

Strategic Plan FY2010 and Beyond

Endowment Fund Investment Board Of the State of Idaho



July 1, 2009

Mission of the Endowment Fund Investment Board

Provide professional investment management services to our stakeholders consistent with our constitutional and statutory mandates.

Goals

We will provide good investment advice and the tools for implementing that advice. As our clients' individual needs require, we will:

- Develop a prudent long-term investment strategy
- Select the best portfolio managers and other agents to execute that strategy
- Diligently evaluate performance over time
- Develop an effective distribution policy
- Help them fulfill their fiduciary responsibilities and communicate with their stakeholders

For our employees, we will:

- Create a work environment which motivates and retains a knowledgeable and professional staff

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Objectives

Some of the objectives of the Endowment Fund Investment Board are similar for all our clients – the land grant endowment funds, the State Insurance Fund, the Judges’ Retirement Fund, the Trail of the Coeur d’Alenes Endowment, and the Ritter Island Endowment Fund, while others only apply to a specific client or our employees.

Objectives Applicable to All Clients

- Seek new approaches to improve portfolio risk/return characteristics and cost/benefit ratios
- Meet or exceed the client’s fund benchmark(s)

Objectives Specific to the Land Grant Endowment Funds

- Avoid reductions in total endowment distributions
- Distribute approximately 5% of the three-year moving average value of the Permanent Funds
- Maintain sufficient Earnings Reserves to protect distributions from temporary shortfalls in fund returns and land revenues
- Grow distributions and the Permanent Fund faster than inflation and population growth by recommending transfer of excess Reserves to the Permanent Fund
- Increase the diversification of the endowment funds to reduce volatility of earnings while maintaining expected return

Objectives Specific to the Judges’ Retirement Fund

- Review asset allocation by May, 2010

Objectives for Our Employees:

- Build relationships with other key agencies

- Train/cross-train the Administrative Assistant, the Investment Officer, and the Senior Financial Specialist in key financial and investment due diligence tasks

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Key performance measures and benchmarks

(including the rationale for their adoption)

The efficacy of the Endowment Fund Investment Board's management can best be measured by:

- *Stability and growth of distributions*
- *The risk-adjusted performance of the portfolios of each of our clients*
- *Growth in permanent corpus*

Risk/Return Measures & Benchmarks

These measures will be calculated annually and over multi-year periods

- *Measure: Absolute return*
 - *Endowment funds: 4% annually after inflation, net of fees*
 - *Judges' Retirement Fund: 7.75% annually net of fees*
 - *Ritter Island Endowment Fund: 6.25% annually net of fees, 4% annually after inflation and fees*
- *Measure: Return vs. benchmark*
 - *Endowment Funds: exceed Fund benchmark on a risk-adjusted basis, net of fees*
 - *Judges' Retirement Fund: exceed Fund benchmark by at least 0.5% annually with the same risk as the benchmark, net of fees*
 - *State Insurance Fund: meet or exceed the Fund's benchmark, net of fees*
- *Measure: Return vs. peers*

- *Endowment funds*: Exceed median of peers on a risk-adjusted basis
- *Judges' Retirement Fund*: Exceed median of peers on a risk-adjusted basis

Rationale for establishing these measures/benchmarks:

There is no single, perfect measure of the performance of an investment portfolio, so multiple performance measurements will be used, customized to the needs of each client and calculated for both annual and multi-year periods.

Absolute return: *This is based on the long-term return needs of the client, relative to the level of risk/volatility they are able to endure. It can be stated in both "nominal" or "real" (after inflation) terms. It is unlikely a portfolio will achieve this return every year, but rather represents the expected return over several market cycles. Achieving the absolute return target over time is generally more critical for clients like pension plans, whose funding needs (e.g. liabilities) do not vary with markets.*

Return vs. benchmark: *This is a relative return measure that calculates the value-added of "active" versus "passive" investing. One can invest in many (but not all) major asset classes in the financial markets thru either index funds or via active management. Index funds essentially own a representative portion of the whole market and are therefore referred to as "passive" investments because they do not attempt to predict which specific securities in the class will perform best. "Active" investing attempts to select the assets within a class that will perform better than average. The efficiency of financial markets makes it challenging to earn active returns in excess of the passive index without taking extra risk.*

Return vs. peers: *Since a rising tide lifts all boats, comparison to relevant peers, adjusted for risk, allows one to measure whether a fund is doing better or worse than similar*

participants in the financial markets. It measures a fund's ability to make investment choices better than average, but is difficult to achieve over time because, by definition, half of all funds striving to be above average end up being below average. Also, certain peer group data is only available annually and one can never find a perfectly similar peer group, which limits the value of peer comparison.

Land Grant Endowment Growth of Corpus Measures & Benchmarks

- *Measure: Percent change in the Permanent Fund*
 - Greater than inflation and population growth
- *Measure: Consecutive years below the loss benchmark for the Public School Permanent fund*
 - Less than 10 years

Rationale for establishing the measure/benchmark: The mission and ultimate purpose of Idaho's land grant endowments is to provide a perpetual stream of income to the beneficiaries. To balance the needs of current and future beneficiaries, over time the corpus of the endowment funds should grow at a rate greater than the growth in inflation and population, so that endowment distributions can keep up with the growth in beneficiary funding needs.

The state Constitution requires the state to make up any losses in the Public School Permanent Endowment Fund. Idaho Code specifies that these losses must be made up after ten consecutive years of cumulative losses. Thru the end of FY2008, the Public School Permanent Fund had been above the Loss Benchmark for three consecutive years. However, weak investment results put the Fund into the cumulative loss column at the end of FY2009. Over time, expected transfers from Earnings Reserves to the

Permanent Fund will significantly reduce the likelihood of falling below the Loss Benchmark.

**Public School Permanent Endowment Fund
Cummulative Gain(Loss) Calculation**
(millions of dollars)

	<u>Loss Benchmark</u>	<u>Actual Fund Balance</u>	<u>Cummulative Gain (Loss)</u>
Beginning Balance FY2000	556.0	556.0	-
Deposits - FY01	1.7		
Balance FY2001	557.7	511.7	(46.0)
Deposits - FY02	1.4		
Balance FY2002	559.1	441.5	(117.5)
Deposits - FY03	2.2		
Balance FY2003	561.3	436.2	(125.1)
Deposits - FY04	0.8		
Balance FY2004	562.1	500.6	(61.5)
Deposits - FY05	1.6		
Balance FY2005	563.6	537.2	(26.5)
Deposits - FY06	1.8		
Balance FY2006	565.4	582.4	17.0
Deposits - FY07	3.4		
Balance FY2007	568.8	662.5	93.7
Deposits - FY08	4.1		
Balance FY2008	572.9	633.1	60.3
Deposits - FY09E	4.1		
Balance FY2009E	577.0	488.0	(89.0)

Source: EFIB records

Federal law requires that losses to the Agricultural College endowment must also be made up by the state, but the methodology for calculating and restoring losses to that endowment has not been established.

Land Grant Endowment Distribution Measures & Benchmarks

- *Measure:* Stability of distributions to beneficiaries
 - No reductions in total endowment distributions
- *Measure:* Percent change in distributions to beneficiaries

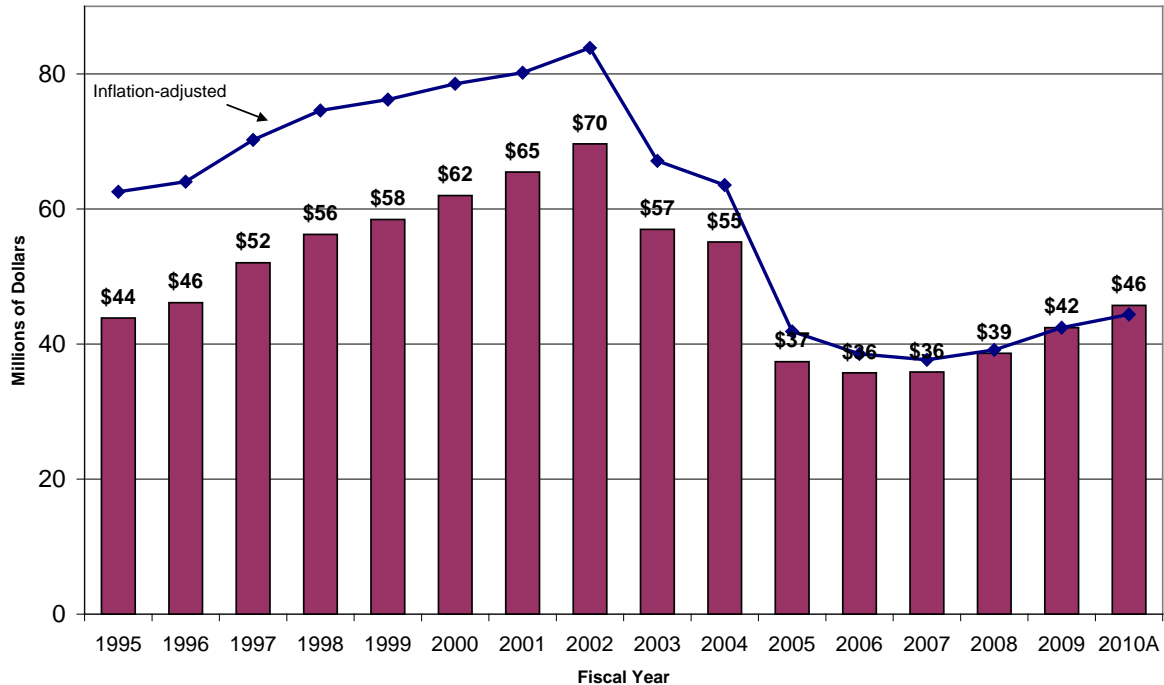
- Exceed inflation and population growth over a five-year period
- *Measure: Level of Earnings Reserves*
 - 500% of the last year of approved distributions

Rationale for establishing the measure/benchmark: The adequacy of the returns of the endowment funds and the efficacy of the Distribution Policy are ultimately measured in terms of the distributions to the beneficiaries, both in absolute dollars and in consistency from year-to-year. While the vision of the state's land and financial endowment assets is to grow distributions over time at a rate in excess of inflation and population growth, endowment beneficiaries experienced declining distributions for four years straight after FY2002 due to lower timber revenues than expected, especially in FY2003 and FY2005, the significant bear market in equities in 2000-2002, and a high level of distributions in FY2001 and FY2002 relative to the size of the reserves. The drop in distributions in FY2003 was especially traumatic, because it coincided with a significant shortfall in expected General Fund revenues.

Since most beneficiary funding supports ongoing personnel costs, maintaining distributions year-over-year is strongly preferred.

**Total Endowment Distributions To Beneficiaries
1996-2010 Actual and Approved
Nominal and Inflation-Adjusted (in 2009\$)**

(Net of General Fund Contribution in 2006 of \$4.6MM)



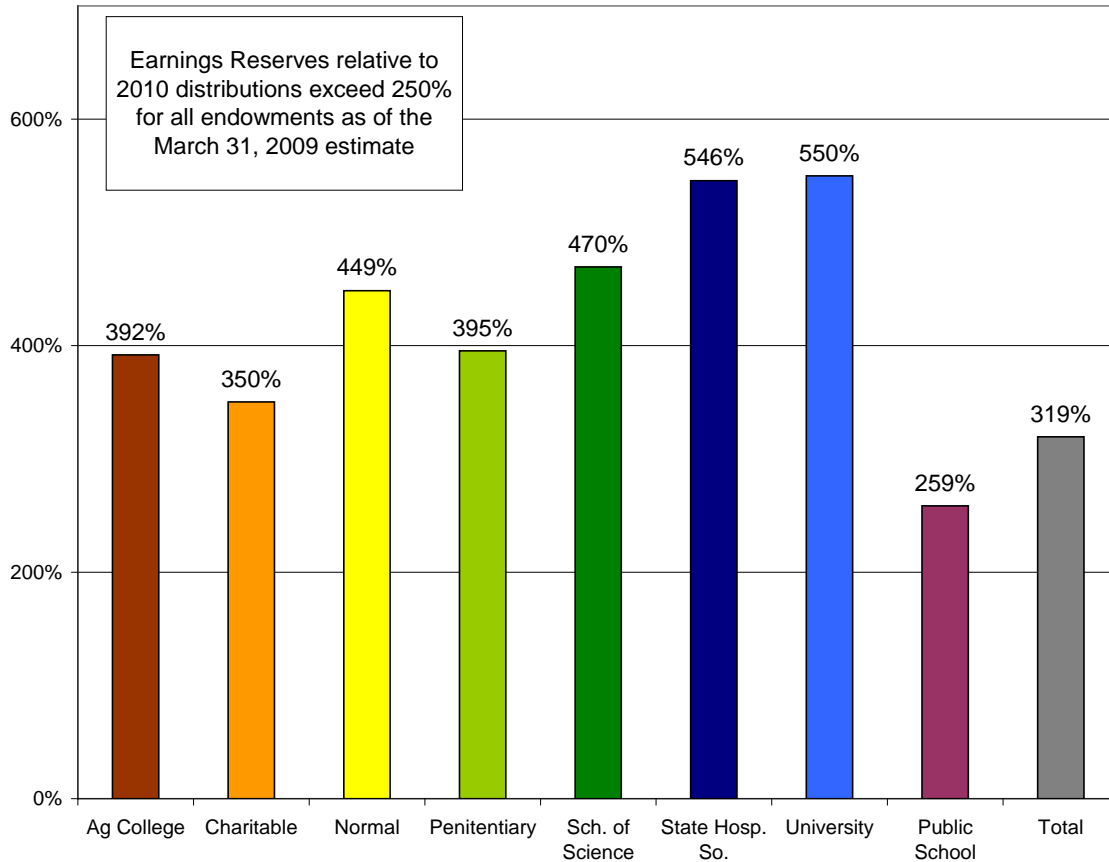
Source: Legislative Services, EFIB records

One challenge to maintaining stable distributions will occur when a statutorily-required change in the cash flow to Earnings Reserve is triggered. As each endowment exceeds its inflation-adjusted target, it can then pay out distributions of total gains, including capital gains, rather than only paying out interest and dividends. However, this will increase volatility of income to the reserves (for further discussion, see the end of the External Factors section).

Earnings Reserve funds for all endowments were at reasonable levels at the end of FY2009. After analyzing the variability of land and fund revenues, the EFIB has determined that having five years of distributions should be sufficient to prevent the need to reduce a beneficiary's

distribution in all but the most extreme disruptions of fund and land revenues.

Coverage Ratio March 31, 2009



At the end of each fiscal year, any Reserves in excess of the level that is adequate and reasonable to secure future distributions thru a market downturn will be transferred to the Permanent Fund. This will allow the Permanent Fund, which is held primarily for the benefit of future beneficiaries, to grow over time at roughly the same rate as the Earnings Reserves, which are primarily for the benefit of current beneficiaries.

Unlike the other eight land grant endowments, the Capitol Permanent Fund has no Earnings Reserve fund and no strict

prohibition on distributing principal, so there is less risk of a disruption in distributions. However, a multi-year reduction in both land revenues and portfolio returns could still trigger a reduction in distributions to protect the corpus.

Ritter Island Endowment Growth of Corpus Measure and Benchmark

- *Measure: Percent real change in the fund*
 - In excess of the rate of inflation over a five-year period

Rationale for establishing the measure/benchmark

The mission and ultimate purpose of the Ritter Island Endowment Fund is to provide a perpetual stream of income to support the Ritter Island unit of the Thousand Springs State Park. To balance the needs of current and future beneficiaries, over time the corpus of the endowment fund should grow at a rate greater than the growth in inflation so that endowment distributions keep up with the growth in beneficiary funding needs.

Trail of the Coeur d'Alenes Endowment Measures and Benchmarks

The EFIB assumed responsibility for managing the Trail of Coeur d'Alenes Endowment at the request of the Department of Parks and Recreation in June. Measures and benchmarks have not formally been established.

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External factors

**that could significantly affect the achievement of
our goals and objectives**

The major outside factors impacting the EFIB are the returns and volatility of the financial markets and the level of timber revenues from endowment lands.

I. Financial Markets

All of the portfolios managed by the Endowment Fund Investment Board are subject to the variability of the financial markets and to the threat of eroding purchasing power due to inflation.

The EFIB attempts to mitigate some of the market risk by investing in diversified portfolios of assets so that the expected variation in the whole portfolio is less than the sum of the variations of each part. The following table demonstrates the sensitivity of each client's portfolio to different asset classes.

Exposure To Financial Markets By Client

	<u>% Of Assets Invested</u>				<u>Five-Year Expected Return*</u>	<u>Annual Absolute Risk</u>
	<u>Endowment Funds</u>	<u>State Ins. Fund</u>	<u>Judges' Fund</u>	<u>Ritter Island</u>		
<u>Equities</u>						
Developed markets						
U.S.	53%	10%	56%	40%	9.5%	16%
Foreign	13%	3%	13%	9%	9.3%	19%
Emerging markets	4%	0%	1%	1%	10.1%	27%
Private equity	0%	0%	0%	0%	11.6%	37%
High yield debt	0%	0%	0%	0%	7.0%	12%
Total Equities	70%	13%	70%	50%		
<u>Fixed Income</u>						
Treasuries/Agencies						
Standard	5%	37%	8%	3%	4.5%	4%
Inflation-protected	3%	9%	0%	10%	4.9%	6%
Mortgages (agency)	3%	9%	3%	5%	5.0%	5%
Mortgages (non-agency)	12%	13%	12%	20%	5.3%	6%
Corporates, other	8%	20%	8%	13%	6.0%	7%
Total Fixed Income	30%	87%	30%	50%		
Real Estate	0%	0%	0%	0%	7.6%	16%
Absolute Return	0%	0%	0%	0%	6.9%	10%
Total	100%	100%	100%	100%		
Duration/Maturity of						
Fixed Income (years)	3.9	3.7	3.7	3.9		

* Assumes annual inflation rate of 2.75%

Source: Callan, EFIB analysis

II. Variation in Timber Revenues

For the endowment funds, the performance of the land assets is another major external factor that can significantly affect the achievement of our objectives of increasing distributions and avoiding reductions. About half of the sensitivity of the return on total endowment assets is driven by the cash return on the lands and about half by the return of the funds.

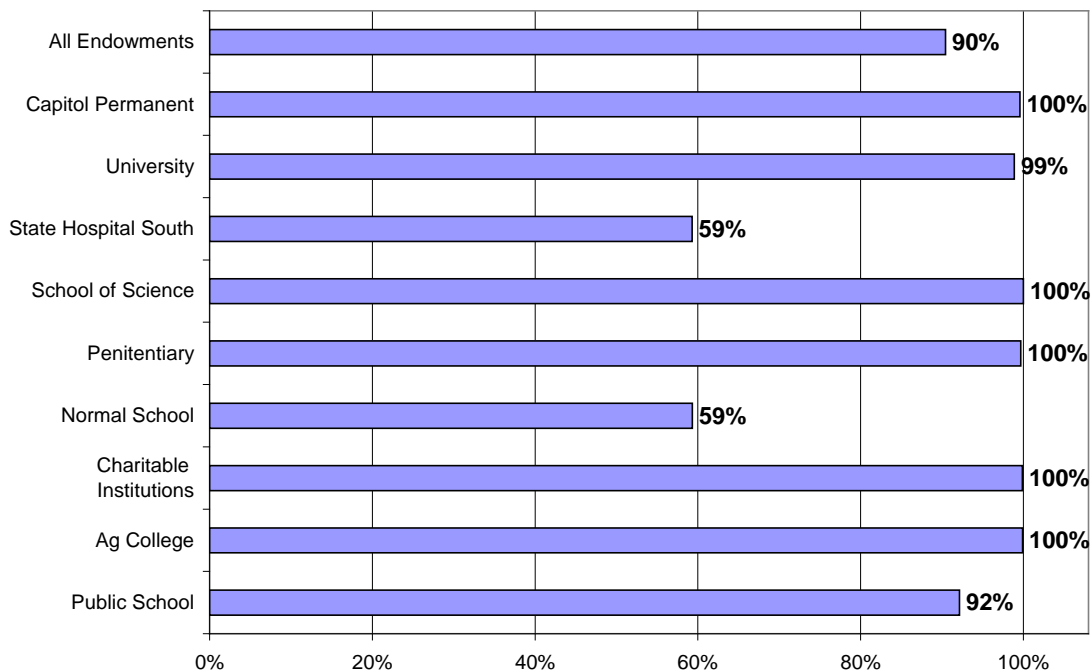
Because the land assets generate a significant portion of each endowment's total revenue, variations in the total cash available for distribution to endowment beneficiaries is highly subject to the variations in net cash earnings of the endowment lands. Over the last nine fiscal years, these earnings have averaged \$44 million annually, with a range of about plus or minus \$7 million (17%).

(Millions of \$)	<u>FY01</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>	<u>FY06</u>	<u>FY07</u>	<u>FY08</u>	<u>FY09E</u>	<u>Average</u>
Net Lands Revenues	49	42	35	50	38	48	54	50	36	44

Source: Legislative Services, EFIB analysis

As shown below, 50% to 100% of the net land revenues of each of the endowments come from the sale of timber, so the earnings from their land is very sensitive to the price and volume harvested of timber.

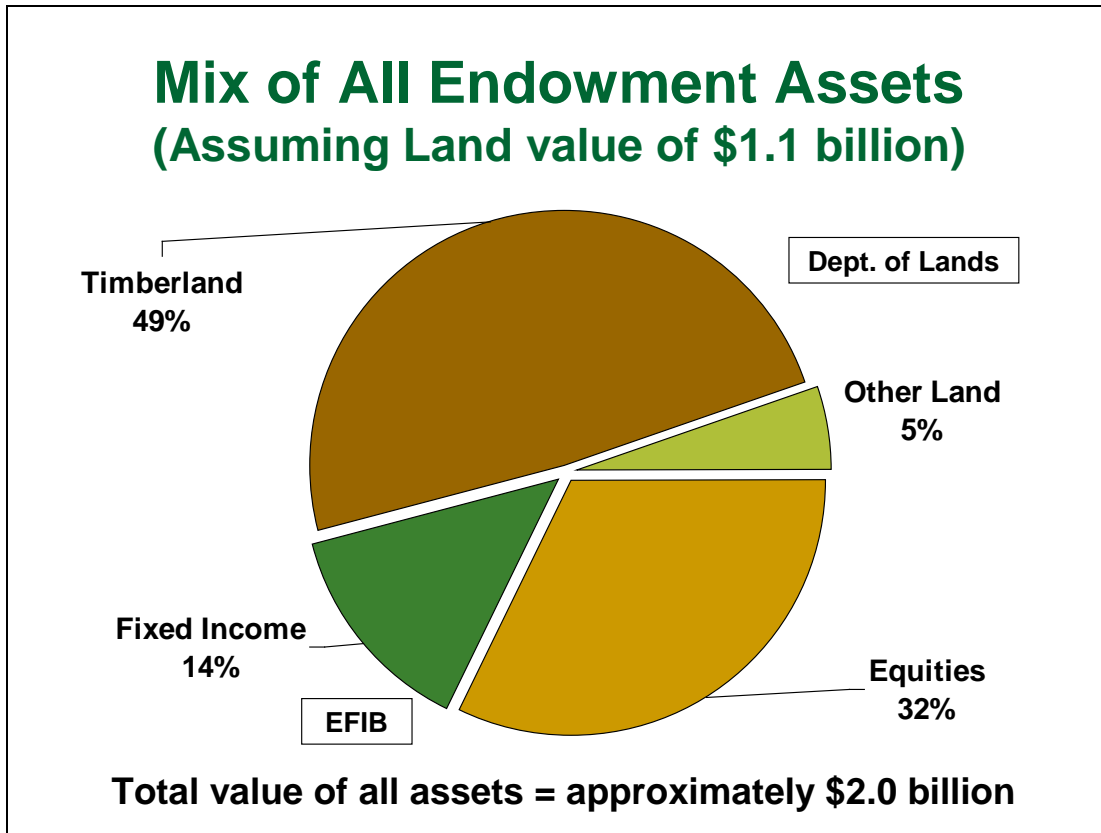
% Of Lands' Earnings Reserve Income From Timber: FY '05-FY '07



Source: Idaho Department of Lands 2005-2007 Annual Reports, EFIB analysis

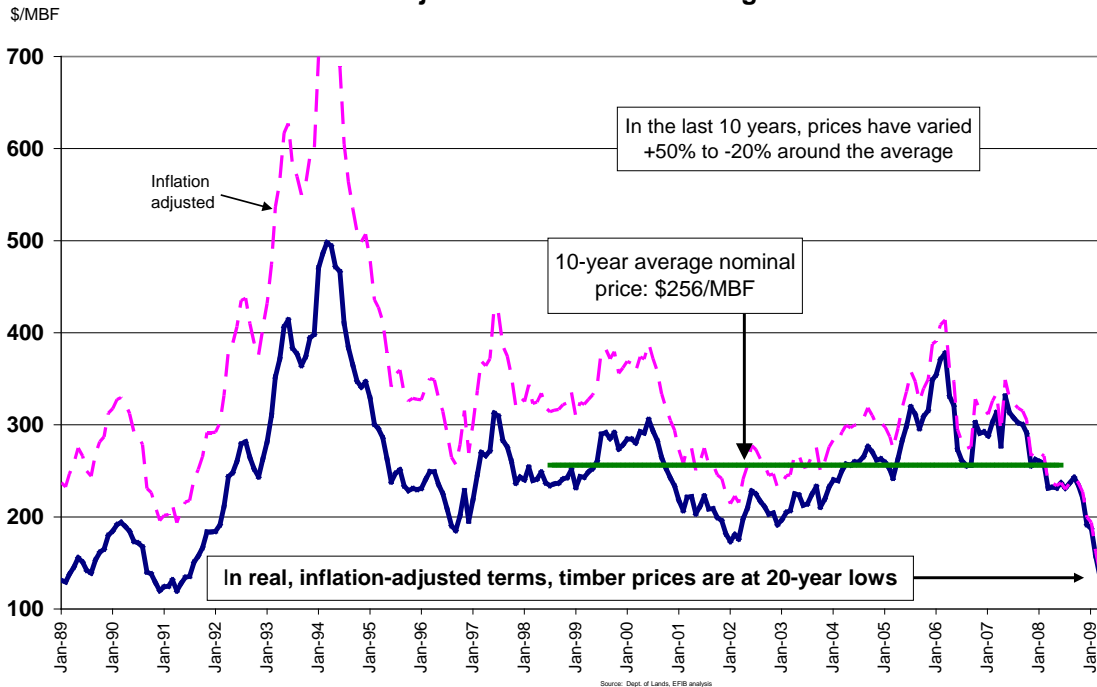
When financial and land assets are combined, the mix of total endowment assets is approximately 49% Timberland,

32% Equities, 14% Fixed Income and 5% other Real Estate (primarily vacation property ground rents). Land assets are valued based on expected cash flow, excluding the value of land being held for conversion to higher and better use.



Since almost half of endowment earnings come from timber, a major external factor outside the Endowment Fund Investment Board's control is the price of timber and the volume of harvest. The following graph demonstrates the variability of timber prices:

Idaho Department of Lands Log Auction Price Trends Actual and Inflation Adjusted -- Six Month Rolling Ave -- 1989-2009

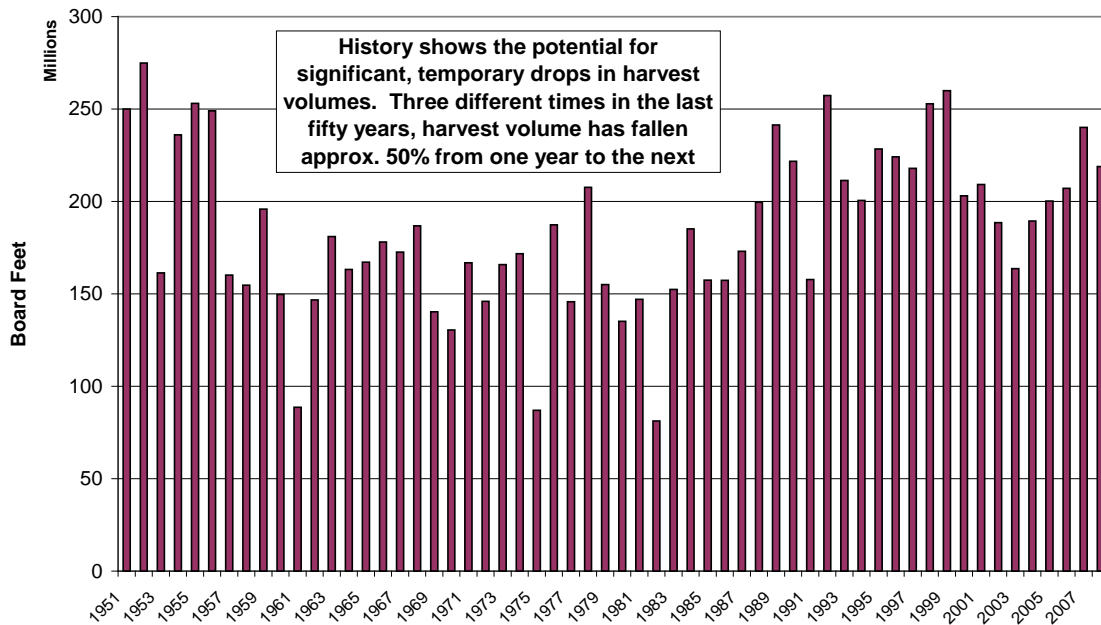


Source: Idaho Department of Lands, EFIB analysis

Like the stock market, timber prices are essentially unpredictable, so this adds significant risk of error to any cash flow forecast the Department of Lands or the EFIB might use to develop recommended distribution levels.

As shown in the graph that follows, the volume of total harvest can also vary significantly from year-to-year.

Idaho Endowment Land Sawlog Harvest Volume By Calendar Year 1951-2008



Source: Department of Lands

Because 70% of the endowment timberlands are for the benefit of public schools, the above graph is a fair representation of the variation in harvest levels on school lands. However, since the land bases of the other eight endowments are significantly smaller (see table below), the variations in their harvest levels from year to year are even larger than the graph above implies and therefore very hard to predict.

At the direction of the Capitol Commission, most of the mature timber on Capitol Permanent Endowment land was harvested in the ten year period ended FY2008. As a result, harvest levels and land revenues are expected to be negligible for the next decade.

<u>Endowment</u>	<u>Forest Land Acres</u>	<u>% of Total</u>
Public School	685,437	71%
School of Science	63,927	7%
Charitable Institutions	62,847	6%
Normal School	42,511	4%
University of Idaho	41,918	4%
Penitentiary	27,047	3%
State Hospital South	25,610	3%
Agricultural College	15,152	2%
Capitol	7,164	1%
Total	971,613	100%

Source: Idaho Department of Lands 6/30/2008 Annual Report

The variability of land revenues for all of the smaller endowments over the past nine years is two to six times greater than the Public School endowment, as shown below.

	<u>Average Annual Revenues (\$ million)</u>	<u>9-Year Standard Deviation (% of Ave.)</u>
Public Schools	39.1	11%
Normal School	3.9	24%
Charitable Institutions	3.3	30%
State Hospital South	4.0	35%
University of Idaho	3.7	38%
School of Science	4.2	39%
Penitentiary	1.8	60%
Agricultural College	0.7	69%
	60.8	12%

Source: EFIB analysis thru FY2009. Data is not available for the Capitol Permanent Fund.

To address this extreme variability, the EFIB is working with the Department of Lands to consolidate the land holdings of the eight small endowments into a common ownership – i.e. rather than having 100% ownership of a few acres; each endowment would have a smaller percentage ownership of a larger number of acres. This would have numerous risk-reducing benefits and help smooth out variability in the level of timber harvests. This effort may also allow the consolidation of the endowment fund into two accounting pools, versus the current nine accounting entities.

A future source of increased revenue variability will arise as each endowment's permanent fund passes its "gain benchmark", essentially the June 2000 level adjusted for inflation and certain deposits (only one endowment, State Hospital South, had reached the gain benchmark by the end of FY2009). When this occurs, the flow of investment income to the earnings reserve fund will change. Currently, interest and dividends are added to earnings reserves each year. However, by statute, a year after the gain benchmark is achieved, only the total gain (interest, dividends, and capital gains/losses) above inflation will flow to earnings reserves annually. While this will increase potential revenues due to the inclusion of capital gains, it will result in zero revenues flowing to reserves in years in which there are capital losses in the stock market. Historically, capital losses in a 70% equity, 30% fixed income portfolio have occurred in one year out of three and in each twenty-five-year period, there has been one period where no income would have accrued to earnings reserve for five consecutive years.

This revised flow of income will help protect the inflation-adjusted corpus or principal in the permanent fund, since interest and dividends will be used to offset capital losses.

However, that means interest and dividend income will no longer be available every year to help fund distributions.