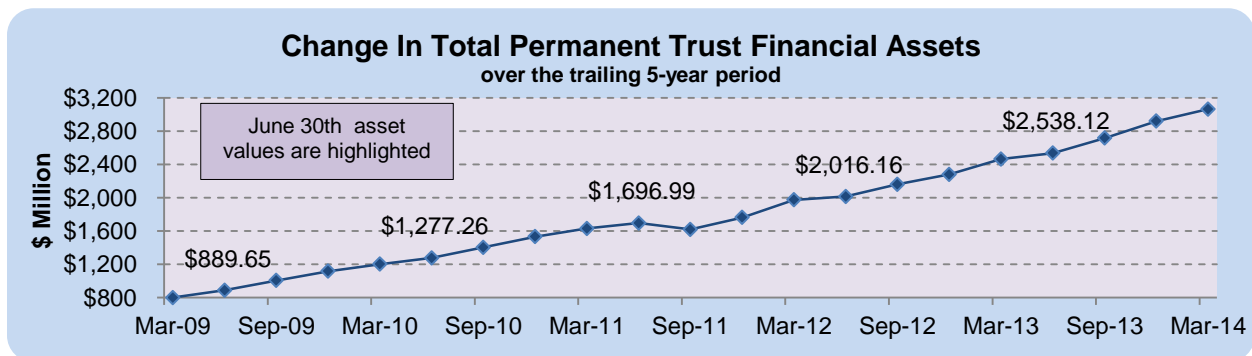
### TOTAL TRUST ASSETS

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.

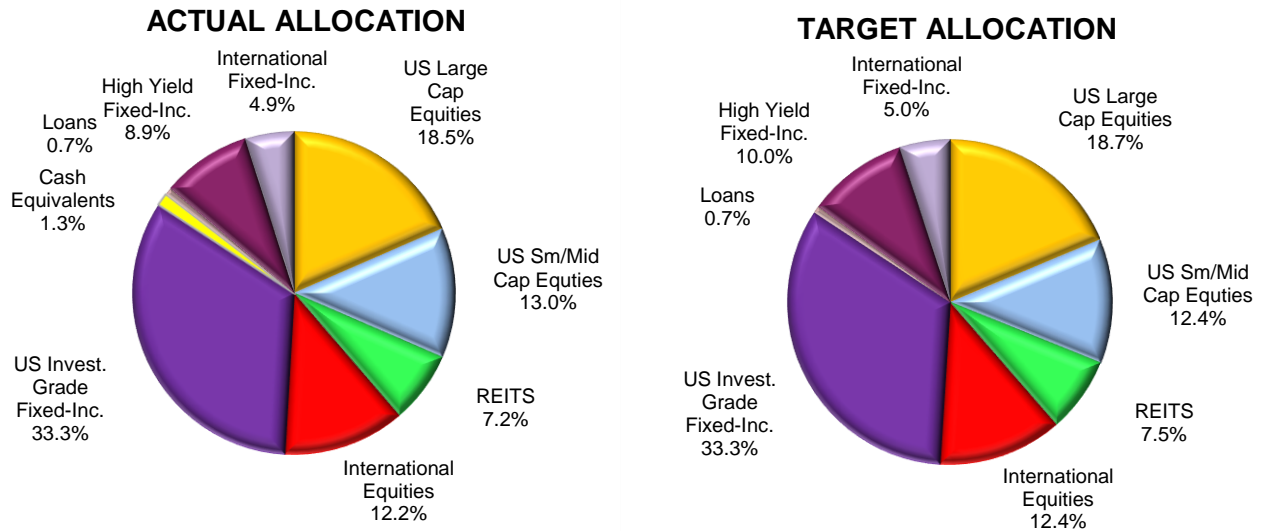
For the schedule below and for all other schedules, tables and charts that follow in this report, all loans, warrants, loan portfolios and certificates of deposit are valued at cost. All other investments in marketable securities, such as stocks, bonds, mutual funds and cash equivalents are valued at 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%
<b>3/31/14 Actual</b>	<b>\$3,065,466,000</b>	<b>\$565,879,000 18.5%</b>	<b>\$399,870,000 13.0%</b>	<b>\$220,918,000 7.2%</b>	<b>\$374,402,000 12.2%</b>	<b>\$1,504,397,000 49.1%</b>
3/31/14 Target	\$3,065,466,000	\$573,242,000 18.7%	\$380,118,000 12.4%	\$229,910,000 7.5%	\$380,118,000 12.4%	\$1,502,078,000 49.0%

- ◆ Total trust assets grew by \$142.75 million for the quarter ended March 31, 2014; total assets grew by more than \$527.34 million during the first 9 months of fiscal year 2014.
- ◆ The investment portfolio earned a total return of 2.24% during the quarter, and was responsible for more than \$66.0 million of the above noted quarterly trust growth. As usual, oil and gas royalties (\$51.29 million) and oil extraction tax collections (\$35.32 million) were the other large contributors to trust growth during the quarter.
- ◆ A total of \$25.2 million was distributed from the Common Schools Trust Fund to K-12 education in North Dakota during the quarter. An additional \$2.1 million was distributed to the beneficiaries of the other 12 permanent trust funds in January 2014.
- ◆ Permanent trust total assets exceeded \$3 billion for the first time during February 2014. It took 120 years for the permanent trusts to grow to \$1 billion, an additional 2.75 years to hit the \$2 billion mark and only 1.67 years to reach \$3 billion. The permanent trusts have grown by more than \$2.26 billion dollars over the 5-year period ended March 31, 2014.



## ACTUAL ALLOCATION VS. TARGET ALLOCATION AS OF MARCH 31, 2014



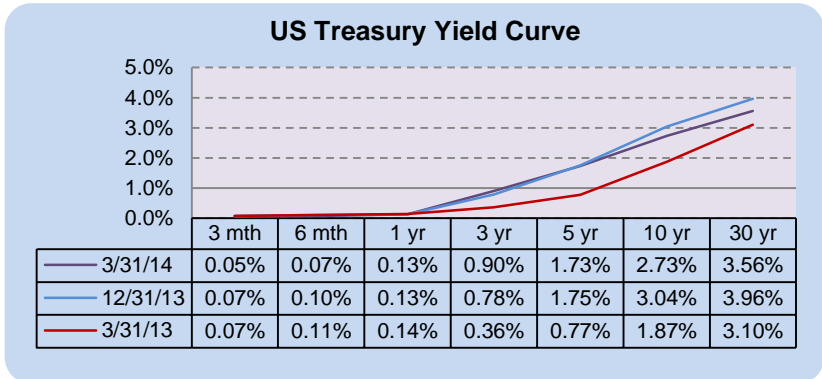
Asset Class	Actual \$ million	Actual %	Target \$ million	Target %	Difference \$ million	% Diff.
US Large Cap Equities	\$ 565.88	18.5%	\$ 573.24	18.7%	(\$7.36)	(0.2%)
US Sm/Mid Cap Equities	399.87	13.0%	380.12	12.4%	19.75	0.6%
REITS	220.92	7.2%	229.91	7.5%	(8.99)	(0.3%)
International Equities	374.40	12.2%	380.12	12.4%	(5.72)	(0.2%)
<b>Total Equities</b>	<b>\$ 1,561.07</b>	<b>50.9%</b>	<b>\$ 1,563.39</b>	<b>51.0%</b>	<b>(\$ 2.32)</b>	<b>(0.1%)</b>
US Invest. Grade Fixed-Income	1,021.34	33.3%	1,020.85	33.3%	0.49	0.0%
Cash Equivalents	38.19	1.3%	0.00	0.0%	38.19	1.3%
Loans	21.40	0.7%	21.40	0.7%	0.00	0.0%
High Yield Fixed-Income	273.69	8.9%	306.55	10.0%	(32.86)	(1.1%)
International Fixed-Income	149.77	4.9%	153.27	5.0%	(3.50)	(0.1%)
<b>Total Fixed-Income</b>	<b>\$ 1,504.39</b>	<b>49.1%</b>	<b>\$ 1,502.07</b>	<b>49.0%</b>	<b>\$ 2.32</b>	<b>0.1%</b>
<b>Total Portfolio</b>	<b>\$ 3,065.46</b>	<b>100.0%</b>	<b>\$ 3,065.46</b>	<b>100.0%</b>		

- ◆ The actual asset allocations to equities and fixed income securities on March 31, 2014 essentially matched the target allocations on that date. The fixed income portfolio was overweight by \$2.32 million, while equities were overweight by the same amount.
- ◆ Within equities, small/mid cap domestic equities were overweight at quarter's end while all other equity asset classes were underweight. This difference is due primarily to the strong performance of small cap over the past year. Because all equity classes will be reduced during the implementation phase of the asset allocation study, the Commissioner and staff have not wanted to buy securities for the underweight portfolios to turn around and sell them when portfolio restructuring begins.
- ◆ The overweight position to cash equivalents was used to rebalance the portfolio in late-April, when \$35.0 million was added to the Payden & Rygel Low Duration Fund. Money is being parked in the Low Duration fund so that it is readily available for the implementation phase of the study. High yield bonds have been purposely left underweight as they are riskier than cash equivalents or the Low Duration Fund and the high yield account will be reduced to 4% of assets during the implementation phase.
- ◆ Work on the implementation phase of the study began in February 2014, when the Board adopted an equity structure for developed markets that was 100% passive. The Board also decided that emerging market equities should be actively managed. In March 2014 the Board approved SSGA as the firm to manage passive equity strategies and also approved 5 managers to be interviewed for the Global Tactical Asset Allocation and emerging markets portions of the permanent trusts' portfolio.

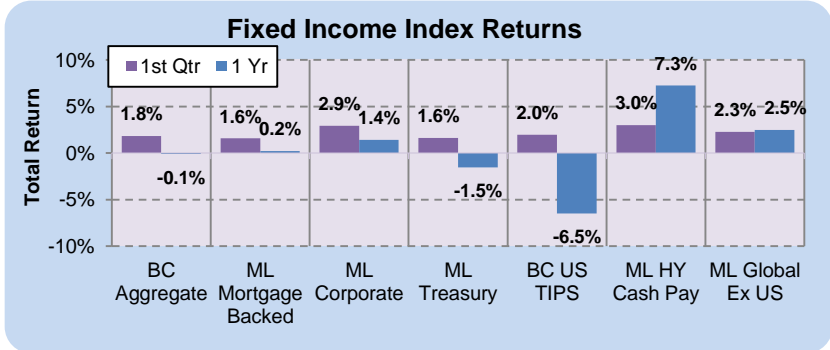
## FINANCIAL MARKET OVERVIEW

### FIXED INCOME MARKETS

- ◆ During the quarter, the Treasury yield curve flattened, although it was still substantially steeper than it was a year ago.
- ◆ Longer-term Treasury rates have been on a roller coaster ride over the past year. The 10-year Treasury rate stood at 2.73% on March 31, 2014, 86 basis points higher than a year ago, but 31 basis points less than 3 months ago. The 30-year Treasury rate was also higher than a year ago and lower than 3 months ago. Disappointing economic data, caused in part by a harsh winter, drove investors into safer assets, even as the Fed continued with plans to reduce the amount of stimulus it was providing markets.

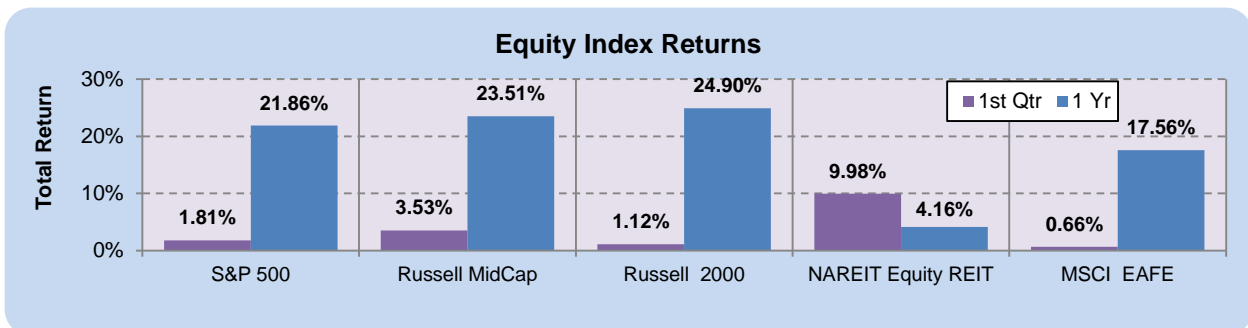


- ◆ Most domestic fixed income indexes posted stronger returns for the quarter ended March 31, 2014 than for the trailing-year there ended. The exception was high yield bonds, which posted strong returns for the trailing year as spreads tighten. Global bonds posted similar returns for both the quarter and year ended March 31, 2014.



### EQUITY MARKETS

- ◆ All equity asset classes in the portfolio posted positive returns for both the quarter and trailing-year ended March 31, 2014.
- ◆ Most equity asset classes posted low single digit returns for the quarter ended March 31, 2014. After a number of quarters of poor performance, REITs were the strongest equity performer during the 1<sup>st</sup> quarter of 2014. After being hurt by the Fed's actions to reduce the stimulus during much of 2013, REITs benefited during the quarter as interest rates fell.
- ◆ Domestic equities of all cap sizes posted the strongest returns (20%+) for the trailing year ended March 31, 2014. International equities, as measured by the MSCI EAFE Index, posted returns in the high teens for the trailing year, while REITs returned far less over the same time period.



## MANAGER AND PORTFOLIO RETURNS

RETURNS FOR PERIODS ENDED MARCH 31, 2014								
<u>Asset Class</u> MANAGER Benchmark/Index	3/31/14 Allocation (\$ mil.)	% of Total Portfolio	Last Qtr.	Last 1 Year	Last 3 Years	Last 5 Years	Last 10 Years	
<b>Large Cap US Equity</b>								
STATE STREET - S&P 500 Index	\$565.88	18.5%	1.79	21.82	14.62	21.14	-	-
S&P 500 Index			1.81	21.86	14.65	21.16	7.42	
<b>Small/Mid Cap US Equities</b>								
NORTHERN TRUST	\$399.87	13.0%	2.29	25.33	13.59	-	-	
STATE STREET - Small/Mid Index	\$154.81	5.0%	2.08	25.06	12.93	23.48	8.39	
STATE STREET - Small/Mid Index	\$245.06	8.0%	2.42	25.51	14.30	25.71	-	
60% Russell 2000/40% Russell Mid Cap			2.08	24.37	13.41	24.65	9.25	
Russell Completeness Index			2.47	25.67	14.23	25.62	9.73	
<b>Real Estate Investment Trusts (REITS)</b>								
DELAWARE INVESTMENT ADVISORS	\$220.92	7.2%	9.82	5.05	10.99	26.70	8.09	
NAREIT Equity REIT Index			9.98	4.16	10.64	28.20	8.22	
<b>TOTAL DOMESTIC EQUITIES</b>	<b>\$1,186.67</b>	<b>38.7%</b>	<b>3.24</b>	<b>19.78</b>	<b>12.59</b>	<b>-</b>	<b>-</b>	
<b>International Equities</b>								
STATE STREET - International Alpha	\$374.40	12.2%	1.41	21.51	6.59			
NORTHERN TRUST - EAFE Index	\$304.19	9.9%	1.58	22.42	6.87	15.99	-	
NORTHERN TRUST - EAFE Index	\$70.21	2.3%	0.68	17.65	-	-	-	
MSCI EAFE Index			0.66	17.57	7.22	16.02	6.53	
<b>TOTAL EQUITIES</b>	<b>\$1,561.07</b>	<b>50.9%</b>	<b>2.80</b>	<b>20.20</b>	<b>11.44</b>	<b>20.21</b>	<b>6.43</b>	
<b>US Investment Grade Fixed Income</b>								
PAYDEN & RYGEL - Aggregate	\$1,059.53	34.6%	1.28	(1.31)	3.47	-	-	
PAYDEN & RYGEL - Aggregate	\$270.84	8.8%	1.95	0.46	4.37	7.01	5.16	
JP MORGAN - Intermediate	\$268.87	8.8%	1.28	0.00	-	-	-	
BND - Project Notes	\$2.04	0.1%	0.99	0.82	3.01	4.53	4.91	
PAYDEN & RYGEL - Low Duration	\$311.21	10.2%	0.37	0.43	3.32	4.05	3.94	
NORTHERN TRUST - TIPS	\$168.38	5.5%	1.97	(6.41)	3.57	5.11	-	
PAYDEN & RYGEL - Cash	\$38.19	1.2%	0.00	(0.05)	0.00	0.07	1.67	
Barclay's Capital US Aggregate Index			1.84	(0.09)	3.76	4.81	4.47	
Barclay's Intermediate Govt./Corp.			1.00	(0.13)	-	-	-	
Barclay's Capital TIPS			1.96	(6.47)	3.50	4.90	-	
6 Month T-Bill			0.01	0.06	0.11	0.17	1.74	
<b>Loans</b>								
BND - Farm Loan Pool	\$21.40	0.7%	1.41	5.66	5.87	-	-	
BND - Farm Loan Pool	\$19.90	0.6%	1.43	5.71	5.89	6.17	6.87	
BND - Energy Construction Loans	\$1.50	0.1%	1.22	5.00	5.48	-	-	
<b>US High Yield Fixed Income</b>								
LAZARD ASSET MANAGEMENT	\$273.69	8.9%	2.53	6.32	7.56	12.88	7.14	
Merrill Lynch US High Yield Cash Pay Index			2.99	7.26	8.62	17.89	8.43	
Merrill Lynch BB/B Index			2.97	6.91	8.50	15.76	7.87	
<b>TOTAL DOMESTIC FIXED INCOME</b>	<b>\$1,354.62</b>	<b>44.2%</b>	<b>1.53</b>	<b>0.44</b>	<b>4.42</b>	<b>-</b>	<b>-</b>	
<b>International Invest. Grade Fixed Income</b>								
FIRST INT'L ADVISORS	\$149.77	4.9%	3.34	1.37	5.27	5.14	4.86	
Merrill Lynch Broad Global (Ex-US) Index - Hedged			2.28	2.48	4.96	4.45	4.49	
<b>TOTAL FIXED INCOME</b>	<b>\$1,504.39</b>	<b>49.1%</b>	<b>1.69</b>	<b>0.51</b>	<b>4.50</b>	<b>6.61</b>	<b>5.25</b>	
<b>TOTAL PORTFOLIO</b>	<b>\$3,065.46</b>	<b>100.0%</b>	<b>2.24</b>	<b>10.24</b>	<b>8.23</b>	<b>13.19</b>	<b>6.26</b>	
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 March 31, 2014, the combined equity portfolio posted a total return of 2.80%. The equity portfolio earned 20.20% for the trailing-year ended March 31, 2014 and has earned an annualized return of 20.21% over the trailing 5-year period there ended.
- ◆ Among active managers, Northern Trust (small/mid portfolio) matched the performance of its benchmark for the quarter ended March 31, 2014, while Delaware (REITs) underperformed by a small margin and State Street (International Alpha) outperformed. All three entities outperformed their respective benchmarks for the trailing year ended March 31, 2014.
- ◆ The various equity index funds used by the permanent trusts continue to provide low cost exposure to equities with minimal tracking error.
- ◆ The Commissioner plans to have Assistant Attorney General Jan Murtha speak to the Board in the near future about securities monitoring and litigations firms. Although not a huge issue due to the fact that most of the permanent trusts' equity exposure comes through index and commingled funds, a pending court case makes it a good time to review the services these firms offer with the Board.

### **Northern Trust – Small/Mid Cap**

- ◆ Although Northern Trust's recent performance has been solid, this portfolio has underperformed the benchmark longer time periods shown in the table on page 4. Northern has outperformed the benchmark by 87 basis points since inception of this account back in April 1996.
- ◆ The mid cap managers in this "manager of managers" portfolio generally underperformed their respective benchmarks during the quarter. Sasco was added as a mid cap manager during the quarter, replacing CRM. Sasco runs a concentrated portfolio that focuses on the materials, industrials and energy sectors.
- ◆ The small cap portion of the portfolio outperformed its benchmark during the quarter, with Rutabaga posting the best performance as a result of strong stock selection in the materials and financials sectors.

### **Delaware Investment Advisors**

- ◆ Delaware either outperformed slightly or underperformed slightly for all periods shown in the table on page 4. They have essentially matched the benchmark for the account, net of fees, since inception of the account more than 10 years ago.
- ◆ Moderate overweight positions in the underperforming lodging and shopping center sectors detracted from performance during the quarter ended March 31, 2014. The portfolio's position in EPR Properties, an owner of theaters, added to performance as that stock returned more than 10% during the quarter, as did an overweight position in Duke Realty.

### **State Street Global Advisors (SSGA) – International Alpha**

- ◆ State Street's International Alpha product continued to post strong returns during the quarter ended March 31, 2014. The portfolio outperformed the benchmark EAFE Index by 92 basis points for the quarter and 481 basis points for the trailing-year ended March 31, 2014. The portfolio has underperformed slightly over the trailing 3 and 5-year periods shown in the table on page 4.
- ◆ Although this portfolio has performed well since a dynamic component was added to SSGA's quantitative model in early 2012, RVK has recommended that these funds be moved over to a low cost World Ex-US Index account as part of the portfolio restructuring.
- ◆ The recent strong performance of this account since 2012 has resulted in about \$3 million of incentive fees being paid on the account during the quarter. The extra \$3 million in fees means that the trusts outperformed the EAFE Index by about \$15 million over the previous 15 months.

## FIXED INCOME PORTFOLIO REVIEW

- ◆ The combined fixed income portfolio posted a total return gain of 1.69% during the quarter ended March 31, 2014, and 0.51% for the trailing-year there ended. It has posted a positive return of 4.5% or more for all periods shown in the table on page 4.
- ◆ Rising interest rates during the early part of the fiscal year had a significant negative impact on the trailing-year performance of the Board's TIPS Index portfolio, which in turn brought down the return of the investment grade portion of the permanent trusts' fixed income portfolio.
- ◆ The steady performance of the farm and energy construction loan portfolios and the strong performance of the high yield bond portfolio, which was driven by shrinking spreads, helped keep the overall fixed income portfolio's returns positive for the trailing-year ended March 31, 2014.

### **Payden & Rygel – Aggregate**

- ◆ Payden outperformed the benchmark for the quarter ended March 31, 2014, and for all other periods shown in the table on page 4.
- ◆ The portfolio's overweight position in credit helped the performance of the portfolio during the quarter as did a reduction of 5% in the portfolio's allocation to Agency mortgage backed securities.

### **J.P. Morgan**

- ◆ The J.P. Morgan intermediate portfolio outperformed the benchmark Barclays Capital Govt./Corp. Intermediate Index for both the quarter and trailing year ended March 31, 2014. It has also outperformed, net of fees, since inception of the account in August of 2012.
- ◆ The higher yield and slightly lower quality of the portfolio as compared to the benchmark index added to the portfolio's performance during the quarter.

### **Payden & Rygel – Low Duration Fund**

- ◆ All new money that is being added to the permanent trusts' fixed income portfolio continues to be added to Payden & Rygel's Low Duration Fund in anticipation of assets being redeployed to other investment strategies during the 2014 implementation phase of the R.V. Kuhn's investment study. A total of \$40 million was added to this account during the quarter.
- ◆ It is expected that this account will begin being drawn down during the 2<sup>nd</sup> quarter of 2014.

### **Bank of North Dakota (BND) – Farm Loan Pool**

- ◆ Falling interest rates during the quarter brought loan rates below the rate floors established by the Board. As a result, no new farm loans were funded during the quarter.

### **Lazard**

- ◆ Lazard's conservative strategy continues to underperform the benchmarks for this account for all periods shown in the table on page 4. This portfolio cannot keep up with the performance of a broad high yield index during a period like the past 4 years when interest rates have consistently contracted from the historic spreads experienced during the 2008-09 recession.
- ◆ The Commissioner has not been adding funds to this portfolio in recent months as the target allocation for high yield bonds will decline from 10% to 4% as the permanent trusts' new asset allocation is implemented during 2014.

### **First International Advisors**

- ◆ Although this portfolio underperformed for the trailing-year ended March 31, 2014, it has outperformed the benchmark for all other periods shown in the table on page 4.
- ◆ No major changes were made to the structure of this portfolio during the quarter.

## 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 more than 750,000 sovereign mineral acres, including those formerly owned by the Bank of North Dakota and State Treasurer, as well as the 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.

	3/31/14 Asset Balances	Current Yield
<b>Strategic Investment and Improvements Fund</b>		
Medical Facility Loan Fund	\$ 50,015,000	0.05%
Loan Guarantee – Fuel Production	\$ 18,000,000	0.05%
School Construction Loans	\$ 65,267,000	1.34%
Cash Equivalents	\$ 28,109,000	0.05%
Treasury Securities	<u>\$ 857,522,000</u>	0.20%
<b>Total</b>	<b>\$ 1,018,913,000</b>	

- ◆ During the quarter ended March 31, 2014, the SIIF collected about \$27.2 million of royalty and lease bonus income.
- ◆ Although \$50 million was transferred to BND for the Medical Facility Loan Fund during the 4<sup>th</sup> quarter of 2013, no loans have been funded to date; the money is being invested in cash equivalents until needed to fund loans during the spring and summer of 2014.
- ◆ During March, \$18.0 million was transferred to BND to be held as a guarantee of loans for the biomass fuel production facility being built by Dakota Spirit AgEnergy in Spirtwood as directed by the legislature. This money will earn interest and a small annual fee while being held by BND.
- ◆ During the quarter the SIIF funded a \$20 million loan to the Wahpeton PSD #37. Staff continued to work with DPI and various bond council attorneys to set up the new gross production tax backed school construction loan program. Final details of the program were completed in April 2014.
- ◆ Due to the fact that this fund is fully expendable, it is currently invested in short-term Treasury securities that mature on or before June 30, 2015. In addition, at various times a substantial amount of the fund will be held in cash equivalents in anticipation of large, short-term cash needs.
- ◆ The Commissioner still expects to bring a recommended SIIF investment policy to the Board during the 2<sup>nd</sup> quarter of 2014.
- ◆ The unobligated balance of the SIIF was \$137.60 million on March 31, 2014. It is expected to hit the \$300 million threshold, at which time 25% of all revenues that go into this fund will instead be deposited into the Legacy Fund, during June 2014.



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.

	3/31/14 Asset Balances	Current Yield
<b>Capitol Building Trust</b>		
Treasury Securities	\$ 3,526,000	0.26%

- ◆ No new monies were appropriated out of this fund for the current biennium, however, \$1.0 million of carryover authority remains from the 2011-13 biennium. The part of this trust that will be spent during the current biennium is invested out to the date Facilities Management has informed the Department they will need the money. The balance of assets in this trust are invested to the end of the biennium.
- ◆ It appears as if this trust will grow faster than it has historically as, during the quarter, four new wells came online in which it participates. This trust collected almost \$300,000 of royalties during the quarter.

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.

	3/31/14 Asset Balances	Current Yield
<b>Coal Development Trust Fund</b>		
Coal Warrants	\$ 7,709,000	3.81%
School Construction Loans	\$ 31,338,000	2.13%
Marketable Securities	<u>\$ 26,989,000</u>	<b>N/A - see returns below</b>
<b>Total</b>	<b>\$ 65,896,000</b>	

- ◆ 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 has either underperformed or outperformed the benchmark for this account by a small margin for most periods noted below. The exception would be for the trailing 5-year period, where the portfolio outperformed the index by 81 basis points.

	3/31/14 Asset Balance	Last Qtr.	Last 1 Year	Last 3 Years	Last 5 Years	Last 10 Years
Payden & Rygel Coal Dev.	\$26.99	0.28	0.50	1.33	2.14	2.48
ML 1-3 Year Treasury Index		0.14	0.54	1.19	1.33	2.59
<b>All return figures for periods of 1 year or greater have been annualized. Returns are net of fees</b>						