
Investment of the Permanent School Fund

CHAPTER 5

The Minnesota Constitution and statutes delegate management of the Permanent School Fund (PSF) principal to the State Board of Investment (SBI) which consists of the Governor, the State Auditor, the Secretary of State, the Attorney General, and the State Treasurer. The board is assisted by a professional investment staff that invests trust fund assets according to board guidelines. The PSF principal amounted to over \$437 million on June 30, 1997.

In this chapter we discuss the investments made on behalf of the trust and issues that may face the trust in the future. We asked:

- **How has the State Board of Investment invested the principal of the fund? What rates of return have been achieved?**
- **How have other states structured their investment and distribution of permanent school trust funds?**

To answer these questions, we reviewed SBI investment policy and investment returns, interviewed other state investment managers, and reviewed relevant investment literature.

INVESTMENT RESTRICTIONS

SBI's investment of the PSF principal is restricted by the Minnesota Constitution and statutes. Figure 5.1 shows the key provisions that limit SBI investment strategies. The major provisions include:

- The Constitution requires that the principal of the Permanent School Fund cannot be spent; it must remain perpetual and inviolate.
- The fund must annually distribute all income and dividends received (net of capital losses) to public school districts.
- Minnesota Statutes require that capital gains from the sale of securities be added to the fund's principal.
- Net realized capital losses must be subtracted in equal installments from capital gains and interest and dividends received over a 10-year period.

The Minnesota Constitution and statutes limit SBI's investment strategies.

Figure 5.1: Restrictions on the Permanent School Fund

<u>Type of Restriction</u>	<u>Constitution</u>	<u>Statutes</u>
Expenditure of the Fund's Principal	Prohibits expenditure of the principal.	NA
Definition of the Fund's Principal	NA	The principal consists of the proceeds from land sales and leases plus the net realized capital gains derived from the investment of these proceeds.
Income Distribution	Net interest and dividends must be distributed to school districts in a manner prescribed by statutes.	Each fiscal year's net income and dividends are transferred to the Endowment School Fund, from which they are distributed to school districts in proportion to the number of students in average daily membership.
Net Capital Losses	Net realized capital losses must be subtracted from the interest and dividends earned thereafter.	Net realized capital losses must be recovered from capital gains apportioned for that year or in equal installments from interest and dividends over a ten-year period.
Net Capital Gains	NA	Capital gains shall be apportioned in equal installments over the next ten fiscal years to offset net losses. Any capital gains not needed to offset losses should be added to the principal of the fund.
Investment Goals	Secure the maximum return consistent with the maintenance of the perpetuity of the fund.	NA
Investment Restrictions	NA***	Same as for retirement funds. (Stocks, bonds, cash equivalents, and alternative investments, including some foreign securities, are permitted.)

***Prior to passage of the constitutional amendment in November 1984, the fund could not have more than 20 percent stocks and 40 percent corporate bonds. In addition, the Constitution imposed certain financial quality restrictions on the stocks and bonds held by the fund. The remainder of the fund had to be invested in the United States Treasury or agency securities guaranteed in full by the United States, or the bonds of Minnesota or other states. These restrictions were removed by the 1984 amendment.

SOURCES: *Minn. Const.*, art. XI, sec. 8, *Minn. Stat.* §§11A.16, 11A.24, 124.08, and 124.09.

Net capital gains are apportioned to the fund's principal in equal installments over ten fiscal years and are first used to offset any security sale losses in that fiscal year. Net losses from the sale of securities are recovered from the portion of capital gains apportioned to that fiscal year and if the gains are insufficient, the losses are recovered from interest and dividend income in equal installments over the following ten fiscal years.¹ SBI's investment of the fund is also constrained by the general statutory restrictions on allowable investments contained in *Minn. Stat.* §11A.24. Prior to a 1984 constitutional amendment, the investment of the PSF portfolio was also limited to 20 percent equities (stocks) and 40 percent corporate bonds.

SBI INVESTMENT STRATEGY FOR THE PSF PORTFOLIO

SBI's investment of the PSF portfolio has also been limited by political constraints. Legislators expected relatively high income from the fund because of state budget pressures in the 1980s and early 1990s. As a result of these pressures, SBI has invested exclusively in fixed-income securities (bonds) to maximize current income. Although the constitutional restriction on equity (stock) investments was removed by the 1984 constitutional amendment:

- **The amount invested in equities actually declined from over 20 percent of the PSF portfolio in the mid-1980s to no equities by 1986.**

In general, over the long-term, total returns from equity investments are higher than from fixed-income investments. Because dividends on equities usually average a return on investment between 2 and 3 percent, and returns on fixed-income securities usually average several percentage points higher, the current income for any fund is maximized in the short term by a portfolio holding only bonds.

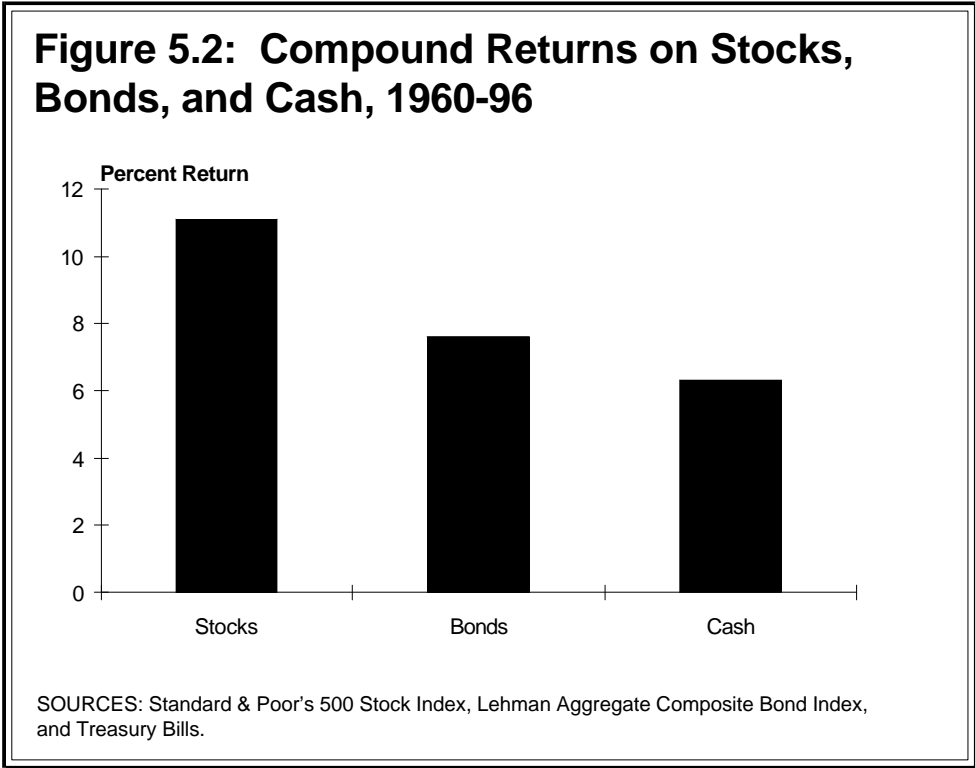
The allocation of assets only to bonds has profound effects on a portfolio's ability to grow in the longer run, especially when inflation is considered. This is because stocks have consistently outperformed bonds over time. For example, Figure 5.2 shows the relative nominal returns of stocks, bonds, and cash since 1960. Figure 5.3 shows that the same pattern of returns has held true during the bull market for stocks of the last 15 years, with stocks outperforming bonds by between 6 and 8 percent annually. Although, in general, stocks consistently outperform bonds over longer time periods, in any one year stock returns can be more volatile than bonds.

SBI Investment Policy 1986-97

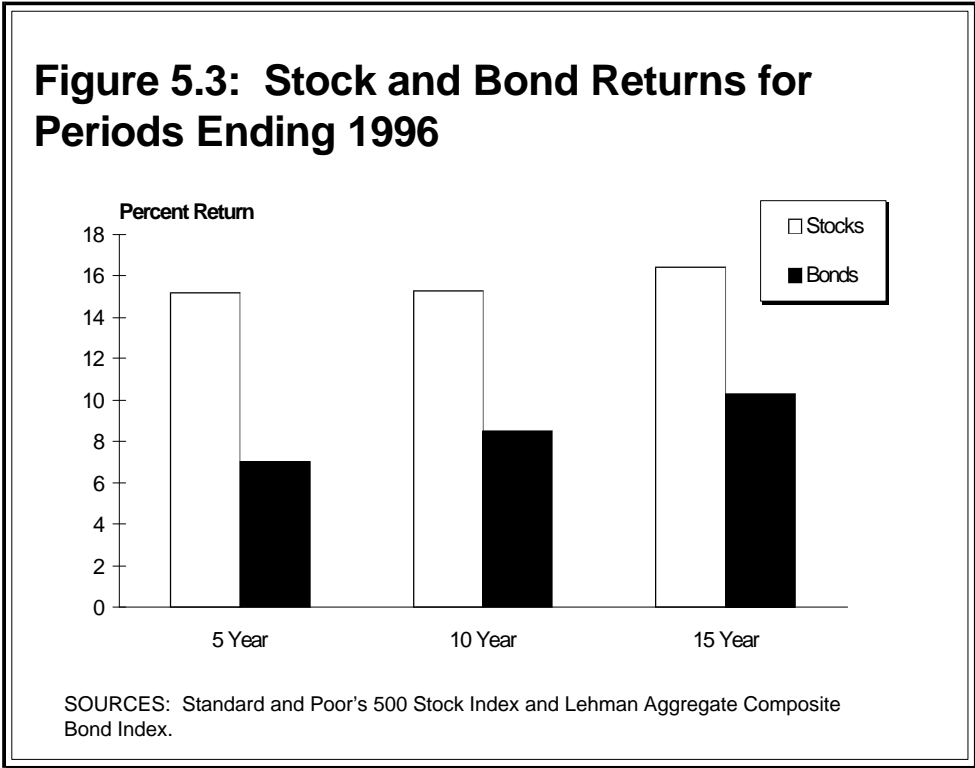
How has SBI responded to the trade-off between long-term returns and short-term income? SBI's investment policy since 1986 has been to produce the maximum

SBI invested the Permanent School Fund exclusively in fixed-income securities over the past ten years.

¹ *Minn. Stat.* §11A.16, subd. 5 (a)(b).



amount of current income while maintaining portfolio quality. The board adopted this policy because the Legislature expected a certain amount of income to be



transferred annually to offset state school aid payments. The board felt that the need for current income, and the requirement that capital gains become part of the fund principal and therefore not be available to reduce potential losses attributable to equity price fluctuations, necessitated a fixed-income security portfolio.

As a result of the need for current income, beginning in 1986 the PSF's relatively small (approximately 20 percent) equity portfolio was eliminated. The board has followed a "laddered" fixed-income security investment approach from 1986 to 1996, purchasing bonds of varying terms and almost always holding them until the bonds' maturity date.² This results in a staggered or "laddered" maturity of the bonds over time.

SBI's short-term investment policy arguably has maximized predictable current spendable income at the expense of long-term principal growth. The board recognized this dilemma in 1986:

The Board believes that the Fund's needs could better be met by a longer-term outlook. Under the current asset allocation, spendable income cannot grow over time. As a result, the value of income produced by the fund, in inflation-adjusted terms, will gradually decline. On the other hand, a longer-term outlook that includes investments in equity assets could allow the Fund's principal, and hence spendable income, to grow.³

Since 1986, SBI staff have recommended consistently that the PSF portfolio contain equity securities.⁴ However, because of the state budget crisis in the early 1980s, the need for current annual income led the board to continue with a bond investment strategy in order to maintain higher current income.

In 1991 our office also recommended that:

SBI, along with the administration and the Legislature, should review the accounting restrictions placed on the fund and the desirability of changing the statutes and/or the Constitution so that stocks could be added to the portfolio once the budget crisis is over.⁵

At that time we estimated that the PSF was losing from \$3 to \$9 million per year over the long term by not holding 50 percent stocks in the portfolio.⁶ We reported that investment of a portion of the portfolio in stocks, although requiring an initial drop in distributed income, would likely allow the PSF portfolio to grow over the longer term.

SBI's past investment policy maximized spendable income at the expense of long-term principal growth.

² See *State Board of Investment Annual Reports 1986-1996*.

³ State Board of Investment, *1986 Annual Report* (St. Paul, 1986).

⁴ State Board of Investment Annual Reports 1986-1996.

⁵ Office of the Legislative Auditor, *State Investment Performance* (St. Paul, 1991), xx.

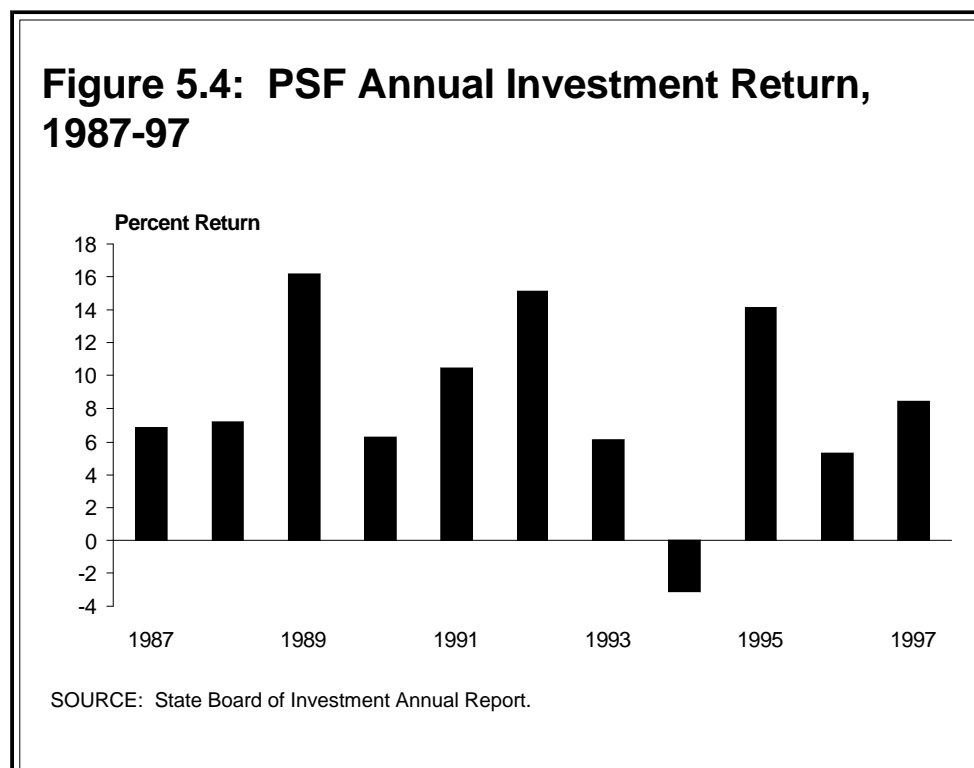
⁶ *Ibid.*, xx. The report compared a 50 percent equity/50 percent bond portfolio to the SBI 100 percent bond approach.

PSF Investment Performance

Figure 5.4 shows the annual percentage returns since fiscal year 1987 resulting from SBI's bond asset allocation strategy. We found that:

- **The investment performance of the PSF portfolio has been comparable to that of similar investments over the last ten years.**

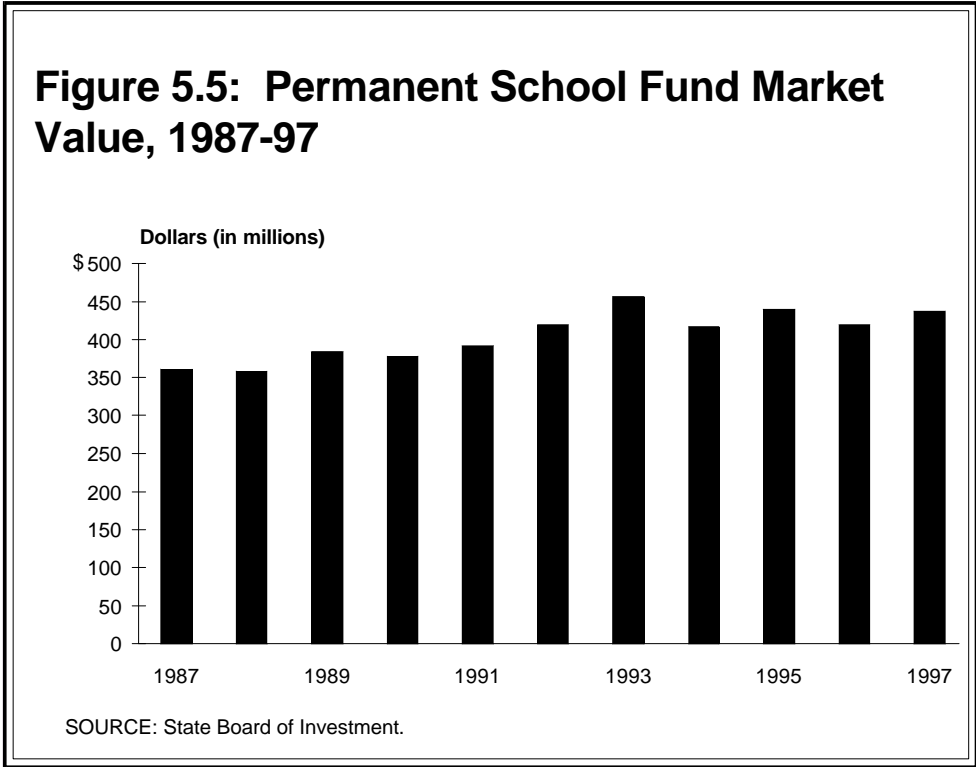
The Permanent School Fund's investment performance has been comparable to similar portfolios but less than stocks.



Over the ten year time period between fiscal years 1988 and 1997 the portfolio has had a compound annual total return of 9.4 percent, comparable to the Lehman Aggregate Composite Bond Index return of 8.8 percent during that period.⁷ However, over the same period of time the Standard and Poor's 500 Stock Index grew at a 15 percent compound rate.

The investment management of the PSF portfolio, combined with \$37 million in deposits from DNR management of trust lands, has resulted in an increase in the portfolio's market value from \$358 million to \$437 million over the last ten years. Figure 5.5 shows the PSF portfolio's market value at the end of each fiscal year since 1987. During the same period the Permanent School Fund paid out \$325.6 million to the Endowment School Fund. Although \$325.6 million is a large sum, it is a small percentage of the total amount of state and local government education funding paid over the last ten years.

⁷ Morningstar Fixed Income Annuity Performance Report, July 1997, 5. The Lehman Aggregate Bond Index is a composite of the performance of a portfolio of 6,500 publicly traded bonds.



SBI has managed an investment portfolio with an equity component for the Environmental Trust Fund since 1994. SBI has managed the portfolio with an asset allocation of approximately 50 percent stocks and 50 percent bonds. Figure 5.6 shows a comparison of the returns from the Environmental Trust Fund’s partial stock portfolio with the returns from the Permanent School Fund bond portfolio between 1994 and 1997. The figure shows that the partial stock allocation used for the Environmental Trust Fund earned a higher return than the PSF portfolio over that period.

Minnesota’s PSF Investments and Distributions

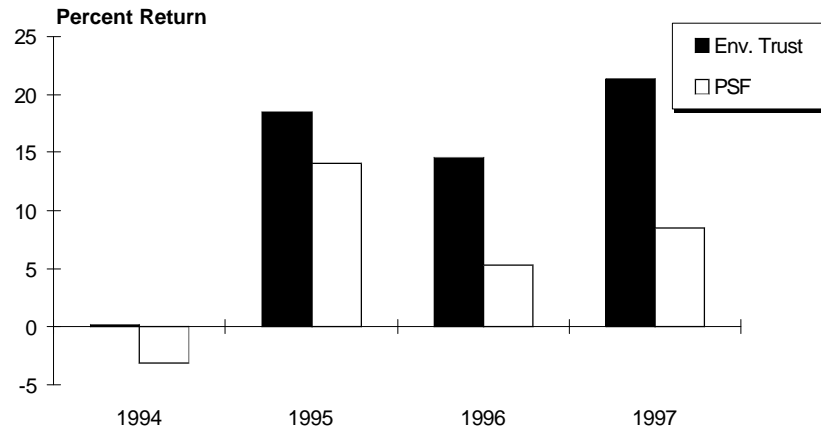
According to investment managers we consulted, permanent school trust fund investment strategy and distribution policy are interrelated. The PSF’s distribution policy is dictated by the constitutional requirement to pay all dividends and interest proceeds to public school districts.⁸ We found that as a result of this requirement:

- **The PSF has paid out a relatively high percentage of its assets to public school districts.**

Table 5.1 shows that over the last ten years, the PSF has distributed income and dividends of between 7 and 9 percent of the trust’s market value each year to

⁸ *Minn. Stat.* §§11A.16, subs. 5 and 6, and 124.08; *Minn. Const.* art. XI, sec. 8. Revenue from the Permanent School Fund is transferred to the Endowment School Fund, an expendable trust fund, and then distributed to school districts. *Minn. Stat.* §§124.08 and 124.09.

Figure 5.6: Environmental Trust and Permanent School Fund Investment Returns, 1994-97



SOURCE: State Board of Investment.

Table 5.1: Percent of PSF Market Value Distributed to Public Schools, 1988-97

<u>Fiscal Year Ending</u>	<u>PSF Market Value (Millions)</u>	<u>Interest/Dividends Earned (Millions)</u>	<u>Percent Distribution</u>
1988	358	32.1	9.0%
1989	385	33.6	8.7
1990	377	33.4	8.8
1991	392	34.2	8.7
1992	419	34.2	8.2
1993	456	33.5	7.3
1994	416	32.5	7.8
1995	439	30.9	7.0
1996	419	31.2	7.4
1997	437	30.0	6.9

SOURCE: State Board of Investment.

The Permanent School Fund has been distributing a high percentage of its assets.

schools. Such a high payout ratio makes it unlikely that the fund will grow relative to inflation. The fund cannot keep pace with inflation unless the additions to the fund’s principal from land management proceeds make up the difference.

Since, as Table 5.2 shows, DNR’s management of the land assets have been contributing approximately 1 percent of the PSF portfolio’s market value each year, land management proceeds are unlikely to make up the difference between investment returns and inflation.

Table 5.2 PSF Deposits from Land Proceeds as a Percent of PSF Market Value, 1988-97

<u>Fiscal Year</u>	<u>PSF Market Value (Millions)</u>	<u>Deposits From Land Proceeds (Millions)</u>	<u>Land Proceeds as a Percent of PSF Market Value</u>
1988	358	1.5	.4%
1989	385	2.2	.6
1990	377	2.8	.7
1991	392	3.9	1.0
1992	419	3.6	.9
1993	456	3.7	.8
1994	416	6.2	1.5
1995	439	4.0	.9
1996	419	4.8	1.1
1997	437	4.4	1.0

SOURCE: Office of the Legislative Auditor analysis of Department of Finance and State Board of Investment data.

The fund’s market value has not kept pace with inflation due to lower returns, a high distribution rate, and small additions to the principal.

We found that:

- **The PSF portfolio has not kept pace with inflation over the last ten years.**

The result of a bond investment strategy, combined with a high distribution ratio and relatively small contributions to the fund’s principal from DNR land management activities, has been a decline in the fund’s market value after considering inflation. Figure 5.7 shows that the market value of the PSF principal, even with additions from DNR land management, has not kept pace with inflation over the last ten years. Figure 5.8 shows that the value of the distributions from the PSF to public school districts has also lost ground to inflation over the same time period.

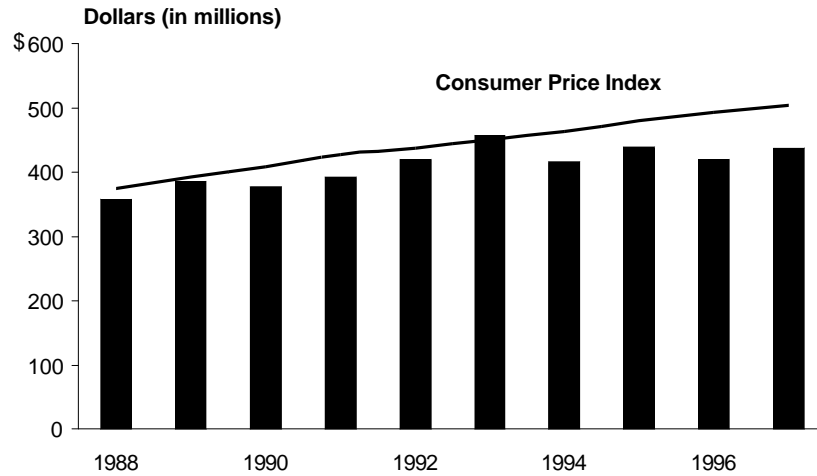
1997 Change in PSF Investment Policy

As noted earlier, SBI staff along with the Legislative Auditor had recommended that the PSF portfolio contain some portion of equities. An initiative to change the portfolio’s asset mix to 50 percent equities was included in the Governor’s recommendations for the 1998-99 budget and was approved by the 1997 Legislature.

- **Actions by the Governor and the 1997 Legislature have allowed SBI to change the PSF portfolio asset allocation to include equities.**

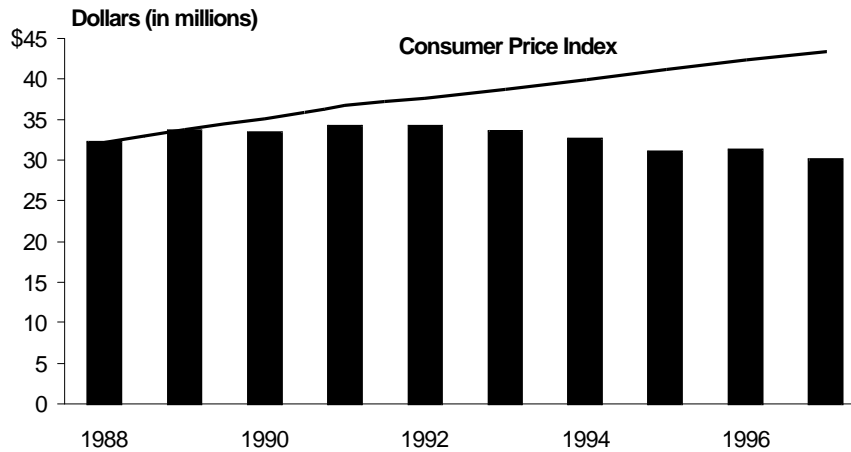
The addition of equities to the PSF portfolio will mean a short-term decrease in distributable income to public education. That reduction is estimated to be \$18 million less in interest income over the 1998-99 biennium. SBI modeling of the effect of changing the portfolio asset mix to 50 percent equity-50 percent bonds projected that interest income might be back to 1997 levels by 2008. Capital

Figure 5.7: PSF Market Value Compared to Inflation, 1988-97



SOURCES: State Board of Investment and U.S. Bureau of Labor Statistics.

Figure 5.8: PSF Distribution to Schools Compared to Inflation, 1988-97



SOURCES: Department of Children, Families, and Learning and U.S. Bureau of Labor Statistics.

appreciation between 1998 and 2008 was projected to add over \$200 million to the total market value of the portfolio. SBI modeling is based on average historical returns and may not occur exactly as projected; nonetheless, it is a reasonable estimate of future investment results.

SBI implemented the initiative by selling \$210 million in bonds in July 1997 (approximately one-half of the PSF market value on June 30, 1997) and purchasing \$212 million of Standard and Poor's 500 index portfolio in July and August 1997. The portfolio is passively managed internally by SBI.⁹

ENDOWMENT FUND INVESTMENT POLICY

Trust funds, like the Permanent School Fund and its counterparts in other states, have much in common with endowment funds. The principle similarity is that the funds are to be held in perpetuity while generating a stream of income for some group or beneficiary. Endowment funds typically manage assets for charitable institutions, such as the Ford or McKnight Foundations, and for universities. In reviewing endowment fund investment management we found:

- **University endowment funds have increasingly moved into equity investments and have begun to consider capital gains as part of the expendable portion of the endowment .**

Endowment funds face the same conflicts as perpetual trusts, such as the PSF, between maximizing predictable short-term revenue and long-term growth in assets and revenues. For both there is a tradeoff between the short term and the longer term. How that tradeoff is balanced depends on the fund's tolerance for risk.

An endowment fund's tolerance for risk is determined by how it trades off short-term versus long-run objectives. In turn, the emphasis on short-run versus long-run objectives is primarily a function of the importance of the endowment fund's spendable income stream compared to the sponsor's total revenue. Where the spendable income stream is a relatively small percentage of total revenues, the risk tolerance of the sponsor will tend to be higher than in a situation where the fund's spendable income stream is a large percentage of the sponsor's total revenue picture. In the latter case, the sponsor must be more cautious. A protracted period of poor investment results could have a serious impact on the various projects that the endowment fund is supposed to finance.¹⁰

In general, endowment funds have increasingly invested in stocks.

⁹ Passively managed portfolios are not actively traded and typically have low management and transaction costs.

¹⁰ State Board of Investment, *The Permanent School Fund Needs and Objectives: Staff Position Paper* (St. Paul, 1997), 10.

Endowment fund management underwent a fundamental change as the result of two influential reports sponsored by the Ford Foundation in 1969.¹¹ The first report found that:

The record of endowment management by most colleges and universities in the United States has not been good. We believe the fundamental reason is that the primary emphasis has been given to avoiding losses and sustaining income. In our opinion, *the most important present responsibility of the trustees of these institutions with respect to endowments is to shift their objective to maximizing the long-term total return.* We believe the total return can be increased significantly to permit both a larger annual contribution to operations and greater long-term growth.¹² [Emphasis added.]

The second Ford report found that there was no legal impediment to trustees considering total return of the endowment portfolio to be a proper objective. The report challenged the widely held view of the time, that the realized gains of endowment funds can never be spent and must be added to the principal.¹³

Endowment funds have begun to consider capital gains as expendable assets.

The result of these two influential reports was a significant shift during the 1970s in the philosophy of endowment trustees about proper investment objectives. By 1975, a Twentieth Century Fund report found that:

There is fairly wide agreement that total return as an investment objective is a good thing. The investment manager is expected to make the endowment fund as profitable as possible, within reasonable risk limitations, without regard for whether the profit takes the form of income yield (dividends, interest, and the like) or appreciation in market value.¹⁴

Over the last two decades, university endowment funds have increasingly moved into equities and have considered capital gains as a part of the expendable portion of the endowment.

Endowment Fund Distribution Policy

When endowment fund managers moved away from the notion of investing mostly in fixed-income securities and distributing the interest earnings, they had to develop new strategies for managing the endowments' investment proceeds. The first Ford Foundation report recommended that endowments transfer to operating funds "an aggregate amount equal to 5% of the three-year, moving average, market value of the fund—whether or not that amount is provided by interest and dividends."¹⁵ The idea behind this recommendation was that by

¹¹ *Managing Educational Endowments* (Report to the Ford Foundation), (New York, N.Y., Aug. 1969); and William Cary and Craight B. Bright, *The Law and the Lore of Endowments*, (Ford Foundation, 1969).

¹² *Managing Educational Endowments*, 45.

¹³ Cary and Bright, *The Law and the Lore*, 66.

¹⁴ J. Peter Williamson, *Funds For the Future: Report of the Twentieth Century Fund Task Force on College and University Endowment Policy* (New York: McGraw Hill, 1975), 111.

¹⁵ *Managing Educational Endowments*, 21.

averaging the distribution over three years, some of the effect of equity investments volatility would be “averaged out” of the distribution, thereby stabilizing the distribution to some extent from the fluctuations of the stock market. Likewise, the ability to distribute capital gains in a planned way lessens the volatility of distributions.

We found that:

- **Endowment funds have moved toward policies that distribute a portion of the fund’s market value each year without regard to whether the source was interest or capital gains.**

With endowment funds’ shift to “total-return” investing has come a shift toward spending rules that emphasize distribution of a percentage of the endowment market value each year. The National Association of College and University Budget Officers (NACUBO) conducts an endowment study every two years. The study found that many endowment funds distribute a percentage of market value with mechanisms often included to smooth out the distributions over time. NACUBO’s 1996 study found that:

Many endowment funds have begun to base distributions on a percentage of market value.

- 64 percent of responding universities distributed a pre-arranged percentage of the moving average market value;
- 6 percent distributed a pre-specified percent of the beginning year’s market value;
- 12 percent used some sort of spending policy relating to the distribution of all or a part of income (interest and dividends); and
- the remaining 18 percent used some other method of distribution, such as a pre-determined increase over the previous year, or a trustee-decided amount.¹⁶

The average institution’s endowment spending rate was 5.7 percent. But the largest endowments distributed an average of 4.8 percent of market value.¹⁷ The NACUBO study noted that the spending policies of all but the largest endowments were not consistent with preserving their purchasing power. So, the NACUBO study shows that despite two decades of movement toward total-return investing by endowment funds, concern remains about fund balances keeping pace with inflation. In order to preserve endowment fund purchasing power, withdrawals must be closely balanced against investment gains.

¹⁶ Cambridge Associates, *1996 NACUBO Endowment Study* (National Association of College and University Budget Officials, 1997), 56-63.

¹⁷ *Ibid.*, 56.

OTHER STATES' SCHOOL TRUST FUND INVESTMENT POLICIES

State school trust fund investment management in the 1990s is in the same position that endowment fund management was in the late 1960s and early 1970s. The primary investment instruments used by state school trust fund managers are fixed-income securities and most states distribute all of the dividends and interest earned annually. Officials in several states are concerned that their trust funds are losing value to inflation because they do not invest enough in stocks. There is a great deal of interest in expanding investments into equities and several states have already changed their asset allocations to include stocks.

We found that:

- **Other state school trust funds are increasingly moving a portion of their investments into equities and several states have changed, or are in the process of changing, their distribution policies.**

Our survey and interviews with other states managing permanent school funds showed seven states (Utah, North Dakota, Oregon, New Mexico, Wyoming, Oklahoma, and Nebraska), in addition to Minnesota, had authority to directly invest in stocks. An earlier 1995 study of 14 western states found that several states had moved to equity investments, but it concluded that most (13 of 14) of the western states did not have “appropriate constitutional and/or statutory provisions that will protect their permanent funds against the effects of inflation.”¹⁸ Since 1995, several states, including Minnesota, have either begun to invest in equities or increased the amount of equities in their portfolios.

Fourteen western states have permanent school or university trust funds derived from federal land grants. New Mexico, the largest (\$4 billion) permanent land fund devoted to public schools and universities, has been studying changing the investment of trust fund principal for the last several years.¹⁹ Officials there were concerned that the fund had been distributing too large a percentage of its principal (between 6.6 and 9.2 percent of market value annually over the previous ten years) and that investment restrictions have limited earning power. In 1996, New Mexico passed a constitutional amendment to loosen restrictions on allowable investments for its permanent school fund and to change its distribution requirement from paying out all income to paying out up to 4.7 percent of the five-year average market value.²⁰

Other state school trust funds are concerned about a lack of stock investments and high distribution rates.

¹⁸ Governor's Permanent Funds Study Committee, *Distributions Policy and Investment Restrictions: Final Report* (New Mexico State Investment Council, August 1995), 5.

¹⁹ *Ibid.*, 4. Four other states have school funds not derived from or restricted by federal land grants: Alaska (\$15 billion), Texas (\$12 billion Common School Fund), California (\$12 million) and Kansas.

²⁰ New Mexico currently is awaiting Congressional approval of the modification of its enabling act. If approved, New Mexico will be able to invest up to 15 percent of market value in foreign securities, up to 65 percent in stocks, and purchase stocks that do not pay dividends and are not listed on national stock exchanges. New Mexico will use an average of the previous five year market value to determine the annual distribution.

Other state school trust funds are beginning to change their investment strategies.

Several other states have invested permanent school funds in equities. Oklahoma, although prohibited from investing in foreign securities, may invest up to 40 percent in domestic stocks and by mid-1997 had moved 28 percent of its portfolio into equities. Oregon began investing in equities in 1989 and between 1989 and 1997 returns have averaged 15 percent while bond yields have averaged 8 percent over the same period.²¹ Wyoming passed a constitutional amendment in November 1996 allowing for equity investments. Nebraska began investing in equities in the early 1980s, maintaining a roughly 50 percent split between stocks and bonds. All income is distributed in Nebraska, but there is an explicit objective of managing the portfolio asset allocation to grow the fund at least by the inflation rate.

North Dakota began investing in stocks in 1990 and currently has 30 percent of its Permanent School Fund invested in equities. In North Dakota, because of the necessity of meeting income distribution goals set by the Legislature, the State Land Department has a longer term strategy of moving to a 60 percent equity allocation over a 10 to 15 year period and decreasing the rate of asset distribution from 6.5 percent to 5 percent of market value. North Dakota adopted this strategy because of concerns that its fund was not keeping up with inflation and its distribution ratio was unsustainable in the longer term.

Although several states have begun to invest in equities, and others are interested in equity investments, there has been only slow change in trust fund distribution policy among states. Minnesota has several choices available to consider for its trust distribution policy.

POLICY OPTIONS FOR MINNESOTA

Compared with other states, Minnesota has dealt, or is dealing, with some of the problems inherent in managing permanent trust funds. School funds are facing similar problems to those endowments faced in the 1970s: a failure of the funds' value to keep pace with inflation and policies of distributing untenable percentages of market value to beneficiaries.

As noted earlier, in 1984, Minnesota loosened investment restrictions that made it difficult for SBI to invest in a diversified portfolio of stocks, bonds, and other investments that might help keep pace with inflation. At that time, budget constraints and legislative expectations of income distribution made it difficult to change PSF investment policy. In 1997, the Legislature modified its income expectations from the PSF and SBI changed the asset allocation policy of the Permanent School Fund to include equities. This will result in a lower distribution of roughly 4.3 percent of the PSF market value in 1998 compared with distributions ranging from 7 to 9 percent over the last ten years.

Although Minnesota has partially addressed the issue of investment restrictions, legislative expectations about the level of income to be distributed from the PSF

²¹ *History of Oregon Common School Fund Investments*. Presentation by Paul Cleary, Director, Oregon Division of State Lands, at the Western States Land Commissioners Investment Conference, July 1997, 18.

SBI has recommended loosening restrictions on capital gains and spending a fixed percentage of the fund each year.

could change, as could the policy of SBI on asset allocation. Regardless, the long-term ability of the PSF to keep up with inflation is affected by the fund's distribution policy. The PSF distribution policy is currently set by constitution and statute; all income must be distributed annually.²² The difficulty with distributing all income annually is that the income reflects both an inflation component and a real return. So, if all income is distributed, the market value may not keep pace with inflation. Some states and many university endowments have addressed this dilemma by adopting an endowment approach to trust distributions, limiting distributions to a maximum of some percentage of the fund's market value.

The State Board of Investment staff have recommended that: "the PSF adopt a policy of spending a set percentage of the PSF, instead of spending only the net dividend and interest income generated."²³ SBI staff advocate having a fixed percentage of market value as the distribution at the beginning of each biennium, with the spending amount being the same for each year of the biennium. This strategy is similar to that adopted by large endowment funds, and has the advantage of eliminating uncertainty about the amount available for school aid during the biennium. In addition, SBI staff have recommended eliminating the constitutional requirement that net capital losses earned from the fund be repaid from spendable income. This would allow the fund to be invested on a total return basis with capital gains available for distribution. In essence, SBI is recommending that the PSF be treated as a typical endowment fund. Income from capital gains under SBI's proposal could be considered when adopting a distribution policy.

We believe that the SBI staff recommendations have considerable merit. Eliminating the restriction on how capital gains are treated would allow SBI to even the cash distribution and provide predictable levels of income to public schools. Adopting a percentage of market value distribution policy (like most endowment funds) in the Constitution also would ensure that future policies will abide by the state's fiduciary responsibility to the permanent school trust. As a result, we recommend:

- **The Legislature should consider Constitutional and statutory changes to the distribution of income and to the treatment of capital gains from the Permanent School Fund.**

Other options exist. If the state does nothing, and SBI policy on asset allocation does not change, it is possible the PSF portfolio will keep up with inflation. It is more likely that the PSF portfolio will keep up with inflation if the Legislature were to change the requirement that net income and dividends be distributed to the schools annually, and that capital gains become part of the fund principal. We believe that on balance the state's school children would be best served, in the long run, by a total return investment policy that distributes a fixed percentage of fund assets annually. In our opinion, distributing a limited percentage of fund assets annually will maximize the distribution to schools and allow the fund to grow in real terms.

²² *Minn. Stat.* §11A.16, and *Minn. Const.* art. XI, sec. 8.

²³ State Board of Investment, *The Permanent School Fund Needs*, 12.

**Dedicating PSF
income to
specific school
needs could
raise the fund's
visibility.**

Another option that could be explored involves using distributions from the Permanent School Fund for special projects within public education instead of offsetting the general fund education appropriation. For example, the annual PSF distribution might be used to finance capital projects or classroom technology improvements in Minnesota's public school districts. The PSF could be used for education much like the Environmental Trust Fund is used to finance environmental projects. Under this option, the Legislature would decide how to appropriate the PSF distribution, perhaps with assistance from an advisory group or other body.

Using the PSF distribution for special projects could increase the visibility of the fund, generating more interest in how the PSF principal is invested and how school trust land is managed. If the PSF distributions were used for specific education projects, school districts around the state would probably become more aware of the trust.

Of the states we contacted, Wisconsin and Iowa distribute PSF interest earnings to specific programs. In Wisconsin, school districts receive an annual allocation for library materials from the PSF. In Iowa, two education programs related to teaching talented and gifted students and encouraging innovative teaching practices receive annual PSF distributions. These programs are required to match the distribution with other funds.

SUMMARY

Over the last ten years the Permanent School Fund portfolio has not kept pace with inflation because it has paid out a relatively high proportion of the fund's principal and because the fund's investments have been largely in bonds. Recent policy changes by the Legislature and SBI have changed the fund's asset allocation to include stocks. The current asset allocation strategy has the prospect of keeping pace with inflation although the fund is still vulnerable to inflation effects. The prospects for the PSF portfolio might be improved by moving toward an endowment trust management strategy. The Legislature should consider statutory and constitutional changes to maximize the chances that the PSF portfolio will continue to grow in the future.

