

**NORTH DAKOTA
BOARD OF UNIVERSITY AND SCHOOL LANDS**

INVESTMENT PERFORMANCE REPORT

For periods ended December 31, 2013



PERMANENT EDUCATIONAL TRUST ASSETS

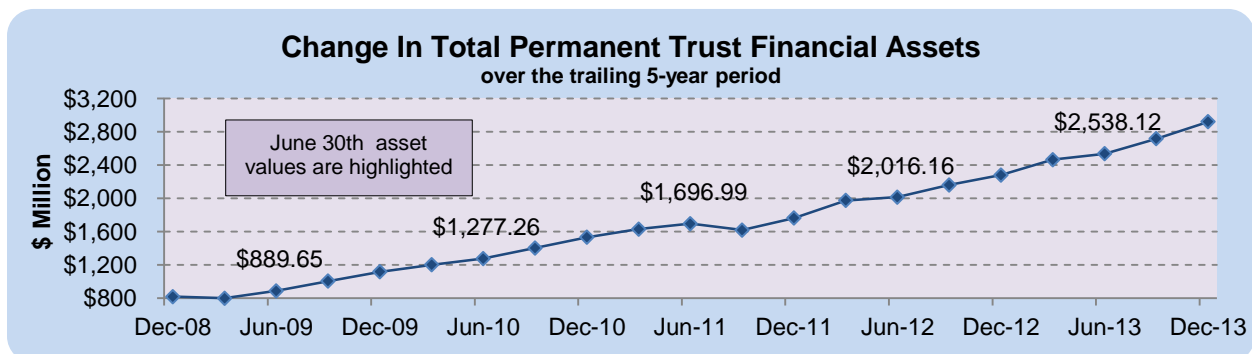
TOTAL TRUST ASSETS

The first section of this report shows combined data for the 13 permanent educational trust funds and the Indian Cultural Education Trust managed by the Board. Most assets of the trusts are invested in a pool. Each trust owns a share of the investments in the pool and each trust shares proportionately in the profits, losses and income generated by those investments.

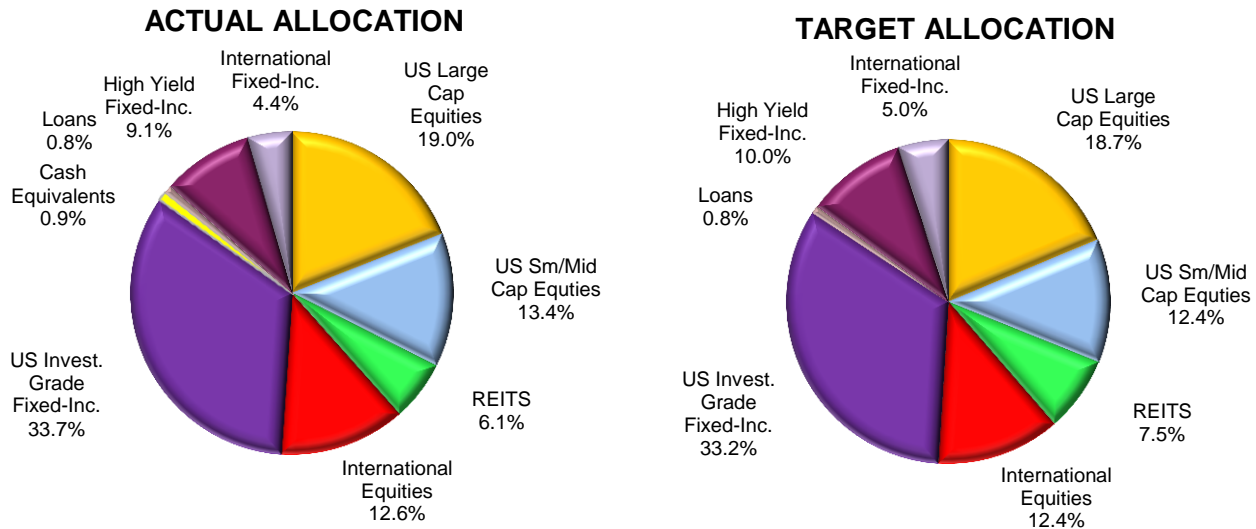
For the schedule below and for all other schedules, tables and charts that follow in this report, all loans, warrants, loan portfolios and certificates of deposit are valued at cost. All other investments in marketable securities, such as stocks, bonds, mutual funds and cash equivalents are valued at market value.

COMPARATIVE ASSET ALLOCATION SCHEDULE						
Date	Total Assets	Large Cap Equities	Sm/Mid Cap Equities	REITS	International Equities	Fixed Income
6/30/13 Rebalanced	\$2,538,122,000	\$474,629,000 18.7%	\$314,727,000 12.4%	\$190,359,000 7.5%	\$314,727,000 12.4%	\$1,243,680,000 49.0%
12/31/13 Actual	\$2,922,720,000	\$555,864,000 19.0%	\$390,905,000 13.4%	\$177,794,000 6.1%	\$368,328,000 12.6%	\$1,429,829,000 48.9%
12/31/13 Target	\$2,922,720,000	\$546,549,000 18.7%	\$362,417,000 12.4%	\$219,204,000 7.5%	\$362,417,000 12.4%	\$1,432,133,000 49.0%

- ◆ Total permanent trust assets stood at \$2,922.72 million as of December 31, 2013. Total trust assets grew by \$205.63 million for the quarter ended December 31, 2013 and \$671.69 million for the year there ended.
- ◆ The investment portfolio earned a total return of 4.25% during the quarter, and was responsible for more than \$115 million of the above noted quarterly trust growth. Oil and gas royalties (\$59.30 million) and oil extraction tax collections (\$39.07 million) were the other large contributors to trust growth during the quarter.
- ◆ A total of \$18.00 million was distributed from the Common Schools Trust Fund to K-12 education in North Dakota during the quarter; a total of \$65.16 million will be distributed to K-12 education during fiscal year 2014. An additional \$4.18 million will be distributed to the beneficiaries of the other 12 permanent trust funds during the fiscal year.
- ◆ Total trust assets have grown by more than \$2.12 billion since March 2009, when equity markets hit the low point reached during the 2008-09 recession. Growth has been driven by both strong equity markets and growing oil and gas royalty and tax revenues. As total trust assets continue to grow, so will trust distributions.



ACTUAL ALLOCATION VS. TARGET ALLOCATION AS OF DECEMBER 31, 2013



Asset Class	Actual \$ million	Actual %	Target \$ million	Target %	Difference \$ million	% Diff.
US Large Cap Equities	\$ 555.86	19.0%	\$ 546.55	18.7%	\$ 9.31	0.3%
US Sm/Mid Cap Equities	390.90	13.4%	362.42	12.4%	28.48	1.0%
REITS	177.80	6.1%	219.20	7.5%	(41.40)	(1.4%)
International Equities	368.33	12.6%	362.42	12.4%	5.91	0.2%
Total Equities	\$ 1,492.89	51.1%	\$ 1,490.59	51.0%	\$ 2.30	0.1%
US Invest. Grade Fixed-Income	985.15	33.7%	970.55	33.2%	14.60	0.5%
Cash Equivalents	26.40	0.9%	0.00	0.0%	26.40	0.9%
Loans	23.17	0.8%	23.17	0.8%	0.00	0.0%
High Yield Fixed-Income	266.75	9.1%	292.27	10.0%	(25.52)	(0.9%)
International Fixed-Income	128.36	4.4%	146.14	5.0%	(17.78)	(0.6%)
Total Fixed-Income	\$ 1,429.83	48.9%	\$ 1,432.13	49.0%	(\$ 2.30)	(0.1%)
Total Portfolio	\$ 2,922.72	100.0%	\$ 2,922.72	100.0%		

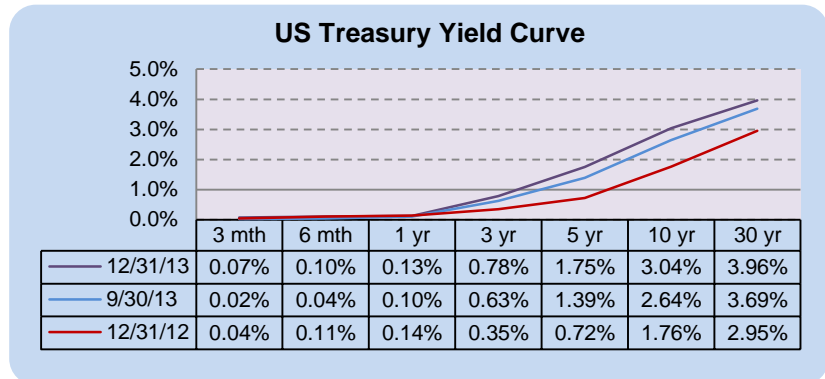
- ◆ The actual asset allocations to equities and fixed income securities on December 31, 2013 essentially matched the target allocations on that date. The fixed income portfolio was underweight by \$2.30 million, while equities were overweight by the same amount.
- ◆ Within equities, both large and small/mid cap domestic equities were overweight at quarter's end while the allocation to REITS was underweight. This difference is due primarily to the strong performance of domestic stocks versus the poor performance of REITS over the past year. No rebalancing has been done between equity portfolios in recent months in anticipation of the implementation phase of the asset allocation study which will be completed in 2014.
- ◆ The overweight position to cash equivalents was used to rebalance the portfolio in late-January, when \$23.0 million was added to the Payden & Rygel Low Duration Fund. Over the past 6 months, all monies that have been allocated to fixed income assets have been invested in Payden & Rygel's Low Duration Fund in anticipation of the completion of the investment study and the implementation of a new asset allocation during 2014.
- ◆ Work was essentially wrapped up on the R.V. Kuhns investment study at year end. A final report will be presented to the Board in February 2014; it is expected that a final Investment Policy Statement will be presented to the Board in March 2014.
- ◆ In September the Land Board adopted a new, broad asset allocation for the permanent trusts that includes 17% U.S. equities, 15% international equities, 23% fixed income, 15% real estate, 20% absolute return strategies and 10% real assets.

FINANCIAL MARKET OVERVIEW

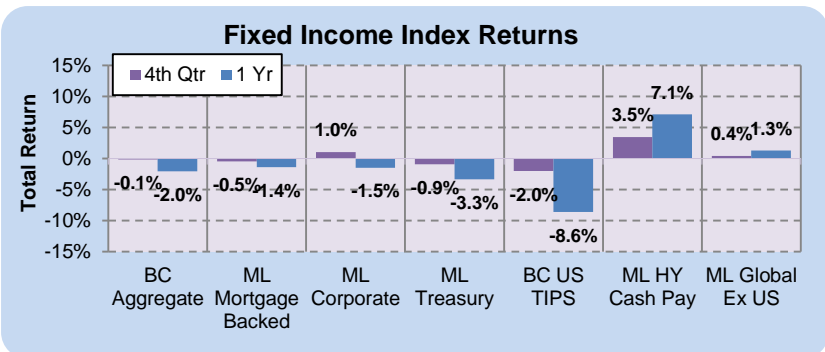
FIXED INCOME MARKETS

- Over the past 3 months the Treasury yield curve continued to steepen as longer-term rates rose more than shorter-term rates did. The curve is substantially steeper than it was a year ago.

- On December 31, 2013 10-year Treasury rates stood at 3.04%, almost 128 basis points higher than a year earlier, while 30-year rates were at 3.96%, more than 1% higher than a year earlier. The sharp rise in longer-term rates has been driven by the expectation that the Fed will tighten monetary policy by reducing the purchase of government bonds sooner than later.



- Returns posted by various fixed income indexes were mixed for both the quarter and year ended December 31, 2013. Spread instruments (corporate and high yield bonds) performed best during the quarter. High yield bonds were by far the best performing fixed income asset class for the trailing-year ended December 31, 2013.



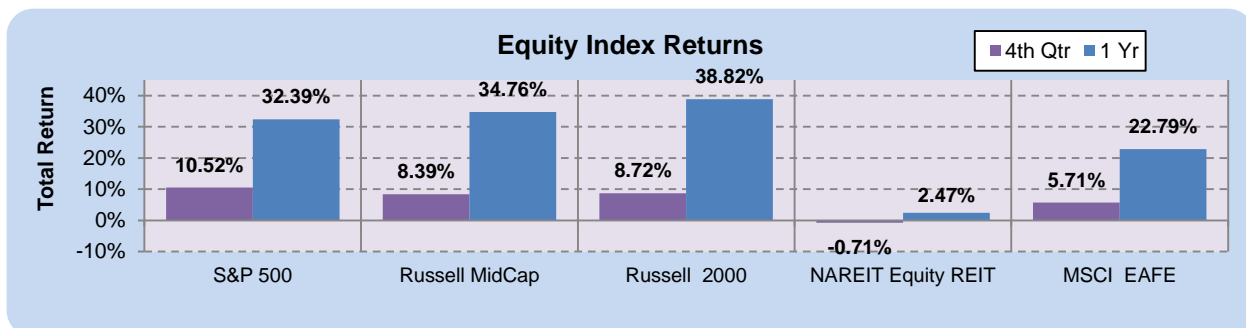
EQUITY MARKETS

- Most of the equity asset classes in the portfolio posted strong positive returns for both the quarter and trailing-year ended December 31, 2013. The exception was REITs, which once again lagged other equities by a large margin for both the quarter and trailing-year there ended.

- The relatively weak returns posted by REITs for both the quarter and trailing-year can be attributed directly to the Fed's May announcement related to the cutting back on stimulus programs.

- Equity indexes were once again at or near their all-time highs on December 31, 2013. The combination of relatively low interest rates and strong earnings growth has resulted in most equity indexes more than doubling in less than 5 years.

- US stock returns were driven primarily by the expansion of PE ratios during the year, while international stocks returns were driven by increased earnings. Despite strong returns, stocks still are not expensive by most measures, when one considers the current economic environment.



MANAGER AND PORTFOLIO RETURNS

RETURNS FOR PERIODS ENDED DECEMBER 31, 2013								
<u>Asset Class</u> MANAGER Benchmark/Index	12/31/13 Allocation (\$ mil.)	% of Total Portfolio	Last Qtr.	Last 1 Year	Last 3 Years	Last 5 Years	Last 10 Years	
Large Cap US Equity								
STATE STREET - S&P 500 Index	\$555.86	19.0%	10.51	32.36	16.15	17.93	-	-
S&P 500 Index			10.52	32.39	16.18	17.94	7.40	
Small/Mid Cap US Equities	\$390.90	13.4%	8.54	37.71	15.63	-	-	
NORTHERN TRUST	\$151.66	5.2%	8.60	36.61	14.99	20.77	8.64	
STATE STREET - Small/Mid Index	\$239.24	8.2%	8.50	38.41	16.38	-	-	
60% Russell 2000/40% Russell Mid Cap			8.60	37.21	15.75	20.87	9.64	
Russell Completeness Index			8.50	38.50	16.25	22.33	10.04	
Real Estate Investment Trusts (REITS)								
DELAWARE INVESTMENT ADVISORS	\$177.80	6.1%	(0.17)	2.27	9.97	15.58	8.38	
NAREIT Equity REIT Index			(0.71)	2.45	9.41	16.50	8.42	
TOTAL DOMESTIC EQUITIES	\$1,124.56	38.5%	8.01	28.14	13.68	-	-	
International Equities								
STATE STREET - International Alpha	\$368.33	12.6%	7.17	26.39	7.91	-	-	
NORTHERN TRUST - EAFE Index	\$298.60	10.2%	7.52	27.20	8.20	12.44	-	
MSCI EAFE Index	\$69.73	2.4%	5.71	22.89	-	-	-	
MSCI EAFE Index			5.71	22.79	8.17	12.44	6.91	
TOTAL EQUITIES	\$1,492.89	51.1%	7.80	27.72	12.62	16.69	6.61	
US Investment Grade Fixed Income								
PAYDEN & RYSEL - Aggregate	\$1,011.55	34.6%	(0.07)	(2.53)	3.43	-	-	
JP MORGAN - Intermediate	\$265.27	9.1%	0.55	(1.45)	4.18	7.03	5.24	
BND - Project Notes	\$265.45	9.1%	0.00	(1.11)	-	-	-	
PAYDEN & RYSEL - Low Duration	\$22.22	0.1%	0.35	1.00	2.21	4.64	4.94	
NORTHERN TRUST - TIPS	\$287.11	9.8%	0.47	0.48	3.42	4.32	4.05	
PAYDEN & RYSEL - Cash	\$165.10	5.6%	(2.05)	(8.61)	3.61	5.60	-	
Barclay's Capital US Aggregate Index	\$26.40	0.9%	(0.01)	0.03	0.02	0.11	1.73	
Barclay's Intermediate Govt./Corp.			(0.14)	(2.02)	3.27	4.45	4.55	
Barclay's Capital TIPS			(0.02)	(0.86)	-	-	-	
6 Month T-Bill			(2.01)	(8.61)	3.55	5.63	-	
			(0.02)	(0.04)	0.01	0.09	1.70	
Loans	\$23.17	0.8%	1.57	5.49	5.91	-	-	
BND - Farm Loan Pool	\$21.68	0.7%	1.60	5.52	5.92	6.23	6.91	
BND - Energy Construction Loans	\$1.49	0.1%	1.27	5.16	5.57	-	-	
US High Yield Fixed Income								
LAZARD ASSET MANAGEMENT	\$266.75	9.1%	1.91	5.26	7.41	9.91	-	
Merrill Lynch US High Yield Cash Pay Index			2.27	6.79	8.75	13.17	-	
Merrill Lynch BB/B Index			2.07	6.04	8.42	11.92	-	
TOTAL DOMESTIC FIXED INCOME	\$1,301.47	44.5%	0.62	(0.54)	4.46	-	-	
International Invest. Grade Fixed Income								
FIRST INT'L ADVISORS	\$128.36	4.4%	0.53	(1.04)	3.71	4.48	-	
Merrill Lynch Broad Global (Ex-US) Index - Hedged			0.44	1.31	3.95	3.96	-	
TOTAL FIXED INCOME	\$1,429.83	48.9%	0.61	(0.59)	4.38	6.84	5.28	
TOTAL PORTFOLIO	\$2,922.72	100.0%	4.25	13.25	8.79	12.00	6.36	

All return figures for periods of 1 year or greater have been annualized. All returns are net of fees.

EQUITY PORTFOLIO REVIEW

- ◆ During the quarter ended December 31, 2013, the combined equity portfolio posted a total return of 7.80%; the equity portfolio earned 27.72% for the trailing-year there ended.
- ◆ Active equity managers (Northern Trust Small/Mid, Delaware REIT and State Street - International Alpha) posted mixed returns for both the quarter and trailing-year ended December 31, 2013. State Street was the only active manager to outperform their benchmarks for both the quarter and trailing-year ended December 31, 2013.
- ◆ All new money being added to equities continues to be added to one of the portfolio's index funds when possible. Doing so will help reduce the cost of transitioning to the new asset allocation that was recently adopted by the Land Board.
- ◆ The permanent trusts' combined equity portfolio has posted a total return of 144.78% during the 4¾ years since the stock market bottomed out during the recession in March of 2009.
- ◆ The various equity index funds used by the permanent trusts' continue to provide low cost exposure to equities with minimal tracking error.

Northern Trust – Small/Mid Cap

- ◆ Northern Trust essentially matched the performance of the custom benchmark for this account for the quarter ended December 31, 2013, but has underperformed the benchmark by a small amount for all other periods shown in the table on page 4. Northern has outperformed the benchmark by 88 basis points since inception of this account back in April 1996.
- ◆ Over time, Northern's "manager of managers" program has provided more index like returns than one would expect. Discussions with R.V. Kuhns lead the Commissioner to believe that this portfolio might have a better chance at adding Alpha if it had fewer managers in it. This issue will be researched in more detail as part of the implementation phase of the asset allocation study that will occur in 2014.

Delaware Investment Advisors

- ◆ Delaware outperformed the benchmark for this portfolio for the quarter ended December 31, 2013, but underperformed the benchmark for the trailing-year there ended. Delaware has essentially matched the benchmark for the account, net of fees, since inception of the account a little more than 10 years ago.
- ◆ A significant underweighting to poor performing healthcare REITs and an overweight position in stronger performing lodging REITs both helped the portfolio's performance during the quarter ended December 31, 2013. The portfolio's holdings of Lexington Realty Trust and underweight positions in various shopping center REITs detracted from performance.

State Street Global Advisors (SSGA) – International Alpha

- ◆ State Street's International Alpha product continued to post strong returns during the quarter. The portfolio outperformed the benchmark EAFE Index by 180 basis points for the quarter and 442 basis points for the year ended December 31, 2013. The portfolio has essentially matched the index over the trailing 3 and 5-year periods shown in the table on page 4.
- ◆ Although this portfolio has performed well since a dynamic component was added to SSGA's quantitative model in early 2012, the Commissioner continues to have concern about the amount of turnover that has occurred in SSGA's active management team.
- ◆ It is expected that R.V. Kuhns will provide a recommendation to the Board as to how to deal with this portfolio at either the February or March 2014 Land Board meetings.

FIXED INCOME PORTFOLIO REVIEW

- ◆ The combined fixed income portfolio posted a total return gain of 0.61% during the quarter ended December 31, 2013, but posted a negative return of -0.59% for the trailing-year there ended. The relatively 1% plus increase in long-term interest rates was the primary driver of negative returns for the trailing-year.
- ◆ The investment grade portion of the portfolio posted negative returns for both the quarter and trailing year ended December 31, 2013. The poor performance of TIPS was the primary driver of this negative performance over the past year.
- ◆ The strong performance of high yield bonds, driven by shrinking spreads, and the consistent performance of loans both bolstered the performance of the overall fixed income portfolio over the past year.

Payden & Rygel – Aggregate

- ◆ Payden outperformed the benchmark for the quarter ended December 31, 2013, and for all other periods shown in the table on page 4.
- ◆ The portfolio's shorter than benchmark duration helped performance during the quarter, as did the portfolio's overweight position to investment grade corporate bonds.

J.P. Morgan

- ◆ The J.P. Morgan intermediate portfolio essentially matched the performance of the Barclays Capital Govt./Corp. Intermediate Index during the quarter, it underperformed the benchmark by a little more than 1% for the trailing-year ended December 31, 2013.
- ◆ The portfolio's large overweight position to mortgage backed securities, which are not included in the benchmark index, was a big contributor to the underperformance of the portfolio over the past year.

Payden & Rygel – Low Duration Fund

- ◆ All new money that is being added to the permanent trusts' fixed income portfolio continues to be added to Payden & Rygel's Low Duration Fund in anticipation of assets being redeployed to other investment strategies during the 2014 implementation phase of the R.V. Kuhn's investment study.
- ◆ The short duration of this fund will help protect the value of these assets if interest rates continue to rise, but will also generate more income than cash equivalents if interest rates stabilize over the next 6 months as these assets wait to be redeployed. During the quarter ended December 31, 2013 more than \$90 million was added to this fund.

Bank of North Dakota (BND) – Farm Loan Pool

- ◆ Rising interest rates during 2013 resulted in loan rates that are above the rate floors established by the Board for the first time since April 2012. During the quarter a total of \$2.4 million of new farm real estate loans were funded.

Lazard

- ◆ Lazard's conservative strategy continues to underperform the benchmarks for this account for all periods shown in the table on page 4. This portfolio cannot keep up with the performance of a broad high yield index during a period like the past 4 years when interest rates have consistently contracted from the historic spreads experienced during the 2008-09 recession.

First International Advisors

- ◆ Although this portfolio has shown mixed performance for the various periods shown in the table on page 4, it has outperformed the benchmark, net of fees, since inception almost 10 years ago.
- ◆ Overweighting of the 7-10 year duration portion of the investment universe detracted from the performance of the portfolio during the quarter and trailing-year ended December 31, 2013.

OTHER TRUSTS MANAGED BY THE LAND BOARD

The **Strategic Investment and Improvements Fund (SIIF)** was created effective July 1, 2011, by legislative action, through the merging of the former Budget Stabilization and Lands and Minerals funds. It holds the assets and collects the revenues earned from more than 750,000 sovereign mineral acres, including those formerly owned by the Bank of North Dakota and State Treasurer, as well as the minerals located under navigable rivers and lakes. The SIIF also receives a substantial portion (more than \$712 million during the 2011-13 bi.) of the oil and gas production and extraction taxes collected by the State.

	12/31/13 Asset Balances	Current Yield
Strategic Investment and Improvements Fund		
Medical Facility Loan Fund	\$ 50,000,000	0.05%
School Construction Loans	\$ 45,268,000	1.19%
Cash Equivalents	\$ 25,475,000	0.03%
Treasury Securities	<u>\$ 877,321,000</u>	0.18%
Total	<u>\$ 998,064,000</u>	

- ◆ During the quarter ended December 31, 2013, the SIIF collected about \$27.1 million of royalty income and \$500,000 of lease bonus income. Two school construction loans, totaling \$16.18 million, were funded during the quarter.
- ◆ Due to the fact that this fund is fully expendable, with expected transfers out of the fund of \$793.75 million for the biennium, it is currently invested in short-term Treasury securities that mature before June 30, 2015. In addition, at various times a substantial amount of the fund may be held in cash equivalents in anticipation of large, short-term cash flows. This is the cash on December 31, 2013, as a \$20 million school construction loan was funded in mid-January.
- ◆ Staff continues to work with DPI and various bond council attorneys to set up the new gross production tax backed school construction loan program. Final details should be completed during the first quarter of 2014.
- ◆ The R.V. Kuhns investment study is exploring whether the SIIF could be invested in a way that better balances liquidity needs with the desire to earn income.
- ◆ The unobligated balance of the SIIF was \$114.62 million on December 31, 2013. The unobligated fund balance is the amount of the fund balance that has not been set aside until potential title disputes to certain riverbed leases are resolved and has not been committed to future distribution or dedicated to various loan programs. Once the unobligated balance reaches \$300 million, 25% of all revenues that go into this fund will instead be deposited into the Legacy Fund.

The **Capitol Building Trust** was created for the construction and maintenance of “public buildings at the capital”. It generates revenues from the almost 10,000 surface and 27,700 mineral acres it owns. Because the entire balance of this trust can be appropriated by the legislature each biennium, it is invested in conservative, short-term fixed income securities which tend to have maturities of two years or less.

	12/31/13 Asset Balances	Current Yield
Capitol Building Trust		
Treasury Securities	\$ 3,223,000	0.26%

- ◆ No new monies were appropriated out of this fund for the current biennium, although \$1.0 million of carryover authority remains from the 2011-13 biennium. The part of this trust that will be spent during the current biennium is invested out to the date Facilities Management has informed us they will need the money. The balance of these assets are invested to the end of the biennium.

The **Coal Development Trust Fund** is a permanent fund from which the Land Board issues loans to energy impacted counties, cities and school districts as provided in NDCC Section 57-62-03, and loans to school districts pursuant to NDCC Chapter 15-60. The Land Board is responsible for investing all funds that have not been loaned to political subdivisions. Because these funds can be loaned at any time, they are invested in a conservative short-term fixed income portfolio managed by Payden & Rygel. The income earned by this fund is transferred to the General Fund each year.

	12/31/13 Asset Balances	Current Yield
Coal Development Trust Fund		
Coal Warrants	\$ 7,709,000	3.82%
School Construction Loans	\$ 31,338,000	2.13%
Marketable Securities	<u>\$ 26,577,000</u>	N/A - see returns below
Total	\$ 65,624,000	

- ◆ The Commissioner expects that the school construction loan balance will reach the statutory cap of \$50 million during the current biennium; this would be the first time the cap has ever been reached. Funding for any new loans will come out of the marketable securities portfolio managed by Payden & Rygel.

Payden and Rygel – Coal

- ◆ Payden & Rygel essentially matched the performance of the benchmark Merrill Lynch 1-3 Year Treasury Index for the quarter ended December 31, 2013; over longer periods of time they have generated returns either slightly above or below the benchmark for this portfolio.

	12/31/13 Asset Balance	Last Qtr.	Last 1 Year	Last 3 Years	Last 5 Years	Last 10 Years
Payden & Rygel Coal Dev.	\$26.58	0.22	0.73	1.28	2.31	2.58
ML 1-3 Year Treasury Index		0.20	1.56	1.11	1.86	2.69
All return figures for periods of 1 year or greater have been annualized. Returns are net of fees						