

Permanent School Fund

The Permanent School Fund is a trust fund created by the Minnesota State Constitution and is designated as a long-term source of revenue for public schools. Proceeds from land sales, mining royalties, timber sales, lake shore and other leases are invested in the Fund. Income generated by the Fund's assets is appropriated directly to school districts. On June 30, 2016, the market value of the Fund was \$1.2 billion.

Investment Objective

The State Board of Investment invests the Permanent School Fund to produce a growing level of spendable income, within the constraints of maintaining adequate portfolio quality and liquidity.

Investment Constraints

The Fund's investment objectives are influenced by the legal provisions under which its investments must be managed. These provisions require that the Fund's principal remain inviolate. Any net realized capital gains from stock or bond investments must be added to the principal. Moreover, if the Fund realizes net capital losses, these losses must be offset against interest and dividend income before such income can be distributed. Finally, all interest and dividend income must be distributed in the year in which it is earned.

Asset Allocation

In order to produce a growing level of spendable income, the Fund is invested to grow over time, and, therefore, has exposure to equities. The current asset allocation is 50% stock/48% fixed income/2% cash.

Prior to fiscal year 1998, the Permanent School Fund had been invested entirely in fixed income securities for more than a decade. While this asset allocation maximized current

income, it limited the long term growth of the Fund and caused the income stream to lose value in inflation adjusted terms, over time.

To solve both issues, a proposal to introduce equities to the Fund's asset mix was presented during fiscal year 1997. Since this modification would reduce short term income and have budgetary implications for the state, the consent of the executive and legislative branches was necessary. It was favorably received by the Legislature and incorporated into the K-12 education finance bill. As a result, the Fund allocation was shifted to a 50% stock/48% fixed income/2% cash allocation during July 1997.

Figure 43 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2016.

Investment Management

SBI staff internally manages all assets of the Permanent School Fund. Given the unique constraints of the Fund, management by SBI staff is considered to be the most cost effective option at this time.

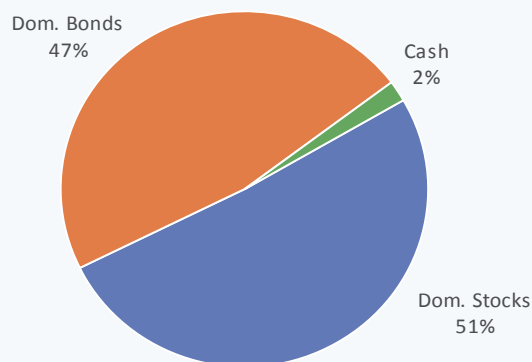
Stock Segment

The stock segment of the Fund is passively managed to track the performance of the S&P 500 (see page 43).

Bond Segment

The bond segment is actively managed to add incremental value through sector, security and yield curve decisions, and its performance is measured against the Barclays Capital Aggregate Bond Index (see page 44).

Figure 43. Permanent School Fund Asset Mix as of June 30, 2016



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Investment Performance

During the fiscal year, the *stock* segment of the Permanent School Fund tracked its benchmark, the S&P 500.

The *bond* segment underperformed its benchmark by 0.3 percentage point during the current fiscal year, primarily due to an overweight to the corporate sector and a short duration position relative to the benchmark.

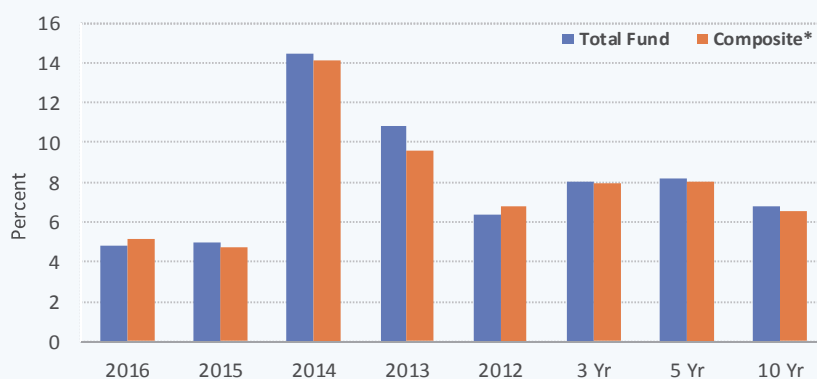
Overall, the Permanent School Fund provided a return of 4.8% for fiscal year 2016, underperforming its composite index by 0.3 percentage point. The Fund outperformed its composite index over the most recent three, five and ten year periods due to the incremental value added by bonds.

Total account performance results for the last three, five and ten years are shown in Figure 44.

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

<u>Fiscal Year</u>	<u>Millions</u>
2012	\$24
2013	\$25
2014	\$24
2015	\$26
2016	\$28

Figure 44. Permanent School Fund Performance For Periods Ending June 30, 2016



	2016	2015	2014	2013	2012	Annualized		
						3 Yr.	5 Yr.	10 Yr.
Total Fund	4.8%	5.0%	14.4%	10.8%	6.4%	8.0%	8.2%	6.8%
Composite*	5.1	4.7	14.1	9.6	6.8	7.9	8.0	6.5
Stock Segment	4.0	7.5	24.5	20.5	5.5	11.7	12.1	7.5
S&P 500	4.0	7.4	24.6	20.6	5.4	11.7	12.1	7.4
Bond Segment	5.7	2.5	5.0	1.4	6.5	4.4	4.2	5.6
Barclays Agg.	6.0	1.9	4.4	-0.7	7.5	4.1	3.8	5.1

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