



Date: November 18, 2009

To: Senator Larry Pogemiller
Senator David Senjem
Senator LeRoy Stumpf
Senator Gen Olson
Senator Charles Wiger

Speaker Margaret Anderson Kelliher
Representative Kurt Zellers
Representative Mindy Greiling
Representative Pat Garofalo
Representative Carlos Mariani

From: Tom J. Hanson, Commissioner *TJH*

Subject: Permanent School Fund Annual Report

During the 2008 Session, language was adopted requiring Minnesota Management & Budget (MMB) to “biannually report to the Permanent School Fund Advisory Committee and the legislature on the management of the permanent school trust fund that shows how the commissioner maximized the long-term economic return of the permanent school trust fund.”

The statute was modified in the 2009 Session to clarify the reporting timeline and align reporting responsibilities with management activities. “The commissioner shall annually report to the Permanent School Fund Advisory Committee and the legislature the amount of the permanent school fund transfer and information about the investment of the permanent school fund provided by the State Board of Investment. The State Board of Investment shall provide information about how they maximized the long-term economic return of the permanent school fund.”

Attached is the first report under the new statute. The report provides an overview of the Permanent School Fund, reviews recent legislative changes, and provides recent transfer totals from the fund to the Minnesota Department of Education. Additionally, this first report highlights procedural changes implemented to ensure efficient and effective management of the permanent school trust fund.

cc: Commissioner Mark Holsten, Dept. of Natural Resources
Commissioner Alice Seagren, Dept. of Education
Executive Director Howard Bicker, State Board of Investment
Assistant Commissioner Lori Mo, Minnesota Management & Budget
Jess Hopeman, Legislative Reference Library
Legislative Staff (electronic copy)



Permanent School Fund

Report to the Legislature

November 2009

*As required by
M.S. 16A.06*

ESTIMATED COSTS OF PREPARING THIS REPORT

This report provides information that Minnesota Management & Budget normally collects as part of its business functions. The cost reported below is the estimated cost of preparing the report.

Special funding was not appropriated for the costs of preparing this report.

In accordance with M.S. 3.197, the estimated cost incurred by Minnesota Management and Budget in preparing this report is \$1,000.

Permanent School Fund Overview

The Permanent School Fund is a trust fund created by the Minnesota Constitution (article XI, Section 8) and designated as a long-term source of revenue for public schools. The fund “consists of (a) the proceeds of lands granted by the United States for the use of schools within each township, (b) the proceeds derived from swamp lands granted to the state, (c) all cash and investments credited to the permanent school fund and to the swamp land fund, and (d) all cash and investments credited to the internal improvement land fund and the lands therein.” Proceeds from the school trust land are generated through land sales, mining royalties, timber sales, lake shore and other leases. The goal of the fund, as stated in M.S. 127A.31, is to “secure the maximum long-term economic return from the school trust lands consistent with fiduciary responsibilities imposed by the trust relationship established in the Minnesota Constitution, with sound natural resource conservation and management principles, and with other specific policy proved in state law”.

The Commissioner of Natural Resources, per M.S. 84.027, has authority and responsibility for the management of school trust lands, including the land and timber sales, royalties, and leases that fund the Permanent School Fund. While much of the initial land granted to the state has been sold, the Department of Natural Resources manages the remaining 2.5 million acres of school trust land and 1 million acres of school trust mineral rights. Administrative costs incurred by the department are deducted from the gross proceeds of land management activities (M.S. 16A.125 & M.S. 93.2236). The net proceeds are added to the principal, or corpus, of the Permanent School Fund monthly. The department reports biannually to the Permanent School Fund Advisory Committee (M.S. 127A.30) and the Legislature on the management of the land¹.

Table 1: School Trust Land by Original Grant Type

Type of Grant	Original Acres	Acres as of 12/31/07
School	2,900,000	957,818
Swamp	4,706,503	1,550,818
Internal Improvements	500,000	6,508
Total	8,106,503	2,515,144

Source: DNR Biannual Report, October 2008

The State Board of Investment, per M.S. 11A.16, has been assigned investment responsibilities over the Permanent School Fund. In accordance with the Minnesota Constitution, the principal of the Permanent School Fund cannot be spent and instead must remain “perpetual and inviolate.” The fund is invested to produce a growing level of spendable income within the constraints of maintaining adequate portfolio quality and liquidity. Prior to FY 1998, the fund had been invested entirely in fixed income securities which maximized current income but limited long term growth. In 1997 the State Board of Investment presented alternative

¹ See DNR Website for additional information on school trust land management: www.dnr.state.mn.us

investment scenarios to the legislature. The decision was made to reallocate the investment to 50% stock, 48% fixed income and 2% cash; this allocation remains today².

Every month the State Board of Investment transfers the net school trust land proceeds deposited by the Department of Natural Resources into the corpus of the Permanent School Fund. Twice a year, in March and September, the State Board of Investment certifies the interest and dividends earned from the fund and informs Minnesota Management & Budget (MMB). This certification includes any interest earned by the net school trust land proceeds while awaiting transfer into the corpus for investment. MMB then transfers the certified earnings to the School Endowment Fund created under M.S. 127A.32. The Department of Education then allocates funds in the School Endowment Fund to school districts in two semi-annual payments under M.S. 127A.33, which requires apportionment based on “the number of pupils in average daily membership during the preceding year.”

The Commissioner of Management & Budget, per M.S. 11A.16, has overall management responsibilities for the fund. MMB works with the Department of Natural Resources to estimate administrative expenses charged back to the fund, oversees the monthly transfers of interest to the appropriation, and transfers the earnings to the Department of Education semiannually. In addition, M.S. 16A.06 requires Minnesota Management & Budget to “annually report to the Permanent School Fund Advisory Committee and the legislature the amount of the permanent school fund transfer and information about the investment of the permanent school fund provided by the State Board of Investment. The State Board of Investment shall provide information about how they maximized the long-term economic return of the permanent school fund.”

Recent Legislative Changes

The interest and dividends earned by the Permanent School Fund are required by the Minnesota Constitution to be distributed to the state’s school districts according to the method described in statute. Prior to FY 2010, the earnings distributed to school districts were offset with an equal reduction in the district’s General Education Aid. The statute requiring this offset (M.S. 126C.21, Subd. 1) was repealed under *Laws 2008, chapter 363, article 2, section 52, paragraph (a)*. Starting in FY 2010, Permanent School Fund earnings are allocated to school districts with no General Education Aid offset. The earnings are additional income for the school districts and are distributed under M.S. 127A.33.

Minnesota Statutes 16A.06 was amended under *Laws 2009, chapter 96, article 1, section 1* to clarify the Commissioner of Management and Budget’s permanent school fund reporting responsibility. Minnesota Management & Budget must “annually report to the Permanent School Fund Advisory Committee and the legislature the amount of the permanent school fund transfer and information about the investment of the permanent school fund provided by the

² See SBI Website for additional information on Permanent School Fund investments: www.sbi.state.mn.us

State Board of Investment. The State Board of Investment shall provide information about how they maximized the long-term economic return of the permanent school fund.”

Certified Transfers

The State Board of Investment calculated that the Permanent School Fund earned \$11,724,652.43 for the period 3/2009 through 8/2009 and certified that amount as available for transfer from the Permanent School Fund to the School Endowment Fund.

Time Period	Certified Earnings	General Education Aid Reduction
3/2009 – 8/2009	\$11,724,652.43	No
9/2008 – 2/2009	\$13,219,628.84	Yes
3/2008 – 8/2008	\$14,203,821.70	Yes
9/2007 – 2/2008	\$14,248,657.66	Yes

Realized Loss

The Permanent School Fund’s asset allocation target, as established by the State Board of Investment, is 50% stock, 48% fixed income, and 2% cash. The State Board of Investment regularly rebalances the portfolio to maintain this asset allocation target. When the fund was rebalanced in October 2008, a loss of \$2.335 million resulted. Realized gains and losses to the fund are amortized over a 10-year period (M.S. 11A.16). Any net loss during a fiscal year is first recovered from 10% of the net gains from the previous ten years. If the gains are not sufficient to cover the net loss, the remaining loss shall be deducted from the earnings over the next ten fiscal years.

The total FY 2009 loss of \$2.335 million was offset with 10% of the prior ten years gains of \$2.183 M. That leaves a total of \$151,906 that must be amortized over the next ten fiscal years and deducted from payments to school districts. This reduction is included in the September 2009 certified earnings.

Addendum

Review of Operational Practices

In accordance with M.S. 11A.16 and in light of the legislative changes that take effect FY 2010, Minnesota Management & Budget reviewed existing practices and procedures pertaining to the Permanent School Fund. The review uncovered oversight gaps resulting from multiple organizations owning various segments of the process. The following issues were identified and corrected and new oversight procedures implemented.

- 1) In the past, monthly interest and dividends earned by the corpus of the Permanent School Fund were transferred to the Trust Fund Pool where additional interest was earned. When the State Board of Investment certified total earnings for the six month period, it certified the interest and dividends transferred to the Trust Fund Pool. However, the additional interest earned in the Trust Fund Pool was never recognized as earnings and transferred to School Endowment Fund for apportionment to school districts.

Finding: A total of \$2.6 million in interest earned in the Trust Fund Pool was not certified and transferred to the School Endowment Fund so that the Department of Education could allocate it to school districts.

Corrective Action: Since this interest was earned prior to FY 2010 when Permanent School Fund earnings distributed to districts were still being offset by an equal reduction in General Education Aid, the \$2.6 million was transferred to the state's General Fund. All future certifications and transfers from the Permanent School Fund to the School Endowment Fund will include any interest earned by the net school trust land proceeds while awaiting transfer into the corpus for investment. The transfers in and out of the fund should reconcile to the earnings plus interest earned and, with the exception of timing differences, net to zero. MMB is preparing statutory language for consideration next session clarifying the definition of Permanent School Fund earnings.

- 2) The use of multiple accounts for the temporary holding of earnings and payments out to schools districts required manual transfers of money. The reliance on manual transfers created unnecessary opportunities for errors.

Finding: The 3/2008 through 8/2008 earnings were certified and transferred to the School Endowment Fund, however the earnings were not moved out of the Trust Fund Pool and into the appropriation account from which the transfer was made. This caused the fund to go negative by \$11,559,626.

The trust fund pool was overdrawn again in December 2008 when the statutorily authorized transfer of administrative expenses reimbursed back to the Department of Natural Resources

was executed. There was not enough money in the Trust Fund Pool since the State Board of Investment had already transferred the funds into the Permanent School Fund corpus.

Corrective Action: The original deposits from the Department of Natural Resources into the Permanent School Fund will earn interest and remain in the account until the balance is greater than the anticipated administrative expenses the Department of Natural Resources will claim for the year. Once the balance is greater than the estimated administrative expenses, the State Board of Investment will sweep the account and move the remainder into the corpus of the Permanent School Fund. The monthly interest earned off the corpus will be transferred directly into the appropriation account where they will earn interest, eliminating the need to manually transfer funds between accounts to make payments.

Agency Contact:

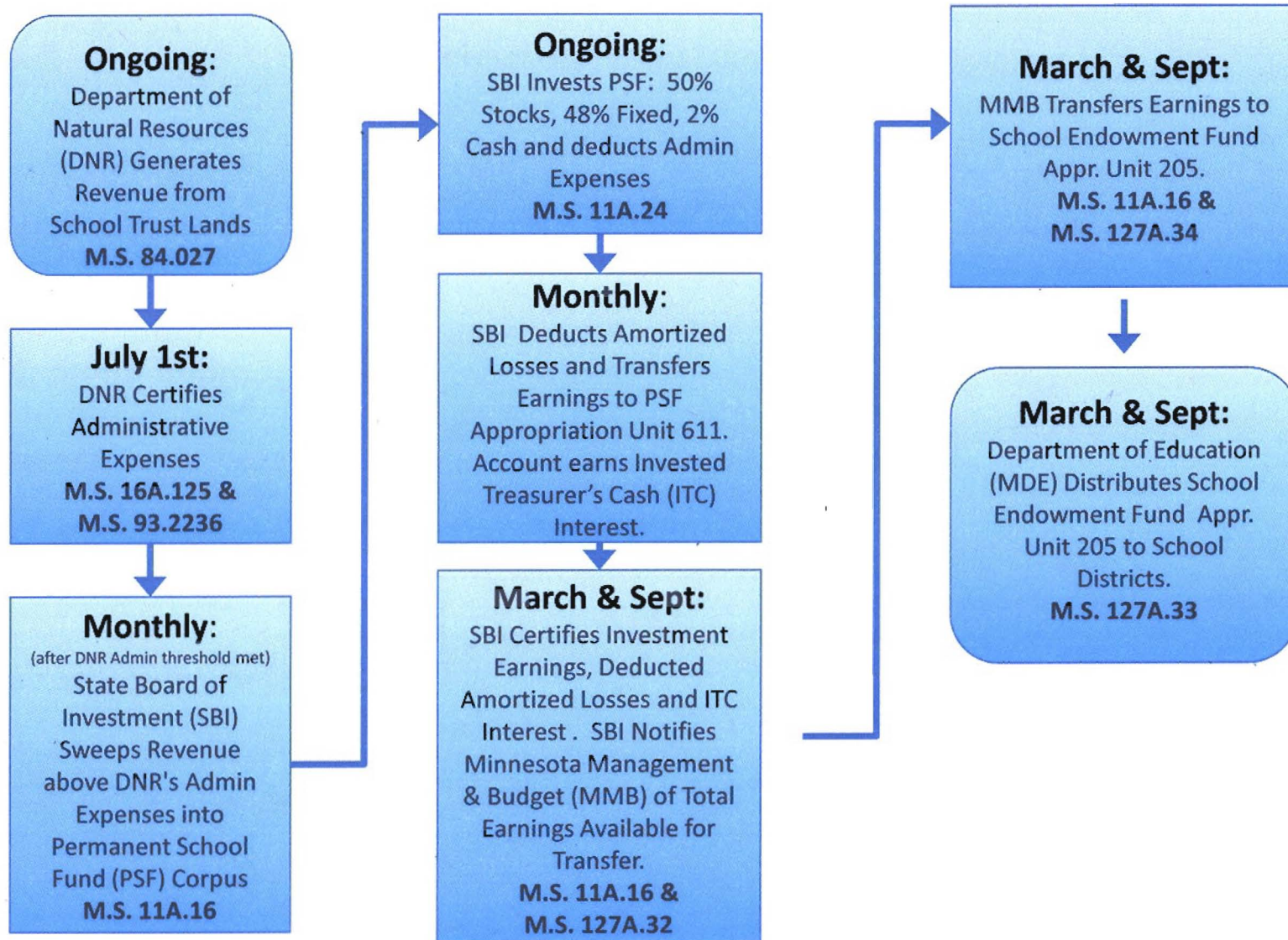
Kristy Swanson, Executive Budget Officer
Minnesota Management & Budget
658 Cedar Street
400 Centennial Office Bldg
St. Paul, MN 55155
Tel: 651-201-8082
Fax: 651-296-8685

Attached:

Permanent School Fund Flow Chart
State Board of Investment: Permanent School Fund Annual Report

Permanent School Fund (860)

Annual Process as of September 2009



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 used to offset state school aid payments. On June 30, 2008, the market value of the Fund was \$690 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 in offsetting state expenditures on school aid.

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 FY 1998, the Permanent School Fund had been invested entirely in fixed income securities for more than a decade. While this

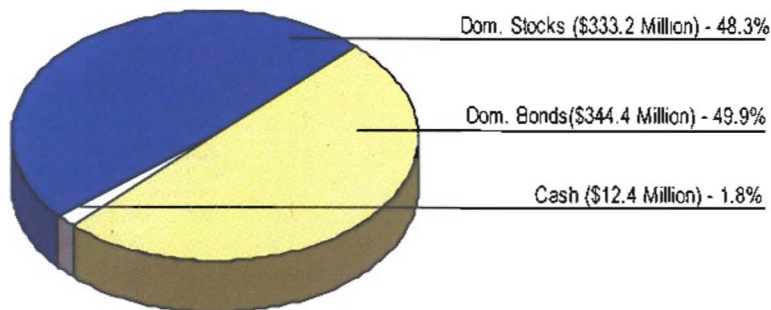
asset allocation maximized current income, it limited the long term growth of the Fund and caused the income stream to lose value in inflation adjusted terms, over time.

To solve both issues, a proposal to introduce equities to the Fund's asset mix was discussed. 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.

A proposal to introduce equities was presented during fiscal year 1997. 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 36 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2008.

Figure 36. Permanent School Fund Asset Mix as of June 30, 2008



Note: Percentages may differ slightly due to rounding of values.

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.

Permanent School Fund

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 Lehman Brothers Aggregate Bond Index.

Investment Performance

The *stock* segment of the Permanent School Fund matched its benchmark, the S&P 500, during the fiscal year. By investing in all of the stocks in the benchmark at their index weighting, the segment attempts to track the benchmark return on a monthly and annual basis. The portfolio is periodically rebalanced to maintain an acceptable tracking error relative to the benchmark.

The *bond* segment underperformed its benchmark by 0.1 percentage point during the current fiscal year.

Overall, the Permanent School Fund provided a return of -3.6% for fiscal year 2008, underperforming its composite index by 0.3 percentage point.

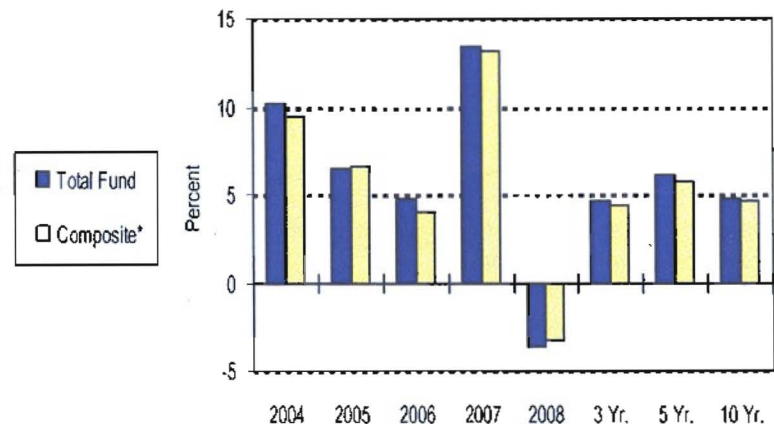
Total account results for the last three, five and ten years are shown in Figure 37.

Spendable Income

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

Fiscal Year	Millions
2004	\$16
2005	\$19
2006	\$22
2007	\$25
2008	\$28

Figure 37. Permanent School Performance FY 2004-2008



	2004	2005	2006	2007	2008	Annualized		
						3 Yr.	5 Yr.	10 Yr.
Total Fund	10.2%	6.5%	4.8%	13.4%	-3.6%	4.6%	6.1%	4.7%
Composite*	9.5	6.6	4.0	13.2	-3.3	4.4	5.8	4.6
Stock Segment	19.0	6.3	8.7	20.6	-13.1	4.5	7.6	3.0
S&P 500	19.1	6.3	8.6	20.6	-13.1	4.4	7.6	2.9
Bond Segment	1.1	7.0	0.5	6.2	7.0	4.5	4.3	6.0
Lehman Agg	0.3	6.8	-0.8	6.1	7.1	4.1	3.9	5.7

* 50% S&P 500/ 48% Lehman Aggregate/ 2% 3 Month T-Bills. Prior to July 1, 1997, the Fund's benchmark was 100% Lehman Aggregate.