

## Permanent School Fund

*The Permanent School Fund is a trust fund created by the Minnesota State Constitution and 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, 2010, the market value of the Fund was \$674 million.*

### 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, that will assist school districts.

### 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 FY 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 discussed. 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.

A proposal to introduce equities was presented during fiscal year 1997. 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 33 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2010.

### 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 at this time.

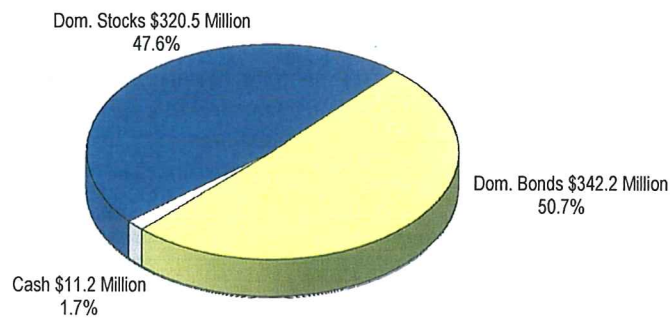
### Stock Segment

The stock segment of the Fund is passively managed to track the performance of the S&P 500.

### 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.

Figure 33. Permanent School Fund Asset Mix as of June 30, 2010



Note: Percentages may differ slightly due to rounding of values.

## Permanent School Fund

### Investment Performance

The *stock* segment of the Permanent School Fund slightly underperformed its benchmark, the S&P 500, by 0.2 percentage point during the fiscal year. By investing in all of the stocks in the benchmark at their index weighting, the segment attempts to track the benchmark return on a monthly and annual basis. The portfolio is periodically rebalanced to maintain an acceptable tracking error relative to the benchmark.

The *bond* segment outperformed its benchmark by 0.2 percentage point during the current fiscal year, primarily due to an overweight to the commercial mortgage backed securities sector.

*Overall*, the Permanent School Fund provided a return of 12.3% for fiscal year 2010, outperforming its composite index by 0.2 percentage point. The Fund outperformed its composite index over the last three, five and ten year periods due to the incremental value added by both the stock and bond segments.

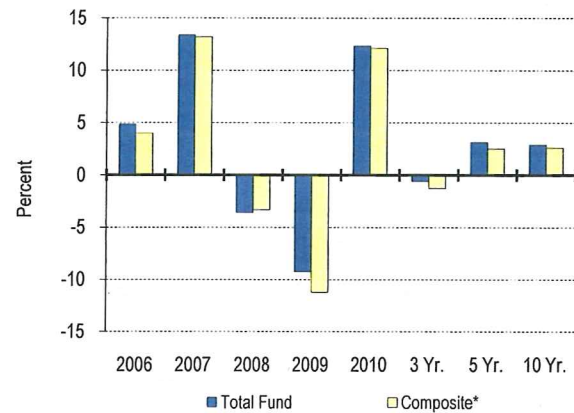
Total account results for the last three, five and ten years are shown in Figure 34.

### Spendable Income

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

Fiscal Year	Millions
2006	\$22
2007	\$25
2008	\$28
2009	\$27
2010	\$23

Figure 34. Permanent School Performance FY 2006-2010



	2006	2007	2008	2009	2010	Annualized 3 Yr.	5 Yr.	10 Yr.
<b>Total Fund</b>	4.8%	13.4%	-3.6%	-9.3%	12.3%	-0.6%	3.2%	2.9%
Composite*	4.0	13.2	-3.3	-11.2	12.1	-1.3	2.5	2.6
<b>Stock Segment</b>	8.7	20.6	-13.1	-25.9	14.2	-9.7	-0.7	-1.5
S&P 500	8.6	20.6	-13.1	-26.2	14.4	-9.8	-0.8	-1.6
<b>Bond Segment</b>	0.5	6.2	7.0	8.5	9.7	8.4	6.3	7.0
Barclays Agg.	-0.8	6.1	7.1	6.0	9.5	7.5	5.5	6.5

\* 50% S&P 500/ 48% Barclays Capital Aggregate/ 2% 3 Month T-Bills.  
Prior to July 1, 1997, the Fund's benchmark was 100% Barclays Capital Aggregate.

PERMANENT SCHOOL FUND  
Returns, Market Values, Income

Fiscal Year	Annual Returns	FY Ending	
		Market Value \$ million	FY Income \$ million
2010	12.3	674	23
2009	-9.3	614	27
2008	-3.6	690	28
2007	13.4	714	25
2006	4.8	635	22
2005	6.5	612	19
2004	10.2	578	16
2003	6.3	527	19
2002	-6.2	503	21
2001	-2.6	549	24
2000	6.1	579	21
1999	14.0	558	19