



Permanent School Fund

Report to the Legislature

February 2016

*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 \$200

This report is provided in accordance with M.S. 16A.06, which requires that Minnesota Management & Budget “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.”

Certified Transfers

Since the last Permanent School Fund report in January 2015, the State Board of Investment calculated that the Permanent School Fund earned \$13,468,473.81 for the period 3/2015 through 8/2015 and \$13,317,714.36 for the period 9/2014 through 2/2015.

Time Period	Certified Earnings
3/2015 – 8/2015	\$13,468,473.81
9/2014 – 2/2015	\$13,317,714.36
3/2014 – 8/2014	\$12,321,341.34
9/2013 – 2/2014	\$11,847,029.83

Investment of the Permanent School Fund

The State Board of Investment, per M.S. 11A.16, is assigned investment responsibilities over the Permanent School Fund. Information about the investment of the corpus of the fund is included in the State Board of Investment Annual Report. The relevant pages of the most recent report are attached.

Additional background information about the Permanent School Fund is provided below.

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 provided 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 of Natural Resources 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	Current Acres
School	2,900,000	957,818
Swamp	4,706,503	1,550,818
Internal Improvements	500,000	6,510
Total	8,106,503	2,515,146

Source: DNR, December 2015

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 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.”

¹ See [DNR Website](http://www.dnr.state.mn.us) for additional information on school trust land management (www.dnr.state.mn.us).

² See [SBI Website](http://www.sbi.state.mn.us) for additional information on Permanent School Fund investments (www.sbi.state.mn.us).

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, per M.S. 16A.06, the State Board of Investment provides information about how they have maximized the long-term economic return of the permanent school fund.

Recent Legislative Changes

Minnesota Statutes 11A.16 was amended under Laws 2011, 1st special session, chapter 11, article 1, section 1 to clarify that the invested treasurer's cash (ITC) interest earned on the Permanent School fund earnings is included in the investment income certified and paid to school districts. Sections 8, 25, and 26 include charter schools in the definition of a "school district" in order to enable charter schools to qualify for Permanent School fund payments. The new law changes the distribution of permanent school fund revenue from resident ADM pupils to adjusted ADM pupils and excludes charter schools from the definition of school district for purposes of aid anticipation borrowing. The law became effective March 1, 2012. Additionally, Laws 2011, 1st special session, chapter 2, article 1, section 4 appropriated \$200,000 in FY 2012 and \$200,000 in FY 2013 from the Permanent School Fund to the Department of Natural Resources for accelerating land exchanges, land sales, and commercial leasing of school trust lands in order to maximize the long-term economic return of the school trust lands.

Minnesota Statutes 127A.351 to 127A.353 was created under Laws 2012, chapter 249, article 1, sections 8 – 11. The purpose of the new statutes is to establish a school trust lands director position to recommend management policies for Minnesota's school trust lands in accordance with the provisions of the Minnesota Constitution, article XI, section 8. The management of the school trust lands must take into consideration long-term interests of the funds so benefits are not lost in an effort to maximize short-term gains. Finally, Laws 2014, chapter 312, article 13, section 2 specified that the revenues to the Permanent School Fund will be reduced by the cost incurred by the Legislative Permanent School Fund Commission and the school trust lands director.

Agency Contact:

Liz Connor, Executive Budget Officer
Minnesota Management & Budget
658 Cedar Street
400 Centennial Office Bldg
St. Paul, MN 55155
Tel: 651-201-8041
Fax: 651-296-8685

Attached:

State Board of Investment [Annual Report 2015](#): Permanent School Fund.

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, 2015, the market value of the Fund was \$1.2 billion.

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 39 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2015.

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.

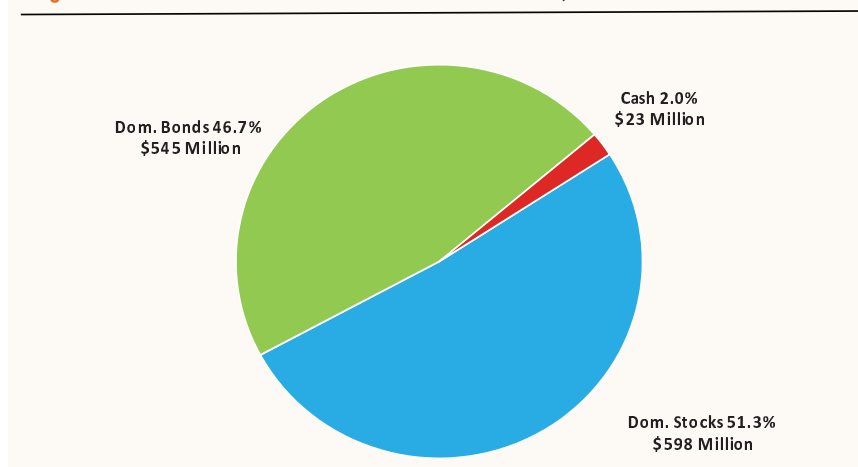
Stock Segment

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

Figure 39. Permanent School Fund Asset Mix as of June 30, 2015



Permanent School Fund

its performance is measured against the Barclays Capital Aggregate Bond Index.

Investment Performance

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

The *bond* segment outperformed its benchmark by 0.6 percentage point during the current fiscal year, primarily due to the overweight to the corporate sector and a short duration position relative to the benchmark.

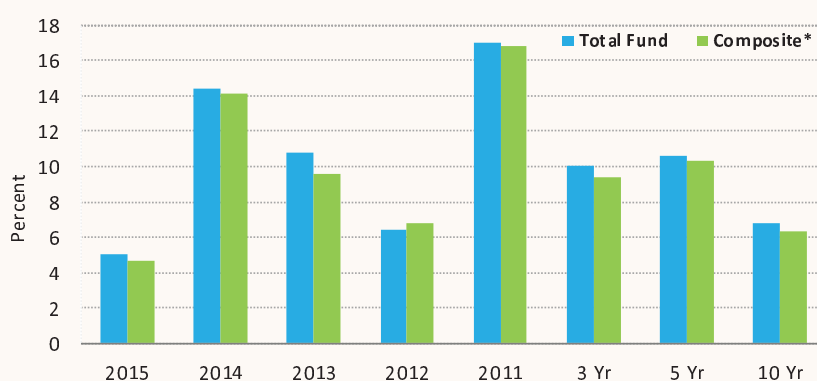
Overall, the Permanent School Fund provided a return of 5.0% for fiscal year 2015, outperforming its composite index by 0.3 percentage point. The Fund outperformed its composite index over the most recent three, five and ten year periods due to the incremental value added by bonds.

Total account results for the last three, five and ten years are shown in Figure 40.

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

<u>Fiscal Year</u>	<u>Millions</u>
2011	\$23
2012	\$24
2013	\$25
2014	\$24
2015	\$26

Figure 40. Permanent School Fund Performance for Periods Ending June 30, 2015



	2015	2014	2013	2012	2011	Annualized		
						3 Yr.	5 Yr.	10 Yr.
Total Fund	5.0%	14.4%	10.8%	6.4%	17.0%	10.0%	10.6%	6.8%
Composite*	4.7	14.1	9.6	6.8	16.8	9.4	10.3	6.3
Stock Segment	7.5	24.5	20.5	5.5	30.8	17.3	17.4	7.9
S&P 500	7.4	24.6	20.6	5.4	30.7	17.3	17.3	7.9
Bond Segment	2.5	5.0	1.4	6.5	4.3	3.0	3.9	5.1
Barclays Agg.	1.9	4.4	-0.7	7.5	3.9	1.8	3.3	4.4

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