

Permanent School Fund Advisory Committee

December 10, 2009

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, 2009, the market value of the Fund was \$614 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 providing state aid to schools.

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.

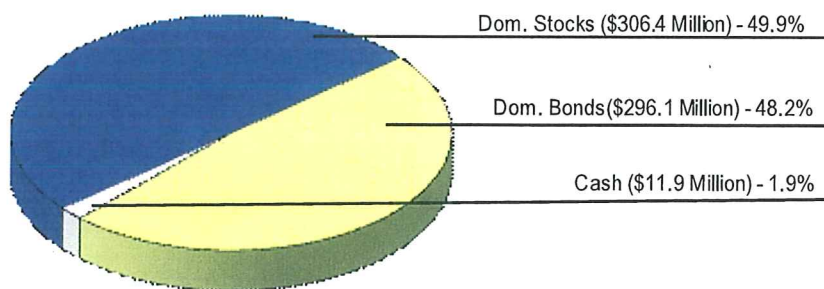
Prior to FY 1998, the Permanent School Fund had been invested entirely in fixed income securities for more than a decade. While this

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 30. Permanent School Fund Asset Mix as of June 30, 2009



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

Figure 30 presents the actual asset mix of the Permanent School Fund at the end of fiscal year 2009.

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.

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 Barclays Capital Aggregate Bond Index.

Investment Performance

The *stock* segment of the Permanent School Fund outperformed its benchmark, the S&P 500, by 0.3 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 2.5 percentage points during the current fiscal year.

Overall, the Permanent School Fund provided a return of -9.3% for fiscal year 2009, outperforming its composite index by 1.9 percentage points.

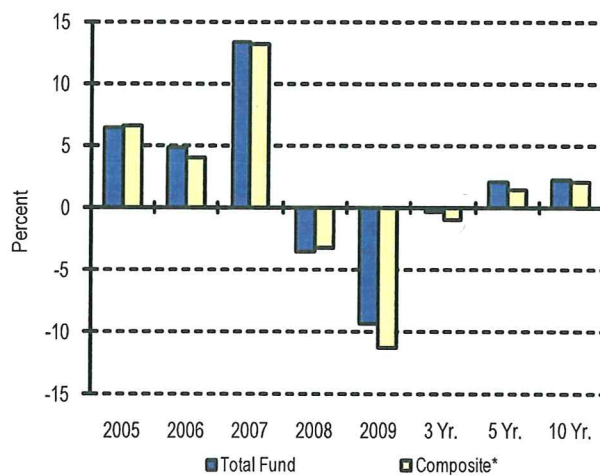
Total account results for the last three, five and ten years are shown in Figure 31.

Spendable Income

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

Fiscal Year	Millions
2005	\$19
2006	\$22
2007	\$25
2008	\$28
2009	\$27

Figure 31. Permanent School Performance FY 2005-2009



	2005	2006	2007	2008	2009	Annualized		
	2005	2006	2007	2008	2009	3 Yr.	5 Yr.	10 Yr.
Total Fund	6.5%	4.8%	13.4%	-3.6%	-9.3%	-0.3%	2.1%	2.3%
Composite*	6.6	4.0	13.2	-3.3	-11.2	-1.0	1.5	2.1
Stock Segment	6.3	8.7	20.6	-13.1	-25.9	-8.1	-2.2	-2.1
S&P 500	6.3	8.6	20.6	-13.1	-26.2	-8.2	-2.2	-2.2
Bond Segment	7.0	0.5	6.2	7.0	8.5	7.2	5.8	6.5
Barclays Capital	6.8	-0.8	6.1	7.1	6.0	6.4	5.0	6.0

* 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

Investment Objectives

The investment objective of the Permanent School Fund is to produce a growing level of spendable income, within the constraints of maintaining adequate portfolio quality and liquidity. The income from the portfolio is used to offset expenditures on school aid payments to local school districts.

Asset Mix

Effective with FY98, the Permanent School Fund is invested in a balanced portfolio of common stocks and bonds. Common stocks provide the potential for significant capital appreciation, while bonds provide portfolio diversification and a more stable stream of current income.

	9/30/2009 Target	9/30/2009 Actual
Stocks	50.0%	52.7%
Bond	48.0	45.8
Cash	2.0	1.5
Total	100.0%	100.0%

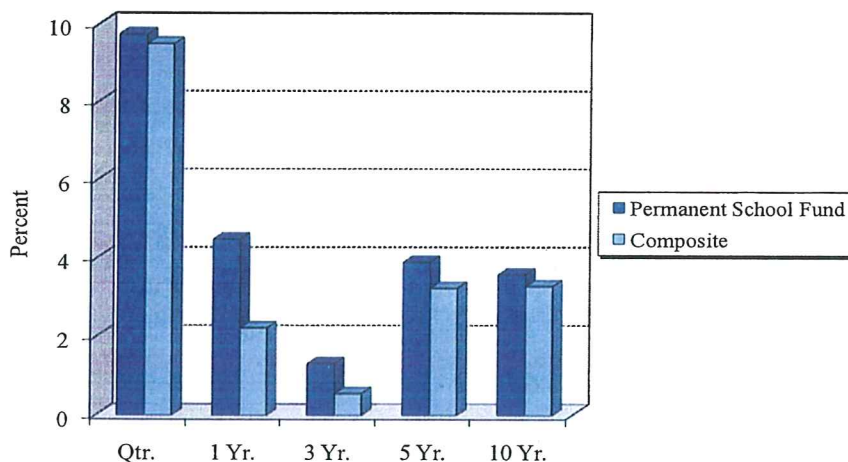
Prior to FY98, the Fund was invested entirely in fixed income securities in order to maximize current income. It is understood that the change in asset mix will reduce portfolio income in the short term, but will enhance the value of the fund, over time.

Investment Management

SBI staff manages all assets of the Permanent School Fund. The stock segment is passively managed to track the performance of the S&P 500. The bond segment is actively managed to add incremental value through sector, security and yield curve decisions.

Market Value

On September 30, 2009 the market value of the Permanent School Fund was \$668 million.



Period Ending 9/30/2009

Annualized

	Qtr.	1 Yr.	3 Yr.	5 Yr.	10 Yr.
Total Fund (1) (2)	9.7%	4.5%	1.3%	3.9%	3.6%
Composite	9.5	2.2	0.5	3.2	3.3
Equity Segment (1) (2)	15.4	-6.9	-5.4	1.1	-0.1
S&P 500	15.6	-6.9	-5.4	1.0	-0.2
Bond Segment (1)	4.2	14.6	7.4	6.0	6.8
Barclays Capital Agg.	3.7	10.6	6.4	5.1	6.3

(1) Actual returns are calculated net of fees.
 (2) Equities were added to the asset mix for FY98. Prior to that date the fund was invested entirely in bonds. The composite Index has been weighted accordingly.