ND STATE INVESTMENT BOARD MEETING

Friday, March 27, 2015, 8:30 a.m.
Workforce Safety & Insurance
1600 E Century Avenue, Bismarck, ND

AGENDA

I. CALL TO ORDER AND ACCEPTANCE OF AGENDA

II. ACCEPTANCE OF MINUTES (February 27, 2015)

III. INVESTMENTS

A. RIO Strategic Mission - Mr. Hunter (enclosed) (20 min) **Board Action**
B. Callan Timber Consulting Capabilities - Ms. Angus (enclosed) (20 min) *Informational*
C. Timber Survey and RIO Recommendation - Mr. Hunter and Mr. Schulz (enclosed) (10 min) **Board Action**
D. Tobacco Prevention and Control Trust Fund - Mr. Hunter and Ms. Murtha (enclosed) (10 min) **Board Action**
E. Private Equity Update - Mr. Schulz and Mr. Hunter (enclosed) (10 min) *Informational*

IV. GOVERNANCE

A. Legislative Update - Mr. Hunter (enclosed) (10 min) *Informational*
B. Governance Policy Review - Mr. Hunter (enclosed) (20 min)
   1. Executive Limitations (Second Reading) **Board Action**
   2. Board Staff Relationship (First Reading) *Informational*

================================== BREAK (10:10 to 10:25) =====================================

V. ADMINISTRATION

A. Executive Review Committee - Mr. Lech (to follow) (20 min) **Board Action**
B. GFOA Certificate - Mr. Hunter (enclosed) (5 min) *Informational*
C. Board Education - Callan Manager Search Process - Mr. Hunter & Mr. Erlendson (enclosed) (30 min) **Board Action**

VI. OTHER

Next Meetings:
SIB meeting - April 24, 2015, 8:30 a.m. - Workforce Safety & Insurance
SIB Audit Committee meeting - May 21, 2015, 3:00 pm - State Capitol, Peace Garden Room

VII. ADJOURNMENT

Any individual requiring an auxiliary aid or service, please contact the Retirement and Investment Office (701) 328-9885 at least three (3) days prior to the scheduled meeting.

NORTH DAKOTA STATE INVESTMENT BOARD
MINUTES OF THE
FEBRUARY 27, 2015, BOARD MEETING

MEMBERS PRESENT:	Drew Wrigley, Lt. Governor, Chair Mike Sandal, Vice Chair Jeff Engleson, Dep. Land Commissioner Adam Hamm, Insurance Commissioner Mel Olson, TFFR Board Kelly Schmidt, State Treasurer Yvonne Smith, PERS Board Cindy Ternes, WSI designee Tom Trenbeath, PERS Board
MEMBERS ABSENT:	Mike Gessner, TFFR Board Rob Lech, TFFR Board
STAFF PRESENT:	Eric Chin, Investment Analyst Connie Flanagan, Fiscal & Invt Op Mgr Bonnie Heit, Assist to the SIB David Hunter, ED/CIO Fay Kopp, Deputy ED/CRO Terra Miller-Bowley, Supvr Audit Services Cody Schmidt, Compliance Officer Darren Schulz, Deputy CIO
OTHERS PRESENT:	Paul Erlendson, Callan Associates Inc. Tom Johnson, Timberland Investment Resources Chris Mathis, Timberland Investment Resources Jan Murtha, Attorney General's Office Mark Seaman, Timberland Investment Resources

CALL TO ORDER:

Lt. Governor Wrigley called the State Investment Board (SIB) meeting to order at 8:30 a.m. on Friday, February 27, 2015, at Workforce Safety & Insurance, 1600 E Century Ave., Bismarck, ND.

AGENDA:

IT WAS MOVED BY MS. TERNES AND SECONDED BY MS. SMITH AND CARRIED ON A VOICE VOTE TO ACCEPT THE AGENDA FOR THE FEBRUARY 27, 2015, MEETING AS DISTRIBUTED.

AYES:TREASURER SCHMIDT, COMMISSIONER HAMM, MS.TERNES, MR. ENGLESON, MS. SMITH, MR. SANDAL, MR. TRENBEATH, MR. OLSON, AND LT. GOVERNOR WRIGLEY
NAYS: NONE
MOTION CARRIED
ABSENT: MR. GESSNER, MR. LECH

MINUTES:

IT WAS MOVED BY MR. TRENBEATH AND SECONDED BY MR. OLSON AND CARRIED ON A VOICE VOTE TO APPROVE THE JANUARY 23, 2015, MINUTES AS DISTRIBUTED.

AYES: MS. SMITH, MR. SANDAL, MR. OLSON, MR. TRENBEATH, MS. TERNES, COMMISSIONER HAMM, MR. ENGLESON, TREASURER SCHMIDT, AND LT. GOVERNOR WRIGLEY

NAYS: NONE
MOTION CARRIED
ABSENT: MR. GESSNER, MR. LECH

INVESTMENTS:

Asset/Performance Overview – Mr. Hunter updated the SIB on the status of the portfolios they manage on behalf of their clients. Highlights included - as of December 31, 2014, assets under management grew by approximately 18 percent or $1.53 billion in the last year. The Pension Trust posted a net return of approximately 6.0 percent with gains of $265 million. All Pension Trust clients generated positive excess returns for the 1, 3, and 5 year periods ended December 31, 2014. The Insurance Trust generated a net return of 5.1 percent with gains of $204 million. Twelve out of 14 of the Insurance Trust's clients generated positive excess returns for the 1, 3, and 5 year periods ended December 31, 2014.

The Legacy Fund's net return was 4.2 percent and assets increased by 71 percent or $1.2 billion for the year ended December 31, 2014. SIB client assets, based on unaudited valuations, approximated $10.1 billion as of December 31, 2014. Mr. Hunter also informed the board the Legacy Fund's asset allocation has been fully implemented as of January 31, 2015. The asset allocation was approved by the Legacy and Budget Stabilization Fund Advisory Board on April 2, 2013, and accepted by the SIB for implementation on April 26, 2013.

Timberland Investment Resources (TIR) – TIR representatives reviewed the Springbank, Teredo, and Eastern Timber Opportunities timber portfolios they are currently managing on behalf of the SIB.

Additional discussion was held on the Springbank property. The management agreement for the property expires on June 30, 2015.

Callan Report – Mr. Erlendson reviewed the Pension and Insurance Trust's performance for the quarter ending December 31, 2014. Mr. Erlendson also provided Callan's economic outlook for both foreign and domestic markets for the same quarter.

IT WAS MOVED BY MR. TRENBEATH AND SECONDED BY TREASURER SCHMIDT AND CARRIED ON A VOICE VOTE TO ACCEPT THE CALLAN REPORTS FOR THE QUARTER ENDING DECEMBER 31, 2014.

AYES: MR. TRENBEATH, TREASURER SCHMIDT, MR. OLSON, MR. ENGLESON, MR. SANDAL, COMMISSIONER HAMM, MS. SMITH, MS. TERNES, AND LT. GOVERNOR WRIGLEY
NAYS: NONE
MOTION CARRIED
ABSENT: MR. GESSNER, MR. LECH

The Board recessed at 10:18 a.m. and reconvened at 10:33 a.m.

ADMINISTRATION:

Audit Committee Report – Ms. Miller Bowley reported on the SIB Audit Committee meeting held on February 26, 2015. Ms. Miller Bowley stated year to date a total of ten school district audits have been completed and one not in compliance follow up review has been completed for a total of eleven audits.

The Audit Committee also met separately with staff and RIO management. The Audit Committee is satisfied that the Audit Division and RIO Management are working cohesively within the organization.

The Audit Committee also reviewed and accepted the final results of the Executive Limitations Audit for the period of January 1, 2014 – December 31, 2014.

IT WAS MOVED BY MR. TRENBEATH AND SECONDED BY MR. OLSON AND CARRIED ON A VOICE VOTE TO ACCEPT THE AUDIT REPORT AS PRESENTED.

AYES: MS. TERNES, MR. OLSON, COMMISSIONER HAMM, TREASURER SCHMIDT, MR. ENGLESON, MR. TRENBEATH, MS. SANDAL, MS. SMITH, AND LT. GOVERNOR WRIGLEY
NAYS: NONE
MOTION CARRIED
ABSENT: MR. GESSNER, MR. LECH

Executive Limitations Audit **–** Ms. Miller Bowley stated the Executive Limitations Audit for the period of January 1, 2014 through December 31, 2014 has been completed. The audit examines the Executive Director/CIO's level of compliance with SIB Governance Manual Executive Limitation policies A-1 through A-11. The Audit Division and the Audit Committee is of the opinion that the Executive Director/CIO is in compliance with the policies.

IT WAS MOVED BY MS. SMITH AND SECONDED BY MR. TRENBEATH AND CARRIED ON A VOICE VOTE TO ACCEPT THE EXECUTIVE LIMITATIONS AUDIT REPORT.

AYES: COMMISSIONER HAMM, MS. TERNES, MR. OLSON, MR. SANDAL, TREASURER SCHMIDT, MS. SMITH, MR. ENGLESON, MR. TRENBEATH, AND LT. GOVERNOR WRIGLEY
NAYS: NONE
MOTION CARRIED
ABSENT: MR. GESSNER, MR. LECH

Executive Review Appointment – Per Governance Policy Board-Staff Relationship/Monitoring Executive Performance C-4, the Chairperson of the SIB will appoint a three member committee to review the board's evaluation of the Executive Director/CIO as well as the Executive Limitations Audit (both completed in February 2015) and bring back a recommendation to the full board regarding compensation. Lt. Governor Wrigley appointed Mr. Lech, Chair, Mr. Sandal, and Ms. Ternes.

Staff Update – Mr. Hunter stated RIO will be fully staffed March 3, 2015, with the appointment of Ms. Denise Osmond as Retirement Programs Specialist.

Callan Conference – Mr. Sandal attended Callan's annual conference January 26-28, 2015, in San Francisco, CA. Mr. Sandal stated the agenda was timely and appropriate given the issues the SIB is facing as well as pension boards across the country. Mr. Sandal stated the conference was very valuable educationally and recommended other trustees attend the conference if they have the opportunity.

Periodicals - Per Governance Policy, Governance Process/Governing Style 1.F., the Executive Director will provide the SIB with a list of periodicals available which would provide current information on pension issues. The board members will review and request subscriptions to appropriate periodicals.

Mr. Hunter provided a listing of pension and investment-related periodicals. Trustees are to let staff know if they are interested in any of the periodicals or any other educational materials and they will be provided to them.

GOVERNANCE:

Timberland Investment Resources Recommendation – Mr. Hunter stated TIR is requesting the SIB extend the term of the Springbank, LLC management agreement by seven years to June 30, 2022, in order to maximize future earnings. The current contract will expire on June 30, 2015, with the option for a one year extension. The agreement includes a 60-day termination notice.

The SIB owns 76 percent of the Springbank properties and the other 24 percent is owned by the Houston Firefighters Relief and Retirement Fund. TIR has managed the property since October 1, 2004. As of December 31, 2014, the market value was $116 million.

TIR's recent returns have underperformed largely due to the slower economic recovery in the southeastern U.S. in which Springbank is located (along the I-75 corridor between Atlanta, GA and Chattanooga, TN). TIR has performed well over the long-term with an Inception to Date Net Internal Rate of Return of 12.3 percent. Springbank's net time weighted return since inception is approximately 7 percent.

Staff requested authorization to continue to move forward to negotiate market terms and fees along with the Houston Firefighters Relief and Retirement Fund. Staff is hoping to conclude negotiations within the next two to three months.

IT WAS MOVED BY TREASURER SCHMIDT AND SECONDED BY MR. SANDAL AND CARRIED BY A ROLL CALL VOTE TO ACCEPT STAFF RECOMMENDATION TO CONTINUE CONTRACT NEGOTIATIONS WITH TIR.

AYES: TREASURER SCHMIDT, MR. OLSON, MR. ENGLESON, MR. TRENBEATH, MR. SANDAL, COMMISSIONER HAMM, MS. SMITH, MS. TERNES, AND LT. GOVERNOR WRIGLEY
NAYS: NONE
MOTION CARRIED
AYES: MR. GESSNER, MR. LECH

Legislative Update – Mr. Hunter provided an update on legislative bills staff is tracking that could possibly affect the SIB and RIO. Lt. Governor Wrigley requested he be notified when hearings are scheduled for HCR3041 - a Legislative Management study which would consist of a comprehensive review and analysis of the investment practices by the state and SIB.

Budget Stabilization IPS – Acceptance of the Budget Stabilization Fund Investment Policy Statement by the SIB was tabled for further clarification. The SIB requested the Bank of North Dakota's (BND) confirm its understanding of the Budget Stabilization Fund's short-term liquidity requirements per NDCC Chapter 54.27.2 in writing. Mr. Hunter indicated Babson and JP Morgan stated they estimate their investment could be liquidated within 5 to 10 trading days. BND noted that its liquidity is strong and they have access to overnight funds in excess of $600 million.

Governance Process Review –

IT WAS MOVED BY MR. SANDAL AND SECONDED BY TREASURER SCHMIDT AND CARRIED BY A ROLL CALL VOTE TO ACCEPT THE SECOND READING OF THE GOVERNANCE PROCESS SECTION OF THE GOVERNANCE POLICIES.

AYES: MS. SMITH, MS. TERNES, TREASURER SCHMIDT, COMMISSIONER HAMM, MR. OLSON, MR. TRENBEATH, MR. SANDAL, AND LT. GOVERNOR WRIGLEY

NAYS: NONE
MOTION CARRIED
ABSENT: MR. ENGLESON, MR. GESSNER, MR. LECH

The Board received the first reading of the Executive Limitations policies. The policies will be presented for a second reading and possible acceptance at the next meeting.

OTHER:

Next scheduled meetings:

SIB Meeting – March 27, 2015, 8:30 a.m. – Workforce Safety & Insurance
SIB Audit Committee Meeting – May 22, 2015, 1:00 p.m. – State Capitol, Peace Garden Room

ADJOURNMENT:

IT WAS MOVED MR. TRENBEATH AND SECONDED BY MS. SMITH AND CARRIED ON A VOICE VOTE TO ADJOURN THE MEETING.

AYES: MR. OLSON, MR. TRENBEATH, COMMISSIONER HAMM, MS. SMITH, MR. SANDAL, TREASURER SCHMIDT, MS. TERNES, AND LT. GOVERNOR WRIGLEY
NAYS: NONE
MOTION CARRIED
ABSENT: MR. ENGLESON, MR. GESSNER, MR. LECH

With no further business to come before the SIB, Lt. Governor Wrigley adjourned the meeting at 11:27 a.m.

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Lt. Governor Wrigley, Chair
State Investment Board

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Bonnie Heit
Assistant to the Board

AGENDA ITEM III. A

TO: State Investment Board

FROM: Dave Hunter

DATE: March 23, 2015

SUBJECT: RIO Strategic Mission – Cover Memo to Recommendation

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Overview:

Section D-1 of the SIB Governance Manual defines RIO's "Mission" statement. The attached presentation outlines the key components of RIO's mission while highlighting the major factors which supports management's assertion that RIO is achieving its stated goals. **In the end, RIO will request the SIB to affirm RIO's mission statement for the upcoming year.**

The attached presentation was provided as testimony to the Senate Industry, Business and Labor Committee with regards to HCR 3041 which proposed that a "<u>Legislative Management study consisting of a comprehensive review and analysis of the investment practices by the state and the State Investment Board</u>." **HCR 3041 was declared lost on a voice vote on March 20, 2015.**

RIO's Strategic Mission Statement

Annual SIB Review and Confirmation

March 23, 2015

Dave Hunter, Executive Director / CIO
ND Retirement & Investment Office (RIO)
State Investment Board (SIB)

RIO's Mission Statement

Background: RIO's "Mission" is defined in SIB Governance Policy D-1 on "Ends".

"The Retirement and Investment Office serves the SIB and exists in order that:

1) SIB clients receive investment returns, consistent with their written investment policies and market variables, in a cost effective investment manner and under the Prudent Investor Rule.

2) Potential SIB clients have access to information regarding the investment services provided by the SIB.

3) TFFR benefit recipients receive their retirement benefits in a cost effective and timely manner.

4) TFFR members have access to information which will allow them to become knowledgeable about the issues and process of retirement.

5) SIB clients and TFFR benefit recipients receive satisfactory services from the boards and staff of the office."

Summary: Based on SIB and TFFR client survey results and noting that every SIB client with a 3-year or 5-year track is generating positive excess return for the 3- and 5-year periods ended 12/31/2014 while adhering to prescribed risk metrics, the SIB and RIO are achieving its' stated goals and mission.

State Investment Board – Client Assets Under Management

Fund Name	Market Values as of 12/31/14 [(1)]	Market Values as of 6/30/14 [(2)]	Market Values as of 12/31/13 [(1)]
Pension Trust Fund			
Public Employees Retirement System (PERS)	2,345,979,927	2,332,744,037	2,204,819,633
Teachers' Fund for Retirement (TFFR)	2,046,439,456	2,061,684,912	1,970,377,031
Job Service of North Dakota Pension	96,920,165	97,825,769	95,276,201
City of Bismarck Employees Pension	79,421,743	78,804,326	74,832,971
City of Grand Forks Employees Pension	56,347,332	57,896,611	53,459,799
City of Bismarck Police Pension	34,834,996	34,643,204	32,887,889
Grand Forks Park District	5,893,072	5,938,993	5,653,023
City of Fargo Employees Pension	9,656	9,702	4,742,525
Subtotal Pension Trust Fund	**4,665,846,347**	**4,669,547,555**	**4,442,049,072**
Insurance Trust Fund			
Legacy Fund	2,900,880,837	2,215,941,142	1,695,950,111
Workforce Safety & Insurance (WSI)	1,710,647,794	1,703,987,980	1,627,545,930
Budget Stabilization Fund	589,598,047	586,199,881	588,744,084
PERS Group Insurance Account	42,705,101	37,425,567	39,626,348
City of Fargo FargoDome Permanent Fund	40,651,973	41,775,992	38,668,924
State Fire and Tornado Fund	25,065,765	29,223,707	28,625,262
Petroleum Tank Release Compensation Fund	7,152,822	7,092,998	6,899,622
State Risk Management Fund	6,771,080	6,948,162	6,593,046
State Risk Management Workers Comp Fund	6,141,008	5,965,322	5,654,121
ND Association of Counties (NDACo) Fund	3,481,321	3,445,373	2,894,408
State Bonding Fund	3,299,303	3,268,991	3,171,622
ND Board of Medical Examiners	2,131,999	1,889,897	
Bismarck Deferred Sick Leave Account	859,648	849,818	807,624
Insurance Regulatory Trust Fund	646,335	1,146,038	1,107,837
Cultural Endowment Fund	373,276	364,979	359,577
Subtotal Insurance Trust Fund	**5,340,406,309**	**4,645,525,847**	**4,046,648,516**
PERS Retiree Insurance Credit Fund	93,282,939	90,360,366	83,492,581
Total Assets Under SIB Management	**10,099,535,595**	**9,405,433,768**	**8,572,190,169**

[(1)] *12/31/14 and 12/31/13 market values are unaudited and subject to change.*

[(2)] *6/30/14 market values as stated in the Comprehensive Annual Financial Report.*

- SIB Client Assets Under Management grew by approximately 18.5% or $1.53 billion in the last year.
- The Pension Trust posted a net return of over 5.9%%, while the Insurance Trust generated a 5.1% net return in 2014. Investments were responsible for gains of $265 million for the Pension Trust and $204 million for the Insurance Trust.
- Legacy assets increased by 71% (or $1.2 billion) primarily due to tax collections, while net returns were 4.2% for the year ended December 31, 2014.
- SIB client assets approximated $10.1 billion based on preliminary valuations as of December 31, 2014.

NOTE: The following pages were provided to the Senate Industry, Business and Labor Committee relating to HCR 3041 which proposed a Legislative Management Study of the SIB's investment practices.

Pension Trust – December 2014 Performance Update

	1 Yr Ended 12/31/2014	3 Yrs Ended 12/31/2014	5 Yrs Ended 12/31/2014	Risk 5 Yrs Ended 12/31/2014
PUBLIC EMPLOYEES RETIREMENT SYSTEM (PERS)				
Total Fund Return - Net	5.95%	11.89%	9.35%	8.7%
Policy Benchmark Return	5.15%	10.90%	9.18%	8.3%
Excess Return	**0.80%**	**0.99%**	**0.17%**	**104.0%**
TEACHERS' FUND FOR RETIREMENT (TFFR)				
Total Fund Return - Net	5.92%	11.96%	9.55%	9.6%
Policy Benchmark Return	5.13%	10.94%	8.91%	9.2%
Excess Return	**0.79%**	**1.02%**	**0.65%**	**103.9%**
CITY OF BISMARCK EMPLOYEES PENSION				
Total Fund Return - Net	6.16%	11.03%	9.36%	7.4%
Policy Benchmark Return	5.22%	9.65%	8.76%	7.1%
Excess Return	**0.94%**	**1.38%**	**0.60%**	**102.9%**
CITY OF BISMARCK POLICE PENSION				
Total Fund Return - Net	5.94%	11.49%	9.55%	8.0%
Policy Benchmark Return	5.09%	10.22%	9.06%	7.9%
Excess Return	**0.85%**	**1.27%**	**0.48%**	**101.9%**
JOB SERVICE PENSION PLAN				
Total Fund Return - Net	6.69%	10.94%	8.77%	6.4%
Policy Benchmark Return	5.55%	8.70%	8.11%	6.0%
Excess Return	**1.14%**	**2.24%**	**0.66%**	**106.0%**
CITY OF GRAND FORKS PENSION PLAN				
Total Fund Return - Net	6.28%	12.48%	9.98%	8.7%
Policy Benchmark Return	5.64%	11.32%	9.61%	8.5%
Excess Return	**0.64%**	**1.16%**	**0.37%**	**102.9%**
GRAND FORKS PARK DISTRICT PENSION PLAN				
Total Fund Return - Net	6.90%	12.94%	10.06%	9.1%
Policy Benchmark Return	6.56%	11.78%	9.75%	8.4%
Excess Return	**0.34%**	**1.16%**	**0.31%**	**107.9%**

Pension Trust:

- **Every SIB client within the Pension Trust generated positive "Excess Return" for the 1-, 3- and 5-year periods ended December 31, 2014.**
- "**Excess Return**" is defined as the actual investment return (after deducting investment fees) over the expected return of the underlying investment policy or benchmark (i.e. a passive index).
- **SIB's use of active management generated over $30 million of net incremental income** (after fees) **in the last year for PERS & TFFR in total**. This is based on $4 billion of managed assets and **Excess Return of 0.79%** ($4 billion x 0.79% = $31.6 million/year).
- These strong returns have been achieved while reducing overall investment risk, as measured by standard deviation, during the past 10 years. Standard deviation measures the amount of variation or dispersion from the average.

Note: Data as of 12/31/2014 is unaudited and subject to change.

Insurance Trust – December 2014 Performance Update

	1 Yr Ended 12/31/2014	3 Yrs Ended 12/31/2014	5 Yrs Ended 12/31/2014
WORKFORCE SAFETY & INSURANCE (WSI)			
$ 1,710,647,794			
Total Fund Return - Net	7.26%	8.86%	8.39%
Policy Benchmark Return	6.28%	6.20%	6.58%
Excess Return	**0.98%**	**2.66%**	**1.82%**
LEGACY FUND			
$ 2,900,880,837			
Total Fund Return - Net	4.23%	3.01%	N/A
Policy Benchmark Return	3.62%	2.01%	N/A
Excess Return	**0.61%**	**1.00%**	
BUDGET STABILIZATION FUND			
$ 589,598,047			
Total Fund Return - Net	1.56%	1.96%	2.47%
Policy Benchmark Return	0.53%	0.41%	0.32%
Excess Return	**1.04%**	**1.55%**	**2.14%**

Note: The 3 largest clients in the **Insurance Trust** are:

1.) WSI - $1.7 billion;
2.) Legacy Fund - $2.9 billion; and
3.) Budget Stabilization Fund - $590 million.

Insurance Trust:

- **Every SIB client within the Insurance Trust generated positive "Excess Return" for the 3- and 5-year periods ended December 31, 2014, while 13 out of our 15 Insurance Trust clients generated positive "Excess Return" for the 1-year ended 12/31/2014.**
- **"Excess return"** is defined as the actual investment return (after deducting management fees) over the expected investment return of the underlying investment policy benchmark (or passive index).
- **Based on WSI plan assets of $1.7 billion and "Excess Return" of 0.98% in 2014, SIB's use of active management generated over $16 million of incremental income (after fees) for WSI ($1.7 billion x 0.98% = $16.66 million) in the last year.**
- These returns were achieved in a risk controlled framework as each Insurance Trust client (with a 5-year track record) generated positive "**Risk Adjusted Excess Return**" for the 5-years ended 12/31/2014.

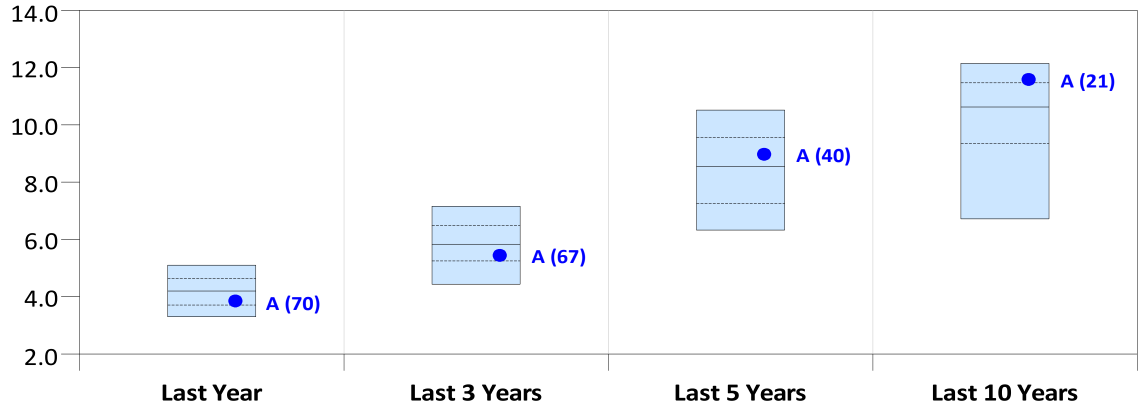
Risk Adjusted Excess Return measures a portfolio's excess return adjusted by its risk relative to a benchmark portfolio. This metric is positive if returns are due to smart investment decisions or negative if driven by excess risk.

Note: Data as of 12/31/2014 is unaudited and subject to change.

Pension “Risk” has declined as measured by Standard Deviation

Standard deviation is used to measure investment volatility whereas a lower standard deviation is generally preferred over a higher standard deviation.

Standard Deviation
for Periods Ended December 31, 2014
Group: CAI Public Fund Sponsor Database



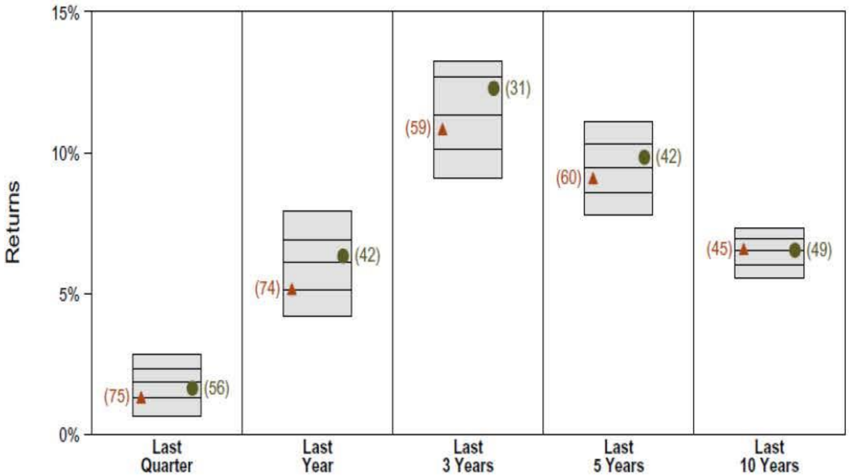
	Last Year	Last 3 Years	Last 5 Years	Last 10 Years
10th Percentile	5.1	7.2	10.5	12.1
25th Percentile	4.6	6.5	9.6	11.5
Median	4.2	5.8	8.5	10.6
75th Percentile	3.7	5.3	7.3	9.4
90th Percentile	3.3	4.4	6.3	6.7
Member Count	265	258	243	208
ND Pen-Total Fund ● A	**3.9**	**5.4**	**9.0**	**11.6**

Portfolio volatility, as measured by Standard Deviation, has declined significantly and currently resides in the 3rd quartile for 3-year period ended December 31, 2014 versus the upper two quartiles for the 5- and 10-year periods ended December 31, 2014.

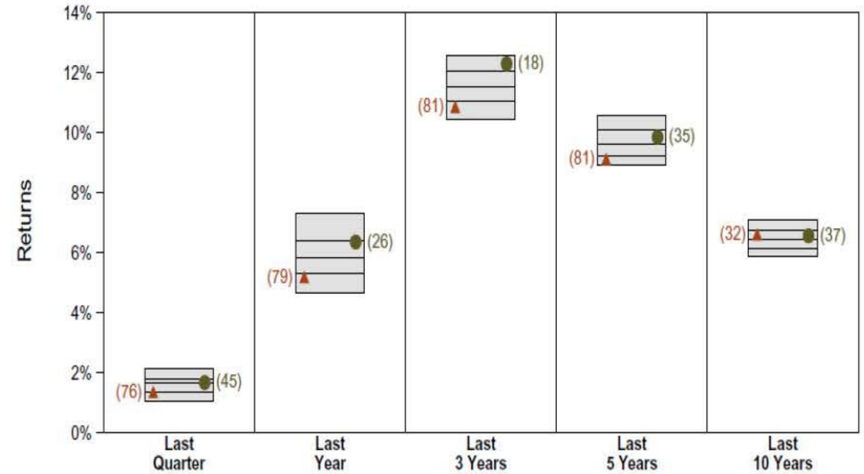
Peer Performance - Pension Trust Total Fund Ranking

The charts display the ranking of the Total Pension Fund's performance relative to the Public Fund Sponsor Database for periods ended December 31, 2014. The left chart does not make any adjustment for the historical asset allocations of the Total Pension Fund, while the right chart adjusts for our asset allocation.

Callan Public Fund Sponsor Database



	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years
10th Percentile	2.86	7.91	13.27	11.10	7.34
25th Percentile	2.32	6.92	12.68	10.29	6.96
Median	1.86	6.09	11.31	9.49	6.52
75th Percentile	1.31	5.15	10.10	8.58	6.00
90th Percentile	0.65	4.20	9.09	7.81	5.56
Total Fund ●	1.65	6.33	12.28	9.83	6.54
Policy Target ▲	1.33	5.16	10.84	9.10	6.59



	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years
10th Percentile	2.11	7.29	12.56	10.56	7.08
25th Percentile	1.77	6.37	12.05	10.06	6.71
Median	1.62	5.80	11.51	9.60	6.41
75th Percentile	1.33	5.30	11.05	9.19	6.13
90th Percentile	1.00	4.63	10.42	8.91	5.86
Total Fund ●	1.65	6.33	12.28	9.83	6.54
Policy Target ▲	1.33	5.16	10.84	9.10	6.59

* Current Quarter Target = 16.5% Russell 1000 Index, 16.0% MSCI World Index, 13.0% Barclays Aggregate Index, 11.1% MSCI EAFE Index, 9.7% NCREIF Total Index, 5.0% Barclays HY Corp 2% Issue, 5.0% Global Agg ex USD, 4.9% CPI-W, 4.9% Russell 2000 Index, 4.9% NDSIB PEN - Private Equity, 4.9% NCREIF Timberland Index, 3.1% MSCI Emerging Mkts - Net and 1.0% 3-month Treasury Bill.

Gross Returns: The Pension Trust generated 2nd quartile returns for the 1-, 3-, 5-, and 10-year periods ended December 31, 2014 based on the Callan Associates Public Fund Sponsor Database (unadjusted basis). On an asset allocation adjusted basis (right chart), the Pension Trust performed at the 26% percentile during the last year, the 18% percentile over the last 3 years and the 35% percentile for the last 5 years.

Focus on Fees – Generated Savings of **22%** in Fiscal 2014

- **The SIB and RIO regularly meet with investment advisors to ensure we obtain competent and prudent investment services at a competitive price.**
- During the past year, investment management fees as a % of average assets under management declined from **0.65%** to less than **0.51%**.

Annual Savings Generated:

COMPARISON OF FISCAL 2013 and 2014 ACTUAL RESULTS:		2013 Fiscal Year End June 30, 2013	2014 Fiscal Year End June 30, 2014	Increase or (Decrease)	Change
Investment Management Fees and Expenses	a	$ 44,703,232	$ 43,639,379	$ (1,063,853)	-2%
Average Assets Under Management ("AUM") for all SIB Clients	b	$ 6,905,312,561	$ 8,632,237,726	$ 1,726,925,165	25%
Investment Manager Fees & Expenses as a % of Average AUM	**a / b**	**0.65%**	**0.51%**	**-0.14%**	**-22%**
Current Year Fee Reduction (of 14.2 basis points)				**0.14%**	
Current Year Average AUM (of approximately $8.6 billion)				$ 8,632,237,726	
Extrapolated Impact of Current Year Fee Reductions				**$ 12,243,526**	

- Based on average total assets under management of approximately **$8.6 billion**, this translates into **over $12 million of reduced fees** for the year ended June 30, 2014.
- **Current Initiatives**: The SIB and RIO have negotiated additional fee savings in recent months and will continue to work towards further fee reductions in upcoming years.

Annual savings of $12 million may be repeated in future years

Annual Savings Generated:

COMPARISON OF FISCAL 2013 and 2014 ACTUAL RESULTS:		2013 Fiscal Year End June 30, 2013	2014 Fiscal Year End June 30, 2014	Increase or (Decrease)	Change
Investment Management Fees and Expenses	a	$ 44,703,232	$ 43,639,379	$ (1,063,853)	-2%
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Current Year Fee Reduction (of 14.2 basis points)				**0.14%**	
Current Year Average AUM (of approximately $8.6 billion)				$ 8,632,237,726	
Extrapolated Impact of Current Year Fee Reductions				**$ 12,243,526**	

TABLE 2 SCENARIO ASSUMPTIONS:	(i) Future AUM	(ii) 2014 Fee Reduction	(i) x (ii) Projected Savings
Projected Future Savings assuming Average AUM declines to $8 billion >>:	$ 8,000,000,000	**0.14%**	$ 11,200,000
Projected Future Savings assuming Average AUM increases to $9 billion >:	$ 9,000,000,000	**0.14%**	$ 12,600,000
Projected Future Savings assuming Average AUM increase to $10 billion >:	$ 10,000,000,000	**0.14%**	$ 14,000,000

TABLE 3	Future AUM	2014 Fee Reduction	Projected Savings
Performance Fee Reductions (Non-Structural)	$ 10,000,000,000	**0.10%**	$ 10,000,000
Structural Fee Reductions (Negotiated and economies of scale)	$ 10,000,000,000	**0.04%**	$ 4,000,000
TOTAL FEE REDUCTIONS (based on $10 billion in average AUM)	**$ 10,000,000,000**	**0.14%**	**$ 14,000,000**

SUMMARY:

1) **SIB Client Fees declined by over 14 basis points from 0.65% (or 65 bps) to 0.51% (or 51 bps) during the last two fiscal years.**
2) **Performance fees represented about 71% of the fee reductions whereas structural reductions accounted for 29% of savings.**
3) **Based on average assets under management of $8.6 billion for fiscal 2014, this translates into over $12.2 million of fee savings during the most recent fiscal year end (or $8.6 billion x 0.142% = $12.2 million).**

Investment Policy, Governance, Service and Staffing Update

- **Investment Policy Statement Review** – RIO reviewed the investment policy statements of all SIB clients with assets in excess of $10 million in 2014 and intends to review the statements of clients with assets less than $10 million in 2015.

- **Fee and Custody Review** - Callan completed a fee review of our investment managers and custodians in 2014 so as to confirm the reasonableness of overall performance standards and fee levels.

- **Governance and Board Education** – The SIB Governance manual was reviewed in 2014. During the past year, the SIB engaged in over 10 hours of board education. This trend continues in 2015 and will include a governance day offsite in late-July.

- **Satisfaction Survey** – SIB clients assigned an "Excellent" or "Above Average" satisfaction rating based on 2014 survey results.

SUMMARY of SIB Client Satisfaction Survey Ratings:

	Excellent	Above Average	Average	Poor	N/A
Totals	63	25	0	0	8
Grade	4	3	2	1	0
Percent	66%	26%	0%	0%	8%
Average	**3.7**				

- **Government Finance Officers Association ("GFOA") Award** – The North Dakota Retirement and Investment Office received a Certificate of Achievement for Excellence in Financial Reporting from the GFOA for its Comprehensive Annual Financial Report ("CAFR") for the year ended June 30, 2014. <u>This marks the 17th consecutive year that RIO has been awarded this honor</u>. RIO's CAFR was judged by an impartial panel to meet the high standards of the program including demonstrating a constructive "spirit of full disclosure" to clearly communicate its financial story. "The Certificate of Achievement is the highest form of recognition in the area of governmental accounting and financial reporting, and its attainment represents a significant accomplishment by a government and its management."

- **RIO Staffing** – In order to be properly staffed based on expected asset levels, RIO filled legislatively approved positions during the past 16 months including *an audit supervisor, compliance officer, information technology specialist, retirement benefits specialist and two investment professionals*. This staffing level will help to ensure that SIB and TFFR clients receive investment returns or retirement benefits, consistent with their written policies and market variables, in a cost effective manner.

Strategic Initiatives – March 25, 2015 Update

- **Fee Saving Updates –** Investment staff of RIO and the North Dakota Department of Trust Lands have been working together to explore additional fee savings with our joint manager relationships. During the past few months, this combined effort has identified $100,000 of incremental savings for SIB clients (PIMCO and State Street) plus up to $75,000 in potential savings for Land Board clients (Northern Trust and State Street). RIO also intends to commence the SIB approved securities lending program in April which Northern Trust previously estimated would generate $900,000 in annual income for SIB clients.

- **Novarca Contract and Pricing Review** – RIO has prioritized the Epoch, LSV and Timberland Investment Resources (Teredo and Eastern Timber Opportunities) investment strategies for an in-depth pricing review with Novarca during the first half of 2015.

- **Governance Manual Review and Board Education –** SIB members will engage in 8 hours of board education relating to overall program governance and various investment related topics during the first eight months of 2015.

- **Budget Stabilization Fund Investment Policy Statement** – RIO intends to meet with Bank of North Dakota management to review contractual terms and liquidity provisions of the existing Match Loan Certificate of Deposit Program.

- **PERS and TFFR Return Expectations** – RIO staff is working with PERS and TFFR personnel, board, actuaries and consultants to confirm the reasonableness of long-term expected return assumptions.

- **Watch List (Ongoing)** – PIMCO, Timber Investment Resources and UBS remain on the Watch List until performance improves and/or recent firm developments are satisfactorily resolved.

- **Enhanced Risk Management Platform** – In order to enhance our existing risk management framework, RIO staff is investigating industry leading third-party provided risk management platforms. RIO investment staff will present its findings to the SIB at a future meeting. The primary goal of this operational initiative is to develop more robust risk analytic tools particularly relating to downside risk management and various economic stress testing scenarios.

Recommendation: RIO requests the SIB confirm the existing "Mission" statement as defined in Section D-1 of the SIB Governance Manual (and restated on page 2 of this presentation).

AGENDA ITEM III. B

TO: State Investment Board

FROM: Dave Hunter

DATE: March 23, 2015

SUBJECT: Callan Timber Consulting – Cover Memo to Recommendation

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Overview:

The Pension Trust currently has a $116 million timber investment managed by Timber Investment Resources ("TIR") in which the existing management agreement expires on June 30, 2015. **In order to improve our ability to negotiate terms and maximize the returns from this investment, RIO is requesting the SIB to approve its recommendation to engage Callan to conduct a search for an alternative manager which could potentially replace TIR in the event contract negotiations do not meet with our expectations**. The negotiated price for this search is expected to approximate $34,000 to $50,000, which is deemed to be reasonable based on peer discussion and opposite potential future fee savings from an improved negotiating position.

Agenda Item III. B

Callan

March 27, 2015

North Dakota State Investment Board

Timber Consulting Capabilities

Sarah Angus, CAIA
Senior Vice President

Agenda

North Dakota State Investment Board

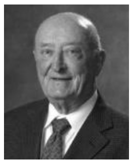
- Callan Real Assets Consulting Practice
  - Overview of Callan
  - Real Assets Consulting Team
  - Relationship Management
  - Timber Clients
  - Consulting Process
  - Searches & Evaluations Process
- Representative Timber Consulting Activity
- Proposed NDSIB Process
- Callan's Edge
- Appendices
  - Peer Review Committees
  - Biographies

Callan Real Assets Consulting Practice

Callan's Organizational and Consultant History

Exceptional Client Service backed by Deep Resources and Unmatched Collective Experience

1973
Ed Callan and associates founded company



1990
Successfully transitioned ownership from Ed Callan to employees, while remaining an independent consulting firm

2007
Successfully transitioned a third generation of employee owners to senior management positions

2013
Callan celebrates 40th anniversary

Independent & Focused with Long Term Commitment to Real Assets

- Established in 1973; real estate consulting established in 1988
- Investment consulting remains our primary focus; Over 360 clients representing $2.0 trillion in assets, including $35 billion in real assets
- 100% employee owned
- Third generation of private ownership; no material changes in past five years
- 75 current owner-employees, including five members of the Real Assets Consulting team

Experienced and Fully Resourced

- Over 165 employees
- Real assets consulting leverages off of shared organizational resources and benefits from strong and financially stable firm
- Measured growth in real assets consulting client base with capacity
- Proprietary systems and databases

Employee Compensation and Retention

- Generous compensation through base salary, bonus, and profit sharing plan
- Firm Ownership
- Continuing Education and Professional Growth
- Firm Culture
- Callan Clients

Organization Chart

Callan was founded as an employee-owned investment consulting firm in 1973. Ever since, we have empowered institutional clients with creative, customized investment solutions that are uniquely backed by proprietary research, exclusive data, ongoing education and decision support. Today, Callan advises on more than $1.8 trillion in total assets, which makes us among the largest independently owned investment consulting firms in the U.S. We use a client-focused consulting model to serve public and private pension plan sponsors, endowments, foundations, operating funds, smaller investment consulting firms, investment managers, and financial intermediaries. For more information, please visit www.callan.com.

Board of Directors — **Compliance**

Chairman and CEO *Ron Peyton*

President and Director of Research *Greg Allen*

COO *Ann De Luce*

- **Fund Sponsor Consulting** *Jim Callahan, CFA*
  - Atlanta Consulting *Elizabeth Hood, CFA*
  - Chicago Consulting *Matthew Shirilla*
  - Denver Consulting *Janet Becker-Wold, CFA*
  - New Jersey Consulting *Millie Viqueira*
  - San Francisco Consulting *Greg DeForrest, CFA* *Greg Ungerman, CFA*
  - Defined Contribution Consulting *Lori Lucas, CFA*
  - Alternatives & Real Assets Consulting *Jamie Shen*
- **Investment Research** *Butch Cliff, CFA*
  - Global Manager Research *Mark Stahl, CFA* *Inga Sweet*
  - Capital Markets Research *Jay Kloepfer*
  - Hedge Fund Research *Jim McKee*
  - Private Equity Research *Gary Robertson*
  - Published Research Group *Anna West*
- **Trust Advisory Group** *Greg Allen*
- **Trust, Custody & Securites Lending** *Bo Abesamis*
- **Operations** *Denise Steele*
  - Client Report Services *Allie Bañuelos* *Paul McGurk*
  - Analytical Solutions Group *Brendan Egan*
  - Measurement Development *Alpay Soyoguz*
  - Information Technology *Michael Apigian* *Joel Schwarz*
- **Corporate Communications** *Scott Brown*
- **Independent Adviser Group** *Eric Davison*
- **Institutional Consulting Group** *Judy McKinney*
- **Callan Educational Services** *Gina Falsetto*
  - Callan Investments Institute *Gina Falsetto*
  - "Callan College" *Kathleen Cunnie*
- **Administration** *Ann De Luce*
  - Legal *Ann De Luce*
  - Finance *Susan Taylor*
  - Human Resources *Rosanna Sangalang*

Real Assets Consulting Highlights

- Dedicated, experienced team supported by broader organization
  - Purely non-discretionary focus – fully dedicated to real assets consulting
  - Consulting, plan sponsor, investment management, acquisitions/asset management, fund of funds, and performance monitoring backgrounds
  - Collaborative team approach
  - Managed growth with 3:1 client to consultant ratio
- Consulting philosophy
  - Create solutions tailored to client objectives; no model portfolio
  - Integrate broader plan considerations
  - Conservative, disciplined, and detail oriented approach
  - Best thinking, communicative and straightforward approach with clients
- Extensive manager research
  - 300+ meetings per year
  - Research across real asset strategies
  - Robust proprietary database
- Long-term commitment to real estate, timber, and other real assets
  - Full service real estate consulting division established in 1988
  - Over 20 years of timber coverage

Real Assets Consulting Team

Jamie Shen
- Practice Leader, Alternative Investments Consulting
- 22 years Real Estate Experience
- Shareholder/Management Committee
- Alternatives Review Committee Chair
- B.S. – University of California at Berkeley, Haas School of Business, PREA, NCREIF
- Research lead for Farmland

Sally Haskins
- Senior Vice President
- 24 years Real Estate Experience
- Shareholder
- Consulting, Manager Selection, Portfolio Management, and Marketing Background
- M.S. in Real Estate – University of Wisconsin-Madison
- Research lead for Asia

Avery Robinson, CAIA
- Vice President
- 10 years Real Estate Experience
- Shareholder
- Real Estate Asset Management Background
- M.B.A. – University of Iowa
- Research lead for Core Funds, Infrastructure, and Emerging Managers

Jay Nayak
- Vice President
- 8 years Real Estate Experience
- Real Estate Acquisitions and Asset Management Background
- M.S. in Real Estate – New York University
- Research lead for Debt

Jonathan Gould, CAIA
- Assistant Vice President
- 4 years with Callan
- Performance Measurement Background
- B.S. – University of Colorado at Boulder
- Research lead for Europe
- New Offerings Research, Database,

Real Assets Consulting Team

Proposed NDSIB Timber Assignment Team

Sarah Angus, CAIA

- Senior Vice President
- 11 years Real Assets Experience and tenure with Callan
- Shareholder
- Performance Measurement Background
- B.A. – College of Charleston
- Research lead for Timber, U.S. Value Added and Latin American real estate

Lauren Sertich

- Vice President
- 7 years with Callan
- Shareholder
- Performance Measurement Background
- Database Management
- B.A. – Dartmouth College
- Research lead for Timber and REITs

Paul Erlendson

- NDSIB and Fund Sponsor Consultant
- 29 years with Callan
- Shareholder/Client Policy Review, Manager Search, DC Committees
- M.A. North Dakota State University

Jamie Shen

- Practice Leader, Alternative Investments Consulting
- 22 years Real Estate Experience
- Shareholder/Management Committee
- Alternatives Review Committee Chair
- B.S. – University of California at Berkeley, Haas School of Business, PREA, NCREIF
- Research lead for Farmland

- Sarah Angus and Lauren Sertich work together as research leads for the timberland asset class.
- We anticipate both Sarah Angus and Lauren Sertich would work on the proposed NDSIB timber assignment with oversight from Paul Erlendson and Jamie Shen.
- All NDSIB deliverables would undergo a review by Callan’s Alternatives Review Committee.

Timber Representative Client List

Client Name	Date of Hire	Timber Assets $ Millions	Consulting Scope
Arkansas Public Employees' Retirement System	1988	$169	Full Service Advisory
Wichita Employees' Retirement Board	1990	$24	Full Service Advisory
New York State Teachers' Retirement System	2005	$271	Full Service Advisory (ex Performance Measurement)
Illinois Municipal Retirement Fund	2010	$75	Full Service Advisory
Public Employees' Retirement System of Mississippi	2011	$104	Full Service Advisory
Total Retainer Clients		**$643**	**Retainer Consulting**
California Public Employees' Retirement System	2007	$2,300	Project Consulting, Real Estate & Timberland
Washington State Investment Board	2013	$1,051*	Project Consulting, Real Assets *Tangible Assets Portfolio
Pension Reserves Investment Management Board of the State of Massachusetts	2014	$2,300	Project Consulting, Real Estate & Timberland
Confidential Client	2014	$1,210	Project Consulting, Timberland
Total Project Clients		**$5,810**	**Project Consulting**

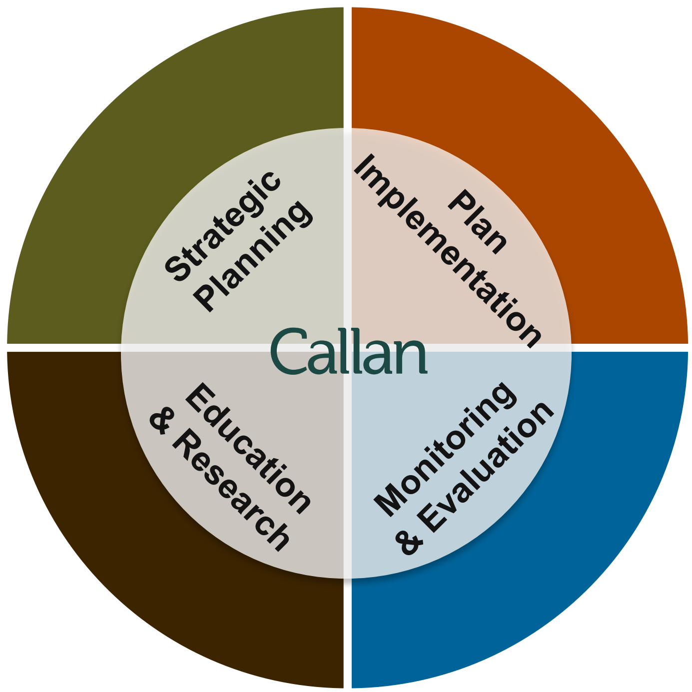
- We have completed 10 timber searches or evaluations since 2009 representing $1.3 billion in timber allocations.

Real Assets Scope of Services

We believe that every large investor has a distinct set of circumstances. We approach each client with an open mind. We strive to build off of the strengths already embedded in a client's program. We do not impose a "one-size-fits-all" policy position onto our clients.

Strategic Plans
Investment Policy/Guidelines
Manager Structure
Annual Investment Plans

Manager Search
Fund Due Diligence
Joint Venture Due Diligence
Annual Portfolio Plans
Fee Analysis & Negotiations



Callan Investments Institute
- Conferences
- White papers
- Market trends
- Surveys

"Callan College"
Client-Driven Research

Performance Measurement
- IRR Analytics
- Vintage Year Database
- Customized to Client

Style Groups
Portfolio Characteristics
Manager & Portfolio Reviews
Transaction & Fund Compliance
Pacing Studies

Manager Selection Process

Two Approaches

Well Defined, Available Universe *Open-end Funds and Separate Accounts*	Limited Market Availability *Closed-end Funds, Club deals, Joint-Ventures*
Client portfolio driven ➢ Candidate and client profile established ➢ No prescreened list or manager rating system ➢ Client participation	Client portfolio driven ➢ Investment priorities established via strategy, pacing model and policies ➢ Client participation
Sourcing ➢ RFP, RFI, Callan database	Sourcing ➢ Callan's active funds database ➢ Manager meetings, out reach, references
Disciplined and consistent ➢ Quantitative and Qualitative screens applied to universe based on questionnaire responses	Disciplined and consistent ➢ Multiple meetings including an onsite meeting ➢ Detailed fund document review; term and fee negotiation ➢ Qualitative and quantitative information collected via meetings, calls, written requests
Manager Search Committee Peer Review ➢ Callan's most experienced fund sponsor consultants ➢ Formal meeting	Alternative Investments Committee Peer Review ➢ Callan's most experienced fund sponsor consultants ➢ Formal meeting
Results in the identification of the managers and products that best fit the client's investment program	Results in yes or no recommendation in formal write up
Client selects finalist	Client approves for portfolio

Representative Timber Consulting Activity

Representative Timber Consulting Activity #1

Multi-phase International Timberland Separate Account Project

- Callan was hired by a large U.S. public plan to complete an international timberland separate account investment management contract renewal and negotiation
- The project included:
  - Review of the existing contract and objectives of the separate account portfolio
  - Analysis of terms and fees from the relevant peer universe
  - Negotiation of key terms within the agreement
  - Verification of ownership and incentive fee from existing agreement
  - Evaluation of Guatemalan teak investment for further capital commitment
- The results included:
  - Development of new international timberland portfolio guidelines
  - Improved terms of the agreement including more favorable incentive fee, elimination of interim incentive payments, a ceiling on management fees, incorporation of key person provisions and leverage limitations
  - Discovery of incentive fee calculation error that resulted in over $300,000 in cost savings
  - Determination of key considerations and recommendations on Guatemalan teak investment

Representative Timber Consulting Activity #2

U.S. Timberland Separate Account Limited Partnership Agreement Review

- Callan was engaged by an existing consulting client to revisit their legal agreement with a timberland advisor
- The review included:
  - Review of existing legal documents
  - Review of strategic plan for the timberland portfolio
  - Negotiation of key terms within the agreement
- The results included:
  - Development of a revised and cleaner legal document that paired the terms with the future outlook of the portfolio
  - Specific term improvements included a reduced management fee during liquidation, reduction of leverage limitation, restrictions on GP transfer rights, incorporation of Key Person provision, enhanced GP removal language, incorporation of LP control provisions, and concrete liquidation timelines

Representative Timber Consulting Activity #3

Timberland Annual Planning Process

- Callan worked with a retainer client on their existing timberland portfolio annual planning process
- The review included:
  - Review of the prior year timberland portfolio results and going forward projections
  - On-site discussion with timberland manager
- The results included:
  - Recommendation to manager to take more active approach to selective tract sales in the coming year
  - Profitable tract sales

ANNUAL LAND SALES					
Tract Unit	**Number of Sales**	**Acres**	**Sales Price**	**Carrying Value**	**Percent Gain Over Carrying Value**
Unit 1	4	426	$1,059,925	$750,882	41%
Unit 2	1	210	$359,921	$294,071	22%
Unit 3	1	<1	$3,000	$200	1,398%
Unit 4	4	360	$693,400	$433,004	60%
Unit 5	3	113	$325,528	$180,855	80%
All Tract Units	**13**	**1,109**	**$2,441,775**	**$1,659,012**	**47%**

Representative Timber Consulting Activity #4

International Timberland Market Research

- Callan was engaged by an existing consulting client to evaluate the international timberland investment landscape
- Callan developed in depth research on the international timberland market, including analysis of the investable universe by country, key benefits and considerations, manager landscape and historical data and term comparison
- In depth research was provided to the client and shortened version was developed into a Callan whitepaper
- The client implemented an international timberland mandate following the research project

Proposed NDSIB Springbank Assignment Process

- Callan recommends a flexible and customized process to evaluate the NDSIB Springbank investment and broader timberland market and manager universe.
  - Callan proposes beginning the process with a thorough review of the history and future projections for the Springbank investment through evaluation of existing investment management agreement, investment and performance history, future projections, the Timberland Investment Resources (“TIR”) organization, on-site meetings and ongoing manager and NDSIB dialogue.
  - Additionally, Callan would gather information from the broader manager universe as it relates to Southeastern timber capabilities, transaction activity, and comparable fees and terms for similarly structured investments.
  - The broader market information would serve to provide real time indication of market activity and terms in the discussions and negotiations with TIR.
- Upon completion of the initial Springbank review and market information gathering process, Callan would work with NDSIB to determine the optimal next steps.

Proposed Timeline for Springbank / TIR Review

Action plan accommodates either retention or replacement of incumbent

- Week 1
  - Obtain investment management agreement, historical investment activity, and other relevant documentation for review
  - Send out request for information to timberland investment managers with U.S. capabilities
- Week 2-3
  - After review of materials, conduct on-site meeting with TIR to review Springbank history, current status, proposed work plan and propose term modifications
  - Review responses to information request from broader manager universe to provide context on market environment, capabilities and terms
  - Summarize observations and prepare preliminary recommendations for NDSIB
- Week 3-5
  - Prepare formal evaluation document and convene Alternatives Review Peer Group to discuss preliminary report and recommendations regarding alternative courses of action (e.g.– potential modifications to Springbank investment agreement; retain or replace TIR; potential timeline and action plan if NDSIB decides to replace TIR)
  - Submit preliminary report to RIO investment staff for review and comment
- Week 5-6
  - Submit final report to NDSIB
  - Schedule in-person presentation to NDSIB
    - If NDSIB decides to retain TIR, Callan will assist with contract and fee negotiation
    - If NDSIB decides to replace TIR, Callan will work with RIO staff to conduct a search for a new TIMO
    - A replacement process is likely to take 6 to 8 weeks, involving on-site candidate due diligence with RIO staff and finalist presentation to NDSIB for ultimate selection of a replacement manager for Springbank
    - Once a selection is made by NDSIB, Callan will assist in contract and fee negotiations

Callan's Edge

Callan's Edge

Independence ➡	• Callan is 100% employee owned and focused exclusively on supporting the needs of institutional investors • Our advice is based on internal, original research in all areas of interest to pension plans • Callan's real assets consulting practice is completely non-discretionary
Experience ➡	• Real assets consulting group established in 1988 • Experienced, compatible team with diverse backgrounds • Senior professionals with long tenure in the institutional real estate and timber markets • Extensive implementation and underwriting experience in all aspects of real assets
Resources ➡	• Team supported by broad, financially stable organization with proprietary systems and analytical tools • Review committees consisting of senior consultants from all Callan offices bring Callan's best thinking to NDSIB • Strong commitment to research and education
Custom Solutions and Innovation ➡	• Our approach and advice will be based on your needs. Callan's heritage, culture, and philosophy promote unique solutions • We value direct and straightforward dialogue with clients
Ethical Conduct And Transparency ➡	• Callan will operate with the highest level of ethical conduct and transparency.

Appendix

Callan's Oversight Committees

Each Client Benefits from Collective Experience and Expertise

Client Policy Review Committee

- Meets as projects occur
- Reviews all strategic planning projects for best thinking and quality control
- 11 senior professionals
- Average experience of 21 years at Callan and 26 years in the industry

Manager Search Committee

- Meets weekly
- Reviews all manager search projects for manager knowledge and quality control
- 14 senior professionals
- Average experience of 13 years at Callan and 20 years in the industry

Alternatives Review Committee

- Meets as projects occur
- Reviews all projects implementing non-traditional investment strategies
- 12 senior consultants
- Average experience of 16 years at Callan and 28 years in the industry

Biographies

Sarah S. Angus, CAIA, is a Senior Vice President and a real estate consultant in Callan's Real Assets Consulting group. She works to implement plan sponsor real estate strategies through manager searches, manager evaluations, and strategic and tactical planning initiatives. Her role includes the intensive evaluation of managers and their respective real estate products for plan sponsor clients. This due diligence process includes meeting and coordinating with investment advisors regarding various strategies, investment processes, track records, and organizational structures. Additionally, she heads manager and strategy research coverage for Timber, Latin American real estate and U.S. value added and specialty real estate markets. Sarah is a shareholder of the firm.

Sarah joined Callan in July of 2004 as an analyst in the client report services group where she was responsible for preparing quarterly and monthly performance measurement reports. Before starting with Callan, Sarah was employed at Bank of America in Chicago. She worked within the Private Bank division and was responsible for the revenue projections and management reports for the unit. Sarah has also interned with the O'Connor Hedge Fund at UBS Global Asset Management as a risk-arbitrage research assistant and at Merrill Lynch as a sales assistant.

Sarah has a BA from the College of Charleston in Charleston, South Carolina and has earned the right to use the CAIA designation.

Jonathan Gould is an Assistant Vice President in Callan's Real Asset Consulting Group. His role includes tracking new real estate offerings and collecting information on various real estate managers. Previously he was an Analyst in Callan's Client Report Services group responsible for calculating investment returns as well as providing support to Senior Analysts in generating monthly and quarterly performance reports Jonathan joined Callan in June, 2010 and is currently. Prior to joining Callan, Jonathan worked at YouTube where he created and maintained spam filters. Before that, he worked at MarketWatch.com tracking website and newsletter traffic and trends.

Jonathan graduated from the University of Colorado at Boulder with a BS in Economics.

Biographies

Sally Haskins, Senior Vice President. Sally is a consultant in Callan's Real Asset Consulting Group and is responsible for strategic planning, implementation, and performance oversight of client's real estate portfolios. She heads manager due diligence and strategy research for Asian real estate markets and investment products. Her role also includes new business development for the real estate consulting group. Sally is a shareholder of the firm.

Sally joined Callan in 2010 from ING Clarion Partners where she was a Director in the Marketing and Client Service Group. Prior to joining ING Clarion in 2007, Sally enjoyed a 15 year career with Russell Investments and Institutional Property Consultants, Inc. (IPC). While at Russell, Sally held multiple positions including consulting, manager research, and portfolio management. She served as the Head of Property, Asia-Pacific and was located in Russell's Sydney office where she led the strategy and launch of Russell's Global Property Fund, an opportunistic real estate fund of funds for Australian investors. In addition, she evaluated property and capital markets for the Asia-Pacific region and directed manager research for the region. While working in the US, she designed Russell's comparative analysis of the core and value added open-end fund universe as well as evaluated European open and closed end funds. At IPC, Sally developed strategy and implementation plans for pension plans and conducted manager due diligence with a focus on opportunistic real estate funds. She started her real estate career in 1989 at the State Teachers Retirement System of Ohio.

Sally received an M.S. in Real Estate Appraisal and Investment from the University of Wisconsin-Madison and a B.A. (Magna cum Laude and Phi Beta Kappa) from St. Olaf College.

Jay Nayak, Vice President. Jay is a consultant in Callan's Real Asset Consulting Group. His role includes the evaluation of managers and their respective real estate products for plan sponsor clients. This due diligence process includes meeting and coordinating with investment managers regarding various strategies, investment processes, track records and organizational structures. Jay also assists in conducting research and generating real estate-related reports and projects. Additionally, he heads research coverage for global real estate securities, commercial real estate debt strategies and European real estate strategies.

Jay joined Callan Associates in September of 2008. Before joining Callan, he was employed as an Analyst with International Partners. He provided acquisitions and asset management analysis for a portfolio of multifamily properties in California and Texas. Prior to that, Jay held internships with Chhatrala Capital, where he assisted in the formation of a real estate private equity fund and Capstar Realty Group, where he provided analytical and marketing support.

Jay received an M.S. in Real Estate from New York University and his B.A. in Economics from the University of California.

Biographies

Avery A. Robinson, CAIA, Vice President. Avery is a consultant in Callan's Real Asset Consulting Group. He works to implement plan sponsor real estate strategies through manager searches, manager evaluations, and strategic and tactical planning initiatives. His role includes the intensive evaluation of managers and their respective real estate products for plan sponsor clients. This due diligence process includes meeting and coordinating with investment advisors regarding various strategies, investment processes, track records, and organizational structures. Additionally, he heads research coverage for core open-end, emerging manager and urban real estate strategies, as well as infrastructure investment research. Avery is a shareholder of the firm.

Avery joined Callan Associates in April of 2008. Before joining Callan, he was employed with the Real Estate Equity Group at Principal Global Investors. He was an Asset Manager for numerous property types throughout the Southeast.

Avery received his B.S. in Engineering and his M.B.A. from the University of Iowa. Avery has earned the right to use the CAIA designation. He is also a member of the Institutional Investing in Infrastructure Editorial Board.

Lauren Sertich, Assistant Vice President. Lauren is an associate consultant in Callan's Real Asset Consulting Group. Lauren is responsible for supporting the real estate consulting group. Her role includes tracking new real estate offerings and collecting information on various real estate managers. Lauren also assists in conducting research and generating real estate-related reports and projects. Lauren is a shareholder of the firm.

Lauren joined Callan Associates in October of 2008 as an analyst in the Client Report Services group, where she was responsible for calculating investment returns and generating monthly and quarterly performance reports. Prior to joining Callan, Lauren was an equity research assistant for the media and entertainment sector at Cowen and Company, LLC.

Lauren earned a B.A. in Environmental Studies from Dartmouth College, where she was a member of the field hockey team.

Biographies

Jamie Shen, Senior Vice President. Jamie is a Practice Leader of Alternative Investments Consulting and she has overall responsibility for Real Assets Consulting services at Callan. While Jamie's particular focus is on real estate, she oversees research and implementation of real estate, timber, infrastructure and agricultural asset classes. She works directly with Boards and/or Staff in the development and implementation of client specific strategic and tactical plans, as well as provides ongoing oversight in the control and monitoring of clients' real estate portfolios. Additionally, Jamie oversees all investment due diligence for real assets and chairs Callan's Alternative Investment Committee. She is also a shareholder and a member of Callan's Management Committee.

Prior to joining Callan, Jamie was a Principal with The McMahan Group, a San Francisco based-management consulting firm specializing in real estate enterprises. Specifically, Jamie consulted to a number of real estate investment advisors on organizational structure and investment vehicle design. She also assisted in preparing testimony for the Department of Labor on fiduciary standard of care relating to real estate investments. Jamie has worked in the real estate consulting groups of both Arthur Andersen and Ernst & Young.

Jamie received her BS in Business Administration from the Walter A. Haas School of Business at the University of California, Berkeley. Jamie serves on the Editorial Board of The Institutional Real Estate Letter and frequently writes papers and leads discussions for the Institute for Fiduciary Education (IFE). She is a member of the Pension Real Estate Association (PREA) and serves on the PREA Board of Directors.

Paul Erlendson is a Senior Vice President and senior consultant in Callan's Denver Fund Sponsor Consulting office. Paul has assisted a variety of institutional investors with a broad array of investment policy formulation, implementation, and evaluation decisions. He is a member of Callan's Client Policy Review, Manager Search and Defined Contribution Committees, and is a shareholder of the firm.

Prior to joining Callan Associates in 1986, Paul served on the staff of a state pension system. During his tenure at Callan, Paul has worked in the Global Manager Research group; headed the Capital Markets Research Group; and headed the San Francisco Fund Sponsor consulting group. His background includes work in the insurance industry, and a stint as a college instructor. Paul's commitment to education extends to participating in speaking roles at various investment forums. Paul served as a member of the Pitzer College Parent Leadership Council.

Paul earned an MA and a BA from North Dakota State University

AGENDA ITEM III. D.

BOARD ACTION REQUESTED

To: State Investment Board

From: Dave Hunter, Executive Director / CIO

Date: March 23, 2015

RE: **Tobacco Prevention and Control Trust Fund as a New SIB Client**

Overview:

At the SIB meeting on January 23, 2015, RIO staff presented the request of the Tobacco Prevention and Control Trust Fund ("TPC") to have the SIB provide investment management services. During this presentation it was noted that this fund had a non-tobacco investment requirement and that this requirement does not fit within the existing Insurance Trust structure. As a result, Board members expressed a concern regarding the SIB's ability to provide investment management services for this fund because of this restriction. **Subsequent to the meeting, legal counsel provided the attached memo which supports a conclusion that the SIB may not decline to provide investment management services for the TPC fund.**

Background:

TPC is interested in contracting for investment services with the SIB as allowed under NDCC 21-10-06 and as recommended in a recent audit. This fund has a current market value of $45 million and is projected to exceed $50 million over the next two years prior to declining by approximately $8 million per year between 2018 and 2023. The TPC funds are currently invested in short-term cash with the Bank of North Dakota and earning approximately 6 to 10 bps per annum.

RIO has met with TPC representatives to discuss their investment objectives and risk tolerance and the possible benefits of developing a formal investment policy statement and engaging with the SIB for investment services. Based on initial discussions, internal staff administrative capacity would not be materially affected by the establishment of this new fund which would be similar to the PERS Retiree Health Insurance Credit Fund as a standalone entity.

RIO Recommendation:

As required by Governance Policy E-13, RIO is asking for SIB approval to move forward with contracting for investment services with the Tobacco Control and Prevention Trust Fund. Upon receiving SIB proposal, RIO will work with TPC representatives to develop a formal investment policy statement and asset allocation recommendation for final approval by the SIB and TPC Board at a later date in mid-2015.

NDCC 21-10-06 states *"The state investment board may provide investment services to, and manage the money of, any agency, institution, or political subdivision of the state, subject to agreement with the industrial commission. The scope of services to be provided by the state investment board to the agency, institution, or political subdivision must be specified in a written contract. The state investment board may charge a fee for providing investment services and any revenue collected must be deposited in the state retirement and investment fund."*

When a request is received by staff from a potential new investor requesting investment services from the State Investment (SIB), the following steps shall be followed.

1. Staff will conduct initial discussions with the potential client regarding type of fund, risk tolerance, size of fund, services to be provided, costs, etc.

2. Staff will recommend that an Asset/Liability study be conducted by the potential client if one has not been done recently. This discussion will include a description of the asset classes available for investment with the SIB to be included in their study.

3. If the potential client is still interested in participating in the SIB program, staff will bring the preliminary request to the SIB for acceptance. It shall be the policy of the SIB to take the following into consideration when determining if a new investor request will be accepted.

   a. Internal staff administrative capacity.
   b. Compatibility of new investor's goals and risk tolerances with the existing SIB program structure.
   c. Whatever other factors the SIB determines to be appropriate to the decision.

4. If the SIB chooses to accept the preliminary request, staff will provide the necessary template documents to the potential client for review and completion. These documents include a contract for services and investment guidelines.

5. Once documentation is completed, staff will request to have the issue included on the Industrial Commission's agenda for their approval. Copies of all documentation will be provided for their review.

6. If approved by the Industrial Commission, final documentation will be presented to the SIB for final acceptance.

7. If accepted, staff will work with the new client to set up transfer of funds and implementation of asset allocation as directed. All new clients will be brought in as of the last day of a calendar quarter.

8. Fees will be charged with the intention of covering all associated costs as described in RIO Fiscal Management procedure "Investment Fee Allocations".

Policy Implemented: November 20, 2009

MEMORANDUM

TO: Connie Flanagan, Retirement and Investment Office

FROM: Janilyn Murtha, Assistant Attorney General

RE: Tobacco Prevention and Control Trust Fund

DATE: February 20, 2015

At the January 23, 2015, meeting of the SIB, RIO staff presented the request of the Tobacco Prevention and Control Trust Fund to have the SIB provide investment management services. During this presentation it was noted that this fund had a non-tobacco investment requirement and that this requirement does not fit within the existing Insurance Trust structure. At this time Board members expressed a concern regarding the SIB's ability to provide investment management services for this fund because of this restriction. Subsequent to the meeting you asked whether the Board could deny the request for services by this fund. Please accept the following in response to your question.

The Tobacco Prevention and Control Trust Fund (hereinafter TPC fund) is created under N.D.C.C. § 54-27-25(2) and consists of a portion of the tobacco settlement dollars obtained by the state under the MSA (Master Settlement Agreement). The term MSA is the acronym used to identify the settlement agreement executed between a majority of states and tobacco manufacturers during the 1990s resolving claims between the parties. The TPC fund is further discussed under N.D.C.C. ch. 23-42 and defined in N.D.C.C. § 23-42-01(4) as consisting of all principal and interest of the TPC fund established by N.D.C.C. § 54-27-25. While there is not specific language in chapter 23-42 directing the SIB to invest the TPC fund, the powers of the TPC executive committee under N.D.C.C. § 23-42-04(1) include "providing direction to the state investment board for investment of the tobacco prevention and control fund." While this language does not contain an explicit mandate to have the SIB invest the fund because it is setting forth the powers of the executive committee and not the SIB, there is an implicit mandate to have the SIB invest the fund because the power of the executive committee to provide direction to the SIB can't be realized if the SIB declines to facilitate the investment.

The SIB is charged with the investment of the funds enumerated under N.D.C.C. § 21-10-06(1) and the TPC fund is not included in the list of funds so enumerated. Under N.D.C.C. § 21-10-06(3) the SIB may provide investment services to any agency, institution, or political subdivision of the state subject to agreement with the industrial commission. The SIB is therefore required to invest the funds listed under subsection 1 of N.D.C.C. § 21-10-06 but has the discretion to agree to invest the funds listed under subsection 3. It is reasonable to conclude that because TPC isn't included under subsection 1 of N.D.C.C. § 21-10-06 that the SIB would need to enter into a contract for providing investment services for it under subsection 3; however, it may not be reasonable to conclude that providing such services is discretionary.

While the word "may" in a statute ordinarily creates a discretionary, non-mandatory duty under settled principles of statutory construction, it can also be construed as a "must" where the context or subject matter compels that construction. See North Dakota Com'n on Medical Competency v. Racek, 527 N.W.2d 262 (N.D., 1995). Failure to include the TPC fund under subsection 1 of N.D.C.C. § 21-10-06, therefore, does not preclude a determination that the SIB is nonetheless charged with its investment by N.D.C.C. § 23-42-04; such that the "may" of subsection 3 be interpreted as a "must" when applied to investment of this fund. Another principle of statutory construction found in N.D.C.C. § 1-02-07 requires that conflicting provisions be reconciled if at all possible to give effect to both provisions but if the conflict between the two provisions is irreconcilable a special provision will prevail over that of a general provision. The direction provided by N.D.C.C. § 23-42-04 refers to a specific relationship between the executive committee and the SIB regarding the TPC fund, this provision is more specific than the contracting authority granted the SIB by N.D.C.C. § 21-10-06(3), such that adherence to N.D.C.C. § 23-42-04 should be favored. Therefore, applying these rules of statutory construction to the language at issue supports a conclusion that the SIB may not decline to provide investment management services for the TPC fund.

Please let me know if you have any questions or would like to discuss this further.

BOARD ACTION REQEUSTED

TO: State Investment Board

FROM: Darren Schulz, Deputy CIO

DATE: March 20, 2015

SUBJECT: Peer Survey of Timberland Consultants

Background:

In an effort to solicit feedback concerning best in class consultants in the timberland asset class, Staff surveyed a universe of 72 state public funds. The following four questions were sent to the public plan sponsor community:

1. Do you invest in timberland?
2. If yes, have you engaged a timber investment consultant?
3. If yes, please identify the investment consultants or consultants you have hired and/or have under serious consideration.
4. If applicable, in which regions have you invested in timberland?

Survey Summary:

Among the 28 respondents to the survey and the 11 plans that held timberland investments, Callan Associates was the most often cited general consultant with expertise in the timberland asset class.

Callan was also cited by "Pensions & Investments – The International Newspaper of Money Management" as being the most often cited "General" investment consultant and the second most often cited "Overall" consultant in the February 9, 2015 edition. Aon Hewitt was cited as the second most often "General" consultant and the most often cited "Overall" consultant in this survey.

RIO Recommendation:

The Pension Trust currently has a $116 million timber investment managed by Timber Investment Resources ("TIR") in which the existing management agreement expires on June 30, 2015. **In order to improve our ability to negotiate terms and maximize the returns from this investment, the SIB is requested to approve RIO's recommendation to engage Callan to conduct a search for an alternative manager which could potentially replace TIR in the event negotiations do not meet with our expectations**. The negotiated price for this search is expected to approximate $34,000 to $50,000, which is deemed to be reasonable based on peer discussion and opposite potential future fee savings from an improved negotiating position.

Private Equity Update

March 27, 2015

Dave Hunter, Executive Director / CIO
Darren Schulz, Deputy Chief Investment Officer
ND Retirement & Investment Office (RIO)
State Investment Board (SIB)

Private Equity Performance Summary

Pension Trust Private Equity
As of September 30, 2014
($ in millions)

		Vintage		Unfunded	Net Asset	% Total	Internal Rates of Return (IRR) – Net Returns				
	Adams Street Partnerships (ASP)	Year	Commitment	Commitment	Value[1]	Pension	1-year	3-years	5-years	10-years	Inception
1	Direct Co-Investment	2006	$ 20.0	$ 0.9	$ 19.6	0.4%	28.9%	14.6%	18.1%		5.3%
2	BVCF IV	1999	$ 25.0	$ -	$ 8.0	0.2%	51.3%	39.4%	55.9%	24.4%	7.8%
3	ASP 2008 Non-US Fund	2008	$ 10.0	$ 3.6	$ 6.8	0.1%	17.3%	11.5%	10.5%		8.4%
4	1999 BPF Non-U.S. Trust Subscription	1999	$ 24.5	$ 0.6	$ 5.8	0.1%	6.0%	7.2%	10.0%	11.3%	6.2%
5	1999 BPF Trust Subscription	1999	$ 24.5	$ 1.1	$ 4.6	0.1%	4.0%	3.8%	8.1%	17.1%	12.0%
6	ASP 2010 US Fund	2010	$ 7.5	$ 3.8	$ 4.2	0.1%	20.3%	14.9%			15.1%
7	1998 BPF Trust Subscription	1998	$ 23.7	$ 0.9	$ 3.1	0.1%	5.3%	6.1%	8.4%	11.8%	5.1%
8	ASP 2010 Non-US Developed Fund	2010	$ 4.5	$ 2.4	$ 2.1	0.0%	8.6%	9.9%			7.3%
9	ASP 2010 Direct Fund	2010	$ 1.5	$ 0.2	$ 1.7	0.0%	25.7%	17.6%			15.6%
10	ASP 2010 Emerging Markets Fund	2010	$ 1.5	$ 0.7	$ 0.9	0.0%	21.4%	7.0%			5.1%
	Total ASP Private Equity		$ 142.7	$ 14.0	$ 56.8	1.2%	21.1%	12.7%	16.6%	14.2%	11.1%
	Non-ASP Primary Fund Partnerships										
11	Matlin Patterson Global III	2007	$ 40.0	$ 3.6	$ 26.9	0.6%	(1.5%)	37.9%	10.2%		5.4%
12	EIG Energy Fund XIV	2007	$ 45.0	$ 4.8	$ 24.0	0.5%	(1.4%)	(0.7%)	6.9%		8.1%
13	Capital International V	2007	$ 35.0	$ 6.3	$ 18.0	0.4%	2.5%	(1.7%)	8.5%		5.1%
14	Corsair III	2007	$ 25.0	$ 2.8	$ 16.8	0.4%	(2.7%)	(1.0%)	0.3%		(3.2%)
15	Capital International VI	2011	$ 35.0	$ 18.2	$ 13.4	0.3%	(7.7%)				(13.6%)
16	Corsair IV	2010	$ 25.0	$ 13.5	$ 13.0	0.3%	13.9%	10.6%			4.2%
17	Quantum Energy Partners IV	2007	$ 15.0	$ 2.3	$ 11.7	0.2%	26.6%	24.8%	25.2%		14.6%
20	Corsair III - ND Investors	2008	$ 10.8	$ -	$ 11.4	0.2%	(2.8%)	3.3%			0.9%
21	Lewis & Clark II	2009	$ 15.0	$ 2.5	$ 10.2	0.2%	(5.9%)	(4.6%)	(6.1%)		(6.1%)
18	Quantum Resources	2006	$ 15.0	$ 1.4	$ 6.8	0.1%	(16.4%)	7.3%	20.4%		5.4%
19	InvestAmerica (Lewis & Clark I)	2002	$ 7.5	$ 0.8	$ 4.0	0.1%	(18.0%)	(2.3%)	8.2%		3.9%
20	Matlin Patterson Global II	2004	$ 40.6	$ 0.0	$ 1.3	0.0%	(14.4%)	(38.4%)	(42.1%)		(27.9%)
20	Coral Partners VI	2002	$ 25.0	$ -	$ 0.6	0.0%	(76.1%)	(33.3%)	(20.0%)	(18.6%)	(18.6%)
21	Hearthstone MSIII	2003	$ 35.0	$ 35.2	$ 0.1	0.0%	1.3%	13.0%	15.3%	35.9%	25.2%
22	Matlin Patterson Global I	2002	$ 25.3	$ -	$ 0.0	0.0%	1.1%	95.0%	18.5%	32.5%	16.7%
23	Hearthstone MSII	1999	$ 3.5	$ 3.5	$ -	0.0%	1.8%	16.9%	18.6%	44.5%	27.5%
	Total - Non-ASP Private Equity		$ 397.7	$ 94.7	$ 158.2	3.4%	(1.6%)	3.5%	3.8%	2.6%	1.2%
	Total - Private Equity		$ 540.4	$ 108.7	$ 215.0	4.6%	3.7%	5.9%	7.1%	6.5%	4.8%

Source: Adams Street ASPIRE

Returns are reviewed, but not audited.

[1] Manager reported Net Asset Values as of 9/30/14. 12/31/14 Callan performance report reflects 9/30/14 NAVs and any investment activity within the fourth calendar quarter.

Summary: The private equity portfolio within the Pension Trust can largely be divided into two groups:

1) **the Adams Street Partnerships which have generally performed in line with expectations with a net IRR of 16.6% in the last 5-years and 11.1% since inception**; and
2) **the Non-ASP Partnerships which have generally performed below expectations with a net IRR of 3.8% in the last 5-years and 1.2% since inception (with a few positive exceptions).**

Key Takeaway: Promote the development of *strategic partnerships* like ASP to leverage a "best ideas" approach while increasing pricing leverage.

Asset Allocations for the Pension Trust Fund as of December 31, 2014

The "Global Asset Allocation" framework is summarized on top.

As of December 31, 2014	Market Value ($ in millions)		%	General Comments
TOTAL FUND	$	4,666	100.0%	Global Asset Allocation Framework
GLOBAL EQUITIES	$	2,656	56.9%	Global Equity includes Public & Private Equity
GLOBAL FIXED INCOME	$	1,139	24.4%	Global Fixed Income includes Private Debt & excludes Inflation Bonds
GLOBAL REAL ASSETS	$	820	17.6%	Global Real Assets includes Inflation Bonds
CASH	$	51	1.1%	

Private Equity, Private Debt and Inflation Bonds are reclassified in the middle table.

TOTAL FUND	$	4,666	100.0%	Reclassifications for Private Capital
GLOBAL EQUITIES - PUBLIC	$	2,459	52.7%	Subtract Private Equity (reclass to Private Capital)
GLOBAL FIXED INCOME - PUBLIC	$	1,022	21.9%	Subtract Private Debt and Add Inflation Bonds
GLOBAL REAL ASSETS including PRIVATE CAPITAL	$	1,134	24.3%	Add Private Equity & Debt and Subtract Inflation Bonds
CASH	$	51	1.1%	

Global Real Assets including Private Capital are classified by sector in the bottom table.

GLOBAL REAL ASSETS including PRIVATE CAPTIAL	$	1,134	24.3%	Private Capital Liquidity < Public Debt and Equity Liquidity
- REAL ESTATE	$	446	9.6%	Represents 39% of Private Capital
- INFRASTRUCTURE	$	183	3.9%	Represents 16% of Private Capital
- TIMBER	$	191	4.1%	Represents 17% of Private Capital
- PRIVATE EQUITY	$	197	4.2%	Represents 17% of Private Capital
- PRIVATE DEBT	$	117	2.5%	Represents 10% of Private Capital

- Private investments in real estate, infrastructure, timber, equity and debt are generally less liquid than public debt and equity investments. This lesser degree of liquidity impacts the ability to change managers in a timely and cost efficient manner.

Asset Allocations for the Insurance Trust Fund as of December 31, 2014

The "Global Asset Allocation" framework is summarized on top.

As of December 31, 2014	Market Value ($ in millions)		%	General Comments
TOTAL FUND	$	5,434	100.0%	Global Asset Allocation Framework
GLOBAL EQUITIES	$	1,964	36.2%	Global Equity includes Public & Private Equity
GLOBAL FIXED INCOME	$	2,659	48.9%	Global Fixed Income includes Private Debt & excludes Inflation Bonds
GLOBAL REAL ASSETS	$	722	13.3%	Global Real Assets includes Inflation Bonds
CASH	$	88	1.6%	

Private Equity, Private Debt and Inflation Bonds are reclassified in the middle table.

TOTAL FUND	$	5,434	100.0%	Reclassifications for Private Capital
GLOBAL EQUITIES - PUBLIC	$	1,964	36.2%	Subtract Private Equity (reclass to Private Capital)
GLOBAL FIXED INCOME - PUBLIC	$	2,868	52.8%	Subtract Private Debt and Add Inflation Bonds
GLOBAL REAL ASSETS including PRIVATE CAPITAL	$	513	9.4%	Add Private Equity & Debt and Subtract Inflation Bonds
CASH	$	88	1.6%	

Global Real Assets including Private Capital are classified by sector in the bottom table.

GLOBAL REAL ASSETS including PRIVATE CAPTIAL	$	513	9.4%	Private Capital Liquidity < Public Debt and Equity Liquidity
- REAL ESTATE	$	254	4.7%	Represents 50% of Private Capital
- INFRASTRUCTURE	$	95	1.7%	Represents 18% of Private Capital
- TIMBER	$	64	1.2%	Represents 12% of Private Capital
- PRIVATE EQUITY	$	-	0.0%	Represents 0% of Private Capital
- PRIVATE DEBT	$	100	1.8%	Represents 19% of Private Capital

- Private investments in real estate, infrastructure, timber, equity and debt are generally less liquid than public debt and equity investments. This lesser degree of liquidity impacts the ability to change managers in a timely and cost efficient manner.

SIB Legislative Bill Tracking Status Report **Agenda Item IV. A.**
As of March 20, 2015

1. SB2022 – RIO Budget Bill (Support)

1/06/2015 – Introduced, first reading, referred to Appropriations Committee
1/14/2015 8:30 am – Committee Hearing - Senate Appropriations
Dave presented testimony (Fay and Connie also attended); there were general investment related questions but no specific budget related questions.
1/29/2015 2:00 pm – Subcommittee Hearing with Senators Krebsbach, Sorvaag and Heckaman on PERS and RIO budget – Connie and Dave answered RIO budget questions without issue.
2/20/2015 9:30 am – Second Subcommittee meeting
Dave attended but no changes were requested for RIO
2/24/2015 – Reported back amended, do pass, 12-1 (removed Governor's market equity and retirement contribution increases and reduced performance based increase by 1% per year)
2/24/2015 – Amendment adopted, placed on calendar
2/24/2015 – Second reading, passed, 46-0
3/04/2015 – Introduced, first reading, referred to House Appropriations Committee
3/11/2015 2:15 pm – Committee Hearing – House Appropriations-Government Operations
Dave, Fay and Connie attended; Dave provided testimony; there were no substantive questions or concerns; an additional meeting will be scheduled in the next few weeks
3/27/2015 8:30 am – Committee Hearing

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2. HB1063 – Relating to modifications to investment policies for and funds under management of the State Investment Board ("administrative changes") (Support)

This is the administrative changes bill submitted by the SIB. It clarifies existing language in Chapter 21-10, corrects an incorrect paragraph reference and updates the list of statutory funds under SIB management

1/06/2015 – Introduced, first reading, referred to House Government and Veterans Affairs Committee.
1/08/2015 9:30 am – Committee Hearing - House Government and Veterans Affairs
Dave provided testimony in support of the bill.
1/09/2015 – Reported back, do pass, 14-0-0
1/12/2015 – Second reading, passed, 92-0
2/19/2015 – Received from House, introduced, first reading, referred to Senate Gov't and Vets Affairs
3/13/2015 10:15 am – Committee Hearing – Senate Government and Veterans Affairs
Dave attended and provided testimony in support
3/13/2015 - Reported back, do pass, 7-0-0
3/16/2015 – Second reading, passed, 47-0

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3. SB2039 – …relating to a public employee retirement stabilization fund and funds managed by the state investment board. (Monitor)

This bill would create the public employee retirement stabilization fund for the purpose of addressing any unfunded retirement obligations of the main state employee retirement plan and put the supervision of the investment of the fund under the SIB.

1/06/2015 – Introduced, first reading, referred to Senate Education Committee.
1/12/2015 – Committee Hearing – 10:15 am
Dave attended but did not provide testimony
2/06/2015 – Reported back amended, do pass, amendment placed on calendar 6-0-0
Amendment changes "public employee retirement stabilization" to "scholarship" and removes from SIB list of statutory clients

2/09/2015 – Amendment adopted, placed on calendar
2/11/2015 – Second reading, passed, 46-0

Note: As amended and passed, this bill no longer applies to the SIB but staff will continue to monitor for additional amendments.

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4. HB1066 – Relating to the balance of and transfers to the budget stabilization fund. (Monitor)

This bill would clarify the timeframe in which the balance is reviewed and would allow the biennial transfers between this fund and the general fund to be netted to avoid liquidating assets and subsequently reinvesting them.

1/06/2015 – Introduced, first reading, (emergency) referred to House Appropriations.
1/20/2015 – Committee Hearing – 9:00 am
    Dave attended and answered questions of the committee
1/20/2015 – Reported back, do pass, 23-0-0
1/22/2015 – Second reading, passed, 90-0, Emergency clause carried
2/23/2015 – Received from House, Introduced, first reading, referred to Senate Appropriations
3/13/2015 9:00 am – Committee Hearing – Senate Appropriations
    Dave attended but did not provide testimony.
3/13/2015 – Reported back, do pass, 13-0-0
3/16/2015 – Second reading, passed, 47-0 (Emergency clause carried)

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5. HB1033 – Relating to definitions for the legacy fund, the legacy fund principal balance, and a transfer of legacy fund earnings. (Monitor)

This bill defines key terms related to the Legacy Fund, including “earnings” and “principal”; requires OMB to calculate the 15% of the principal balance that may be spent each biennium after 6/30/2017; requires earnings of the fund after 6/30/17 become part of principal until certain thresholds are met.

1/06/2015 – Introduced, first reading, referred to House Appropriations Committee
1/20/2015 – Committee Hearing – 3:15 pm
    Dave attended but did not provide testimony.
1/30/2015 – Reported back, do pass, 21-0-2
2/02/2015 – Second reading, passed, 82-9
2/19/2015 – Received from House, introduced, first reading, referred to Senate Appropriations
3/13/2015 8:30 am – Committee Hearing – Senate Appropriations
    Dave attended but did not provide testimony; an amendment was submitted by Rep. Keiser that would require at least 10% of the legacy fund to be placed “with one or more financial institutions chartered in and located in this state and which are experienced in and hold considerable knowledge of the field of investments.” A second hearing was scheduled due to this amendment for 3/17/2015.
3/17/2015 10:00 am – Committee Hearing – Senate Appropriations
    Lt. Gov. Wrigley, Treasurer Schmidt and Dave provided testimony about the legal conflict raised with the language of the proposed bill amendment which states that this “10%” investment should be made “notwithstanding the prudent investor rule”.

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6. SB2038 – Relating to a defined contribution retirement plan for state employees… (Monitor)

Among other things specific to PERS administration, this bill would close the existing PERS defined benefit plan to new entrants effective January 1, 2016.

1/06/2015 – Introduced, first reading, referred to Senate Government and Veterans Affairs Committee
1/22/2015 – Committee Hearing – 9:00 am

Two current legislators and one former legislator testified in support while opposition included OMB, HRMS, ND United, AARP and other retiree groups.
2/09/2015 – Reported back, do not pass, 4-3-0
2/11/2015 – Laid over one legislative day
2/16/2015 – Second reading, failed to pass, 8-39

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7. HB1329 – Relating to the membership of the state investment board. (Monitor)

This bill adds two additional members to the State Investment Board; "one member appointed by the majority leader of the senate, one member appointed by the majority leader of the house …".

1/13/2015 - Introduced, first reading, referred to House Political Subdivisions Committee
1/30/2015 – Committee Hearing – 9:00 am
Rep. Gary Kreidt testified in support; the Lt. Governor opposed; discussion revolved around constitutional authority. Dave attended and addressed a RIO staffing question, but did not provide written testimony.
1/30/2015 – Reported back, do not pass, 8-5-1
2/02/2015 – Second reading, failed, 46-45

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8. HB1250 – Relating to the publishing of minutes of boards and commissions. (Monitor)

This bill would require each governing body to which the governor appoints any member to publish on the governor's office website the minutes of each meeting within sixty days after the meeting.

1/13/2015 – Introduced, first reading, referred to House Political Subdivisions Committee
1/23/2015 – Committee Hearing – 9:00 am
Connie attended and provided testimony.
2/09/2015 – Reported back amended, do not pass, 9-4-1
Amendment adds language to allow link to agency website and adds language that would require information to remain on the governor's website for one year after publication.
2/10/2015 – Amendment adopted, placed on calendar
2/12/2015 – Second reading, failed to pass, 32-59

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9. HB1053 – Relating to centralized desktop support services through ITD (Monitor)

This bill would require certain state agencies not specifically exempted (RIO is not exempted) to obtain centralized desktop support services from the state Information Technology Department (ITD).

1/06/2015 – Introduced, first reading, referred to House Government and Veterans Affairs Committee
1/15/2015 – Committee Hearing – 8:30 am
1/19/2015 – Referred to Appropriations
2/09/2015 – Committee Hearing – 8:30 am
Subsequent to the hearing, information was requested by ITD/OMB from agencies that would be affected by this bill; RIO provided information regarding IT desktop hardware, software and budget
2/19/2015 – Reported back, do pass, 22-1
2/23/2015 – Second reading, passed, 72-21
2/25/2015 – Introduced, first reading, referred to Senate Government and Veterans Affairs Committee
3/12/2015 9:45 am – Committee Hearing – Senate Government and Veterans Affairs Committee
Dave and Rich attended; Dave provided testimony in opposition

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10. HB1374 – Relating to oil and gas tax revenue put options and swaps (Monitor)

This bill would allow the SIB to purchase oil swaps at the request of the OMB Director and Industrial Commission approval to offset lower state general fund oil and gas tax revenues.

1/19/2015 – Introduced, first reading, referred to House Industry, Business and Labor Committee
1/26/2015 – Committee Hearing – 2:00 pm
The meeting was postponed until further notice.
2/11/2015 – Reported back amended, do pass, 13-0-2
Amendment changes the bill to a study bill for the interim.
2/12/2015 – Amendment adopted, placed on calendar
2/16/2015 – Second reading, passed, 85-8
2/23/2015 – Received from House, Introduced, first reading, referred to Senate Industry, Business and Labor Committee
3/09/2015 11:00 am – Committee Hearing – Senate Industry, Business and Labor Committee
Dave provided testimony regarding the use of put options and swaps
3/10/2015 – Reported back, do pass, place on calendar, 6-1-0
3/11/2015 – Second reading, passed, 34-13
3/17/2015 – Signed by Governor

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11. SB2344 – Creating of a Legacy Foundation Committee (Monitor)

This bill would create a new 9-member committee appointed by the Governor and is privately funded. This committee would provide recommendations on use of the Legacy Fund earnings.

1/26/2015 – Introduced, first reading, referred to House Government and Veterans Affairs Committee
2/05/2015 – Committee Hearing – 8:30 am
Dave attended but did not provide testimony.
2/09/2015 – Reported back, do not pass, 5-2-0
2/24/2015 – Second reading, failed to pass, 16-29

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12. HCR3041 – Concurrent resolution to provide for a Legislative Management study consisting of a comprehensive review and analysis of the investment practices by the state and the State Investment Board. (Monitor)

2/20/2015 – Introduced, first reading, referred to House Industry, Business and Labor Committee
2/23/2015 – Reported back, do pass, 13-0-2, placed on consent calendar
2/25/2015 – Second reading, adopted
2/26/2015 – Received from House, introduced, first reading, referred to Senate Industry, Business and Labor Committee
3/18/2015 11:00 am – Committee hearing, Senate Industry, Business and Labor Committee
Dave provided informational testimony regarding the SIB program
3/19/2015 – Reported back, do not pass, 4-2-1
3/20/2015 – Second reading, failed to pass on a voice vote

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13. HCR3042 – A concurrent resolution to amend and reenact section 26 of article X of the State Constitution. This measure would require the state treasurer to transfer four percent of the funds in the legacy fund to the state general fund at the end of each state fiscal year, beginning in 2018. (Monitor)

2/20/2015 – Introduced, first reading, referred to House Appropriations Committee
3/04/2015 – Committee hearing – 2:45 pm
3/06/2015 – Reported back, do not pass, 15-4-4 placed on calendar
3/09/2015 – Second reading, failed to pass, 23-68

MEMORANDUM

TO: **Dave Hunter, Executive Director, Retirement and Investment Office**

FROM: **Janilyn Murtha, Assistant Attorney General**

RE: **Amendment to House Bill No. 1033**

DATE: **March 26, 2015**

You asked me to briefly summarize any potential legal implications the attached proposed amendment to HB 1033 may have on the ability of the State Investment Board (hereinafter SIB) to invest the legacy fund.

The legacy fund was created by Article X, Section 26 of the North Dakota Constitution. This section establishes the source of fund assets, provides for limitations on the use of its principal and earnings, and designates the SIB as responsible for its investment. HB 1033 seeks to establish in statute the terms and process applicable to transfers of legacy fund principal and earnings for use by the state in accordance with N.D. Const. art. X, § 26. **The amendment to HB 1033 seeks to limit the flexibility and discretion of the SIB in its investment of the fund by mandating utilization of local financial institutions be a goal for investment of the fund and that in furtherance of this goal at least 10% of the fund be placed with state chartered financial institutions for investment regardless of whether such placement would be in accordance with the prudent investor rule found in N.D.C.C. § 21-10-07.**

The threshold question is whether the proposed amendment to HB 1033 frustrates the constitutional directive given the SIB by N.D. Const. art. X, § 26. Generally, statutes enjoy a presumption of constitutional compliance. N.D.C.C. § 1-02-38. Legislative enactments, however are subordinate to constitutional requirements. N.D.A.G. 2001-L-33. The SIB functions under the authority of the state executive branch and existed prior to the enactment of the state constitutional provision creating the legacy fund. N.D.C.C. §§ 21-10-01, 21-10-02. The precise wording of N.D. Const. art. X, § 26 directs the SIB to invest the fund, and consequently the fund is subject to, and the SIB responsible for, its management and asset allocation decision making authority. N.D.A.G. 2011-L-05. While an advisory committee is responsible for providing recommendations to the SIB regarding the asset allocation of the legacy fund, the SIB remains the entity ultimately responsible for its asset allocation and investment. N.D.C.C. § 21-10-11. The North Dakota Supreme Court has recognized an implied exclusion of each branch of government from the exercise of the functions of the others. Lamb v. State Board of Law Examiners, 777 N.W.2d 343, 345-6 (ND 2010). This separation of powers doesn't prohibit one branch from acting within the sphere of another, but nor does it allow for unfettered encroachment. N.D.A.G. 2009-L-08.

The proposed amendment may implicate an encroachment of the constitutional directive given the SIB to invest the fund in three respects: in its limitation of the flexibility of the asset allocation, in its mandate to act without regard to the prudent investor rule, and in its mandate for utilization of state chartered financial institutions to invest the fund. Comments on the prudent investor rule found in the Restatement (Third) of Law: Trusts (2007) offer a perspective on how these proposed requirements may implicate such an encroachment:

> (regarding limiting the flexibility of the asset allocation) "Asset allocation decisions are a fundamental aspect of an investment strategy, and are a starting point in formulating a plan of diversification (as well as an expression of judgments concerning suitable risk-return objectives)... These decisions are subject to adjustment from time to time as changes occur in the portfolio, in economic conditions or expectations, or in the needs or investment objectives of the trust." Restatement (Third) of Law: Trusts § 90 Com. g (2007) (p. 309);
>
> (regarding a mandate to act without regard to the prudent investor rule) "In managing investments, as in other matters relating to the administration of the trust, the trustee must adhere to fundamental fiduciary standards... The trustee's duties apply not only in making investments but also in monitoring and reviewing investments, which is done in a manner that is reasonable and appropriate to the particular investments, course of action, and strategies involved." Restatement (Third) of Law: Trusts § 90 Com. b (2007) (p. 295);
>
> (regarding a mandate to utilize state chartered financial institutions to invest the fund) "The strict duty of loyalty in the trust law ordinarily prohibits the trustee from investing or managing trust investments in a manner… that is intended to serve interests other than those of the beneficiaries or the purposes of the settlor." Restatement (Third) of Law: Trusts § 90 Com. c (2007) (p. 297).

While I decline to offer an opinion as to whether the proposed amendment to HB 1033 impermissibly frustrates the executive function performed by the SIB in its administration of the Legacy Fund, I do raise it as an issue worthy of further research and discussion.

If adopted and enacted, the proposed amendment to HB 1033 may result in additional management and fiduciary considerations for the SIB. Such considerations may include the inability to pool some legacy fund assets with other funds for investment purposes as permitted under N.D.C.C. § 21-10-02; and an acknowledgment that while the prudent investor rule may not apply to the obligation to place a certain percentage of fund assets with state chartered institutions by statute, the SIB must still abide by the prudent investor rule in managing and monitoring investments within that placement.

It is worth noting that a stated preference for investment of legacy fund assets with state chartered financial institutions could be accomplished without a constitutional or statutory amendment, or directly raising fiduciary concerns, under the terms of its existing Investment Policy Statement (hereinafter "IPS"). Section 7(g) of the IPS permits "economically targeted investing" so long as such an investment or placement meets the exclusive benefit rule. The IPS defines economically targeted investing in part as an investment designed "to create collateral economic benefits for a targeted geographic area, group of people, or sector of the economy". A stated preference for placement of legacy fund assets with North Dakota state chartered financial institutions would meet this definition of economically targeted investing, and is permitted under the terms of the IPS if it meets the exclusive benefit rule. The criteria for determining whether this type of investment meets the exclusive benefit rule is also contained with the IPS, as is a statement that the advisory board's policy favors investments that may have a positive impact on North Dakota's economy.

Please let me know if you have any questions or would like to discuss this matter further.

RIO Update:

Based on recent discussion with sponsor affiliated representatives of HB 1033, RIO intends to engage in a discussion with a group of North Dakota related investment firms and our investment consultant (Callan Associates). The goal of this discussion is to gain a better understanding of the investment capabilities of a group of North Dakota related investment firms while sharing the screening criteria commonly utilized by Callan Associates to identify eligible investment managers. As example, RIO and Callan could review the asset size of firms historically deemed large enough to be considered as an eligible manager candidate without raising a material concern about business (or investment strategy) concentration risk. RIO and Callan would summarize our findings and share them with the SIB at a future meeting.

15.0057.03004
Title.

Prepared by the Legislative Council staff for Representative Keiser
January 29, 2015

PROPOSED AMENDMENTS TO HOUSE BILL NO. 1033

Page 1, line 3, replace "repeal section" with "amend and reenact sections 21-10-11 and"

Page 1, line 4, replace "a definition of" with "investment of the"

Page 1, line 4, remove "earnings"

Page 1, after line 5, insert:

"**SECTION 1. AMENDMENT.** Section 21-10-11 of the North Dakota Century Code is amended and reenacted as follows:

21-10-11. Legacy and budget stabilization fund advisory board.

The legacy and budget stabilization fund advisory board is created to develop recommendations for the investment of funds in the legacy fund and the budget stabilization fund to present to the state investment board. The goal of investment for the legacy fund is principal preservation while maximizing total return and utilizing local financial institutions. The board consists of two members of the senate appointed by the senate majority leader, two members of the house of representatives appointed by the house majority leader, the director of the office of management and budget or designee, the president of the Bank of North Dakota or designee, and the tax commissioner or designee. The board shall select a chairman and must meet at the call of the chairman. The board shall report at least semiannually to the budget section. Legislative members are entitled to receive compensation and expense reimbursement as provided under section 54-03-20 and reimbursement for mileage as provided by law for state officers. The legislative council shall pay the compensation and expense reimbursement for the legislative members. The legislative council shall provide staff services to the legacy and budget stabilization fund advisory board. The staff and consultants of the state retirement and investment office shall advise the board in developing asset allocation and investment policies.

SECTION 2. AMENDMENT. Section 21-10-12 of the North Dakota Century Code is amended and reenacted as follows:

21-10-12. Legacy fund - ~~Earnings defined~~Investment.

~~For the purposes of section 26 of article X of the Constitution of North Dakota, the term "earnings" means net income in accordance with generally accepted accounting principles, excluding any unrealized gains or losses~~Notwithstanding section 21-10-07, the state investment board shall place at least ten percent of the legacy fund with one or more financial institutions chartered in and located in this state and which are experienced in and hold considerable knowledge of the field of investments."

Page 2, remove line 22

Renumber accordingly

AGENDA ITEM IV. B.

TO:	State Investment Board
FROM:	Dave Hunter, Executive Director/CIO
DATE:	March 27, 2015
SUBJECT:	SIB Governance Manual Review - **BOARD ACTION**

As directed by SIB Governance Manual Policy B-7 Section 4.C, the SIB conducted an annual review of the governance manual on September 26, 2014. Based on Board member discussion during this annual review, the Executive Director proposed a section by section review of the governance manual over the next six months which will culminate in a "Governance Day Offsite" scheduled July 24, 2015. The Governance Day Offsite is intended to take the place of a regularly scheduled SIB meeting, but is expected to be expanded in length to allow for a deeper and more holistic discussion of overall Board governance policies.

January 2015	Governance Process – Accepted 2-27-15
February	**Executive Limitations – Board Acceptance**
March	**Board Staff Relationship – "First Reading" (Informational)**
April	Ends
May	Investments and Guidelines
June	By-Laws and Century Code
July	Governance Day Offsite

RIO will conduct a "second reading" of the "Executive Limitations" section of the Governance Manual at this meeting and then request SIB approval. RIO will then seek to review the "Board Staff Relations" section of the Governance ("first reading") with the SIB.

NOTE: If the Board Staff Relations section can be read in advance of our meeting, we may be able to reduce our combined review time.

Sections B. and C. of the SIB Governance Manual on "Executive Limitations" and "Board Staff Relations" follow.

POLICY TYPE: GOVERNANCE PROCESS

POLICY TITLE: *POLICY INTRODUCTION/AMENDMENT/PASSAGE*

New policies or policy amendments may be proposed by the Executive Director or a Board member. All new policies or amendments may be submitted to the Board's Legal Counsel for drafting in the approved style.

Upon request of the Executive Director or a Board member a new policy or amendment shall be placed on the Board's agenda for action as follows:

1. Introduction and first reading. A brief explanation or summary of the new policy or amendment shall be presented to the Board. Upon approval of introduction and first reading, the measure shall be placed on the agenda of the next scheduled meeting of the Board for second reading and adoption. When appropriate, the measure shall be distributed to interested parties.

2. *Second reading and adoption. Interested parties and the public shall be allowed an opportunity to comment on the policy or amendment before final action by the Board. The measure shall take effect immediately following second reading and adoption by the Board, unless a different effective date is stated.*

3. Amendments. Amendments may be proposed at any time before final adoption of the measure. Upon determination by the Board that adoption of an amendment constitutes a substantive change that significantly changes the meaning or effect of the measure, the Board shall continue consideration of second reading and adoption to the next meeting to permit further review and comment.

Emergency measures. The Board may, upon determination that an emergency or other circumstances calling for expeditious action exists, waive the requirement of a second meeting and immediately approve second reading and adoption following introduction and first reading.

Policy Implemented: February 27, 2009

A. *EXECUTIVE LIMITATIONS*

PAGE

EXHIBITS

POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: *GENERAL EXECUTIVE CONSTRAINT*

The executive director shall not knowingly cause or allow any practice, activity, decision, or organizational circumstance which is either imprudent or in violation of commonly accepted business and professional ethics, state law, rules, and policies.

1. With respect to treatment of staff, the executive director shall not knowingly cause or allow any condition or any communication which is unfair, undignified, or disrespectful.

2. In relating to the public and other governmental entities, the executive director may not knowingly cause or allow any action which is unfair, undignified, or disrespectful. In addition, the executive director may not allow any communications from the staff which are inaccurate or fail to distinguish between fact and personal opinion.

3. Budgeting for any fiscal year or the remaining part of any fiscal year shall not knowingly deviate materially from board *Ends* priorities, or create fiscal jeopardy, or fail to be derived from the biennial planning calendar.

4. With respect to the actual, ongoing condition of the organization's financial health, the executive director may not cause or allow the development of fiscal jeopardy or a material deviation of actual expenditures from board priorities established in *Ends* policies.

5. With respect to providing information and counsel to the board, the executive director may not permit the board to be uninformed.

6. The executive director may not allow assets to be unprotected, inadequately maintained, nor unnecessarily risked.

7. Compensation and benefits for staff shall not deviate from applicable state and federal law, including N.D. Administrative Code, Chapter 4-07-02.

8. In order to protect the board from sudden loss of executive services, the executive director may not have fewer than three other executives familiar with board and chief executive issues and processes. The executive director shall not fail to inform the Deputy Executive Director, the Deputy Chief Investment Officer, and the Fiscal and Investment Operations Manager of executive and board issues and processes.

9. The executive director will not allow a conflict of interest in the procurement of goods and services.

10. The executive director will not operate the office without a code of conduct for all RIO Employees. This code of conduct will be a part of the office Administrative Policy Manual.

Policy Implemented: July 23, 1995.
Amended: January 22, 1999; November 19, 1999; September 26, 2014.

POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: ***STAFF RELATIONS***

With respect to treatment of staff, the executive director shall not cause or allow any condition or any communication which is unfair, undignified, or disrespectful.

Accordingly, the executive director may not:

1. Operate without personnel procedures which clarify personnel rules for staff, provide for effective handling of grievances, and protect against wrongful conditions or violate any state or federal law.

2. Fail to provide staff with the opportunity to complete an employment termination questionnaire and an exit interview with the Supervisor of Audit Services.

Policy Implemented: June 23, 1995.
Amended: May 31, 1996; September 26, 2014.

POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: *RELATING TO PUBLIC AND GOVERNMENT*

In relating to the public and other governmental entities, the executive director may not cause or allow any action which is unfair, undignified, or disrespectful. In addition, the executive director may not allow any communications from the staff which is inaccurate or fails to distinguish between fact and personal opinion.

Policy Implemented: June 23, 1995.

POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: *BUDGETING*

Budgeting for any fiscal year or the remaining part of any fiscal year shall not deviate materially from board *Ends* priorities, or create fiscal jeopardy.

Accordingly, the executive director may not cause or allow budgeting which:

1. Contains too little information to enable credible projection of expenses, cash flow, and disclosure of planning assumptions.

2. Plans the expenditure in any fiscal year of more funds than are authorized by legislative appropriation.

3. Reduces the level of service, or anticipates a reduction in the level of service, of any Retirement and Investment Office program without the prior approval of the State Investment Board.

Policy Implemented: June 23, 1995.
Amended: November 2, 1997; June 26, 1998.

POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: *FINANCIAL CONDITION*

With respect to the actual, ongoing condition of the organization's financial health, the executive director may not cause or allow the development of fiscal jeopardy or a material deviation of actual expenditures from board priorities established in *Ends* policies.

Accordingly, the executive director may not:

1. Make any expenditure that exceeds the appropriation authority authorized by the North Dakota legislature.

2. Create policies for payment of administrative obligations that are in conflict with the policies of the Office of Management and Budget.

3. Initiate a transfer of appropriation authority between budget line items without board and Emergency Commission approval.

4. Allow appropriation expenditures to be made unless reported on PeopleSoft.

Policy Implemented: June 23, 1995.
Amended: September 26, 2014.

POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: *COMMUNICATION AND COUNSEL TO THE BOARD*

With respect to providing information and counsel to the board, the executive director may not permit the board to be uninformed.

Accordingly, the executive director may not:

1. Neglect to submit monitoring data required by the board (see policy on Monitoring Executive Performance) in a timely, accurate, and understandable fashion, directly addressing provisions of the board policies being monitored.

2. Let the board be unaware of relevant trends, anticipated adverse media coverage, material external and internal changes, and particularly changes in the assumptions upon which any board policy has previously been established.

3. Fail to advise the board if, in the executive director's opinion, the board is not in compliance with its own policies on *Governance Process* and *Board-Staff Relationship*, particularly in the case of board behavior which is detrimental to the work relationship between the board and the executive director.

4. Fail to marshal for the board as many staff and external points of view, issues, and options as needed for fully informed board choices.

5. Present information in unnecessarily complex or lengthy form.

6. Fail to provide a mechanism for official board, officer, or committee communications.

7. Fail to deal with the board as a whole except when (a) fulfilling individual requests for information or (b) responding to officers or committees duly charged by the board.

8. Fail to report in a timely manner an actual or anticipated noncompliance with any policy of the board, particularly *Ends* and *Executive Limitations*.

9. Fail to inform the board in a timely manner of any intention to hire or dismiss the Deputy Executive Director, the Deputy Chief Investment Officer, or the Fiscal and Investment Operations Manager.

10. Fail to keep the board informed concerning the delegation of fiduciary authority to any staff member. Every person to whom such fiduciary responsibility is delegated is ultimately accountable to the board as to the exercise and execution of the delegated authority.

Policy Implemented: June 23, 1995; November 19, 1999.
Amended: September 26, 2014.

POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: *ASSET PROTECTION*

The executive director may not allow assets to be unprotected, inadequately maintained, nor unnecessarily risked.

Accordingly, the executive director may not:

1. Fail to insure against theft and casualty losses to at least 80 percent replacement value and against liability losses to board members, staff, or the organization itself in an amount greater than the average for comparable organizations.

2. Allow non-bonded personnel access to funds.

3. Subject plant and equipment to improper wear and tear or insufficient maintenance.

4. Unnecessarily expose the organization, its board, or staff to claims of liability.

5. Fail to protect intellectual property, information, and files from loss or significant damage.

6. Receive, process, or disburse funds under controls which are insufficient to meet the state auditor's standards.

7. Invest or hold operating capital in a manner that is inconsistent with state law or board policy.

8. Acquire, encumber, or dispose of real property.

9. Endanger the organization's public image or credibility, particularly in ways that would hinder its accomplishment of mission.

10. Deviate from the investment process set by the State Investment Board (SIB) as contained in the board's policy on investments.

Policy Implemented: June 23, 1995.

POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: *COMPENSATION AND BENEFITS*

Compensation and benefits for staff shall not deviate from applicable state and federal law, including N.D. Administrative Code, Chapter 4-07-02.

Accordingly, the executive director may not:

1. Change the compensation and benefits of any program officer reporting directly to the SIB.

2. Promise or imply permanent or guaranteed employment.

Policy Implemented: June 23, 1995.
Amended: January 22, 1999; November 19, 1999.

POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: *CONFLICT OF INTEREST*

Conflicts of interest and the appearance of impropriety shall be avoided by the executive director. The executive director must not allow family, social, professional, or other relationships to influence their judgment in discharging their responsibilities. The executive director must refrain from financial and business dealings that tend to reflect adversely on their duties. If a conflict of interest unavoidably arises, the executive director shall immediately disclose the conflict to the SIB. Conflicts of interest to be avoided include, but are not limited to: receiving consideration for advice given to a person concerning any matter over which the executive director has any direct or indirect control, acting as an agent or attorney for a person in a transaction involving the board, and participation in any transaction for which the executive director has acquired information unavailable to the general public, through their position.

"Conflict of Interest" means a situation in which a board member or staff member has a direct and substantial personal or financial interest in a matter which also involves the member's fiduciary responsibility.

The executive director will be required to affirm their understanding of this policy annually, in writing, and must disclose any conflicts of interest that may arise (See Exhibit A-I).

Policy Implemented: June 23, 1995.
Amended: January 22, 1999; February 25, 2011.

POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: *CODE OF CONDUCT*

The executive director will not operate the office without a code of conduct for all RIO employees. This code of conduct shall be a part of the office Administrative Policy Manual.

Policy Implemented: June 27, 1997.

POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: *UNRELATED BUSINESS INTERESTS*

In the pursuit of personal business interests, the Executive Director will not allow a situation to exist that presents a conflict of interest to the SIB investment program, nor shall such activity be in violation of RIO Administrative Policy 3.47, Use of Office Facilities and Equipment.

Policy Implemented: August 18, 2000

Memorandum

To: **RIO Executive Director/CIO**

From: **RIO Compliance Officer**

Date: **July 1, 20--**

RE: **Annual Affirmation of Conflict of Interest Policy**

Executive Limitations Policy A-9, *Conflict of Interest,* which is attached to this memorandum, details the conflict of interest policy for the executive director. This policy also indicates that the executive director is required to reaffirm their understanding of this policy annually and disclose any conflicts of interest. Therefore, please read and sign the statement below to comply with this requirement.

“I have read and understand SIB Executive Limitations Policy A-9, *Conflict of Interest*. I have disclosed any conflicts of interest as required by this policy.”

Name (printed) ________________________________

Signature____________________________________

Date____

Detail of any conflicts of interest (if any):

C. *BOARD-STAFF RELATIONSHIP*

POLICY TYPE: BOARD-STAFF RELATIONSHIP

POLICY TITLE: *CHIEF EXECUTIVE ROLE*

The executive director, as chief executive officer, is accountable to the board acting as a body. The board will instruct the executive director through these written policies, delegating to the executive director the implementation and administration of these policies.

Policy Implemented: June 23, 1995.

POLICY TYPE: BOARD-STAFF RELATIONSHIP

POLICY TITLE: *DELEGATION TO THE EXECUTIVE DIRECTOR*

All board authority delegated to staff is delegated through the executive director.

1. The board authority will direct the executive director to achieve specified results, for specified recipients, at a specified cost through the establishment of *Ends* policies. The board will limit the latitude the Executive Director may exercise in practices, methods, conduct, and other "means" to the *Ends* through establishment of *Executive Limitations* policies.

2. The Executive Director must use reasonable judgment in the implementation or administration of the board's *Ends* and *Executive Limitations* policies; the executive director is authorized to establish practices, and develop activities.

3. The board may change its *Ends* and *Executive Limitations* policies. By so doing, the board changes the latitude of choice given to the Executive Director. If any particular delegation is in place, the board and its members will respect and support the Executive Director's choices, provided that the Executive Director's choice is consistent with the board's fiduciary responsibility.

4. Only decisions of the board acting as the body are binding upon the Executive Director.
    a. Decisions or instructions of individual board members, officers, or committees are not binding on the Executive Director except in rare instances when the board has specifically authorized such exercise of authority.
    b. In the case of board members or committees requesting information, other than a public record, or assistance without board authorization, the Executive Director may refuse such requests that require a material amount of staff time or funds or is disruptive.

5. The Executive Director will be responsible for the hiring, termination, and annual evaluation of all employees of the Retirement and Investment Office.

Policy Implemented: June 23, 1995.
Amended: November 22, 1996; November 19, 1999.

POLICY TYPE: BOARD-STAFF RELATIONSHIP

POLICY TITLE: *EXECUTIVE DIRECTOR JOB DESRIPTION*

As the board's single official link to the operating organization, the executive director's performance will be considered to be synonymous with the RIO's total performance.

Consequently, the executive director's job contributions can be stated as performance in the following areas:

1. Organizational accomplishment of the provisions of board policies on *Ends*.

2. Organizational operation within the boundaries of prudence and ethics established in board policies on *Executive Limitations*.

3. Maintain accurate records of the proceedings of the SIB and TFFR Board.

Policy Implemented: June 23, 1995.

POLICY TYPE: BOARD-STAFF RELATIONSHIP

POLICY TITLE: *MONITORING EXECUTIVE PERFORMANCE*

Monitoring executive performance is synonymous with monitoring organizational performance against board policies on *Ends* and on *Executive Limitations*. Any evaluation of the executive director's performance, formal or informal, may be derived only from these monitoring data.

1. The purpose of monitoring is simply to determine the degree to which board policies are being fulfilled. Information which does not do this will not be considered to be monitoring. Only a minimum amount of board time as necessary will be devoted toward monitoring so that meetings can best be used to create the future rather than to review the past.

2. A given policy may be monitored in one or more of three ways:

   A. Internal report: Disclosure of compliance information to the board from the executive director.

   B. External report: Discovery of compliance information by a disinterested, external auditor, inspector or judge who is selected by and reports directly to the board. Such reports must assess executive performance only against policies of the board, not those of the external party unless the board has previously indicated that party's opinion to be the standard.

   C. Direct board inspection: Discovery of compliance information by a board member, a committee, or the board as a whole. This is a board inspection of documents, activities, or circumstances directed by the board which allows a "prudent person" test of policy compliance.

3. The board will monitor each *Ends* and *Executive Limitations* policy according to the following frequency and method:

   Quarterly internal reports for policies:

   A-2 Staff Relations
   A-4 Budgeting
   A-5 Financial Condition
   D-3 Investment Services
   D-4 Investment Performance

   Annual external reports for policies:

   A-2 Staff Relations
   A-4 Budgeting
   A-7 Asset Protection
   D-3 Investment Services
   D-4 Investment Performance

C. *BOARD-STAFF RELATIONSHIP*

PAGE

POLICY TYPE: BOARD-STAFF RELATIONSHIP

POLICY TITLE: *CHIEF EXECUTIVE ROLE*

The executive director, as chief executive officer, is accountable to the board acting as a body. The board will instruct the executive director through these written policies, delegating to the executive director the implementation and administration of these policies.

Policy Implemented: June 23, 1995.

POLICY TYPE: BOARD-STAFF RELATIONSHIP

POLICY TITLE: *DELEGATION TO THE EXECUTIVE DIRECTOR*

All board authority delegated to staff is delegated through the executive director.

1. The board authority will direct the executive director to achieve specified results, for specified recipients, at a specified cost through the establishment of *Ends* policies. The board will limit the latitude the Executive Director may exercise in practices, methods, conduct, and other "means" to the *Ends* through establishment of *Executive Limitations* policies.

2. The Executive Director must use reasonable judgment in the implementation or administration of the board's *Ends* and *Executive Limitations* policies; the executive director is authorized to establish practices, and develop activities.

3. The board may change its *Ends* and *Executive Limitations* policies. By so doing, the board changes the latitude of choice given to the Executive Director. If any particular delegation is in place, the board and its members will respect and support the Executive Director's choices, provided that the Executive Director's choice is consistent with the board's fiduciary responsibility.

4. Only decisions of the board acting as the body are binding upon the Executive Director.
    a. Decisions or instructions of individual board members, officers, or committees are not binding on the Executive Director except in rare instances when the board has specifically authorized such exercise of authority.
    b. In the case of board members or committees requesting information, other than a public record, or assistance without board authorization, the Executive Director may refuse such requests that require a material amount of staff time or funds or is disruptive.

5. The Executive Director will be responsible for the hiring, termination, and annual evaluation of all employees of the Retirement and Investment Office.

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   D-4 Investment Performance

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   A-2 Staff Relations
   A-4 Budgeting
   A-7 Asset Protection
   D-3 Investment Services
   D-4 Investment Performance

STATE INVESTMENT BOARD MEMO
March 27, 2015

RE: Executive Review Committee Evaluation

FROM: Robert Lech, Chairperson of Executive Review Subcommittee

BOARD FOCUS: Action

The purpose of this memo is to share the rationale for the formal summative evaluation for Mr. David Hunter, Executive Director/Chief Investment Officer for the North Dakota Retirement and Investment Office as well as make preliminary salary recommendations to the State Investment Board.

Formal Summative Evaluation

A perceptual survey of progress of the Executive Director/Chief Investment Officer was conducted in February. The survey, involving 9 members of the State Investment Board as well as a self-reflection by Mr. Hunter, encompassed the Ends Policy (D-3, D-4) and Compliance to Executive Limitations (A-2, A-3, A-4, A-5, A-6, A-7, A-9) while focusing on 6 major categories (Board Meetings, Board Relations, Office Operations, Investment Programs and Program Operations, Public/Legislative Relations, and Professional Skills and Development).

The Executive Review Committee met on March 12, 2015 and reviewed all surveys and comments for the purpose of drafting the formal summative evaluation. Based on the members ratings and comments, the committee discussed both areas of strength as well as areas to develop. It is important to note that all major categories and individual indicators were considered to meet or exceed expectations. With no areas of deficiency, the committee outlined areas Mr. Hunter should consider developing to enhance his work at NDRIO.

Role of Audit Committee

During the March 12, 2015 meeting of the Executive Review Committee, all of the State Investment Board Member surveys were reviewed. During this review, there were a number of areas in which scores of Not Applicable were given or questions were skipped entirely. Through the comments, it was easy to ascertain that this was a result of the reviewer not feeling he/she had the ability to accurately rate an area because of our governance structure or due to these areas being more related to day-to-day office operations.

It is important to note that State Investment Board members are provided all of this information through the Audit Committee reviews of Executive Limitations. It is the recommendation of the Executive Review Committee to review these audits prior to completion of the perceptual survey. It may also be helpful for those completing the surveys if, in the future, the compiled audit reviews could be sent to board members along with the link to the survey. This should assist raters in feeling more comfortable with rating all areas on the assessment.

Salary Compensation Recommendations
The State Investment board requested the Executive Review Committee also recommend salary compensation for the fiscal year starting July 1, 2015. The Executive Review Committee discussed that Mr. Hunter's situation is somewhat atypical because of his start date in December of 2013 and the decision in July of 2014 to maintain his salary at the present level. This action was recommended by the Executive Review Committee and approved by the State Investment Board because Mr. Hunter had not yet worked for NDRIO a full year. In addition, the State Investment Board wanted to continue the cycle of July 1 for salary increases. It was the intention of the committee, at that time, to provide an appropriate salary increase that would encompass the 19-month timespan of December 2, 2013 through June 30, 2015.

Due to the positive summative evaluation and the longer time period between the start date and any salary increase, the Executive Review Committee is recommending a range of 5% to 7% be considered for Mr. Hunter as the Executive Director/Chief Investment Officer for the North Dakota Retirement and Investment Office.

The Executive Review Committee came to this range based on the actual legislative increase in July 2014 (3%) and the proposed legislative increase in July 2015 (3%) coupled with the 2012 Investment Compensation Survey of similar public retirement and investment organizations that was aged by 3% each year to offer an effective comparison. When considering a 3% increase to Mr. Hunter's present salary of $210,000 for 2014 and the proposed 3% legislative increase for 2015, the salary for the position would be $222,789, which represents a 6.09% increase. When calculating the aging of 3% from the compensation survey at the 2012 median of $205,000, the salary in that comparison would be $224,009, which represents a 7% increase.

Because of the fluctuation that may take place with the percentages of legislative increases due to the decreased revenue forecasts, the recommendation is to make a formal recommendation at the May 22, 2015 or June 26, 2015 meetings of the State Investment Board, but within that range of 5% to 7%.

Recommended Action:
Approve the formal summative evaluation for Mr. David Hunter, ED/CIO
Approve the salary range of 5% to 7% with a final recommendation to be made upon conclusion of the legislative session

State Investment Board
Formal Evaluation
Mr. David Hunter, Executive Director/Chief Investment Officer
March 27, 2015

A perceptual survey of progress of the Executive Director/Chief Investment Officer was conducted in February. The survey, involving 9 members of the State Investment Board as well as a self-reflection by Mr. Hunter, encompassed the Ends Policy (D-3, D-4) and Compliance to Executive Limitations (A-2, A-3, A-4, A-5, A-6, A-7, A-9) while focusing on 6 major categories (Board Meetings, Board Relations, Office Operations, Investment Programs and Program Operations, Public/Legislative Relations, and Professional Skills and Development). The survey utilized a Likert scale from 1 - 3 (1 – Does Not Meet Expectations, 2 – Meets Expectations, and 3 – Exceeds Expectations). The State Investment Board Members completing the survey rated Mr. Hunter, at a minimum, of Meets Expectations in all 6 categories and in all 31 individual indicators.

The Executive Review Committee met on Thursday, March 12, 2015 to review all surveys and discuss areas of strength and areas to develop for the Executive Director/Chief Investment Officer for the purpose of drafting the formal summative evaluation. This formal evaluation will be reviewed with Mr. Hunter and presented for approval to the State Investment Board at the March 27, 2015 meeting.

AREAS OF STRENGTH AND COMMENDATIONS

Mr. Hunter has provided the State Investment Board with outstanding guidance related to investments. During Mr. Hunter's leadership, the overall portfolio risk has decreased to the 3rd quartile. After taking into account the lower risk profile, the North Dakota pension trust generated investment returns at the 26th percentile for the year ended December 31, 2014 (on an asset allocation adjusted basis). This assessment is based on the Callan Associates Public Fund Sponsor Database, which includes 265 U.S. pension plans.

Along with the NDRIO team, Mr. Hunter is to be commended for his aggressive approach in the reduction of client fees. While the process to reduce fees was initiated prior to Mr. Hunter's employment, he has led the NDRIO team in leveraging increasing funds to continue fee reduction. State Investment Board clients benefitted from a 14 bps reduction, or approximately $12 million, between fiscal year 2013 and fiscal year 2014. Throughout the course of fiscal year 2015, Mr. Hunter has continued this initiative and State Investment Board clients will see an even greater reduction in the area of fees.

Mr. Hunter has done an excellent job in communicating investment performance to the State Investment Board in a format that is easily communicated with board members as well as constituents. Through these reports, Mr. Hunter helps to reassure the public that the State Investment Board and NDRIO are providing a prudent and effective investment strategy.

AREAS TO DEVELOP

The State Investment Board encourages Mr. Hunter to continue to develop staff relations within the collaborative culture of the North Dakota Retirement and Investment Office. The collective and unified power of the full staff has been the main driver for past successes. While the State Investment Board recognizes that Mr. Hunter has only been with NDRIO for approximately 15 months, the board would like Mr. Hunter to continue to prioritize cultivating a positive and collaborative organizational culture.

The State Investment Board recognizes its role as fiduciaries and depends greatly on Mr. Hunter's direct recommendations and rationale, as well as any potential options. The State Investment Board supports Mr. Hunter on his present path of growth in this area of board leadership. The State Investment Board encourages Mr. Hunter to continue to utilize and expand the board memos as a form of communication as he best expresses complex issues to all stakeholders through this written format.

The State Investment Board recognizes the work that Mr. Hunter has already done in developing positive relationships with various entities, including clients, organizations, and legislators. The board encourages Mr. Hunter to continue to foster positive relationships and expand the influence of the ED/CIO position and NDRIO.

GENERAL THOUGHTS

Mr. Hunter consistently showcases great judgment in decision-making related to all areas of investment, passion for the NDRIO team, drive for self-improvement and good overall leadership abilities. The State Investment Board feels fortunate to have Mr. David Hunter as the Executive Director/Chief Investment Officer for the North Dakota Retirement and Investment Office and look forward to many additional years of his leadership.

If there are areas that the State Investment Board can assist in helping you professionally achieve your goals, please do not hesitate to ask.

3/26/2015

Mr. David Hunter, State Investment Board ED/CIO

Date

3/26/15

Mr. Robert Lech, Executive Review Committee Chairperson

Date

North Dakota Retirement and Investment Office
2015-17 Strategic Plan

Fundamental Investment Beliefs

Asset allocation decisions are the primary driver of investment returns, but the prudent use of active investment management is an important contributor towards ensuring our clients attain their stated investment objectives. SIB clients generated $200 million of incremental income via the prudent use of active investment management over the past five years including $60 million of excess return in 2014.

Strategic Investment Plan

1. Reaffirm the organizational commitment to our current governance structure including a persistent awareness to the importance of continuing board education.

2. Enhance transparency and understanding of our core goals and beliefs.
    a. Remain steadfast in our commitment to the prudent use of active investment management.
    b. Expand awareness to downside risk management which is essential to achieving our long term investment goals.
    c. Given actual and projected growth of SIB client assets and the heightened public awareness of the Legacy Fund, align our investment platforms to promote greater clarity and efficiency in reporting and implementing client investment policies.

3. Expand RIO's influence and ability to create positive and sustainable change by developing relationships with existing clients, organizations and legislative leaders.
    a. Enhance community outreach to build upon public awareness and confidence.
    b. Develop concise presentations which highlight our overall risk, return and cost control framework including our progress towards attaining our long-term goals.

4. Heighten employee engagement by promoting an open and collaborative work environment while encouraging employee participation in staff meetings, offer more opportunities to impact RIO's change initiatives and improve overall compensation levels.
    a. RIO's ability to continue to deliver strong results is dependent on the combined efforts of our highly valuable team members.

5. Enhance our existing risk management tools and processes by developing a more robust risk management framework utilizing proven risk management solutions with a focus on portfolio construction and downside risk management (or "stress test" scenarios).
    a. A robust risk management framework provides a foundation to understand downside risks and our ability to withstand market corrections in varying stress test scenarios.

6. Evaluate and expand the efficient use of technology in our investment program activities including risk management, compliance monitoring, client satisfaction surveys, website design and communications in order to increase overall efficiency and effectiveness.

Annual Board Planning Cycle
Biennial Agenda

Fiscal 2015-16	July 2015	August	September	October	November	December	January 2016	February	March	April	May	June
	Gov. Offsite - Election of Officers, - Appoint Audit Comm. - Plan Annual Agenda - Plan Board Education	**Annual Investment Performance Review** - Establish Investment Work Plan - Add Invest. Education	**Annual Review of Gov. Manual** *(Done)* - New Board Member Orientation Complete	**Annual Evaluation of RIO vs. *Ends* policies** - Annual Board Evaluation	**Investment Director Report on Investment Work Plan**	No Meeting Scheduled		**Investment Director Report on Investment Work Plan** - Exec. Limit. & CIO Review	**Review Budget Guidelines for next Biennium**		**Investment Director Report on Investment Work Plan** - Investment Guidelines	No Meeting Scheduled

Fiscal 2016-17	July 2016	August	September	October	November	December	January 2017	February	March	April	May	June
The SIB Meeting Agenda has not been establised for Fiscal 2016-17	**Gov. Offsite** - Election of Officers, - Appoint Audit Comm. - Plan Annual Agenda - Plan Board Education	**Annual Investment Performance Review** - Establish Investment Work Plan - Add Invest. Education	**Annual Review of Gov. Manual** - New Board Member Orientation Complete	**Annual Evaluation of RIO vs. *Ends* policies** - Annual Board Evaluation	**Investment Director Report on Investment Work Plan**	No Meeting Planned	- Legislative Update	**Investment Director Report on Investment Work Plan** - Exec. Limit. & CIO Review	**Confirm Budget Guidelines** - Legislative Update	- Legislative Update	**Investment Director Report on Investment Work Plan**	No Meeting Planned

1.) SIB Governance Policy B-7 on Governance Process states that "the Board will follow a biennial agenda which (a) completes a re-exploration of Ends policies annually (April) and (b) continually improves its performance through attention to board education and to enriched input and deliberation."

2.) "In the first three months of the new cycle, the Board will develop its agenda for the ensuing year. Scheduled monitoring will be used to evaluate and adjust the annual agenda as needed."

3.) "The Board will identify areas of education and input needed to increase the level of wisdom forethought it can give to subsequent choices. A board education plan will be developed during July and August of each year."

AGENDA ITEM V. B.

INFORMATIONAL

To: State Investment Board

From: Dave Hunter, Executive Director / CIO

Date: March 23, 2015

RE: **Certificate of Achievement for Excellence in Financial Reporting**

Government Finance Officers Association ("GFOA") Award:

The North Dakota Retirement and Investment Office received a **Certificate of Achievement for Excellence in Financial Reporting** from the GFOA for its Comprehensive Annual Financial Report ("CAFR") for the year ended June 30, 2014. <u>This marks the 17th consecutive year that RIO been awarded this honor</u>. RIO's CAFR was judged by an impartial panel to meet the high standards of the program including demonstrating a constructive "spirit of full disclosure" to clearly communicate its financial story. **"The Certificate of Achievement is the highest form of recognition in the area of governmental accounting and financial reporting, and its attainment represents a significant accomplishment by a government and its management."**

I would like to sincerely thank our entire accounting and financial reporting team for this outstanding achievement including Connie Flanagan, Susan Walcker, Cody Schmidt, Dottie Thorsen, Bonnie Heit, Darlene Roppel, Darren Schulz and Fay Kopp.

Government Finance Officers Association
203 N. LaSalle Street - Suite 2700
Chicago, IL 60601

Phone (312) 977-9700 Fax (312) 977-4806

March 13, 2015

Lt. Governor Drew Wrigley
Chair, State Investment Board
North Dakota Retirement and Investment Office
PO Box 7100
Bismarck ND 58507-7100

Dear Lt. Governor Wrigley:

We are pleased to notify you that your comprehensive annual financial report for the fiscal year ended **June 30, 2014** qualifies for a Certificate of Achievement for Excellence in Financial Reporting. The Certificate of Achievement is the highest form of recognition in governmental accounting and financial reporting, and its attainment represents a significant accomplishment by a government and its management.

An award for the Certificate of Achievement has been shipped to:

Connie Flanagan
Fiscal and Investment Operations Manager

We hope that you will arrange for a formal presentation of the Certificate and Award of Financial Reporting Achievement, and that appropriate publicity will be given to this notable achievement. A sample news release is enclosed to assist with this effort. In addition, details of recent recipients of the Certificate of Achievement and other information about Certificate Program results are available in the "Awards Program" area of our website, www.gfoa.org.

We hope that your example will encourage other government officials in their efforts to achieve and maintain an appropriate standard of excellence in financial reporting.

Sincerely,
Government Finance Officers Association

Stephen J. Gauthier

Stephen J. Gauthier, Director

Technical Services Center

SJG/ds

Government Finance Officers Association
203 N. LaSalle Street - Suite 2700
Chicago, IL 60601

Phone (312) 977-9700 Fax (312) 977-4806

03/13/2015

NEWS RELEASE

For Information contact:
Stephen Gauthier (312) 977-9700

(Chicago)--The Certificate of Achievement for Excellence in Financial Reporting has been awarded to **North Dakota Retirement and Investment Office** by the Government Finance Officers Association of the United States and Canada (GFOA) for its comprehensive annual financial report (CAFR). The Certificate of Achievement is the highest form of recognition in the area of governmental accounting and financial reporting, and its attainment represents a significant accomplishment by a government and its management.

An Award of Financial Reporting Achievement has been awarded to the individual(s), department or agency designated by the government as primarily responsible for preparing the award-winning CAFR. This has been presented to:

Connie Flanagan, Fiscal and Investment Operations Manager

The CAFR has been judged by an impartial panel to meet the high standards of the program including demonstrating a constructive "spirit of full disclosure" to clearly communicate its financial story and motivate potential users and user groups to read the CAFR.

The GFOA is a nonprofit professional association serving approximately 17,500 government finance professionals with offices in Chicago, IL, and Washington, D.C.

Government Finance Officers Association

Certificate of Achievement for Excellence in Financial Reporting

Presented to

North Dakota Retirement and Investment Office

For its Comprehensive Annual Financial Report for the Fiscal Year Ended

June 30, 2014

Jeffrey R. Emer

Executive Director/CEO

AGENDA ITEM V. C.

BOARD ACTION REQUESTED

TO: State Investment Board

FROM: Dave Hunter

DATE: March 23, 2015

SUBJECT: Callan Manager Search Process – Recommendation Cover Memo

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Background:

RIO was recently made aware of a proposed amendment to House Bill No. 1033 which seeks to revise NDCC Section 21-10-12 pertaining to the Legacy Fund. The amended bill proposes to insert the following wording (in green).

21-10-12. Legacy fund – Investment. (Newly Proposed)

Notwithstanding section 21-10-07, the state investment board shall place at least 10% of the legacy fund with one or more financial institutions chartered in and located in this state and which are experienced in and hold considerable knowledge of the field of investments.

The proposed language would replace the current language (in blue) which follows.

21-10-12. Legacy fund – Earnings defined. (Existing)

For the purpose of section 26 of article X of the Constitution of North Dakota, the term "earnings" means net income in accordance with generally accepted accounting principles, excluding any unrealized gains or losses.

The SIB Chairman, State Treasurer and Executive Director/CIO provided testimony to the Senate Appropriations Committee on March 17th citing a concern with two provisions.

First, we expressed a concern about the "Notwithstanding section 21-10-07" phrase which states that "The SIB shall apply the prudent investor rule in investing funds under its supervision. The 'prudent investor rule' means that in making investments the fiduciaries shall exercise the judgment and care, under the circumstances then prevailing, than an institutional investor of ordinary prudence, discretion, and intelligence exercises in the management of large investments entrusted to it …". The prudent investor rule is a core governing principle which should not be disregarded lightly.

Second, we expressed a concern about the SIB being required to "place at least 10% of the legacy fund with one or more" predetermined financial institutions. The requirement to invest a minimum % without regard to the prudent investor rule creates an internal legal conflict.

Recommendation:

Given the legal conflict raised by being required to invest at least 10% of the legacy fund assets without regard to the prudent investor rule, **RIO recommends the SIB direct RIO staff and our Callan consultant to meet with representatives promoting the proposed bill so as to increase their awareness and understanding of our existing investment manager search process**. This process would seek to explain and highlight our existing investment manager selection criteria which does not contain any specific prohibitions against investing with North Dakota based or chartered financial institutions.

Callan Manager Search Process:

In an effort to enhance overall SIB understanding of the Callan Manager Search Selection Criteria and Process, RIO has invited Callan to provide a presentation on this topical matter. Callan's Manager Search Process was last reviewed with the SIB in April of 2014 in advance of an Emerging Markets Equity search for the Pension Trust.

Callan

March 27, 2015

North Dakota State Investment Board

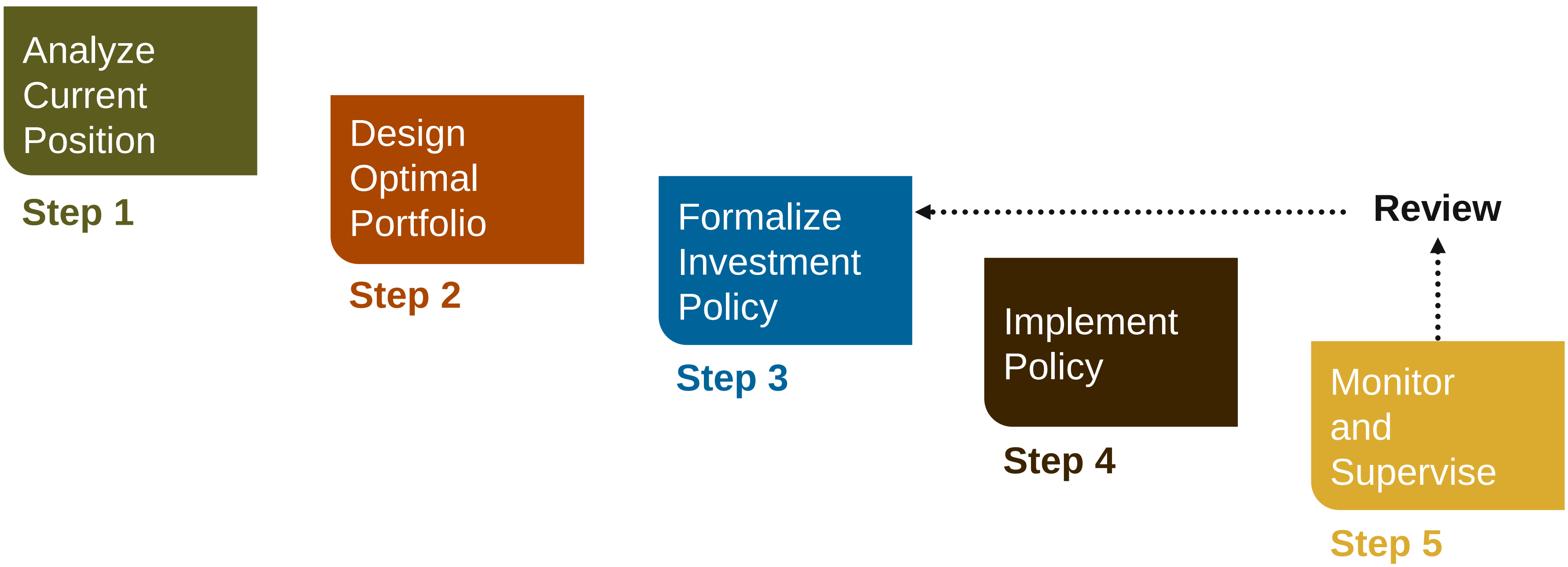
Manager Search Process

Paul Erlendson
Senior Vice President

Framing the Discussion

A Recommended Fiduciary Process for All Types of Funds

There is an increased focus on the fiduciary oversight of institutional investment programs.



Manager Search Process Overview

As conducted by Callan Associates

- The Process:
  - Every search should start from scratch
  - Supported by extensive due diligence and accumulated knowledge of specialist and generalist consultants
  - Selection Process: Discipline and Consistency
  - Customization of criteria based on investment needs and objectives
  - Peer review ensures quality control and mitigation of any individual biases
- The Outcome:
  - The identification of the managers and products that are the best fit for the investment program and the specific mandate.
- Client Cooperation:
  - All parts of this process are transparent and client involvement is encouraged. Any part of this process can be used to supplement a client's existing search process.

Manager Search Process

- Client and Manager Profiles
- Quantitative Screening
- Qualitative Screening
- Manager Search Committee
- Semi-Finalist Review
- Finalists

Plan Implementation

Quantitative Screening from Available Database

- Many consultants maintain their own proprietary database.
  - Only available through a consultant/client relationship.
- Shared Databases are available.
  - eVestment Alliance, PSN, Mobius, Morningstar (especially of DC related Searches)
- Callan's database combines both proprietary and third-party data sources

Callan's "Universe" of Managers

Database Groups	Organizations	Products
Domestic Equity	725	2994
Domestic Fixed-Income	294	1489
Domestic Balanced	84	486
International Equity	303	980
Global Equity	259	563
Emerging Market Equity	184	447
International Fixed-Income	42	82
Global Fixed Income	80	243
Emerging Market Debt	73	179
International /Global Balanced	43	76
Currency	18	34
Real Estate	65	193
Hedge Funds	121	269
Derivatives / Alternative Investments	20	22
Total	**1515**	**7854**

As of December 31, 2014

Manager Search

Why Use a Consultant in a Manager Search Project?

- Independent and objective third party.
- Adherence to a consistent search process that maintains clear, written guidelines to govern the search, which helps plan sponsor reduce fiduciary liability.
- Consistency will allow for a fair, repeatable process that will serve the organization as a whole, no matter the individuals involved at certain time periods.
- A resource that is committed to conducting manager due diligence.
  - Computer database availability.
  - Continuity over time.
  - Help ensure ERISA-based safe harbor protections (not required by public funds).

Factors in the Search Process

- Every search should be based on the needs of the investor / ultimate beneficiaries.
- Client defined search specifics will narrow candidate universe (plan type, size, continuing managers, risk preferences, ‘emerging manager’, or other relevant factors).
- Searches are conducted through a series of steps:
  - Client-Driven Considerations
  - Screening Criteria
  - Quantitative review
  - Qualitative Assessment
  - Search Review by Senior Policy Committee
  - Document semi-finalist candidates for Client
  - Identify Finalists
  - Interview Finalists
  - Select Firm

How do Consultants Collect the Data?

General Information ● Organizational statistics ● Product specific information	● Annual questionnaire
Performance Database ● Quarterly rates of return ● 1,049 organizations; 4,082 different funds; all mutual funds	● Updated quarterly from money managers
Money Manager Visit Reports – On-site ● Qualitative impressions of money manager’s philosophy, style, investment process ● Verification of Information	● Visits to money manager’s offices by Global Manager Research staff and consultants ● Average of 500 visits per year
Money Manager Visit Reports – In-House ● Qualitative impressions of money manager’s philosophy, style, investment process ● Verification of Information	● Visits by money managers to Callan’s four offices ● Average of 1,000 visits per year
Mutual Client Relationships ● Qualitative impressions of money manager’s philosophy, style, investment process ● Verification of Information	● Active evaluation of Callan’s performance evaluation work with clients

Common Considerations in a Search

Search considerations are client-specific and depend on a variety of items:

- Purpose (i.e., search rationale)
- Active vs. Passive
- Choice of Benchmark
- Acceptance of Style Drift
- Size Spectrum
- Risk Tolerance
  - Benchmark Aware/Unaware
  - Concentration
  - Active Share
- Specialty Management
  - Small Cap
  - Emerging Markets
  - Currency
  - Distressed Debt
  - Thematic
  - ESG
  - “Emerging” Managers

Key Requirement: Appropriate Selection Criteria

- Manager Type
- Investment Style
- Investment Vehicle
- Managed Assets
- Size of Professional Staff
- Years of Experience
- Geographic Location
- Involvement With Other Businesses
- Flexibility of Individual Portfolio Managers
- Security Analysis Orientation
- Risk Levels
- Capitalization Levels
- In-House Research Emphasis
- Use of Cash Equivalents
- Use of ADRs, 144As, and futures and/or options
- Historical Performance Criteria
- Experience and Education of Professionals
- Financial Well Being of Firm
- Client-Servicing Capabilities
- Fees
- Organizational Ownership
- Informational Technology

Investment Manager Evaluation

A Combination of Qualitative and Quantitative Analysis

- Quantitative research:
  - Consistency of investment performance
  - Analyzing the portfolios
    - *Return-based style analysis*
    - *Traditional holdings based analysis*
    - *MSCI's "Z-score" methodology*
  - Portfolio characteristics (e.g. duration, quality, liquidity) relative to client's objective and risk tolerance
- Qualitative research: Kicking the tires
  - Requires ongoing interaction with managers to understand their philosophy, process and people
  - It is instructive to know how managers view themselves
  - Observe how the "key" people interact with one another
  - Confirm that the "marketing" pitch and confirms to "reality"

Quantitative Portfolio Characteristics

Frequently Used Quantitative Factors

Stocks

- Z-Scores
- P/E Ratio
- Price-to-Book Value Ratio
- Earnings Per Share Growth Rate (Short and Long)
- Dividend Yield
- Market Capitalization
- Internal Growth Rate
- Regional/Country Allocation
- Sector/Industry Allocation
- Diversification Ratio

Bonds

- Type
- Credit Quality
- Duration
- Maturity
- Yield to Worst
- Convexity

Qualitative Considerations

Frequently Used Qualitative Factors

PEOPLE!!!

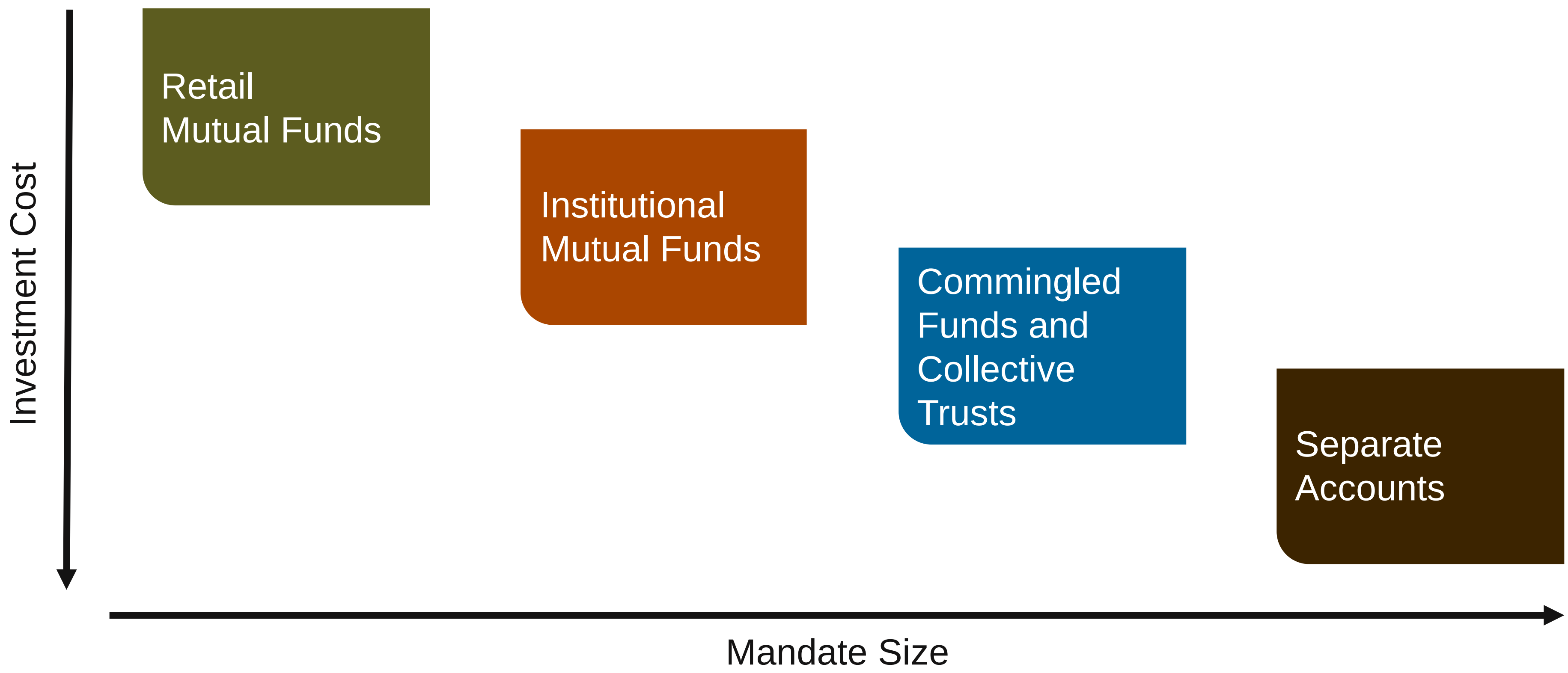
1. Who are the “idea generators?”
2. Intelligence, creativity, and innovation
3. Tenure working together
4. Depth of resources – “star” system or team effort
5. Succession planning
6. Communication infrastructure
7. Integrity
8. Stability
9. Organizational culture
10. Compensation, incentive, and retention – “skin in the game”

Other Important Qualitative Factors

- Investment Philosophy:
  - Clearly articulated?
  - Based on sound theory and empirical evidence?
  - Consistency – buy-in
- Investment Strategies:
  - Top down? Bottom up?
  - Sector based? Thematic?
- Research Orientation:
  - Quantitative? Qualitative?
  - Fundamental price/value framework?
- Decision-Making Process:
  - Central Research? Committee/PM Team-driven? Star PM? "Blackbox?"
- Cultural and Environmental Values
- Risk Controls:
  - What tools or strategies does the manager use to control risk?

Fees: A Function of the Investment Vehicle

Vehicle Decisions Can Have Important Cost Impacts to the Investor



After a Manager Selection Decision

- Negotiate an Investment Management Agreement, including guidelines, and fees.
- Development of written plan that assigns accountabilities during the transition.
  - *Date by which transition will be complete.*
  - *Identity of transition broker (if any).*
  - *Create documentation of process for files.*
- The amount of discretion given to the manager is the client's responsibility (with a possible assist from a consultant).
- Execute a contract and make sure manager receives a copy of the investment policy statement including a clear understanding of benchmarks and peer expectations.
- Establish reporting and client service protocol.

"Why was the manager hired?" is the best question to answer when monitoring a portfolio

Making the Case for Emerging Managers

- "Does Size Matter: Assets Under Management a Questionable Criterion": White paper authored by Callan's Greg Allen and published in The Journal of Portfolio Management, Spring 2007.
  - Defines large vs. small manager
  - Used clearly defined benchmarks
  - Adjusts for back-fill, or instant history, bias

Other studies include:

- Beckers, Stan and Vaughan, Greg. "Small Is Beautiful – An attempt to quantify the comparative disadvantage of large asset managers." The Journal of Portfolio Management, Summer 2001.
- Krum, Ted. "Insight On: Potential Benefits of Investing with Emerging Managers: Can Elephants Dance?" Northern Trust Global Advisors, 1995.
- Williams, Tina Byles and Yang, Xiaofan. "Study on The Performance Drivers for Emerging Managers, Three Years Ending December 31, 2006." Emerging Manager Monthly. Vol. II, Issue 9. Financial Investment News, July 30, 2007. 1-12.

Statistically Significant Outperformance

Annualized Mean Excess Return by Asset Class and Size Quartile—Truncated Universe

	Annualized Mean Excess Return						
Asset Class	Smallest Quartile	Second Quartile	Third Quartile	Largest Quartile	Difference in Means	T-Stat.	Confidence Level
US Large Cap Core	0.72%	0.68%	0.55%	0.43%	0.29%	1.48	93.05%
US Large Cap Growth	2.53%	2.26%	1.89%	1.78%	0.75%	1.87	96.92%
US Large Cap Value	0.40%	-0.10%	0.20%	0.00%	0.41%	1.66	95.15%
US Mid Cap Core	-0.40%	0.25%	1.03%	-0.47%	0.06%	0.09	53.59%
US Mid Cap Growth	2.29%	2.19%	1.66%	1.18%	1.11%	1.55	93.94%
US Mid Cap Value	0.07%	0.33%	0.28%	-0.47%	0.54%	1.11	86.65%
US Small Cap Core	4.45%	3.65%	3.32%	3.00%	1.45%	2.01	97.78%
US Small Cap Growth	8.47%	6.06%	4.16%	4.36%	4.10%	5.65	100.00%
US Small Cap Value	2.25%	1.68%	1.01%	0.95%	1.31%	2.49	99.36%
Core Fixed Income	0.02%	0.08%	0.15%	0.19%	-0.17%	-4.29	100.00%
Core Plus Fixed Income	0.83%	0.71%	0.67%	0.73%	0.10%	0.44	67.00%
High Yield Fixed Income	1.41%	0.99%	0.37%	0.50%	0.92%	2.59	99.52%
Developed Non US Equities	2.93%	2.62%	2.42%	2.63%	0.30%	0.92	82.12%
Emerging Non US Equities	2.14%	2.43%	2.81%	2.58%	-0.44%	-0.56	28.78%

Source: “Does Size Matter?” The Journal of Portfolio Management, Spring 2007

Conclusions from the JPM Study[1]

1) Studies that use self-reported manager databases are inherently subject to an upward bias.

2) In capacity-constrained asset classes, all things held equal, there is a statistically significant negative relation between assets under management and performance.

3) The results of core fixed-income, and to a lesser extent emerging markets equities, suggest that there are asset classes and strategies where advantages that come with additional resources can outweigh the negative impact of portfolio size.

1 "Does Size Matter?" The Journal of Portfolio Management, Spring 2007

Defining Emerging Managers

- There is no standard definition for what defines an "emerging manager" – investors, consulting firms and even regulatory agencies all define the term differently.

- The most common definition relates to an investment manager with assets under management below a certain threshold (i.e. managers with < $3bn in AUM, or the smallest X% of institutional managers).

- Less commonly, emerging managers are defined as those with a track record of less than 2 years. This is most prevalent in alternative asset categories such as private equity and real estate.

- Some include Minority, Women and Disabled-Owned (MWDO) firms in the emerging manager category.

- Callan defines emerging managers as those with between $10 million and $3 billion in AUM.
  - Those classified as majority MWDO are emerging with assets less than $10 billion.

Use of Emerging Managers: Why, or Why not?

Factors to consider when using firms that are newer to the large institutional world

- Pros
  - Strong incentives (both monetarily and professionally) to perform well.
  - Ability to take concentrated positions.
  - Ability to be more nimble and take positions that differ significantly from the benchmark (able to allocate more assets to alpha ideas rather than beta idea).
  - Able to better capitalize on smaller opportunities than larger managers.
  - Large body of research that suggests emerging managers outperform most notably in illiquid or capacity-constrained asset classes.
- Cons
  - Higher failure rate than larger firms.
  - More exposure to business and operational risks.
  - Difficult to perform extensive due diligence.
  - Difficult for large institutional investors to make a meaningful allocation without becoming a large percentage of the firm's assets.
  - Is performance differential real or the product of backfill and survivorship bias?

Evaluating Emerging Managers

- Investment Philosophy, Process, Track Record
  - Evolution of the product
  - Key decision makers and functional responsibilities
  - Differentiating features of the philosophy and approach
  - Historical track record

Callan's History and Commitment to Emerging Managers

- Callan's founder, Edwin Callan, identified the need to research and evaluate emerging firms for Callan's clients.
- Based on our research, Mr. Callan co-founded Progress Investment Management in 1990, a minority-owned firm specializing in multi-manager solutions of emerging and MWDO (minority, women and disabled owned) managers for institutional investors. Callan is committed to the research and due diligence necessary to identify and bring value-added EM managers to our clients.
- Callan established an internal EM/MWDO Committee comprised of senior consultants at Callan and is chaired by our CEO. This Committee:
  - Plans, coordinates, and focuses our EM/MWDO search and outreach activities
  - Strategizes on how best to communicate our efforts internally and externally to provide maximum transparency on our initiatives
  - Functions to ensure that we hear and act on valuable feedback on the program from clients and our Associates

Callan's History and Commitment to Emerging Managers

- Callan is active with organizations that support and provide educational venues for emerging managers. Organizations include:
  - National Association for Securities Professionals
  - New America Alliance
  - Opal Financial Group
  - RG & Associates
  - The Robert Toigo Foundation
  - Real Estate Executive Council
  - Association of Asian American Investment Managers
- Annually, Callan hosts a best practices workshop on working with institutional investors for emerging managers.
- Callan launched "Callan Connects" in 2010 to expand our universe of emerging managers and MWDO firms.
  - Callan holds quarterly meetings in major U.S cities to minimize travel for managers.
  - Since inception, 204 firms (132 emerging and 72 MWDO) have participated in Callan Connects through November 2014.

Callan

Manager Search Process

April 15-16, 2014

Rationale for a Manager Search

- New Allocation to an Asset Class
- Expansion of an Existing Asset Allocation Structure
- Replacement of an Existing Manager
  - Performance Issues
  - Organizational Issues
  - Deviation from Investment Strategy or Style

Manager Search

Why Do Most Plan Sponsors Use a Consultant in Their Manager Search Projects?

- Independent and objective third party.
- Adherence to a consistent search process that maintains clear, written guidelines to govern the search, which helps plan sponsor reduce fiduciary liability.
- Consistency will allow for a fair, repeatable process that will serve the organization as a whole, no matter the individuals involved at certain time periods.
- A resource that is committed to conducting manager due diligence.
  - Computer database availability.
  - Continuity over time.
  - Help ensure ERISA safe harbor protection.

Factors in the Search Process

- Every search should be unique.
- Client defined search specifics will narrow candidate universe (plan type, size, continuing managers, risk preferences, etc.).
- Searches are conducted through a series of steps:
  - Client-Driven Considerations
  - Screening Criteria
  - Quantitative review
  - Qualitative Assessment
  - Search Review by Senior Policy Committee
  - Document semi-finalist candidates for Client
  - Identify Finalists
  - Interview Finalists
  - Select Firm

Other Consultants Approach

Factors Considered

- Consultant A: Specific rankings for each product and organization
  - Idea generation
  - Portfolio construction
  - Implementation
  - Business management
    - Recently added ESG as part of the ranking process
- Consultant B: “Preferred lists” refreshed every 12 – 18 months
  - Scoring based on multiple quantitative criteria and a qualitative opinion
  - Quantitative:
    - *Net of fee alpha returns*
    - *Rolling periods*
    - *Information ratios and upside/downside capture*
    - *Contrarian Indicator*
  - Qualitative opinion
    - *Have you done it?*
    - *Why can you keep doing it?*
    - *Who is going to do it?*

How do Consultants Collect the Data?

General Information
- Organizational statistics
- Product specific information
- Annual questionnaire

Performance Database
- Quarterly rates of return
- 1,049 organizations; 4,082 different funds; all mutual funds
- Updated quarterly from money managers

Money Manager Visit Reports – On-site
- Qualitative impressions of money manager's philosophy, style, investment process
- Verification of Information
- Visits to money manager's offices by Global Manager Research staff and consultants
- Average of 500 visits per year

Money Manager Visit Reports – In-House
- Qualitative impressions of money manager's philosophy, style, investment process
- Verification of Information
- Visits by money managers to Callan's four offices
- Average of 1,000 visits per year

Mutual Client Relationships
- Qualitative impressions of money manager's philosophy, style, investment process
- Verification of Information
- Active evaluation of Callan's performance evaluation work with clients

Step No. 1: Client-Driven Considerations in a Search

Search considerations are client-specific and depend on a variety of items:

- Purpose (i.e., search rationale)
- Active vs. Passive
- Choice of Benchmark
- Acceptance of Style Drift
- Size Spectrum
- Risk Tolerance
  - Benchmark Aware/Unaware
  - Concentration
- Specialty Management
  - Small Cap
  - Currency
  - Distressed Debt

Step No. 2: Develop Appropriate Screening Criteria

- Manager Type
- Investment Style
- Investment Vehicle
- Managed Assets
- Size of Professional Staff
- Years of Experience
- Geographic Location
- Involvement With Other Businesses
- Flexibility of Individual Portfolio Managers
- Security Analysis Orientation
- Risk Levels
- Capitalization Levels
- In-House Research Emphasis
- Use of Cash Equivalents
- Use of ADRs, 144As, and futures and/or options
- Historical Performance Criteria
- Experience and Education of Professionals
- Financial Well Being of Firm
- Client-Servicing Capabilities
- Fees
- Organizational Ownership
- Informational Technology

Investment Manager Evaluation

A Combination of Qualitative and Quantitative Analysis

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  - Observe how the "key" people interact with one another.
  - Confirm that the "marketing" pitch and confirms to "reality."

Objectives of Quantitative and Qualitative Screens

- Compare/contrast candidate information.
- Weigh quantitative and qualitative factors to find the appropriate balance.
- Take into account recent developments.
- Identify approximately 12 surviving candidates.

Step No. 3:

Conduct Quantitative Screening from Available Database

- Many consultants maintain their own proprietary database.
  - Only available through a consultant/client relationship.
- Shared Databases are available.
  - eVestment Alliance, PSN, Mobius, Morningstar (especially of DC related Searches)

Callan's "Universe" of Managers

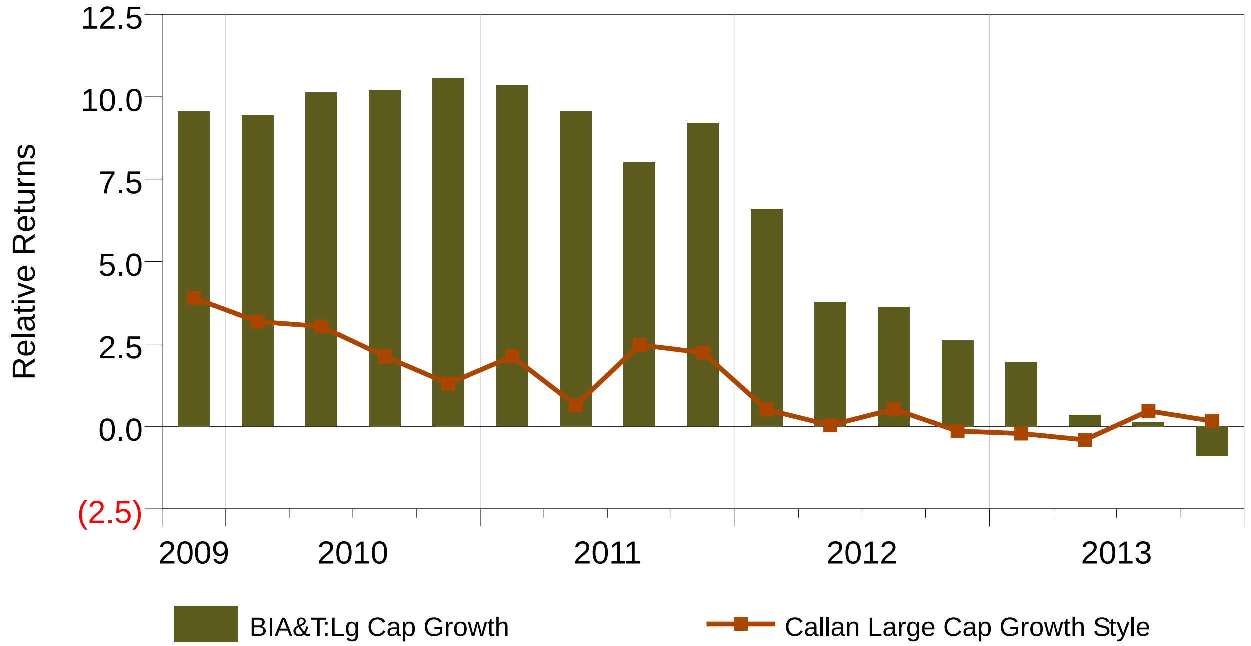
Database Groups	Organizations	Products
Domestic Equity	706	2,896
Domestic Fixed-Income	294	1,467
Domestic Balanced	80	422
International Equity	287	903
Global Equity	237	509
Emerging Market Equity	172	407
International Fixed-Income	38	70
Global Fixed Income	71	209
Emerging Market Debt	67	166
International /Global Balanced	33	64
Currency	22	45
Real Estate	62	194
Hedge Funds	122	270
Derivatives / Alternative Investments	24	26
Total	**1485**	**7648**

As of December 31, 2013

Historical Performance Assessment

- GIPS compliant composite return data
- Benchmark and Style-Group Comparisons
- Annual, cumulative, rolling three-year (**consistency**) return data
- Rising and falling market-cycle returns—**expectations**
- Risk-adjusted returns (e.g., Sharpe Ratios)
- Other risk measures (e.g., Information ratio, downside risk, alpha, standard deviation)

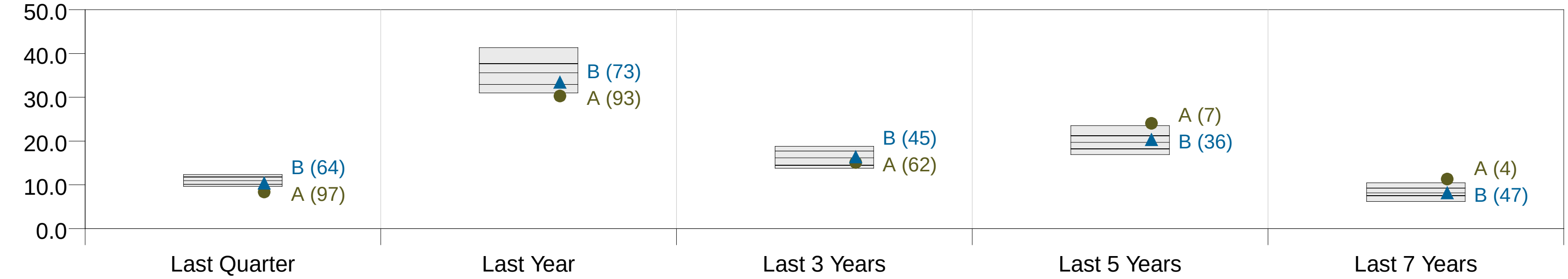
Rolling Three Year Relative Returns vs S&P 500 Index



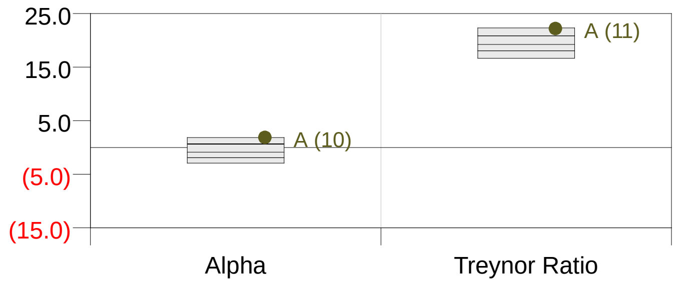
Historical Performance Assessment

What Consultants and Clients Utilize

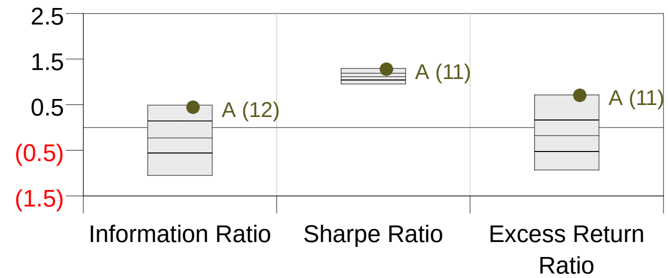
Performance vs. Callan Large Cap Growth Style (Bottom Charts: Five-Year Period)



	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 7 Years
10th Percentile	12.38	41.37	18.81	23.52	10.49
25th Percentile	11.81	37.70	17.76	21.26	9.30
Median	10.98	35.60	16.18	19.72	8.18
75th Percentile	10.15	32.93	14.53	18.24	7.53
90th Percentile	9.68	31.02	13.83	16.93	6.20
Manager A ● A	8.38	30.30	15.14	24.10	11.34
Russell:1000 Growth ▲ B	10.44	33.48	16.45	20.39	8.24



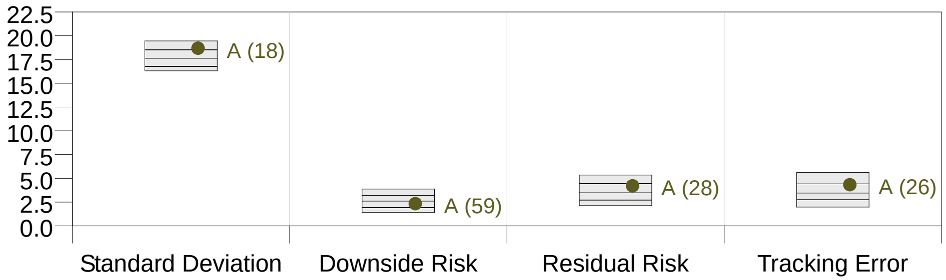
	Alpha	Treynor Ratio
10th Percentile	1.88	22.33
25th Percentile	0.67	20.88
Median	(0.85)	19.25
75th Percentile	(1.91)	18.07
90th Percentile	(2.90)	16.68
Manager A ● A	1.89	22.21



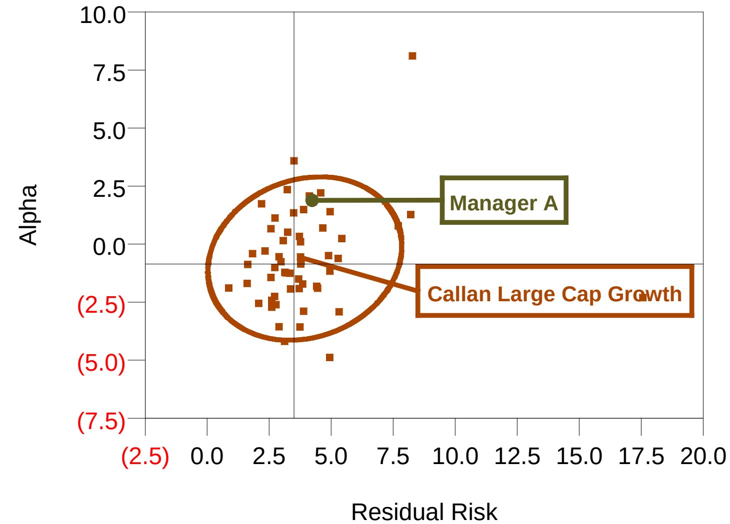
	Information Ratio	Sharpe Ratio	Excess Return Ratio
10th Percentile	0.49	1.30	0.72
25th Percentile	0.15	1.19	0.17
Median	(0.23)	1.11	(0.18)
75th Percentile	(0.56)	1.05	(0.52)
90th Percentile	(1.05)	0.96	(0.93)
Manager A ● A	0.45	1.28	0.71

Historical Risk Assessment

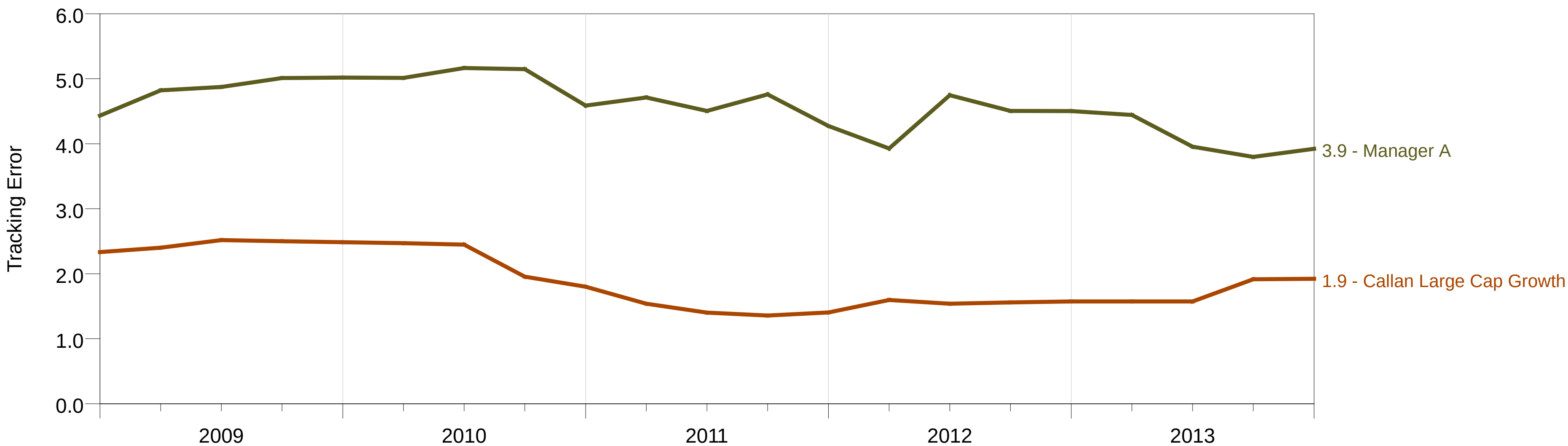
What Consultants and Clients Utilize



		Standard Deviation	Downside Risk	Residual Risk	Tracking Error
10th Percentile		19.47	3.87	5.36	5.63
25th Percentile		18.54	3.22	4.45	4.42
Median		17.64	2.60	3.50	3.47
75th Percentile		16.79	1.93	2.73	2.75
90th Percentile		16.31	1.43	2.14	1.99
Manager A	● A	18.70	2.35	4.22	4.35



Rolling 12 Quarter Tracking Error vs Russell 1000 Growth Index



Quantitative Portfolio Characteristics

Certain Quantitative Portfolio Characteristic (“PCR”) Data Can Also be Very Helpful

Stocks

- Z-Scores
- P/E Ratio
- Price-to-Book Value Ratio
- Earnings Per Share Growth Rate (Short and Long)
- Dividend Yield
- Market Capitalization
- Internal Growth Rate

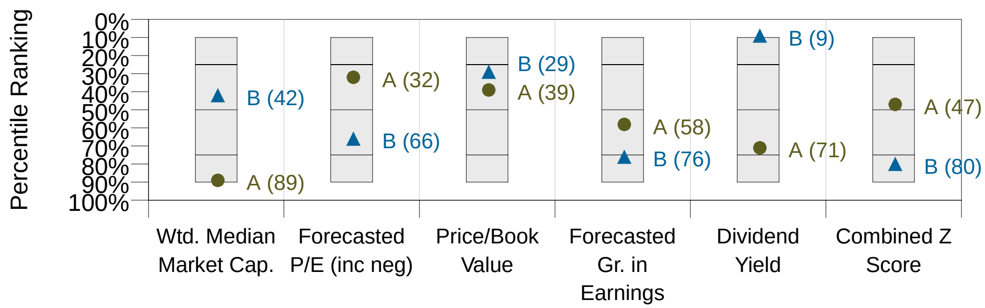
Bonds

- Type
- Credit Quality
- Duration
- Maturity
- Yield to Worst
- Convexity

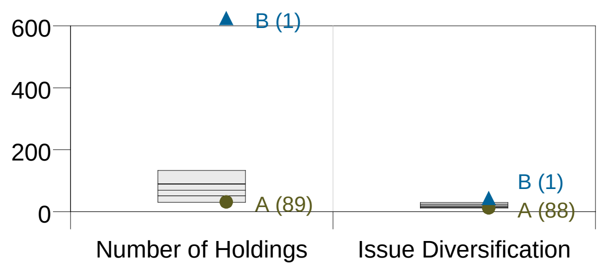
Historical Portfolio Characteristics

Do PCRs Match Investment Philosophy and Performance Pattern?

Portfolio Characteristics against Callan Large Cap Growth Style

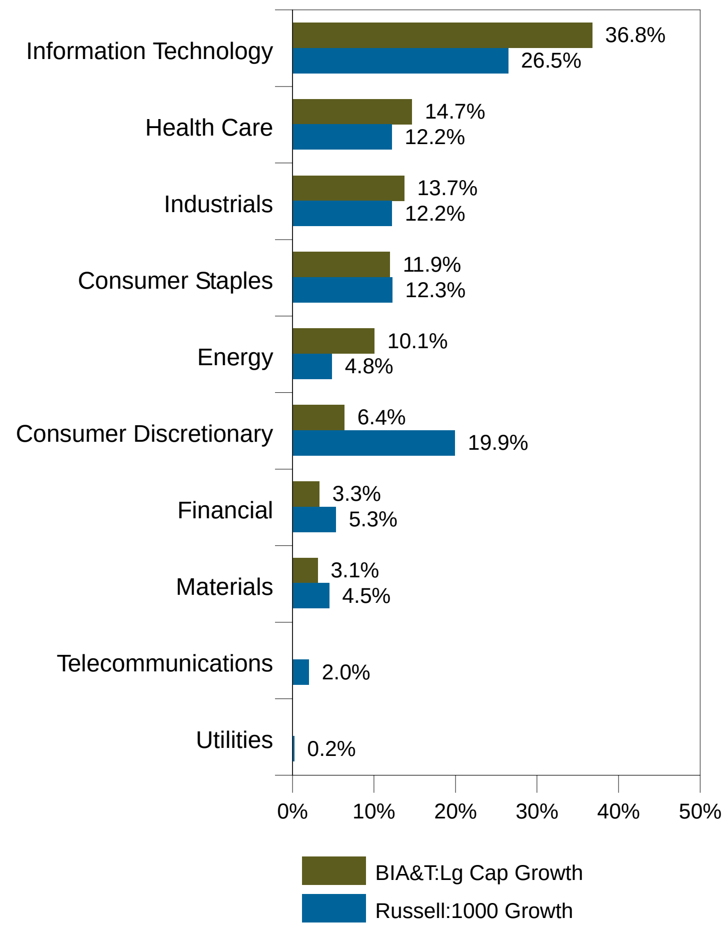


		Wtd. Median Market Cap.	Forecasted P/E (inc neg)	Price/Book Value	Forecasted Gr. in Earnings	Dividend Yield	Combined Z Score
10th Percentile		66.68	23.67	5.62	20.80	1.51	1.73
25th Percentile		62.10	21.09	4.93	18.41	1.30	1.44
Median		53.80	18.99	4.26	16.61	1.00	1.14
75th Percentile		42.38	17.67	3.90	14.93	0.72	0.77
90th Percentile		29.64	16.87	3.46	13.52	0.55	0.60
Manager A	● A	31.71	20.69	4.52	15.92	0.74	1.15
Russell:1000 Growth	▲ B	55.54	18.03	4.83	14.73	1.54	0.72



		Number of Holdings	Issue Diversification
10th Percentile		133.50	30.15
25th Percentile		90.00	24.35
Median		69.50	20.42
75th Percentile		51.50	15.95
90th Percentile		30.50	11.81
Manager A	● A	32.00	12.49
Russell:1000 Growth	▲ B	625.00	44.14

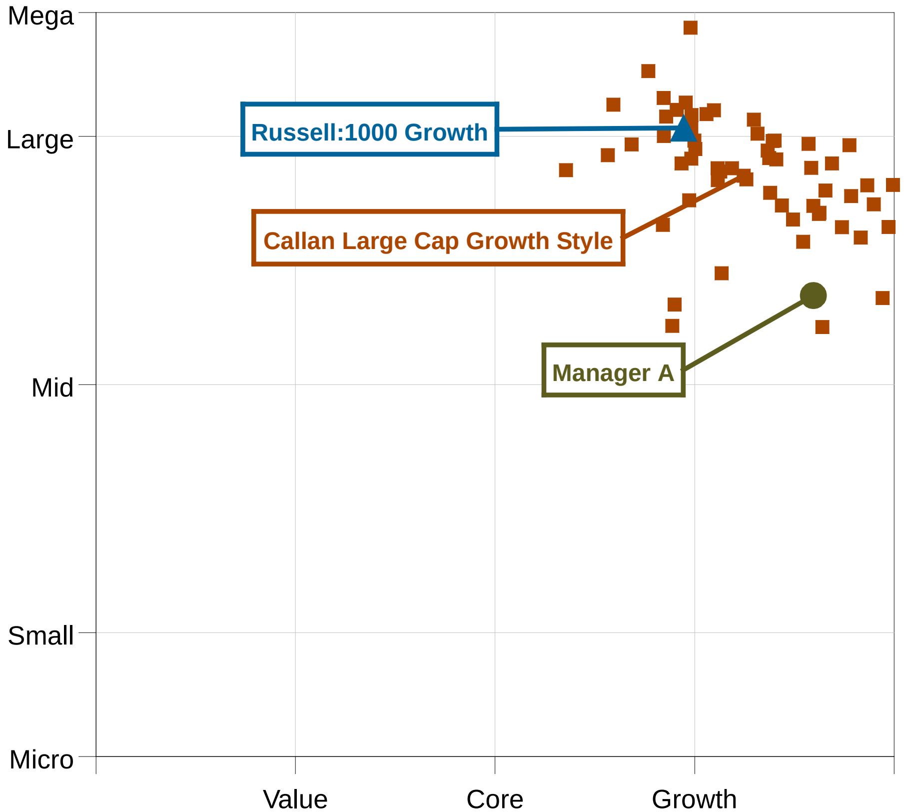
Sector Allocations



Historical Portfolio Characteristics

Do PCRs Match Investment Philosophy and Performance Pattern?

Average Style Map vs. Callan Large Cap Growth Style
Three-Year Holdings



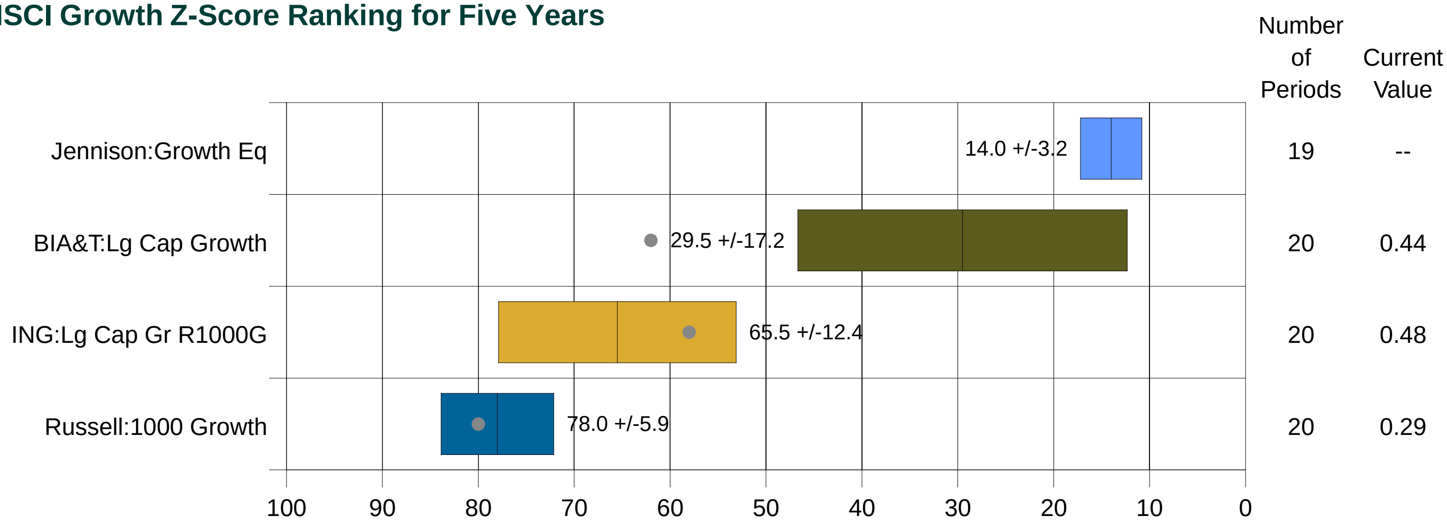
Average Style Exposure Matrix
Three-Year Holdings

	Value	Core	Growth	Total
Large	0.4% / 4.7% (17)	7.6% (2) / 29.8% (72)	60.3% (18) / 45.5% (98)	68.2% (21) / 80.0% (187)
Mid	-- / 1.2% (35)	6.2% (2) / 6.1% (130)	25.6% (9) / 11.8% (172)	31.8% (12) / 19.0% (336)
Small	-- / 0.1% (12)	-- / 0.4% (27)	-- / 0.5% (24)	-- / 1.0% (63)
Micro	-- / 0.0%	-- / 0.0% (1)	-- / 0.0% (1)	-- / 0.0% (1)
Total	0.4% / 6.0% (64)	13.8% (5) / 36.3% (229)	85.8% (27) / 57.7% (294)	100.0% (32) / 100.0% (587)

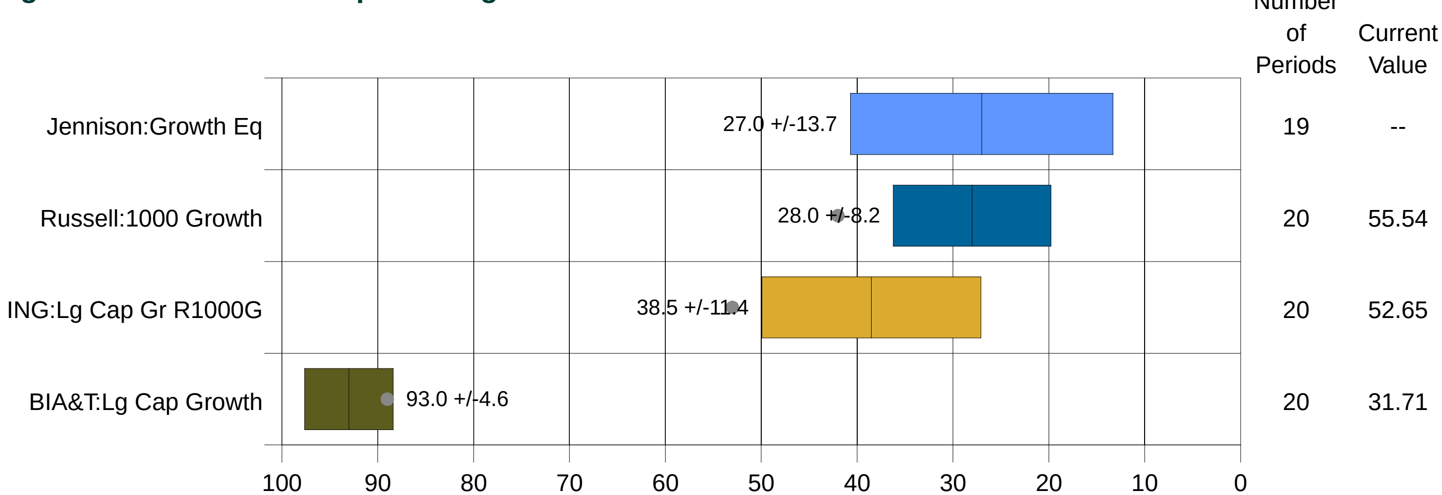
Historical Portfolio Characteristics

Do PCRs Match Investment Philosophy and Performance Pattern?

MSCI Growth Z-Score Ranking for Five Years



Weighted Median Market Cap Ranking for Five Years



Step No. 4: Conduct Qualitative Screening

What Qualitative Factor Matters the Most

PEOPLE!!!

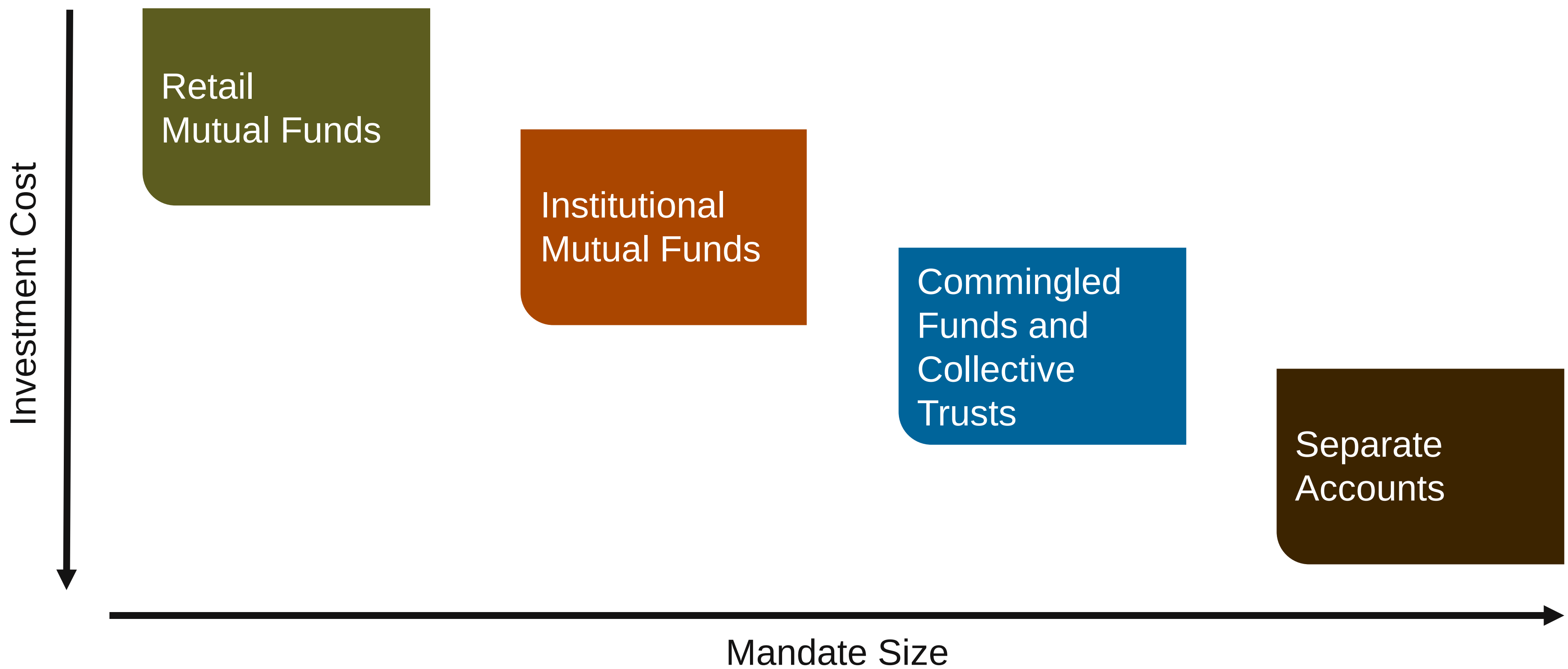
1. Who are the “idea generators?”
2. Intelligence, creativity, and innovation
3. Tenure working together
4. Depth of resources – “star” system or team effort
5. Integrity
6. Stability
7. Organizational culture

Other Important Qualitative Factors

- Investment Philosophy:
  - Clearly articulated?
  - Based on sound theory and empirical evidence?
- Investment Strategies:
  - Top down? Bottom up?
  - Sector based? Thematic?
- Research Orientation:
  - Quantitative? Qualitative?
  - Fundamental price/value framework?
- Decision-Making Process:
  - Central Research? Committee/PM Team-driven? Star PM? “Blackbox?”
- Cultural and Environmental Values
- Risk Controls:
  - What tools or strategies does the manager use to control risk?

Speaking of Fees…Vehicle Expense Comparison

Vehicle Decisions Can Have Important Cost Impacts to the Client



Step No. 5: Review by Senior Decision Makers

Objective is to identify approximately six Semi-Finalists.

Step No. 6: Prepare Search Review Book for Client

- Contains detailed information about each semi-finalist and comparative performance information.
- Book serves as tool to help identify the finalists.

Step No. 7: Identify Finalists

- Field consultant works with client to select finalist managers (typically three to four) for consideration.
- Schedule interviews.

Step No. 8: Interview Finalists

- Schedule interview in client's office or on site and conduct manager due diligence on site.
- What to look for during a finalist interview:
  - Enthusiasm and energy
  - Understanding of client's specific situation
  - Focus on client's specific interests and needs
  - Cogent description of investment process—who makes what decisions when?
  - Excellent listening skills
  - Excellent Q&A skills
  - Excellent time-management skills
  - Harmony among multiple presenters

Step No. 9: Manager Selection

- Development of written plan that assigns accountabilities during the transition.
- Discretion is the client's responsibility (with a possible assist from a consultant).
- Execute a contract and make sure manager receives a copy of the investment policy statement including a clear understanding of benchmarks and peer expectations.
- Develop transition plan:
  - Date by which transition will be complete.
  - Identity of transition broker (if any).
  - Create documentation of process for files.
- Establish reporting and client service protocol.

Why was a manager hired is the best question to keep in mind when monitoring a portfolio?

Cost Considerations for Manager Termination and Transitions

What explicit (and hidden) costs are associated with manager terminations and transitions?

- Portfolio transfers can be costly.
- Accountabilities need to be placed with specific parties.
- Primary direct costs, primary indirect costs, and primary timing risks.
- Benefits of a well-developed transition (portfolio restructuring) plan.

Appendix

Manager Search Process Overview

- The Process:
  - Every search starts from scratch, no “Approved” or “Buy” lists
  - Backed by extensive due diligence and accumulated knowledge of specialist and generalist consultants
  - Disciplined and Consistent
  - Client driven, customized
  - Utilizes peer review—Manager Search Committee to ensure quality control
- The Outcome:
  - The identification of the managers and products that are the best fit for the investment program and the specific mandate.
- Client Cooperation:
  - All parts of this process are transparent and client involvement is encouraged. Any part of this process can be used to supplement a client’s existing search process.

Manager Search Process

- ▼ Client and Manager Profiles
- ▼ Quantitative Screening
- ▼ Qualitative Screening
- ▼ Manager Search Committee
- ▼ Semi-Finalist Review
- **Finalists**

Vehicle Comparison

Mutual Funds

- Benefits
  - SEC registered funds
  - Tickers and public disclosures
  - Performance and price quotes readily available from third parties
  - Branded funds
- Challenges
  - Higher, more rigid fee structures
  - Not customizable
  - May be subject to manager trading restrictions
  - No ERISA exclusivity—open to the public

Collective Trusts

- Benefits
  - Potentially lower and more flexible fee structure
  - Increases investment opportunities
  - ERISA exclusivity
- Challenges
  - Not a registered product; no prospectus
  - Third party opinions may not be readily available
  - May not be as well supported by record keeper
  - May or may not be a branded product

Vehicle Comparison

Separate Accounts

- Benefits
  - Lower fee structure
  - Customizable
  - Multi-manager approach may be used
  - Provides the ability to leverage DB investment strategies
  - ERISA exclusivity
- Challenges
  - Complexity of operating the funds
  - Investment manager oversight
  - Communication

	Org. Name	Total Org Assets for 12/31/13	Total Org Assets for 12/31/12	Total Product Assets for 12/31/13	Total Product Assets for 12/31/12	Avg. of Number of Holdings for 12 Quarters Ended 12/31/13	Avg. of Wtd. Average Market Cap. for 12 Quarters Ended 12/31/13	Avg. of Wtd. Median Market Cap. for 12 Quarters Ended 12/31/13	Avg. of Emerging Markets for 12 Quarters Ended 12/31/13	Avg. of 12 Qtr Tracking Error vs. MSCI:Emer Markets for 28 Quarters Ended 12/31/13	Avg. of 12 Qtr Standard Deviation for 28 Quarters Ended 12/31/13	Relative CAI Matrix Score vs. CAI:Emer Mkt Broad Style for 12/31/13	Relative CAI Matrix Score vs. MSCI:Emer Markets for 12/31/13	Up Market Capture vs. MSCI:Emer Markets for 28 Quarters Ended 12/31/13	Up Market Capture vs. MSCI:Emer Markets for 20 Quarters Ended 12/31/13	Up Market Capture vs. MSCI:Emer Markets for 12 Quarters Ended 12/31/13	Down Market Capture vs. MSCI:Emer Markets for 28 Quarters Ended 12/31/13	Down Market Capture vs. MSCI:Emer Markets for 20 Quarters Ended 12/31/13	Down Market Capture vs. MSCI:Emer Markets for 12 Quarters Ended 12/31/13	Relative Returns vs. MSCI:Emer Markets for 4 Quarters Ended 12/31/13	Avg. of 12 Qtr Relative Returns vs. MSCI:Emer Markets for 28 Quarters Ended 12/31/13	Avg. of 12 Qtr Information Ratio vs. MSCI:Emer Markets for 28 Quarters Ended 12/31/13	Avg. of 12 Qtr Alpha vs. MSCI:Emer Markets for 28 Quarters Ended 12/31/13	Returns for 4 Quarters Ended 12/31/13	Returns for 16 Quarters Ended 12/31/13	Returns for 20 Quarters Ended 12/31/13	Effective Annual Fee for a 50,000,000 Mandate for 12/31/13	Effective Annual Fee for a 100,000,000 Mandate for 12/31/13	Effective Annual Fee for a 250,000,000 Mandate for 12/31/13
	Dimensional Fund Adviso	337,781	261,794	3,995	3,463	2,851	1.3	1.0	99	7.67	29.15	100	100	121	124	90	98	88	90	1.74	3.02	0.44	2.84	(0.57)	6.29	20.75	0.82	0.82	0.82
	J.P. Morgan Asset Manag	1,598,074	1,426,401	21,025	19,730	63	40.1	24.3	91	3.60	24.39	85	85	90	89	87	94	91	87	(1.73)	1.20	0.45	1.33	(3.95)	4.02	14.69	1.30	1.30	1.30
	Callan Database Compos	100,090	71,776	3,627	3,681	97	34.4	14.5	93	3.49	26.15	50	53	97	97	97	98	95	94	2.57	(0.05)	0.06	0.13	0.25	3.59	15.33	0.95	0.95	0.85
	MSCI Inc.					819	34.5	16.0	100	-	25.86	50	100	100	100	100	100	100	100	-	-	-	-	(2.27)	3.12	15.15			
1	AQR Capital Managemen	98,770	79,711	5,068	2,225	231	34.7	13.0	100	2.40	26.08	100	100		127	125		98	96	4.92	3.24	1.73	3.10	2.54	6.55	19.69	0.85	0.85	0.81
2	Axiom International Investors LLC		8,612	2,079	1,443	74	38.2	15.6	90	2.93	28.23	100	100		125	120		92	92	6.72	4.27	1.58	4.28	4.30	7.74	20.36	0.95	0.93	0.85
3	Columbia Management Ir	321,500	297,826	2,919	1,969	103	28.9	14.9	88	2.91	25.23	86	86		105	103		89	87	2.26	1.47	0.56	1.59	(0.05)	5.66	17.80	0.80	0.73	0.65
4	Franklin Templeton Inves	879,139	781,769	8,327	9,444	63	38.0	26.4	78	3.66	26.56	100	95	109	111	97	101	101	96	(0.30)	0.50	0.23	0.74	(2.56)	3.91	16.82	0.95	0.95	0.86
5	Harding Loevner LP	36,302	24,711	6,182	3,859	77	33.0	13.5	92	3.63	25.60	75	65	98	99	112	94	81	79	8.08	1.00	0.28	0.94	5.63	7.80	17.87	0.97	0.97	0.80
6	MFS Investment Manage	412,159	321,417	3,947	3,240	129	33.3	12.6	88	3.21	25.80	55	55	96	97	96	100	95	96	(1.59)	(0.28)	0.25	0.15	(3.82)	4.73	15.48	0.95	0.93	0.85
7	Morgan Stanley Investme	311,551	281,494	12,649	11,755	155	31.1	13.8	92	3.62	26.14	65	55	90	84	79	96	76	73	3.32	0.48	0.13	0.28	0.97	5.07	16.08	0.80	0.80	0.76
8	Quantitative Managemen	109,743	86,273	6,143	4,722	291	34.8	13.5	98	1.62	26.67	100	100	113	111	114	100	98	99	0.37	1.39	0.79	1.24	(1.90)	5.09	17.08	0.65	0.63	0.58
9	Schroder Investment Management No		344,545	19,321	18,505	131	46.9	21.5	97	2.24	25.53	85	75	103	101	116	98	98	96	1.98	0.80	0.47	0.84	(0.33)	3.90	15.68	1.00	1.00	0.85
10	William Blair & Company	61,979	49,613	757	296	59	38.8	22.3	98	5.18	24.87	86	86		97	90		77	82	3.78	1.65	0.41	2.01	1.42	6.03	18.21	0.78	0.69	0.57

BOARD LEADERSHIP

INNOVATIVE APPROACHES TO GOVERNANCE

NUMBER 138, MAR.–APR. 2015

www.boardleadershipnewsletter.com

The Positive Use of Negative Language

by Ted Hull

Policy Governance® consultant and practitioner, Ted Hull, ponders the benefits of using negative language for effective delegation.

HE WAS THIRTEEN years old when I exercised my authority as a father in providing him with a clear directive. As adamant as I was that he comply, he was equally adamant that my request was unreasonable. It ended—almost—with his averse acquiescence, followed by some incoherent muttering and punctuated with foot stomping as he headed back to his bedroom. I ordered him not to stomp his feet, at which point he resorted to tiptoeing. I then told him not to tiptoe. He countered defiantly, "How do you want me to walk?" By this time I had grown tired of the game, and so I played my trump card: "You figure it out and if you don't get it right, you are in even bigger trouble than you are now."

Without making this an evaluation of my parenting skills—or lack thereof—where did I go wrong? While his foot stomping was annoying, it wasn't doing any permanent damage to the structure of the house and his tiptoeing should have been a pleasant reprieve. The problem was my enforcement of a behavioral solution to a compromised value: it was not good for either of us if he behaved disrespectfully. I can see you sitting there piously wondering why I didn't start out by clearly communicating my value of respectful behavior. But before we make this a treatise on my ineffective parenting talents, let's transfer your intrigue to the Policy Governance system principle of Executive Limitations policies and specifically the use of negative language.

Negative is not always a negative word. If you have a biopsy on a tumor and the tests for malignancy come back negative, that's positive. Furthermore, telling someone not to do something may be negative, but telling them they must do something hardly fosters an environment that could be described as *positive*. So the opposite of negative is not simply *positive*.

If you are going to use the Policy Governance model effectively, you must state the Executive Limitations policies in negative language. That's the rule. However, unlike some of my parenting practices, the use of

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ALSO IN THIS ISSUE

EVENTS

APRIL 8, 2015

Getting to Great Dialogue

— Webinar 11:30 a.m.–1:30 p.m. EST

For chairs, board members, and staff who are interested in how to generate productive dialogue at the board table and between boards and their owners and staff and their organizations' other stakeholders. This will be an expert presentation and Q & A session. For more information see http://bit.ly/1LpU7nu

APRIL 13, 2015

An Introduction to Policy Governance

— Calgary, Alberta, Canada with Jannice Moore, The Governance Coach

For more information see http://bit.ly/1Hqxzn8

APRIL 14, 2015

Advanced Policy Governance Application: The Power of Monitoring and Future-Focused Board Agendas

— Calgary, Alberta, Canada with Jannice Moore, The Governance Coach

For more information see http://bit.ly/1Hqxzn8

(continued on page 3)

Negative Language

(continued from front page)

proscriptive or negative language is not there just because John Carver (the original author of the Policy Governance system) says so. Indeed, it is not helpful if Policy Governance practitioners commit to the practice of using negative language in Executive Limitations policies without embracing the underlying value of proscriptive wording.

Deciding to adopt an Executive Limitation that, for example, states that *the CEO shall not fail to insure the physical assets of the organization* illustrates the point. We can twist and bend the English language in an attempt to shape it in a way that complies with the requirement that Executive Limitations be stated in the negative, but if the net effect of such a policy still directs the CEO to insure the physical assets of the organization, we have compromised the underlying value we are seeking to put in place.

In the same way by which I attempted to solve the problem of disrespect by insisting my son neither stomp his feet nor tiptoe, this Executive Limitation attempts to ensure compliance to an as yet unstated value. We know what the answer is, we just aren't sure of the question. We have a solution; we just aren't sure what the problem is. In this case, the solution appears to be insurance, but what is the problem? What underlying value is being addressed in the purchase of insurance? Obviously, it is the board's value of seeing that the physical assets of the organization are not exposed to irrecoverable loss. So if that is its value, why didn't it state it?

Suppose you enter a small park where there are paths meandering through pristine lawns. Immediately, you see a sign that reads "Please do not walk on the grass." Later on, you see another sign that reads "Please stay on the path." Because there are only paths and grass in the park, the signs ostensibly say the same thing. In both cases, the instructions are directive. Clearly, if you are not to walk on the grass, you must walk on the path. However, neither sign identifies the problem or addresses a value. In each case, they directly or indirectly insist on a behavior. Note that the behavioral directive does not say you can't run or rollerblade on the grass, either of which you could deem to be permissible, keeping in mind that you do not know what the value is. One obvious possibility—

> It is easier for a board to point out the result it wants without having to carefully develop genuine model-consistent Executive Limitations policies.

although not the only one—is that the park owner does not want the grass to be damaged. If that is the value, then why was it not stated in the first place? If the sign had said "Do not cause or allow damage to the grass," you could reasonably interpret that walking, running, or rollerblading on the grass would have contravened the value of the owner.

Let's go back to our "shall not fail to" example of insurance. The board might question omitting any direct reference to insurance on the grounds that the CEO could not possibly protect the physical assets of the organization from irrecoverable loss if there was not proper insurance coverage in the event of a fire or some other catastrophe. However, the fact remains that by including a direct reference to insurance, it has effectively used an Executive Limitation as an answer to an unasked question. It has provided a solution to an unidentified problem. It is explicitly protecting itself from the compromise of an implied but unstated value.

The problem with stating solutions rather than underlying values is that it takes away the CEO's scope for making any interpretation that he or she can justify to the board as reasonable. Without this scope, the CEO is merely following direct orders rather than wielding delegated authority. While in any given example this unnecessary limiting of the scope of the CEO's authority may seem harmless enough, it is a slippery slope. And at the bottom this slope lie organizations that lack the agility and creativity so needed in today's world.

There are several reasons why a board may lean toward the use of unnecessarily prescriptive language.

1. The Board Lacks Trust in Its CEO and/or Itself

If the board believes there is a reasonable possibility that the person it has hired as its chief executive won't figure out the right answers on his or her own, it will want to dictate the answers itself. While that may be a stinging indictment on the competency of the CEO it is even more so reflective of an inept board that would abandon its fiduciary responsibility by wasting the money of the moral owners on an incompetent employee. By the time a board has reached this point, the nuances of negative language are the least of its problems. Alternatively, the board may not trust its own ability to recognize and act on an unreasonable interpretation, in which case some good training is clearly needed.

2. The Board Is Using Outdated Generic Policies

There are enough boilerplate policies floating around to guarantee the use of the "shall not fail to" wording for a long while. Miriam Carver says that "this [the 'shall not fail to' language in Executive Limitations policies] started with us [John and Miriam Carver]." She goes on to say that "John and I have been assisting boards in wording these policies so they never use the 'shall not fail to' construction."[1]

3. The Board Is Lazy

This reason may be more common than many of us want to admit. It is easier for a board to point out the result it wants without having to carefully develop genuine model-consistent Executive Limitations policies. The hard work comes when the board develops legitimate proscriptive policies because it must then rigorously monitor compliance to those policies. Part of the monitoring process is the tenacious insistence on reasonable interpretations that contain sound operational definitions. Once the Executive Limitations policies are reasonably interpreted, the board must see the accompanying data. To avoid this challenge a board finds it easier to interpret its own policy by subliminally burying its interpretation in the policy itself. *The CEO shall not fail to obtain five million dollars' worth of general liability and casualty insurance from ABC Insurance Company with a copay of not more than $1,000 per incident.* This way the board can impose its preference on the CEO by effectively forcing its hand through the *unacceptable means fence* and seizing its preferred means without actually climbing over the fence. In turn, this can lead to sluggishness on the part of the CEO as there is little that the CEO needs to interpret. After all, what part of *obtain insurance* needs to be interpreted? The CEO's instructions on how to protect the assets of the organization from irrecoverable loss will come from the board. The board is now well on its way to setting aside the principle of Executive Limitations. By the use of the "shall not fail to" terminology the board has subtly taken back the authority that it explicitly stated it had delegated to the CEO.

One of the cornerstones of Policy Governance is nonambiguity. It is impossible to skate around the edges of proscriptive Executive Limitations without creating haziness. Slightly altering a church metaphor, *if there is a mist in the boardroom, there will be a fog in the CEO's office.*

A healthy Policy Governance board will create a positive atmosphere by the uncompromising delegation of authority to its CEO to use *any* means *except* those that violate its values, rather than a negative culture where clandestine board preferences are passed off as Executive Limitations policies. As a board relates in this manner, negative language will result in positive outcomes. ❑

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Note

1. Miriam Carver, "Avoiding 'Shall Not Fail To' Language in Executive Limitations Policies," *Board Leadership* no. 120 (2012 March/April): 4.

Events

(continued from front page)

May 6, 2015

The Policy Governance Practitioner's Voice

— Webinar 11:30 a.m.–1:30 p.m. EST

For staff and board members who want to explore the benefits and challenges of Policy Governance. This is an opportunity to hear from current practitioners about what using Policy Governance means for their boards. Come and meet chairs, CEOs, and board members from three different organizations and get your questions answered. For more information see: http://bit.ly/1LpU7nu

May 13–15, 2015

The Private Company Governance Summit 2015

— Grand Hyatt, Washington, DC

For more information see http://privatecompanydirector.com/index.php?/pcgs/program

June 18–20, 2015

12th International Policy Governance Association Conference: Leading Together and International Young Governance Professionals' Summit

— Pinnacle Vancouver Harbourside Hotel, Vancouver, Canada

Preconference sessions include a full-day Policy Governance Orientation. Two full days of other workshops on wide ranging governance system topics. Keynote speaker Craig Freshley, author of *The Wisdom of Group Decisions.*

For more information see www.policygovernanceassociation.org ❑

Aligning CEO Compensation

by Richard Stringham

Getting CEO compensation right is a perennial source of board concern. Richard Stringham has been exploring CEO compensation approaches and issues and recently attended a webinar[1] on the topic. Here, he reviews his learning through his lens as a consultant to boards implementing the Policy Governance system.

EARLY ON IN MY WORK with Policy Governance, I realized that what may be a good practice in traditional approaches to governance is not necessarily a good practice when using the Policy Governance system. Nonetheless, I continue to look at practices elsewhere to consider their potential value for use with Policy Governance. Such was the case when I recently participated in a webinar—*Age of Alignment: Linking Compensation & Business Strategy,* presented by the National Association of Corporate Directors.

The following article outlines the key points from the webinar, the differences between the approach to governance the presenters used and Policy Governance, and the implications for boards that use Policy Governance.

Aligning Pay and Strategy

The premise behind the presentation is that the board should be engaged in the organization's strategic direction to an appropriate level that achieves "oversight." Tied to this engagement, the board should ensure that the compensation program aligns with the strategic direction. According to the presenters, doing so ensures that employees are aware of the importance of the strategy, that their acceptance of the strategy is reinforced, and that their actions are aligned, thereby accomplishing the strategy.

The presenters advocate a balanced perspective in which the compensation program recognizes both the results that the organization is expected to achieve and how the organization achieves those results. They recognize that there is usually a lag between drivers (e.g., new products and new market penetration) that contribute to the success of the organization tomorrow but that typically require investment that negatively impacts outcomes today. Consequently, providing incentives for the right mix of both the drivers and the outcomes is essential in the compensation program.

> The use of calibration tools enables the board to determine if performance targets are too hard or too easy. This can prove especially useful when management is either missing targets frequently or is attaining targets too readily.

Boards are cautioned not to build their compensation programs on external practices and views, but to use them only to inform their program. The presenters advocate building compensation programs on the basis of the organization's business and leadership strategy. "We need to be more comfortable with being different and having our own [compensation] plans."

Boards are also cautioned not to be complacent about their compensation programs: "There is a tendency to spend a lot of time on a plan and then hold it ... keep the metrics, keep the design." Instead, the presenters suggest that the board should continually review the compensation program: "... you have to constantly test it against the changes in strategy because strategy doesn't remain [constant] anymore ... it's constantly changing."

Effective tools suggested included a Value Driver Tree and a Balanced Scorecard approach. The Balanced Scorecard is not new for this purpose. In 2006 Kaplan and Norton noted: "A Balanced Scorecard program for the board of directors provides visibility into corporate strategy and management's actions ..."[2] making it clear that the Balanced Scorecard is designed to align reporting with the organization's strategy and, ultimately, expected outcomes.

In this approach, board-approved compensation programs not only include the executive but also management and others. Accordingly, the board is counseled to approve programs that offer different types of incentives to align with the various levels of responsibility and that are intended to satisfy different incentive objectives. For example, the program for the senior leadership could include a mix of incentives (e.g., stock options, performance shares, and restricted stock). The intent of these various incentives would be to realize multiple compensation objectives of "shareholder alignment," "accountability for results," and "line of sight." At the management level, the "shareholder alignment" would not be an objective; consequently, managers would not be offered stock options.

Because of a philosophy that compensation should reinforce strategy, compensation at each level of the organization to which the board-approved compensation program reaches should result in better "line of sight." In other words, the employees can understand how they contribute to the strategy execution.

Corporate boards have access to sophisticated tools that draw upon data from both peer groups and the organization's historical performance to "pressure test the link between compensation and strategy" and to calibrate the levels of board expectations and probabilities of achievement. By using these tools, the board can evaluate whether its proposed compensation plan will achieve the incentive objectives.

Furthermore, the use of calibration tools enables the board to determine if performance targets are too hard or too easy. This can prove especially useful when management is either missing targets frequently or is attaining targets too readily.

Differences between the Presenters' Approach to Governance and the Policy Governance Model

Policy Governance practitioners will quickly recognize three significant differences between the approach to governance portrayed above and the Policy Governance system. Operational strategies are means used to achieve Ends. Accordingly, the board using Policy Governance does not engage in strategic plans. Instead, it determines Ends policies and gives the CEO authority to determine and use strategies that achieve a reasonable interpretation of the Ends. Of course, the board will also have limitations policies that speak to what would make any strategy unacceptable, even if it worked, and the CEO would be accountable for complying with a reasonable interpretation of all such policy.

Second, as the board's only means decisions in the CEO's operations are to put off-limits what is unacceptable, then the board that uses Policy Governance will not make decisions regarding compensation programs for staff other than the CEO, except to proscribe conditions or decisions that are imprudent or unethical. And finally, the board evaluates the CEO's performance based on achievement of a reasonable interpretation of the Ends and compliance with a reasonable interpretation of the Executive Limitations policies.

It is beyond the scope of this article to explain the rationale for the relevant Policy Governance principles. But as a coherent and complete system, to inject practices from another approach to governance without critical consideration would be folly.

Lessons for Boards that Use Policy Governance

What, then, can be drawn from the webinar that has application to boards that use Policy Governance?

A. Obviously, the ultimate measure of successful strategy and strategy execution is successful achievement of a reasonable interpretation of the Ends. Outstanding strategies and execution should result in outstanding Ends achievement.

Strategy should address risk. However, it is also inherently subject to risk. The organization that takes on a strategy and ignores the dynamic marketplace and uncertain environment may find that a once successful strategy has less-than-desirable results. And there will be a lag period between strategy determination and achievement of Ends, which means that timely signals regarding the strategy's effectiveness become critical for enabling the

(continued on page 8)

WHEN WE SAY ...

Board Leadership's mission is "to discover, explain and discuss innovative approaches to board governance with the goal of helping organizations achieve effective, meaningful, and successful leadership to fulfill their missions."

Board Leadership aims to fulfill this mission by engaging its readers in a lively and illuminating inquiry into how board governance can be made more effective. This inquiry is based on three key assumptions:

- Boards exist to lead organizations; not merely monitor them.
- Effective board governance is not about either systems, structures, processes, theories, practices, culture, or behaviors—it is about all of them.
- Significant improvements are likely to come only through challenging the status quo and trying out new ideas in theory and in practice.

Uniquely among regular publications on board governance, *Board Leadership* primarily focuses on the job of board leadership as a whole, rather than on individual elements of practice within the overall job.

Over time, *Board Leadership* will provide a repository of different approaches to governance created through its regular "One Way to Govern" feature.

Here's what a few of the key terms we use mean to us:

- **Innovative:** Creating significant positive change.
- **Approaches to:** principles, theories, ideas, methodologies, and practices.
- **Board governance:** The job of governing whole organizations. ❑

For Your Bookshelf …

Reviewed by Jannice Moore

Jannice Moore specializes in coaching boards to apply Policy Governance principles for optimum effectiveness. Here, she reviews a recent book that proposes key questions that can propel a board to good governance.

Owning Up: The 14 Questions Every Board Member Needs to Ask
by Ram Charan
Jossey-Bass, April 2009

IN A VERY READABLE STYLE, with a summary of key points at the end of each chapter, Ram Charan poses fourteen questions that boards need to ask. The book is written from the perspective of the corporate sector, but most of the questions are equally applicable to the not-for-profit sector. There is much wisdom in this book regarding areas that are important for boards to consider. If your board is using the Policy Governance model, I will note where the methods suggested are not consistent with Policy Governance principles (e.g., authorizing some board committees to be totally responsible for certain aspects of board function, rather than using them to inform decisions of the board as a whole).

FOOD FOR THOUGHT

"Developing and advancing institutions is about mission and purpose and moral values. Only secondarily is it about resources."

Robert L. Payton, "Presidents as Public Teachers," *Robert L. Payton Educational Record* 78, no. 1 (1977): 55–59.

Boards using Policy Governance can learn from the ideas in this book but should use methods that are consistent with the principles.

Charan encourages boards to be much more deliberate regarding governance succession, recommending a five- to ten-year succession plan, a skills matrix designed around the board's job (I agree with Charan on skills being matched to the job, but not completely on what that job is), a pipeline of potential candidates, and a rigorous method of interviews and checking references. He also emphasizes the board's critical role of ensuring that the organization has the right CEO and always being prepared for CEO succession, even when there is a very successful CEO in place.

He advises considering risk through many different lenses—financial vulnerability, political and geopolitical, reputation, people, and culture. Policy Governance boards address operational risk through carefully constructed Executive Limitations policies, which are then rigorously monitored. Addressing risk by looking at it through varied lenses, at least annually, is a great way of ensuring that those policies are sufficiently robust to address major risks. Boards also need to be prepared for the "knowable unknowns" and the "unknowable unknowns." Again, how the board addresses these challenges will be different for Policy Governance boards, but the concept of exercising vigilant foresight is vital.

Charan advocates that boards should "own" the company's strategy. On this point I part ways with him. From a Policy Governance perspective, I agree that boards should be aware of environmental trends, but I suggest that this knowledge should contribute to strategic *thinking* rather than strategic *planning*. Strategic thinking leads to development of clear direction as to what results are to be achieved, and the CEO should then develop the "how to" portion of strategy. The board may wish to create Executive Limitations that require the CEO to demonstrate that he or she has a multiyear strategy appropriate to achieving those results—which has the board performing a monitoring function, rather than taking ownership of the strategy.

In another chapter, the "information architecture" for a board is addressed. While Charan and I would place some of this information in different categories (Policy Governance divides information into decision, monitoring, and incidental categories), his point that the board needs the right information to enable it to ask insightful, penetrating questions is well taken. His concept of requiring benchmarking information can be applied to monitoring data. He also encourages boards to obtain information from external sources and hear insights from experts outside of management.

A chapter is devoted to getting CEO compensation right, with particular attention to connecting pay and performance, considering which factors the CEO can control, and having a range of metrics to measure performance. He emphasizes the importance of having a compensation philosophy, with a framework that translates the philosophy into annual specifics as conditions change. Transparency is highlighted, with a quotation from Warren Buffett that "when dealing with shareholders' money … [Directors] should behave as if it were their own." That philosophy is certainly consistent with the Policy Governance principle that boards govern on behalf of their owners.

I found the chapter on the Governance Committee somewhat confusing. On one hand, Charan advocates that "committees must be extensions of the board, not replacements for it" and that all key issues must get back to the board as a whole (I heartily agree). On the other hand, he then suggests that Governance Committees "must take ownership for the board's output." I would counter that the board as a whole—not any one committee—bears the ownership and accountability for the board's output. He makes solid points about the importance of having good leadership on committees. He also addresses the need to "denominate" board members who are not contributing.

Using board meeting time efficiently means putting the most important items first. Information presented to the board should be structured to create a clear foundation for an informed discussion. Creating an annual priorities list used to structure board agendas is recommended (in Policy Governance this is often called a *perpetual agenda cycle*).

Board self-evaluation "should be designed and conducted in a way that sheds light on whatever will take the board to the next level and improve the quality of its output." Rather than relying on questionnaires, he recommends one-to-one interviews with board members, with assured anonymity, conducted by a lead director, governance committee chair, or a third party in whom the board has a high degree of confidence. A great idea—in Policy Governance boards these questions would be connected to the board's Governance Process policies. He also highlights the importance of peer review, a practice that many boards are reluctant to undertake. He points out there is a difference between a director who has room to improve but is valued by colleagues and one who disrupts the board and is unwanted. He also notes the difference between a disruptive board member and a dissenting member, who earns respect by asking tough questions and sharpening the board's thinking.

The difference between appropriate questioning and micromanaging is explored. Micromanaging drains energy and makes management less effective.

> *Owning Up* provides practical, experience-based wisdom regarding how boards can "own up" to their accountability for the performance of the corporation or organization.

He notes that CEOs often bring micromanaging on themselves by the nature of their presentations to the board. Board members should ask questions "at the right altitude, with the right tone, and about the right things ... while respecting the CEO's decision-asking authority." (Policy Governance boards have a very concrete approach to using this advice: creating sound Executive Limitations and Ends policies, and then rigorously monitoring compliance with them.)

The chapter devoted to working with shareholder activists is written to a corporate audience. However, the notion that the board needs to communicate with shareholders (or legal and moral owners, in Policy Governance terms) is crucial for any kind of board. This is an area where the Policy Governance model has been well ahead of most corporate-sector governance, as it clearly recognizes that the board holds an organization in trust on behalf of owners and has an obligation to connect with them on a regular and ongoing basis.

The role of a lead director is addressed. This position applies only in corporations where the roles of chief executive officer (CEO) and chief governance officer (CGO; commonly called board chair) have not been clearly separated. In organizations where CEO and CGO roles are already separate, many of the qualities suggested for this position can be applied to selection of a CGO: ability to facilitate, guide, and sometimes counsel fellow directors; help the board focus on the right things; be a calming influence and at times the voice of reason; explore and encourage diverse viewpoints; and have the courage to do what is needed to make the board function better. Executive sessions excluding insider board members are also discussed. Much of this content is more relevant to corporations whose boards are composed of both independent directors and management. Therefore, determining when the independent directors need to meet separately becomes an important consideration. For boards that do not have this dynamic, a comparable issue is when to hold an in-camera session and whether the CEO should be included.

In summary, *Owning Up* provides practical, experience-based wisdom regarding how boards can "own up" to their accountability for the performance of the corporation or organization. It emphasizes that governance now means leadership—that "directors need to reinvent the content of their work and their modus operandi." It does, however, lack the benefit of being derived

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CEO Compensation

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CEO to revise strategy and adjust execution as needed.

In all of this, the board's concern is that Ends are achieved and what is unacceptable is avoided. This latter concern raises questions for boards that use Policy Governance.

1. Do we have the Executive Limitations policies which speak to those conditions that are unacceptable regarding strategy?
   a. If the CEO were to achieve a reasonable interpretation of the Ends and did so without a current strategy in place, would it be acceptable? (Consider the lag element for this one—achievement today does not necessarily translate into achievement tomorrow.)
   b. What would be unacceptable in a strategy? (For example, developing a new and untested enterprise using a substantial proportion of the organization's resources could be an inappropriate risk.) Is there a reasonable interpretation of our current policies that would allow such an unacceptable condition?
2. Are we diligently monitoring the respective policies?
3. Is some portion of the CEO's total rewards at risk if there is a lack of compliance with the respective policies?

B. The ability to validate the link between compensation and performance is becoming more critical as stakeholders demand greater accountability. Whether it is shareholders, regulators, or funding agencies, there is increasing scrutiny. Where available, the ability to use peer data for determining probabilities of achieving varying levels of results enables the board to determine incentive rewards that have greater ability to stand up to the increased scrutiny. (Obviously, this is much easier in corporations where the business and the Ends are very similar versus the nonprofit sector.)

C. Clarity regarding the objectives of the compensation program enables better program design. Is the intent to align pay with performance? Is it to retain the CEO? Or is the intent to incent the CEO to higher levels of Ends achievement?

D. Review and revise the CEO compensation program regularly. Ongoing review and revisions to Ends and Executive Limitations policies create different expectations. Ensure that the compensation program is aligned with those changes.

E. Finally, don't follow the herd. The webinar presenters made an astute point in asserting that boards that create compensation programs for their organization's unique needs can create a distinct advantage in the marketplace. ❑

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Notes

1. Richard Goeglein et al., "Age of Alignment: Linking Compensation and Business Strategy" (webinar, December 16, 2014). http://www.nacdonline.org/resources/WebinarDetail.cfm?ItemNumber=12868
2. Robert S. Kaplan and David P. Norton, "Aligning the Board of Directors," *Harvard Business Review* (2006, March 15): 9.

For Your Bookshelf

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from a system-based theory of the role of a board. Given that John Carver's Policy Governance model, which provides a clear, systems-based approach to all of the questions raised in this book, has been around for over 30 years, I find it surprising that Charan makes not even one reference to the wisdom of that model, nor does he cite it in his bibliography. Charan's practical experience with corporate boards teamed with the wisdom of the Policy Governance system would make a dynamic duo! ❑

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BOARD LEADERSHIP
INNOVATIVE APPROACHES TO GOVERNANCE

NUMBER 138, MAR.–APR. 2015

BOARD LEADERSHIP: INNOVATIVE APPROACHES TO GOVERNANCE
ISSN 1061-4249 (print) ISSN 1542-7862 (online)

www.boardleadershipnewsletter.com

Editor: Caroline Oliver

Published bimonthly. Annual subscription rates are: Print only: $169 (individual, U.S./Can./Mex.), $205 (individual, all other), $744 (institutional, U.S.), $804 (institutional, Can./Mex.), $855 (institutional, all other); Electronic only: $126 (individual), $744 (institutional); Print and electronic: $186 (individual, U.S./Can./Mex.), $222 (individual, all other), $893 (institutional, U.S.), $953 (institutional, Can./Mex.) and $1004 (institutional, all other). Discounts on additional board subscriptions are available. Call the circulation manager at (415) 782-3232.

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Board Leadership is indexed in Current Abstracts (EBSCO).

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