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F I S C A L   I M P A C T   R E P O R T

SPONSOR Smith **DATE TYPED** 2/18/2004 **HB**

SHORT TITLE Permanent Fund Investments in Real Estate **SB** 316/aSCORC/aSFC/aSFl#1/aSFl#2/aSFL#3/aHTRC

ANALYST Garcia

REVENUE

Estimated Revenue		Subsequent Years Impact	Recurring or Non-Rec	Fund Affected
FY04	**FY05**			
		FY06: $70.0; FY07: $135.0; FY08: $271.0	Recurring	General Fund
$7,400.0 (increase in market value)	$14,400.0 (increase in market value)	Greater Than $14,400.0 (increase in market value)	Recurring	Severance Tax Permanent Fund

(Parenthesis ( ) Indicate Revenue Decreases)

HB 209 is the companion bill.

SOURCES OF INFORMATION
LFC Files

Response Received From
State Investment Council

SUMMARY

Synopsis of HTRC Amendment

The House Taxation and Revenue Committee Amendment to SB 316, as amended, removes previous amendments and adds language to duplicate HB 209. The following are the HTRC changes:

(1) The HTRC Amendment removes the Senate Finance Committee Amendment 5, which stipulates requirements for real estate investment trusts. The removed language requires that any real estate investment trusts the SIC invests in; must have a minimum of $50 million already invested, a three-year performance record, and provide reports detailing underlying assets.
(2) The HTRC Amendment strikes Senate Floor Amendment 2, which adds a sunset provision to the bill.
(3) The HTRC Amendment strikes items 3 and 4 of Senate Floor Amendment 3. The Senate Floor Amendment 3 reduced the allocation from the Severance Tax Permanent Fund

from "ten" percent to "five" percent, the HTRC Amendment reinstates the "ten" percent allocation from the Severance Tax Permanent Fund.

(4) The HTRC strikes the word derivatives and short-selling, eliminating the ability of the SIC to invest directly in derivatives and conduct short-selling. The bill still allows for the ability to invest in hedge funds.

(5) The HTRC strikes all authorization allowing the SIC to invest directly in derivatives and conduct short-selling.

<u>Fiscal Implications of HTRC Amendment</u>

The fiscal impact research was conducted by New England Pension Consultants (NEPC), the SIC investment consultant. NEPC included a 10 percent asset allocation in real estate investments and hedge funds in its projections and concluded the proposed changes would increase the total return to the STPF by 0.40 percent without increasing risk. For FY04, the increase in allocation to the two asset classes would result in an estimated increase in the STPF market value of $7.4 million (from the 4.7 percent distribution from the STPF). The estimated increase in the market value of the STPF for FY05 from an increase in these investment classes would amount to roughly $14.4 million. Because the distribution formula for the STPF is determined on December 31 of each year for the next fiscal year, the FY05 distribution has already been determined and the bill will not affect FY05 distribution but will increase the FY06 distribution. The estimated increased general fund revenue from the increase in market value of the STPF from the bill is $70 thousand for FY06, $135 thousand for FY07, and $271 thousand for FY08.

The first year estimate assumes that only one-third of the real estate will be placed in FY05. The SIC's real estate policy anticipates that this minimum will be invested in publicly traded real estate investment trusts (REITs) and real estate "mutual funds" for institutional investors that are easily placed and redeemed. Finally, the out-year estimates for all these proposals assume no growth or compounding in permanent fund market values; they are all based on the December 31, 2004 balance of $11.1 billion.

As of December 31, 2004 the severance tax permanent fund market value was roughly $3.6 billion. The additional allocations from the bill will not affect the Land Grant Permanent Fund and will only affect the Severance Tax Permanent Fund.

<u>Synopsis of SFl Amendment #3</u>

The Senate Floor Amendment #3 to SB 316 strikes any reference to "ten" percent allocation from the permanent funds to "five" percent. Consequently, the amendment only allows a "five" percent allocation of real estate and hedge funds from the Severance Tax Permanent Fund. The amendment still allows the SIC to directly invest in derivative investment instruments.

<u>Fiscal Implications</u>

The amendment and consequently the entire bill will only be referenced to the Severance Tax Permanent Fund (STPF) since a ¾ vote on the Land Grant Permanent Fund investments failed. The result of the decrease in allocation from ten percent to five percent will reduce the fiscal impact on the market value of the STPF and revenue to the general fund from the 4.7 percent distribution of the STPF.

The State Investment Council's investment advisor, New England Pension Consultant (NEPC), estimates that allowing the SIC to invest 5 percent of the STPF in real estate and hedge funds and allowing direct investment in derivatives will increase the STPF market value by roughly $4.4 million in FY04. The resulting revenue to the general fund from the increase in market value (based on a 4.7 percent distribution formula) will be an additional $41 thousand. For FY05, NEPC estimates the market value of the STPF will increase to around $7.9 million and revenue to the general fund (based on a 4.7 percent distribution formula) will be roughly $74.5 thousand. Moreover, in FY06, NEPC estimates the general fund revenue increase will jump to $149 thousand and will move up to $223 thousand in FY07 and beyond.

Synopsis of SFl Amendment #2

The Senate Floor Amendment #2 adds a sunset provision on page 17, line 17 that states: "this bill shall sunset on January 1, 2009."

Synopsis of SFl Amendment #1

The Senate Floor Amendment #1 reinstates the word "first" on page 4, line 1. Section 1 (7) now reads: "real estate investments, including real property and undivided interests in real property, debt instruments secured by first liens on real property or limited partnership interests…."

Synopsis of SFC Amendment

The Senate Finance Committee amendments repeal the SCORC amendment and emergency clause. The SFC amendments add the following language for administering investments in real estate trusts: "investments in hedge funds that invest primarily in real estate investment trusts may be made pursuant to this paragraph only if the fund advisors: 1) provide audited financial statements to the state investment officer; 2) agree to provide regular reports detailing underlying fund investment holdings and transactions to the state investment officer and a third party risk assessment firm designated by the state investment officer; 3) possess a three-year performance record that has been reviewed by the state investment officer; and 4) manage a minimum of fifty million dollars ($50,000,000) of investments in the investment strategy to be used for the investment made pursuant to this subparagraph."

The amendments also add the following language to for administering investments in hedge funds: "the hedge fund advisors: 1) provide audited financial statements to the state investment officer; 2) agree to provide regular reports detailing underlying fund investment holdings and transactions to the state investment officer and a third party risk assessment firm designated by the state investment officer; 3) possess a three-year performance record that has been reviewed by the state investment officer; and 4) manage a minimum of one hundred million dollars ($100,000,000) of investments in the investment strategy used."

Significant Issues of SFC Amendments

The Senate Finance Committee amendments resolve concerns about the execution of the State Investment Council's proposed hedge fund allocation. Besides mandating transparent reporting, the amendments require that stock and bond hedge fund managers possess a three year track record managing at least $100 million; the requirement is reduced to $50 million for hedge fund managers specializing in real estate investment trusts (REIT's). The amendments strengthen the

bill for SIC administering of hedge funds and higher real estate allocations.

The lowered threshold for REIT hedge funds was recommended by the SIC's real estate consultant, Courtland Partners. REIT's are not like other stocks; they are securities real estate holdings and hedge fund managers that specialize in public equity real estate have only recently evolved. Courtland believes that the hedge fund strategies might be an appropriate response to recent REIT market performance; the one year increase in the NAREIT equity index is almost 40 percent.

Synopsis of SCORC Amendment

The Senate Corporations and Transportation Committee Amendment adds an emergency clause.

Synopsis of Original Bill

The bill allows the SIC to invest in additional alternative asset classes and allows a higher allocation of real estate investments in the portfolio.

Specifically, the bill allows:

- A 10% allocation for real estate (currently 3% of the permanent funds' market value).
- A 10% allocation for hedge funds (currently not allowed).
- The use of forward contracts such as options, interest rate swaps, and short selling arrangements for the purposes of hedging and asset reallocation.

Significant Issues

1) Background of Investments: Currently, the State Investment Council (SIC) is not authorized to invest in derivatives, conduct short-selling, and is limited to invest only 3 percent of the market value of the land grant permanent fund in real estate assets. Consequently, the bill will allow the investment agency the ability to invest in derivative instruments, conduct short-selling, and invest more of the permanent fund's portfolio (up to 10 percent) in real estate.

Derivatives are assets such as futures, forwards, and options, assets that are derived from an underlying asset. Instead of directly buying and selling an asset, an investor who invests in derivatives pays a premium for the opportunity to buy an underlying asset with features. For instance, with a future, an investor is obtaining a contract to buy or sell an asset (such as: wheat, corn, gold, silver, etc.) at a certain time in the future at an agreed upon price. A forward is the same type of contract as a future; however, a forward contract is traded over-the-counter whereas a future is traded in an open market such as the Chicago Board of Trade. Lastly, an option contract gives the investor a right to do something. For example, in a call option, the holder has a right to buy an asset by a certain date at an agreed upon price. A put option gives the holder a right to sell an asset by a certain date for an agreed upon price.

Short-selling is the opposite of regular stock or other securities purchases. An investor who short-sells will profit when the stock price falls and will lose when the stock price rises. For example, an investor will make an order with a broker to buy 'short' on a given stock, that current stock price, say $30, is then recorded and any price decline from the stock say to $25, is a $5 gain to the investor and is charged to the investor's account.

The use of derivatives and short-selling enable the portfolio to hedge its assets. Hedging is the practice of buying and selling a particular asset to offset an otherwise risky position. For example, if a company knows its going to gain $1,000 for each 1 cent increase in the price of an asset, but also knows it will lose $1,000 for each 1 cent decrease in the price of the asset; the company can hedge by taking a short futures position on the asset. If the asset decreases, the short position makes up for the decrease in the prices of the asset to net the investment loss at zero. On the other hand, if the price of the asset goes up, the loss to the company is only the price of buying the short position, thus resulting in a net investment gain.

Hedging is a common practice among institutional investors and is a strategy that attempts to protect a portfolio against market downturns. Moreover, the derivative market, otherwise known as hedging, is a huge market internationally. The futures, options, and forwards markets dwarf the equity markets in size and are growing rapidly.

Real Estate investments do not include speculation in raw land (which are prohibited by SIC policy). The classic core investment is an office building that is almost completely leased to an investment grade (BBB or greater by Standard & Poor's) tenant for longer than 5 years.

Real estate behaves differently than other financial assets. The very nature of real property makes these investments illiquid and unique. Unlike stocks, cash flow to tax exempt investors is not reduced by income tax. Although real estate equity and stocks both represent ownership interest, real estate has many characteristics that provide stable income. Like bonds, the majority of returns from real estate are generated from cash distributions. Unlike bonds, property values are not adversely affected by inflation.

2) SIC contends the ability to use the additional investment strategies will provide added diversification effects that will (1) reduce or maintain the same level of risk of the portfolio; and (2) increase the expected return of the portfolio. Specifically, the ability to invest in derivatives and short-sell allows the investment agency to invest in hedge funds. These types of funds and investments are regarded by the SIC advisor to typically have higher risk-adjusted returns.

3) According to SIC's advisor, New England Pension Consultants, the additions of hedge funds and real estate add no economic risk, as measured by standard deviation, to the portfolio. However, an implicit risk does exist to the portfolio. The risk lies in management and structure of the new program.

- Risk lies in the ability of the SIC to develop a comprehensive due diligence process that chooses competent managers and monitors them extensively.
- The success of the asset relies on investment manager skill

Without a well structured management and implementation plan that adequately oversees the hedge fund asset class, the portfolio return is at risk due to the complexity of the asset. Thus far, SIC has not provided a management or implementation plan of how the organization will oversee this new asset class.

4) The LFC subcommittee on Investment Performance and Pension Review can further study this complex issue in the interim.

FISCAL IMPLICATIONS

The following table is a breakdown of the current portfolio target mix, and the additional columns show the portfolio asset allocation with the addition of 8 percent in hedge funds as well as 8 percent in real estate (5 percent above the current real estate allocation). This is used just to illustrate the possible new asset mixes of the portfolio with the additions of the new asset classes and the impact the assets would have on expected return and risk of the whole portfolio.

	Current Target Allocation	**Hedge Funds Addition**	**Hedge Funds + Real Estate**
Equity	61%	58%	59%
Fixed Income	31%	27%	21%
Alternatives	7%	14%	19%
Private Equity	4%	3%	3%
Market Neutral Hedge Funds	0%	4%	4%
Mkt. Directional Hedge Funds	0%	4%	4%
Real Estate	3%	3%	8%
Cash	1%	1%	1%
Expected Long-term Compound Return	8.32%	8.43%	8.63%
Expected Risk (standard deviation)	11.46%	11.46%	11.46%
Additional Return (%)	n/a	0.11%	0.31%

Source: New England Pension Consultants, State Investment Council

The fiscal impact research was conducted by NEPC. NEPC included a 10 percent asset allocation in real estate investments in its projections and concluded the proposed changes would increase the total return to the funds by 0.43 percent without increasing risk. For FY05 the estimated additional distribution out of the permanent funds due to higher returns would amount to $285 thousand. This would increase to $668 thousand in FY06 and is estimated to increase into the future.

The first year estimate assumes that only one-third of the real estate will be placed in FY05. The SIC's real estate policy anticipates that this minimum will be invested in publicly traded real estate investment trusts (REITs) and real estate "mutual funds" for institutional investors that are easily placed and redeemed. Finally, the out-year estimates for all these proposals assume no growth or compounding in permanent fund market values; they are all based on the December 31, 2004 balance of $11.1 billion.

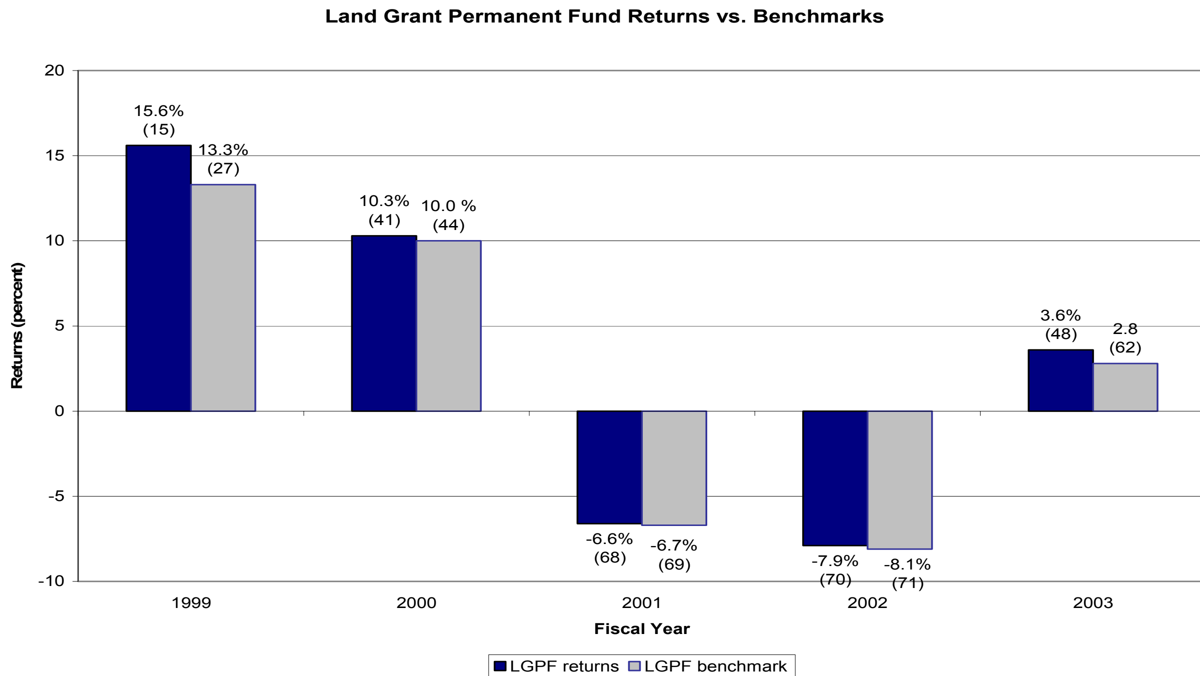
ADMINISTRATIVE IMPLICATIONS

Although the SIC proposal raises the expected return of the portfolio and does not raise the standard deviation (risk), there are still risks to using the new asset classes. Chief among the risks is the ability of SIC to implement and adequately administer the assets. For instance, successful short-selling and buying of hedge funds is dependent on investment manager skill and a mechanism that properly monitors investment managers. SIC has experienced problems in its due dili-

gence mechanism in another asset class, private equity, that resulted in the investment council back-tracking on approval of a few deals. As a result, it is necessary for SIC to present a plan on how the investment agency will implement and administer this possible new and complex asset class in order to establish the program on good footing from the start.

OTHER SUBSTANTIVE ISSUES

The following graph is a 5 year history of the returns of the LGPF versus its benchmark.



As the table shows, SIC met or exceeded its benchmarks for each of the past five years. However, these benchmarks are set at a lower standard as compared with other endowment funds. The numbers in the parenthesis represent SIC benchmark and actual return rankings (in percentile) in a universe of approximately 1,800 endowment funds. As the peer ranking shows, the majority of endowment funds in the universe had more aggressive benchmarks than SIC and nearly half of the endowment funds had higher returns for FY03.

Risk Adjusted Return - The historical average return of an asset or portfolio can be extremely misleading and should not be considered alone when selecting assets or comparing the performance of portfolios. One also has to take into account the historical variability or riskiness of return. The following table shows the return of different assets per unit of risk; the statistic is known as a “Sharpe ratio”.

Sharpe Ratios by Asset Class	
Asset Class	**Ratio**
Core Bonds	0.15
Mortgages	0.17
Mid Cap Equities	0.29
Large Cap Equities	0.33
Int'l Equities	0.33
Real Estate	0.34
Hedge Funds	0.43

Source: NEPC

As the table shows, hedge funds currently have the highest risk adjusted return of any major asset class. The second highest level of risk adjusted return is found in real estate. This result drives a considerable part of the fiscal impact shown above.

POSSIBLE QUESTIONS

Does the SIC have an adequate plan to implement this asset class and avoid the due diligence problems the agency encountered with private equity?

Is this a proposal that needs further study and possibly referred to the LFC for interim study?

DG/lg:yr:dm