

June 30, 2022

# In-State Investment in North Dakota: Update on Projects 1 and 2

North Dakota Legacy Fund Advisory Board



# Update on In-State Investments Policy



# Overview and Meeting Objectives

- The purpose of this meeting is to provide a progress update on North Dakota Legacy Fund, Project 2: In-State Equity Investments.
- The RVK Project Team has been extremely active since we last met with the NDLF Board on April 8th, 2022.
- We feel our work thus far confirms all of the initial implementation challenges we outlined at the last meeting regarding to House Bill 1425. Indeed, that list has grown.
- Our findings to date indicate that this Board may want to **reconsider the scope** of work set out in the initial Project 2 assignment.
  - The current scope of work focuses on creating a policy structure for implementation of House Bill 1425.
  - Much of the feedback we have received thus far suggests that you may wish us to shift our emphasis to:
    - 1) potential legislative revisions to 1425 that may serve to more effectively achieve its core goals, and
    - 2) observations regarding the “transmission mechanism” connecting Legacy Fund capital to actual investment in and resulting economic development within North Dakota.

***We seek guidance from you on this potential shift in scope.***



# A Summary of Our Efforts Thus Far: Interviews

- RVK has performed the following interviews since April 8<sup>th</sup> to date:

Name	Affiliation	Title	Date of Interview
<b>RIO and Advisory Board Members</b>			
Scott Anderson	RIO	Chief Investment Officer	April 7th
Eric Chin	RIO	Deputy Chief Investment Officer	April 7th
Jan Murtha	RIO	Executive Director	April 18th
Glenn Bosch	Advisory Board, House	Representative	April 20th
Jerry Klein	Advisory Board, Senate	Chair	April 4th
Thomas Beadle	Advisory Board, Citizen Member	State Treasurer	April 29th
Kathy Hogan	Advisory Board, Senate	Senator	April 29th
Jon Godfread	Advisory Board, Citizen Member	Insurance Commissioner	May 31st
Scott Meyer	Advisory Board, Senate	Senator	June 1st
Todd Steinwand	Advisory Board, Citizen Member	President of Bank of North Dakota	June 3rd
Keith Kempenich	Advisory Board, House	Vice Chair	requested meeting
Gary Kreidt	Advisory Board, House	Representative	requested meeting
Brian Kroshus	Advisory Board, Citizen Member	Tax Commissioner	requested meeting
<b>Other</b>			
Mike Nathe	Commerce Committee	Representative	May 18th
Josh Teigen	ND Dept. of Commerce	Director, Economic Development & Finance	May 13th
Joe Raso	Fargo Moorhead Economic Dev Corp	President & CEO	May 18th
Keith Lund	Grand Forks EDC	President & CEO	May 20th
Kodee Furst	50 South	Director	March 17th & 24th
Mina Nazemi	Barrings	Co-Head of the Funds & Co-Investments	June 1st
Saied Ezzeddine	Barrings	Consultant Relations, Managing Director	June 1st
Dan Villa	Montana Board of Investments	Executive Director	June 2nd
Dough Hill	Montana Board of Investments	Director of In-State Loans	June 2nd
Mike Kell	Thornlea Capital	Managing Partner	June 28th
Marcus Frampton	Alaska Permanent Fund Corporation	Chief Investment Officer	July 13th
David Lee	New Mexico State Investment Council	Director of Private Equity	July 12th
Charles Wollman	New Mexico State Investment Council	Director of Communications & Legislative Affairs	July 12th
Chris Cassidy	New Mexico State Investment Council	Private Equity Portfolio Manager	July 12th

# A Summary of Our Efforts Thus Far: Documents

Document	Source
Legacy Fund Investment Policy Statement	RIO
North Dakota Constitution	ND Legislature
ND Century Code, Chapter 21-10	ND Legislature
House Bill 1425	ND Legislature
House Bill 1089	ND Dep't. of Commerce
House Bill 1380	ND Legislature
ND SIB Meeting Materials (October 23, 2020)	RIO
ND SIB Meeting Materials (November 20, 2020)	RIO
RIO's In-State Investment Asset Allocation Study Recommendation ( Dave Hunter & Darren Schulz, 01/29/21)	RIO
ND SIB Meeting Materials (March 26, 2021)	RIO
ND SIB Meeting Materials (May 21, 2021)	RIO
<b>Economic Development Related Documents</b>	
ND STRATEGIC PLAN: 2017 – 2025	ND Department of Commerce
An Economic Guide for the State of ND	Mercatus Center
ND Broadband Report	USDA Rural Development
ND Development Fund Fact Sheet	ND Department of Commerce
State Small Business Credit Initiative (SSBCI) Asset Manager RFP	ND Department of Commerce
ND Growth Fund Investment Policy	50 South
The Pioneer Fund, LLC, "Strategic Development with a Purpose"	RIO
<b>Asset Allocation Related Documents</b>	
2013 Asset Allocation Study	RVK
2018 Asset Allocation Study (Callan)	ND Staff
2021 Asset Allocation Study (Callan)	ND Staff
Revenue and Oil Forecasts	State Tax Commissioner; OMB
Legacy Fund Historical Earnings	RIO
Oil Extraction & Gross Production Distribution Chart	State Tax Commissioner; OMB
ND SIB Match CD Statement (May 31, 2022)	Bank of North Dakota
Bank of ND, Match Projects (Active, Pending, Paid)	Bank of North Dakota

# Initial Implementation Issues Are Confirmed

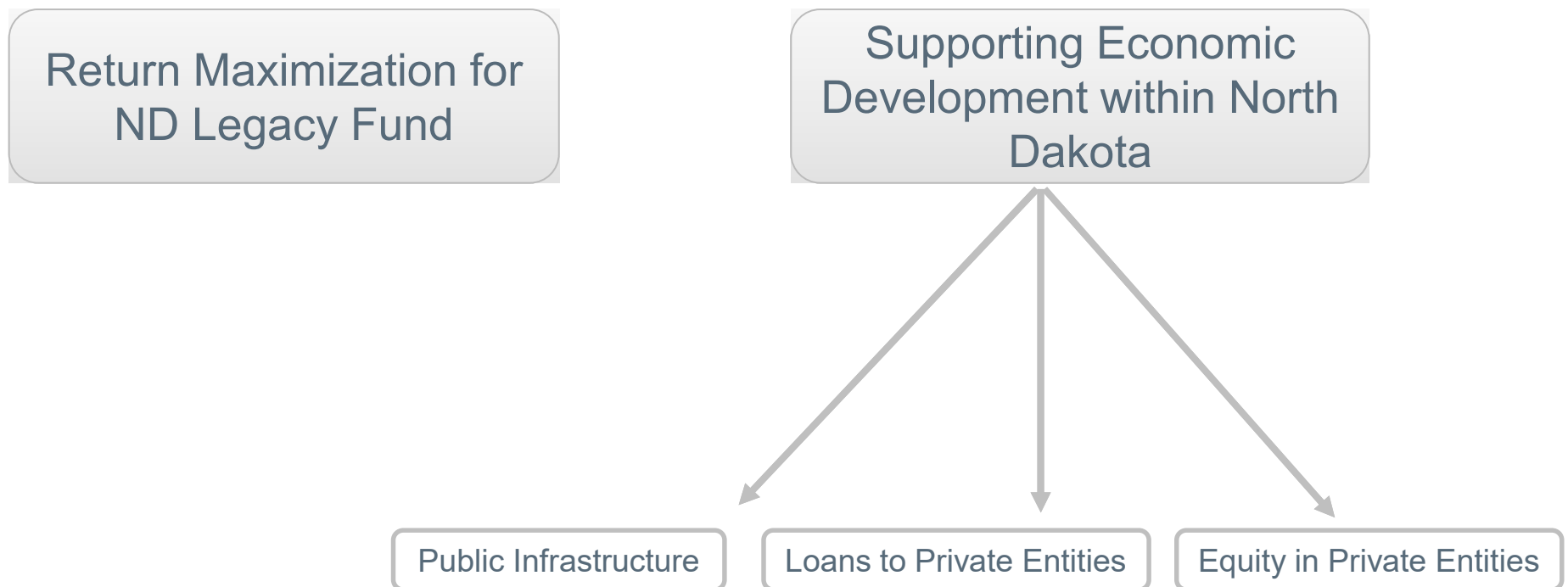
- Our interviews, continued discussions with staff, and our team's research has confirmed the initial list of implementation issues related to 1425 that we presented at the NDLF meeting on April 8th.
- Those interviews and research have also –
  - led us to add to that list of challenges.
  - led us toward a focus on 1425's objectives which in turn, led us to a greater focus on the key elements in a successful economic development effort in ND, the “transmission mechanism” for connecting Legacy Fund capital (or any other public capital) to actual economic activity and/or infrastructure assets.

# We are – Unless Directed Otherwise – Proceeding on the Following Assumptions

- Unless you direct us otherwise, we are proceeding in Project #2 with the following assumptions:
  1. A shift in emphasis away from the implementation of Bill 1425 as written toward possible structural revisions and their implementation.
  2. That the core objective of 1425 should be preserved in any proposed revisions.
  3. That this core objective be defined not as in-state investment of Legacy Fund assets for its own sake, but rather to further the direct and indirect fostering of economic activity within North Dakota – essentially “investing in North Dakota” means investing in the expansion and diversification of the State’s economy.
  4. That investments of Legacy Fund capital to further that objective may include indigenous North Dakota businesses (owned and operated by North Dakotans” as well as business investments/projects within the State and contributing to its economic growth by companies domiciled elsewhere.
  5. That prudent investment of Legacy Fund capital requires a series of evaluations and criteria designed to target in all cases a positive return, with ancillary economic benefits an important but secondary criteria.

# Two Related but Distinctly Different Missions

Distinctly different in fund risk and return, in skills required, in dependence on in-state expertise and experience in economic development, and in dependence on detailed knowledge of the North Dakota economy.





# Any Proposed Revision to Bill 1425 Should Target:

## Key Policy Requirements for Success

- To achieve the objectives of 1425 using Legacy Fund assets requires at least these elements:
  1. A clear direction establishing the relationship between two (likely conflicting) goals – return maximization and investment targeting economic development in North Dakota.
  2. A policy and structure addressing precisely how and in what magnitude Legacy Fund assets can be invested for this purpose.
  3. A decision on whether the *current* Legacy Fund governance structure pursues both return maximization and supporting economic development in ND or those missions are executed separately by entities specifically focused on their respective missions.
  4. A policy designating permissible investments and investment vehicles.
  5. A structure for creating, directing, monitoring and overseeing the use of Legacy Fund assets in any form for the purpose of In-state Investment.
  6. An investment entity empowered to make final in-state investment decisions, if those decisions are to be placed outside the current Legacy Fund governance structure.
  7. Simplify and Clarify the Returns Seeking Goal and strategies at the Legacy Fund When Some Assets Are Dedicated to In-state Investment.

# Any Proposed Revision to Bill 1425 Should Target:

## Key Implementation Requirements for Success – The “Transmission Mechanism”

- A car needs more than gasoline. It needs an engine, wheels, a transmission connecting the engine to the wheels, and a driver. Similarly economic development in North Dakota needs more than just Legacy Fund (or other) capital to generate jobs, create and sustain companies, etc.

Implementation Phases	Debt	Equity
Source deals	Yes	Yes
Perform Due Diligence	Yes	Yes
Review and Decide Investment Proposals	Yes	Yes
Structure and Negotiate Investments	Yes	Yes
Execute Funding	Yes	Yes
Monitor on On-Going Basis	Yes	Yes
Perform Ongoing Business Decision-making	No	Yes
Exit to Recycle Legacy Fund Capital	No	Yes

# Any Proposed Revision to Bill 1425 Should:

## Balance Expected Return vs. Economic Development

- Any proposed revision to Bill 1425 should have a deliberate and realistic balancing by the State between the expected return to the Legacy Fund to pursue goals in perpetuity vs. the expected economic development outcomes from the use of fund assets.

### Risk and Return Thresholds for Legacy Fund Assets

*Versus*

### Economic Development Thresholds

- Jobs created
  - Earnings and Wage Income
  - Indigenous companies created
- State economic diversification achieved

# Alternative In-State Investments Funding Structures

- Through our research and interviews with multiple Board members and stakeholders, we believe there are two viable alternative structures for funding North Dakota's in-state investment with the Legacy Fund assets:

**Alternative A:** Participation in the **Bill 1380 Spending Policy** Stream Based on Legacy Fund Earnings.

**Alternative B:** **Partition** of Legacy Fund Assets Targeting In-state Investment Outside of the LF Corpus and Funded Via **Call Rights** on A Specified Amount of Capital

# HB 1380 vs. HB 1425

## Please Note at the Outset!

- The 1380 Spending Stream and 1425 Currently Compete for Financial Support from the Legacy Fund Assets.
- Every dollar of the Legacy Fund assets invested in the specific investment categories called out in 1425 almost certain to consistently reduce the value of the assets provided by the Legacy Fund to other uses in North Dakota via the 1380 spending policy stream.



# Alternative In-State Investments Funding Structures

## Using the 1380 Spending Policy Stream

- Using the 1380 Spending Policy Stream to provide capital for in-state investment in North Dakota addresses multiple challenges.
  - It allows the State to allocate returns from Legacy Fund to multiple purposes in a deliberate fashion.
  - It allows the State to reallocate the spending policy stream among uses depending on shifting priorities.
  - It allows the Legacy Fund itself...
    1. To remain intact.
    2. With a pure focus on generating returns at prudent risk to serve the priorities of North Dakota.
    3. With its current governance structure and staff to focus on that straightforward mission.

# Alternative In-State Investments Funding Structures

## Call Rights by In-state Investment Program(s)

- Partition of “Called Capital” to an In-state “Invest in North Dakota” economic development fund addresses multiple challenges.
  - It allows the large corpus of the Legacy Fund to be invested to maximize return at prudent levels of risk
  - It creates a pool of capital that can be called for in-state investment to foster economic development that is known in advance as available for approved investments.
  - It focuses a pool of callable capital that, in turn, can foster whatever “transmission mechanism” for economic development in North Dakota the state wishes to create.
  - It permits separate, and more mission appropriate, metrics for monitoring both the Legacy Fund corpus and this separate fund as it is invested.

# Aspiration versus Outcomes – The Importance of Clear, Fundamentally Sound Implementation

- Allow us to end by emphasizing a point made earlier. Simple provision of capital – whether from the Legacy Fund or elsewhere – is but one in a series of critical steps that are needed to produce an ongoing successful in-state economic development program in North Dakota.
- For this reason, we cannot emphasize enough the importance of the “**transmission mechanism**” that links capital to positive economic outcomes for North Dakota.
  - Sourcing
  - Due diligence
  - Review of investment proposals
  - Structuring and negotiation of investments
  - Funding
  - Monitoring
  - Ongoing business decision-making
  - Exist and recycling of the capital

# In Conclusion

- This is a preview of our work and thoughts thus far.
- The RVK Project Team's work continues.
- Thanks

# Update on Asset Allocation



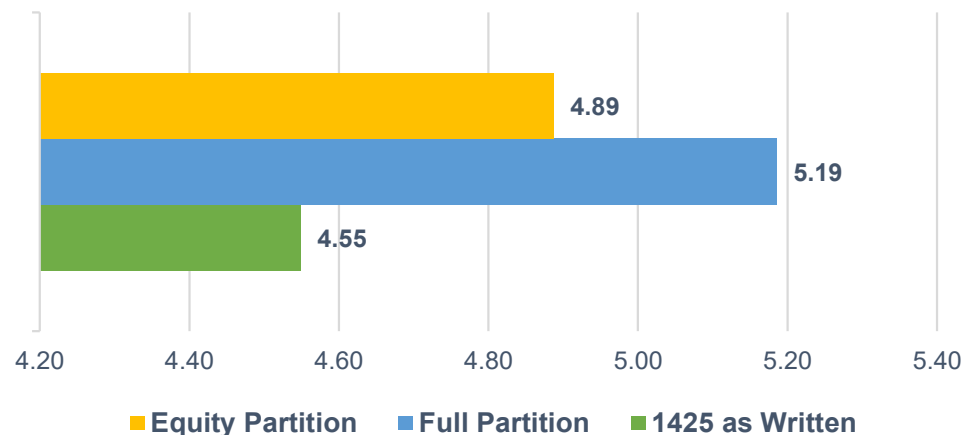


# Estimated Return Implications

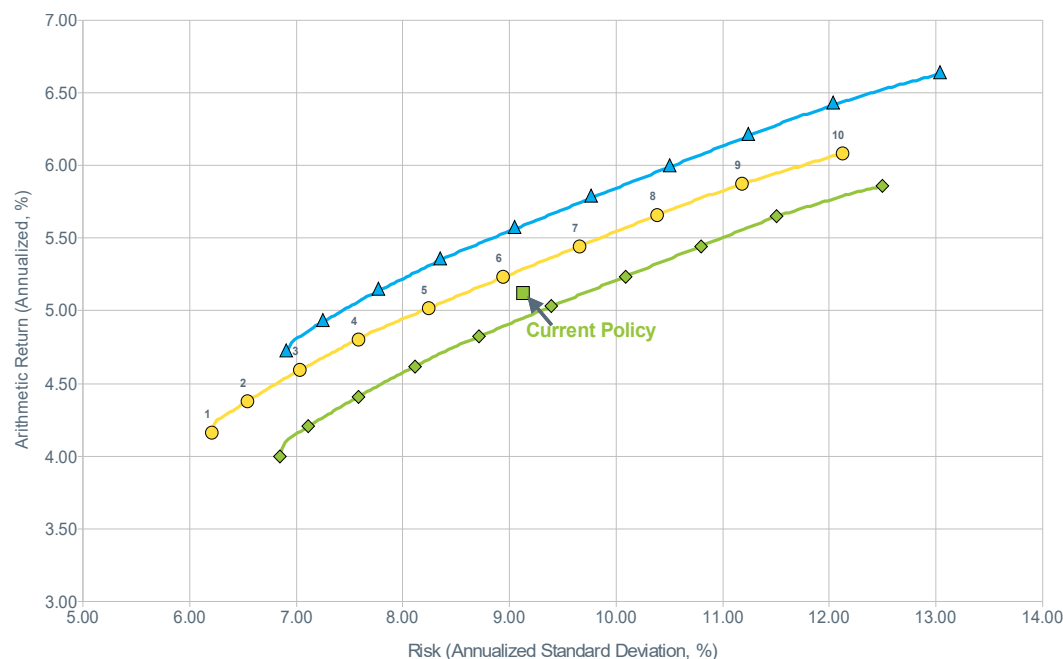
- For purposes of this analysis, we developed preliminary assumptions regarding the return and risk profile of the various potential forms of in-state investment as described in 1425.
  - Private Equity (both equity and Infrastructure): returns = 50% of similar traditional investments; and risk = 150% of similar traditional investments.
  - Infrastructure Loan: returns = 1.5% as defined in 1425; and risk = RVK's private credit assumption.
  - Bank of North Dakota CD Match: returns and risk = 10-year Treasury Bonds.
- Utilizing these custom assumptions alongside RVK's standard 2022 capital markets assumptions, we optimized three different efficient frontiers that represent various implementations approaches:
  - 1425 as currently written.
  - **Equity Partition:** Retaining the debt related investments currently in 1425 (Bank of ND CD match and Infrastructure Loans) while partitioning out the equity investments.
  - **Full Partition:** Partitioning out all in-state investments (either as recipients of 1380 revenue streams or as a separate asset pool).

# Estimated Return Implications

Forecasted Long-Term Compound Returns:  
Optimized Portfolios at 9% Risk



- Assets invested in the Legacy Fund are projected to annualize at a lower rate of long-term returns with 1425 implemented as currently written.
- Utilizing the assumptions described, “1425 as Written” could reduce total Legacy Fund annualized long-term returns by approximately 0.64% assuming a risk profile similar to current policy.



- Green Efficient Frontier: 1425 As Written
- Yellow Efficient Frontier: Equity Partition
- Blue Efficient Frontier: Full partition

# Estimated Return Implications

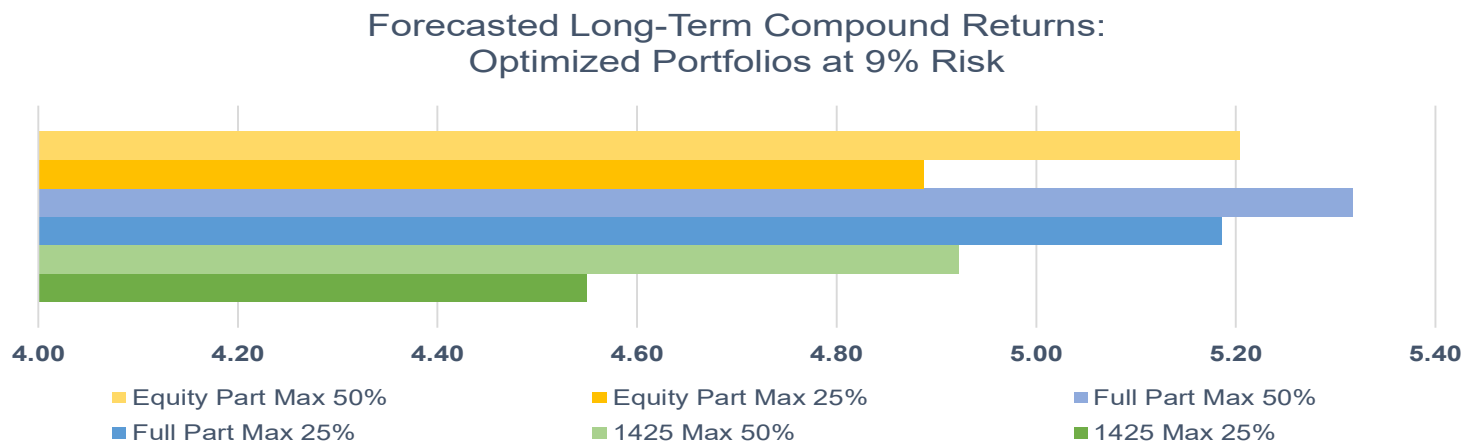


- Assuming a starting value of \$8.1 billion for each portfolio and no subsequent cash flows, we have modeled the potential range of wealth values over the next 10 and 20 years using the risk and return characteristics of the portfolios detailed on the previous slide.
- The **median** market value difference between the 1425 as Written portfolio and the Full Partition portfolio is \$845 million over 10 years and \$2.6 billion over 20 years.

Floating bars charts represent the 25<sup>th</sup> to 75<sup>th</sup> percentile of outcomes utilizing Monte Carlo simulations

# A Note on Distributions and Illiquidity

- The distribution framework established under 1380, as we understand it, results in the distribution of all earnings with the possible exception of up to \$100 M that could flow back to Legacy Fund principal. Distributing all or most of the earnings limits the ability to preserve the purchasing power of current Legacy Fund assets.
- Additionally, the potential appropriation of up to 15% of the principal of the Legacy Fund per biennium can have implications for investment choices, particularly as it pertains to allocations to illiquid investments. 1425 potentially compounds this issue as in-state investments are likely to be illiquid.
- We optimized three additional efficient frontiers with the following allowances for total illiquid investments (including in-state):
  - Max 25% Illiquid (Represents an approximate prudent maximum illiquid allocation with potential appropriation of corpus as currently allowed)
  - Max 50% Illiquid (Represents an expanded illiquid profile that may be prudent if appropriation of corpus is not a possibility)
- The expected returns from these efficient frontiers at approximately the same risk as the current policy are inserted in the graphic for each of the 3 previously discussed implementation approaches.



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