

## 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 used to offset state school aid payments. On June 30, 2002, the market value of the Fund was \$503 million.**

### Investment Objective

The State Board of Investment (SBI) 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 in offsetting state expenditures on school aid.

### 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

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 36 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2002.

### Investment Management

SBI staff manage 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.

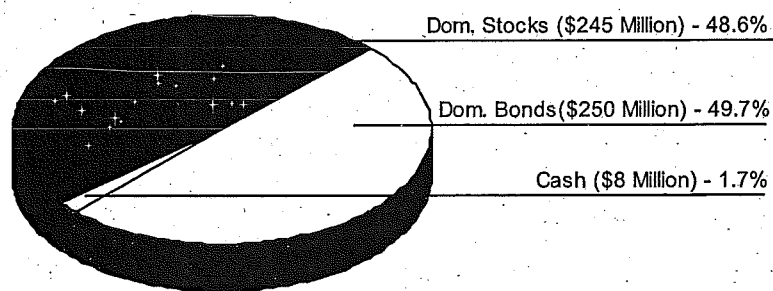
#### Stock Segment

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 Lehman Brothers Aggregate Bond Index.

Figure 36. Permanent School Fund Asset Mix as of June 30, 2002



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

## Permanent School Fund

### Investment Performance

The **stock** segment of the Permanent School Fund underperformed its benchmark, the S&P 500, during the fiscal year by 0.2 percentage point. 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 underperformed its benchmark by 1.5 percentage points during the current fiscal year.

**Overall**, the Permanent School Fund provided a return of -6.2% for fiscal year 2002, underperforming its composite index by 1.0 percentage point.

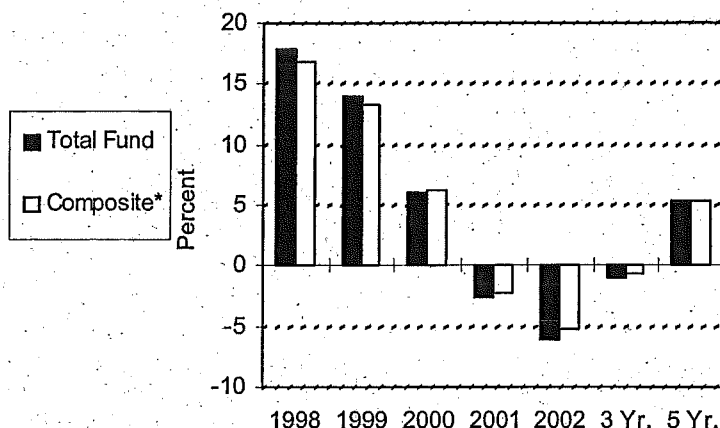
Total account results for the last three and five years are shown in Figure 37.

### Spendable Income

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

| Fiscal Year | Millions |
|-------------|----------|
| 1997        | \$30     |
| 1998        | \$20     |
| 1999        | \$19     |
| 2000        | \$21     |
| 2001        | \$24     |
| 2002        | \$21     |

Figure 37. Permanent School Performance FY 1998-2002



|               | 1998  | 1999  | 2000 | 2001  | 2002  | Annualized<br>3 Yr. | 5 Yr. |
|---------------|-------|-------|------|-------|-------|---------------------|-------|
| Total Fund    | 17.8% | 14.0% | 6.1% | -2.6% | -6.2% | -1.0%               | 5.4%  |
| Composite*    | 16.9  | 13.3  | 6.2  | -2.3  | -5.2  | -0.6                | 5.4   |
| Stock Segment | 22.8  | 23.1  | 7.4  | -14.7 | -18.2 | -9.2                | 2.5   |
| S&P 500       | 22.7  | 22.8  | 7.2  | -14.8 | -18.0 | -9.2                | 2.5   |
| Bond Segment  | 10.7  | 3.7   | 4.7  | 11.2  | 7.1   | 7.6                 | 7.4   |
| Lehman Agg    | 10.5  | 3.1   | 4.6  | 11.2  | 8.6   | 8.1                 | 7.6   |

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

## 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 used to offset state school aid payments. On June 30, 2003, the market value of the Fund was \$527 million.**

### Investment Objective

The State Board of Investment (SBI) 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 in offsetting state expenditures on school aid.

### 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

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 36 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2003.

### Investment Management

SBI staff manage 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.

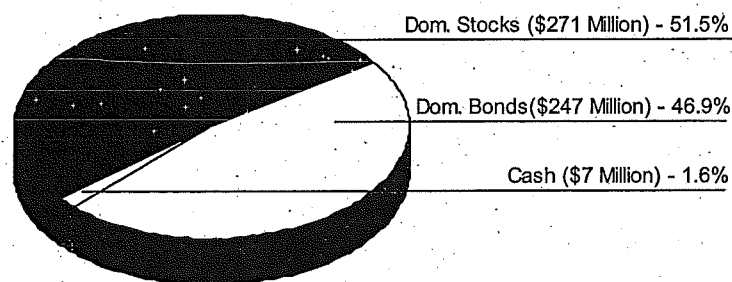
### Stock Segment

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 Lehman Brothers Aggregate Bond Index.

Figure 36. Permanent School Fund Asset Mix as of June 30, 2003



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

## Permanent School Fund

### Investment Performance

The **stock** segment of the Permanent School Fund outperformed its benchmark, the S&P 500, during the fiscal year by 0.4 percentage point. 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 1.5 percentage points during the current fiscal year.

**Overall**, the Permanent School Fund provided a return of 6.3% for fiscal year 2003, outperforming its composite index by 0.6 percentage point.

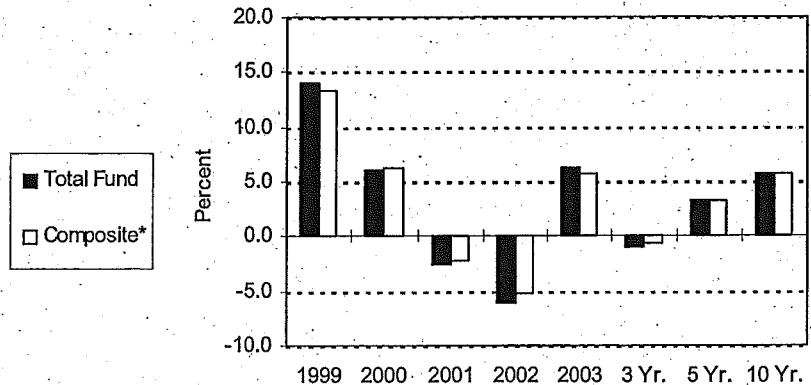
Total account results for the last three, five and ten years are shown in Figure 37.

### Spendable Income

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

| Fiscal Year | Millions |
|-------------|----------|
| 1999        | \$19     |
| 2000        | \$21     |
| 2001        | \$24     |
| 2002        | \$21     |
| 2003        | \$14     |

Figure 37. Permanent School Performance FY 1999-2003



|               |       | Annualized |       |       |      |       |       |        |
|---------------|-------|------------|-------|-------|------|-------|-------|--------|
|               | 1999  | 2000       | 2001  | 2002  | 2003 | 3 Yr. | 5 Yr. | 10 Yr. |
| Total Fund    | 14.0% | 6.1%       | -2.6% | -6.2% | 6.3% | -1.0% | 3.3%  | 5.7%   |
| Composite*    | 13.3  | 6.2        | -2.3  | -5.2  | 5.7  | -0.7  | 3.3   | 5.7    |
| Stock Segment | 23.1  | 7.4        | -14.7 | -18.2 | 0.7  | -11.1 | -1.5  | N/A    |
| S&P 500       | 22.8  | 7.2        | -14.8 | -18.0 | 0.3  | -11.2 | -1.6  | N/A    |
| Bond Segment  | 3.7   | 4.7        | 11.2  | 7.1   | 11.9 | 10.0  | 7.6   | 7.5    |
| Lehman Agg    | 3.1   | 4.6        | 11.2  | 8.6   | 10.4 | 10.1  | 7.5   | 7.2    |

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

## 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 used to offset state school aid payments. On June 30, 2004, the market value of the Fund was \$578 million.**

### Investment Objective

The State Board of Investment (SBI) 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 in offsetting state expenditures on school aid.

### 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

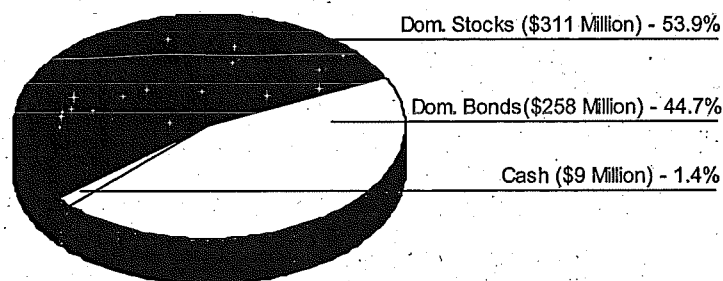
asset allocation maximized current income, it limited the long term growth of the Fund and caused the income stream to lose value in inflation adjusted terms, over time.

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 36 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2004.

Figure 36. Permanent School Fund Asset Mix as of June 30, 2004



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

### Investment Management

SBI staff manage 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.

## Permanent School Fund

### 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 Lehman Brothers Aggregate Bond Index.

### Investment Performance

The *stock* segment of the Permanent School Fund underperformed its benchmark, the S&P 500, during the fiscal year by 0.1 percentage point. 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 0.8 percentage points during the current fiscal year.

*Overall*, the Permanent School Fund provided a return of 10.2% for fiscal year 2004, outperforming its composite index by 0.7 percentage point.

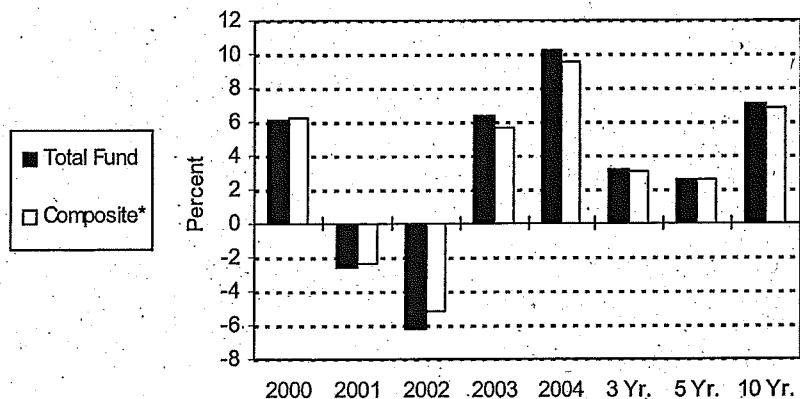
Total account results for the last three, five and ten years are shown in Figure 37.

### Spendable Income

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

| Fiscal Year | Millions |
|-------------|----------|
| 2000        | \$21     |
| 2001        | \$24     |
| 2002        | \$21     |
| 2003        | \$19     |
| 2004        | \$16     |

Figure 37. Permanent School Performance FY 2000-2004



|               | 2000 | 2001  | 2002  | 2003 | 2004  | Annualized |      |      |
|---------------|------|-------|-------|------|-------|------------|------|------|
| Total Fund    | 6.1% | -2.6% | -6.2% | 6.3% | 10.2% | 3.2%       | 2.6% | 7.1% |
| Composite*    | 6.2  | -2.3  | -5.2  | 5.7  | 9.5   | 3.1        | 2.6  | 6.8  |
| Stock Segment | 7.4  | -14.7 | -18.2 | 0.7  | 19.0  | -0.7       | -2.1 | N/A  |
| S&P 500       | 7.2  | -14.8 | -18.0 | 0.3  | 19.1  | -0.7       | -2.2 | N/A  |
| Bond Segment  | 4.7  | 11.2  | 7.1   | 11.9 | 1.1   | 6.6        | 7.1  | 7.9  |
| Lehman Agg    | 4.6  | 11.2  | 8.6   | 10.4 | 0.3   | 6.4        | 6.9  | 7.4  |

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

## 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 used to offset state school aid payments. On June 30, 2005, the market value of the Fund was \$612 million.**

### Investment Objective

The State Board of Investment (SBI) 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 in offsetting state expenditures on school aid.

### 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.

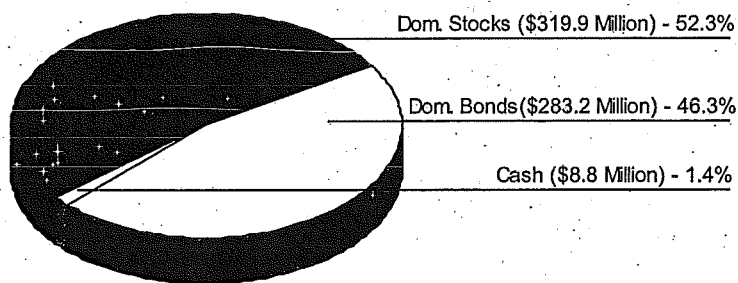
A proposal to introduce equities was presented during fiscal year 1997. It was favorably received by the Legislature and incorporated into the K-12 education finance bill. As a result, the Fund allocation was shifted to a 50% stock/48% fixed income/2% cash allocation during July 1997.

Figure 36 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2005.

### Investment Management

SBI staff manage all assets of the Permanent School Fund. Given the unique constraints of the Fund, management by SBI staff is

Figure 36. Permanent School Fund Asset Mix as of June 30, 2005



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

## Permanent School Fund

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 Lehman Brothers Aggregate Bond Index.

### Investment Performance

The *stock* segment of the Permanent School Fund matched its benchmark, the S&P 500, 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.

**Overall**, the Permanent School Fund provided a return of 6.5% for fiscal year 2005, underperforming its composite index by 0.1 percentage point.

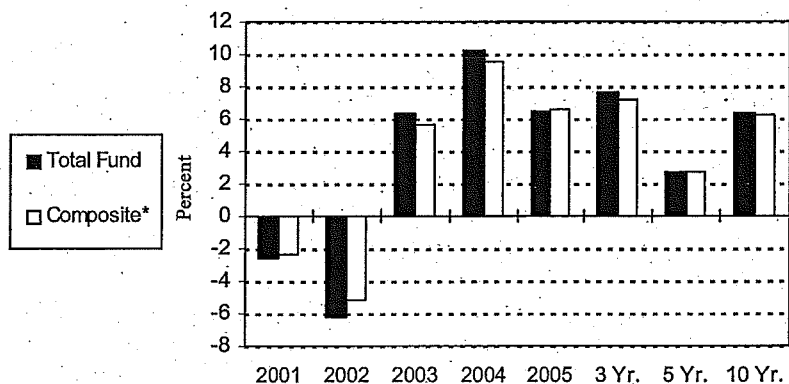
Total account results for the last three, five and ten years are shown in Figure 37.

### Spendable Income

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

| Fiscal Year | Millions |
|-------------|----------|
| 2001        | \$24     |
| 2002        | \$21     |
| 2003        | \$19     |
| 2004        | \$16     |
| 2005        | \$19     |

Figure 37. Permanent School Performance FY 2001-2005



|               | 2001  | 2002  | 2003 | 2004  | 2005 | Annualized |      |      |
|---------------|-------|-------|------|-------|------|------------|------|------|
| Total Fund    | -2.6% | -6.2% | 6.3% | 10.2% | 6.5% | 7.7%       | 2.7% | 6.4% |
| Composite*    | -2.3  | -5.2  | 5.7  | 9.5   | 6.6  | 7.2        | 2.7  | 6.2  |
| Stock Segment | -14.7 | -18.2 | 0.7  | 19.0  | 6.3  | 8.4        | -2.3 | N/A  |
| S&P 500       | -14.8 | -18.0 | 0.3  | 19.1  | 6.3  | 8.3        | -2.4 | N/A  |
| Bond Segment  | 11.2  | 7.1   | 11.9 | 1.1   | 7.0  | 6.6        | 7.6  | 7.1  |
| Lehman Agg    | 11.2  | 8.6   | 10.4 | 0.3   | 6.8  | 5.8        | 7.4  | 6.8  |

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

## Permanent School Fund

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### Investment Objective

The State Board of Investment (SBI) 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 in offsetting state expenditures on school aid.

### 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.

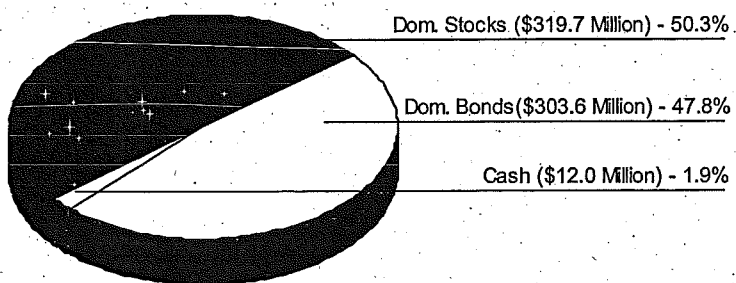
A proposal to introduce equities was presented during fiscal year 1997. It was favorably received by the Legislature and incorporated into the K-12 education finance bill. As a result, the Fund allocation was shifted to a 50% stock/48% fixed income/2% cash allocation during July 1997.

Figure 36 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2006.

### Investment Management

SBI staff manage all assets of the Permanent School Fund. Given the unique constraints of the Fund, management by SBI staff is

Figure 36. Permanent School Fund Asset Mix as of June 30, 2006



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

## Permanent School Fund

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 Lehman Brothers Aggregate Bond Index.

### Investment Performance

The *stock* segment of the Permanent School Fund had positive tracking error of 0.1 percentage point, compared to its benchmark, the S&P 500, 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 1.3 percentage points during the current fiscal year.

**Overall**, the Permanent School Fund provided a return of 4.8% for fiscal year 2006, outperforming its composite index by 0.8 percentage point.

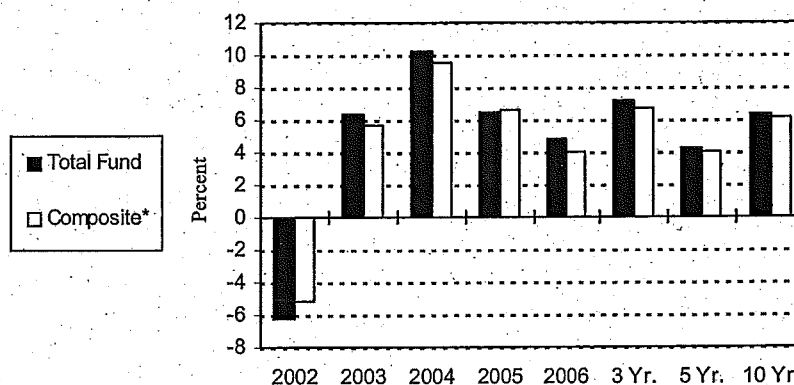
Total account results for the last three, five and ten years are shown in Figure 37.

### Spendable Income

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

| Fiscal Year | Millions |
|-------------|----------|
| 2002        | \$21     |
| 2003        | \$19     |
| 2004        | \$16     |
| 2005        | \$19     |
| 2006        | \$22     |

Figure 37. Permanent School Performance FY 2002-2006



|               | 2002  | 2003 | 2004  | 2005 | 2006 | Annualized |      |      |
|---------------|-------|------|-------|------|------|------------|------|------|
| Total Fund    | -6.2% | 6.3% | 10.2% | 6.5% | 4.8% | 7.2%       | 4.2% | 6.3% |
| Composite*    | -5.2  | 5.7  | 9.5   | 6.6  | 4.0  | 6.7        | 4.0  | 6.1  |
| Stock Segment | -18.2 | 0.7  | 19.0  | 6.3  | 8.7  | 11.2       | 2.5  | N/A  |
| S&P 500       | -18.0 | 0.3  | 19.1  | 6.3  | 8.6  | 11.2       | 2.5  | N/A  |
| Bond Segment  | 7.1   | 11.9 | 1.1   | 7.0  | 0.5  | 2.8        | 5.4  | 6.6  |
| Lehman Agg    | 8.6   | 10.4 | 0.3   | 6.8  | -0.8 | 2.1        | 5.0  | 6.2  |

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

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### Investment Objective

The State Board of Investment (SBI) 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 in offsetting state expenditures on school aid.

### 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.

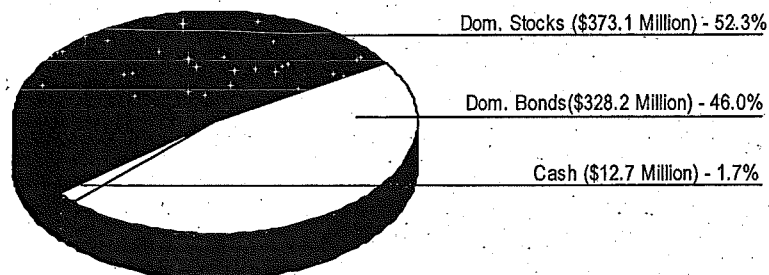
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Figure 36. Permanent School Fund Asset Mix as of June 30, 2007



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

Figure 36 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2007.

### Investment Management

SBI staff manage 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.

## Permanent School Fund

### 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 Lehman Brothers Aggregate Bond Index.

### Investment Performance

The *stock* segment of the Permanent School Fund matched its benchmark, the S&P 500, 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 0.1 percentage point during the current fiscal year.

**Overall**, the Permanent School Fund provided a return of 13.4% for fiscal year 2007, outperforming its composite index by 0.2 percentage point.

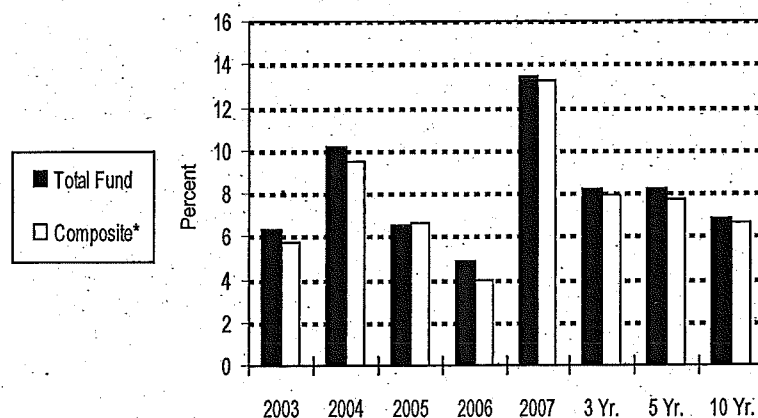
Total account results for the last three, five and ten years are shown in Figure 37.

### Spendable Income

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

| Fiscal Year | Millions |
|-------------|----------|
| 2003        | \$19     |
| 2004        | \$16     |
| 2005        | \$19     |
| 2006        | \$22     |
| 2007        | \$25     |

Figure 37. Permanent School Performance FY 2003-2007



|               | 2003 | 2004  | 2005 | 2006 | 2007  | Annualized |      |      |
|---------------|------|-------|------|------|-------|------------|------|------|
| Total Fund    | 6.3% | 10.2% | 6.5% | 4.8% | 13.4% | 8.2%       | 8.2% | 6.8% |
| Composite*    | 5.7  | 9.5   | 6.6  | 4.0  | 13.2  | 7.9        | 7.7  | 6.6  |
| Stock Segment | 0.7  | 19.0  | 6.3  | 8.7  | 20.6  | 11.7       | 10.8 | 6.6  |
| S&P 500       | 0.3  | 19.1  | 6.3  | 8.6  | 20.6  | 11.7       | 10.7 | 6.5  |
| Bond Segment  | 11.9 | 1.1   | 7.0  | 0.5  | 6.2   | 4.6        | 5.3  | 6.3  |
| Lehman Agg    | 10.4 | 0.3   | 6.8  | -0.8 | 6.1   | 4.0        | 4.5  | 6.0  |

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

## 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 used to offset state school aid payments. On June 30, 2008, the market value of the Fund was \$690 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 in offsetting state expenditures on school aid.

### 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.

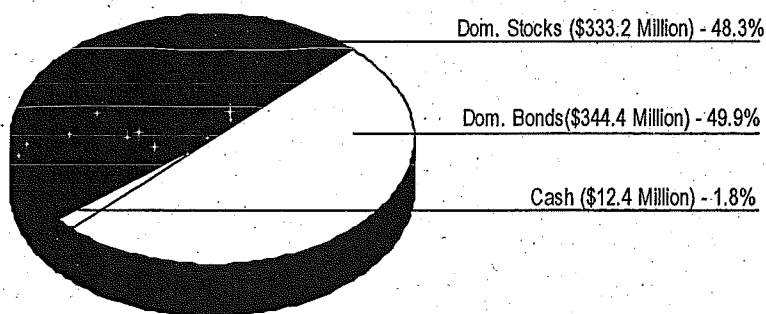
A proposal to introduce equities was presented during fiscal year 1997. It was favorably received by the Legislature and incorporated into the K-12 education finance bill. As a result, the Fund allocation was shifted to a 50% stock/48% fixed income/2% cash allocation during July 1997.

Figure 36 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2008.

### 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.

Figure 36. Permanent School Fund Asset Mix as of June 30, 2008



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

## Permanent School Fund

### 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 Lehman Brothers Aggregate Bond Index.

### Investment Performance

The *stock* segment of the Permanent School Fund matched its benchmark, the S&P 500, 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 underperformed its benchmark by 0.1 percentage point during the current fiscal year.

*Overall*, the Permanent School Fund provided a return of -3.6% for fiscal year 2008, underperforming its composite index by 0.3 percentage point.

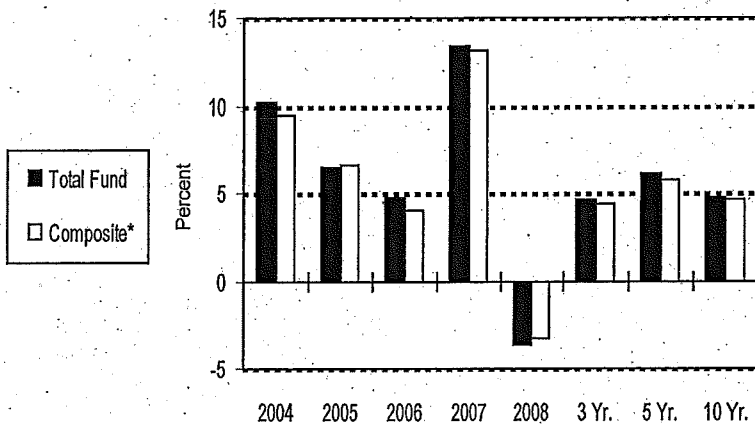
Total account results for the last three, five and ten years are shown in Figure 37.

### Spendable Income

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

| Fiscal Year | Millions |
|-------------|----------|
| 2004        | \$16     |
| 2005        | \$19     |
| 2006        | \$22     |
| 2007        | \$25     |
| 2008        | \$28     |

Figure 37. Permanent School Performance FY 2004-2008



|                      | 2004         | 2005        | 2006        | 2007         | 2008         | 3 Yr.       | 5 Yr.       | 10 Yr.      |
|----------------------|--------------|-------------|-------------|--------------|--------------|-------------|-------------|-------------|
| <b>Total Fund</b>    | <b>10.2%</b> | <b>6.5%</b> | <b>4.8%</b> | <b>13.4%</b> | <b>-3.6%</b> | <b>4.6%</b> | <b>6.1%</b> | <b>4.7%</b> |
| <b>Composite*</b>    | <b>9.5</b>   | <b>6.6</b>  | <b>4.0</b>  | <b>13.2</b>  | <b>-3.3</b>  | <b>4.4</b>  | <b>5.8</b>  | <b>4.6</b>  |
| <b>Stock Segment</b> | <b>19.0</b>  | <b>6.3</b>  | <b>8.7</b>  | <b>20.6</b>  | <b>-13.1</b> | <b>4.5</b>  | <b>7.6</b>  | <b>3.0</b>  |
| <b>S&amp;P 500</b>   | <b>19.1</b>  | <b>6.3</b>  | <b>8.6</b>  | <b>20.6</b>  | <b>-13.1</b> | <b>4.4</b>  | <b>7.6</b>  | <b>2.9</b>  |
| <b>Bond Segment</b>  | <b>1.1</b>   | <b>7.0</b>  | <b>0.5</b>  | <b>6.2</b>   | <b>7.0</b>   | <b>4.5</b>  | <b>4.3</b>  | <b>6.0</b>  |
| <b>Lehman Agg</b>    | <b>0.3</b>   | <b>6.8</b>  | <b>-0.8</b> | <b>6.1</b>   | <b>7.1</b>   | <b>4.1</b>  | <b>3.9</b>  | <b>5.7</b>  |

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

Value as of Sept 2002

Table 3. Acreage and Valuation by County and Land Type

| LAND TYPE |                       | COUNTY       |              |              |              |              |              | Land Category | TOTALS       |              |
|-----------|-----------------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|--------------|--------------|
|           |                       | St. Louis    |              | Cook         |              | Lake         |              |               | Acres        | Value        |
|           |                       | Acres        | Value        | Acres        | Value        | Acres        | Value        |               |              |              |
| LAND TYPE | School Trust Fund     | 34672.1      | \$29,478,531 | 25982.7      | \$19,737,211 | 25640.7      | \$23,088,565 |               | 86295.5      | \$72,304,306 |
|           |                       | 2383.4       | \$11,916,750 | 792.6        | \$3,963,100  | 1471.3       | \$7,356,450  | A             | 4647.3       | \$23,236,300 |
|           |                       | 4396.9       | \$5,276,256  | 3587.1       | \$4,304,568  | 5454.0       | \$6,544,812  | BC            | 13438.0      | \$16,125,636 |
|           |                       | 3519.6       | \$3,343,601  | 5951.5       | \$5,653,878  | 3533.7       | \$3,356,987  | DE            | 13004.7      | \$12,354,465 |
|           |                       | 20255.8      | \$7,089,544  | 12275.0      | \$4,296,254  | 10014.7      | \$3,505,135  | FG            | 42545.5      | \$14,890,932 |
|           |                       | 4116.4       | \$1,852,380  | 3376.5       | \$1,519,412  | 5167.1       | \$2,325,182  | HI            | 12659.9      | \$5,696,973  |
|           | University Trust Fund | 390.2        | \$172,760    | 2070.0       | \$1,672,878  | 0.0          | \$0          |               | 2460.1       | \$1,845,637  |
|           |                       | 0.0          | \$0          | 23.5         | \$117,500    | 0.0          | \$0          | A             | 23.5         | \$117,500    |
|           |                       | 30.8         | \$36,900     | 505.7        | \$606,840    | 0.0          | \$0          | BC            | 536.5        | \$643,740    |
|           |                       | 0.0          | \$0          | 628.1        | \$596,648    | 0.0          | \$0          | DE            | 628.1        | \$596,648    |
|           |                       | 258.8        | \$90,563     | 588.3        | \$205,888    | 0.0          | \$0          | FG            | 847.0        | \$296,450    |
|           |                       | 100.7        | \$45,297     | 324.5        | \$146,003    | 0.0          | \$0          | HI            | 425.1        | \$191,300    |
|           | DNR Acquired          | 17804.5      | \$10,198,843 | 0.0          | \$0          | 0.0          | \$0          |               | 17804.5      | \$10,198,843 |
|           |                       | 281.3        | \$1,406,500  | 0.0          | \$0          | 0.0          | \$0          | A             | 281.3        | \$1,406,500  |
|           |                       | 682.0        | \$818,340    | 0.0          | \$0          | 0.0          | \$0          | BC            | 682.0        | \$818,340    |
|           |                       | 2732.0       | \$2,595,400  | 0.0          | \$0          | 0.0          | \$0          | DE            | 2732.0       | \$2,595,400  |
|           |                       | 9705.4       | \$3,396,897  | 0.0          | \$0          | 0.0          | \$0          | FG            | 9705.4       | \$3,396,897  |
|           |                       | 4403.8       | \$1,981,706  | 0.0          | \$0          | 0.0          | \$0          | HI            | 4403.8       | \$1,981,706  |
|           | County Tax Forfeit    | 3662.1       | \$2,082,243  | 2262.3       | \$2,187,592  | 4074.6       | \$3,092,863  |               | 9999.0       | \$7,362,698  |
|           |                       | 0.0          | \$0          | 120.8        | \$603,850    | 120.0        | \$600,000    | A             | 240.8        | \$1,203,850  |
|           |                       | 605.1        | \$726,096    | 332.8        | \$399,312    | 453.3        | \$543,900    | BC            | 1391.1       | \$1,669,308  |
|           |                       | 331.8        | \$315,229    | 893.4        | \$848,683    | 964.4        | \$916,142    | DE            | 2189.5       | \$2,080,054  |
|           |                       | 1854.0       | \$648,914    | 762.1        | \$266,718    | 1088.1       | \$380,825    | FG            | 3704.2       | \$1,296,456  |
|           |                       | 871.1        | \$392,004    | 153.4        | \$69,030     | 1448.9       | \$651,996    | HI            | 2473.4       | \$1,113,030  |
|           | TOTALS                |              |              |              |              |              |              |               |              |              |
|           | 56528.7               | \$41,932,376 | 30315.0      | \$23,597,680 | 29715.3      | \$26,181,427 |              | 116559.0      | \$91,711,483 |              |

Source: UMD Bureau of Business and Economic Research

Permanent School Fund Investment Analysis  
Using State Board of Investment Annual Reporting Data

| Reported    |               | Hypothetical          |              |                |                     |
|-------------|---------------|-----------------------|--------------|----------------|---------------------|
|             | Invest. Asset | \$ Paid - Investments | % of Invest. | Land Sale Amt. | \$ Paid - Land Sale |
| 30-Jun 2003 | 527 million   |                       |              | 72.3 million   |                     |
| 2004        | 578 million   | 16 million            | 3.04         |                | 2.20 million        |
| 2005        | 612 million   | 19 million            | 3.29         |                | 2.38 million        |
| 2006        | 635 million   | 22 million            | 3.59         |                | 2.60 million        |
| 2007        | 714 million   | 25 million            | 3.94         |                | 2.85 million        |
| 2008        | 690 million   | 28 million            | 3.92         |                | 2.83 million        |
| Totals      |               | 110 million           |              |                | 12.86 million       |

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December 2, 2009