



## Annual Report – Fiscal Year 2016

Welcome to the inaugural Annual Report of the State of Utah, School and Institutional Trust Funds Office! We intend for this report to be a helpful source of information and to provide insights on our goals each year. We cover a lot of ground in this report and recommend utilizing our website as an ongoing source of information regarding the agency, our investment policies, and portfolio activities <https://sitfo.utah.gov>.

### **Introduction**

In 2014, the Utah State Legislature passed the statutes that created the School and Institutional Trust Fund Office (SITFO). SITFO's purpose is to invest the profits from the School & Institutional Trust Lands Administration (SITLA) for the sole benefit of their respective beneficiaries. While the trusts represent different underlying beneficiaries, they are managed with a similar asset allocation, as the return and risk objectives are similar. There are significant benefits to the trusts to be investing in a uniform manner, such as greater diversification and operational efficiencies from pooling resources together.

Shortly after the enactment of the statutes creating the agency, a 5-person Board of Trustees was assembled, with the State Treasurer as the permanent Chairperson of the Board, and the other 4 trustees nominated via a formal committee comprised of investment professionals and beneficiary representatives. In September 2015, SITFO was up and running with a new Director and Chief Investment Officer. In early 2016, we added a Senior Investment Analyst and an Administrative Analyst. More recently we have instituted an internship program.

In addition to the full-time staff of investment professionals, the Board of Trustees have retained an institutional investment consulting firm – Fund Evaluation Group (FEG) – to work closely with the Board and SITFO staff to develop and implement the agency's investment program.

## FY 2016

Returns for FY 2016 were low, driven by equity volatility in late 2015 and into the beginning of 2016. Since the end of the fiscal year, returns have improved as the markets recovered; the global economy appears to remain on its trajectory of slow but steady growth indicated in the strong trailing 1 year returns.

Annualized Returns				
	FY16 (as of 6/30/2016)	Trailing 1 Yr. (as of 9/30/2016)	Trailing 3 Yr. (as of 9/30/2016)	Trailing 10 Yr. (as of 9/30/2016)
School Fund	0.9%	9.1%	7.7%	6.3%
Miners Hospital	1.1%	9.6%	8.1%	6.5%
Institute for the Blind	0.8%	9.4%	8.1%	6.4%
Reservoirs Fund	0.9%	9.6%	7.5%	6.1%
Normal School	0.8%	9.5%	7.4%	5.9%
University of Utah	0.7%	9.4%	7.3%	5.9%
School of Mines	0.7%	9.3%	7.5%	5.9%
Utah State Hospital	0.9%	9.1%	7.4%	6.1%
Utah State University	0.8%	9.3%	7.5%	5.8%
Deaf School Fund	0.8%	9.5%	7.4%	5.9%
State Industrial School	1.5%	9.6%	7.6%	5.9%

Distributions for FY 2016 including and excluding SITLA revenues are displayed in the table below. The distributions excluding SITLA represent only the dividends and interest of the portfolios. The distributions including SITLA represent the revenues from SITLA that distributed in addition to the interest and dividends from investments. There were modest increases this year in the distributions from dividends and interest. For this fiscal year, we expect increases in distributions based on implementation of the new asset allocation. The distributions for FY 2018 will be based on the new distribution policy (further discussion regarding policy below).

	Total Value of Trust (As of 9/30)	FY 16 Distribution (ex. SITLA)	Percent Distributed (ex. SITLA)	FY 2016 Distribution (incl. SITLA)	Percent Distributed (incl. SITLA)
School Fund	\$ 2,146,378,741	\$ 49,744,530	2.3%	\$ 49,744,530	2.3%
Miners Hospital	\$ 48,880,996	\$ 1,591,072	3.2%	\$ 1,773,263	3.5%
Institute for the Blind	\$ 19,228,689	\$ 626,529	3.2%	\$ 749,294	3.8%
Reservoirs Fund	\$ 6,374,544	\$ 148,150	2.3%	\$ 357,828	5.5%
Normal School	\$ 4,465,622	\$ 103,342	2.3%	\$ 354,366	7.8%
University of Utah	\$ 4,314,717	\$ 100,042	2.3%	\$ 619,887	14.0%
School of Mines	\$ 3,304,785	\$ 77,756	2.3%	\$ 183,440	5.4%
Utah State Hospital	\$ 3,031,621	\$ 61,491	2.0%	\$ 156,018	5.0%
Utah State University	\$ 2,985,600	\$ 67,925	2.2%	\$ 310,939	10.2%
Deaf School Fund	\$ 2,074,119	\$ 47,017	2.2%	\$ 308,664	14.6%
State Industrial School	\$ 1,131,995	\$ 26,605	2.3%	\$ 43,270	3.7%

### **Setting the Foundational Elements:**

Much of our time during fiscal year 2016 was spent working with the State Treasurer's Office and our Board of Trustees to lay the foundation and build the infrastructure within which SITFO will operate going forward. These five projects are significant milestones in the institutionalization of the trust funds and provide the framework by which decisions of long-term importance are made.

#### **Foundational Elements:**

- Documenting our *investment beliefs*
- Writing a new *investment policy*
- Drafting new *distribution policies*
- Developing a long-term *asset allocation*
- Transitioning the assets to an *independent custodian*

The investment beliefs statement, while not a governing policy document, sets forth a collective investment philosophy for the current Board and SITFO staff to reference when decision making and to provide a common basis for investment policy.

The Investment Policy Statement (IPS) formally defines the objectives of the trusts, the responsibilities of the Board of Trustees, SITFO staff, FEG, investment managers and the custodian, as well as defining the asset allocation, risk management, performance monitoring processes and the distribution policy.

Both documents are available on our website. The distribution policy, asset allocation, and custodian will be reviewed in more detail below.

### **Distribution Policy:**

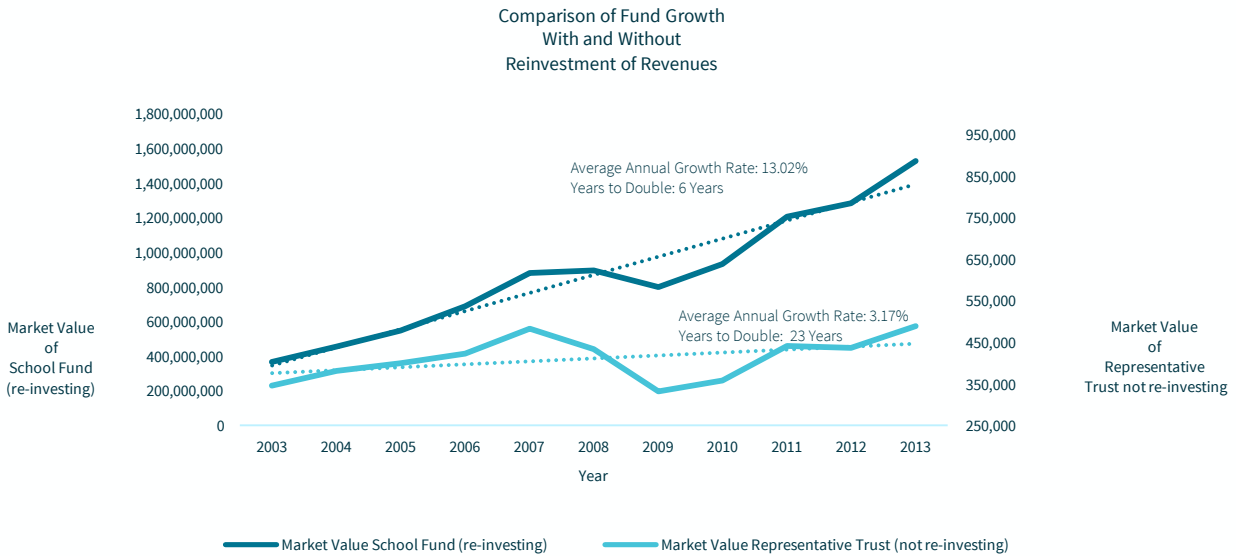
As many of you are aware, the State Legislature passed statutes that provide for new distribution policies for each of the trusts. The new distribution policy for the School Fund requires a constitutional amendment, Amendment B, which will be on the November 8<sup>th</sup> ballot. For all other trusts the distribution policy goes into effect July 1, 2017.

The new distribution policy is intended to treat each of the trusts as permanent funds or endowments to balance current distributions for current beneficiaries with future growth for future generations. The new distribution policy is intended to allow for improved diversification and better risk management, while protecting and growing the trusts.

Should Amendment B pass, the distribution policy for the School Fund will be based off population growth, inflation, and average market values of the trust. For the other trusts, the new distribution policy will use a 4% average of the quarterly market values over a three-year period. Each distribution policy will be capped at 4%. Further details on the distribution policy are available [online](#).

The primary driver of growth for the School Fund has been the reinvestment of revenues from SITLA, as policy only allowed the distribution of interest and dividends from investment activities and not SITLA revenues. This resulted in strong growth favoring future beneficiaries.

However, rather than re-investing SITLA revenues, the other trusts distributed revenues from SITLA on top of distributing the interest and dividends. This has resulted in a slower growth rate for these trusts, but higher current distributions favoring current beneficiaries.



The chart above shows the School Fund’s growth rate over time as well as a representative trust that reflects the average growth rate of the other trusts that do not re-invest revenues. While this chart is a useful tool for reflection and the message is valuable, it is just an example and pulls from the past when SITLA revenues were arguably at their peak. The new distribution policy will direct all revenues for each trust to be re-invested, to maximize the impact of the diminishing land assets, while simultaneously increasing the portfolio distribution. This is aimed at striking a balance between current distributions and future growth. Thus, the future growth rate is likely to be somewhere between the two trusts shown as examples above.

**Asset Allocation:**

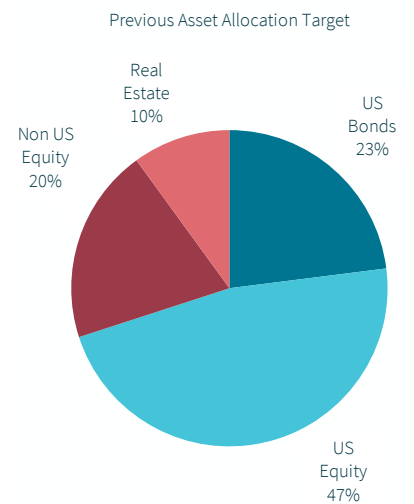
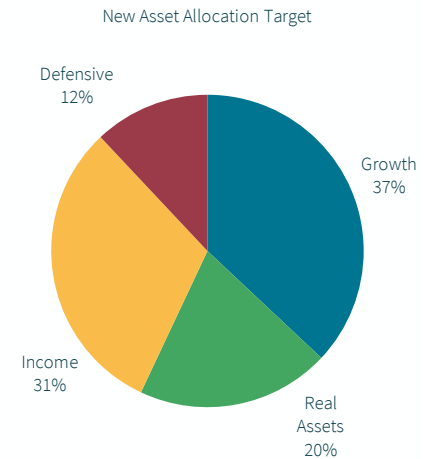
The new asset allocation was developed to optimize the expected amount of return relative to the level of risk the Board of Trustees views as acceptable. Given the long-term horizon of the trusts and sophistication of the staff and Board of Trustees, the trusts are able to take advantage of a myriad of sophisticated investment strategies.

One of the first steps in developing the new asset allocation was to modify the framing of the portfolio to maintain a pragmatic level of transparency, utility for risk management, and to facilitate understanding. Given the increase in the number and the potential complexity of future investments, we created categories for investments that align with the expected role or purpose of each asset class in the portfolio. We established categories to represent the primary drivers of a given economic scenario. We believe that this will facilitate communication, both internally and externally, as to which economic scenarios the portfolio is prepared for as well as the amount of true diversification implemented.

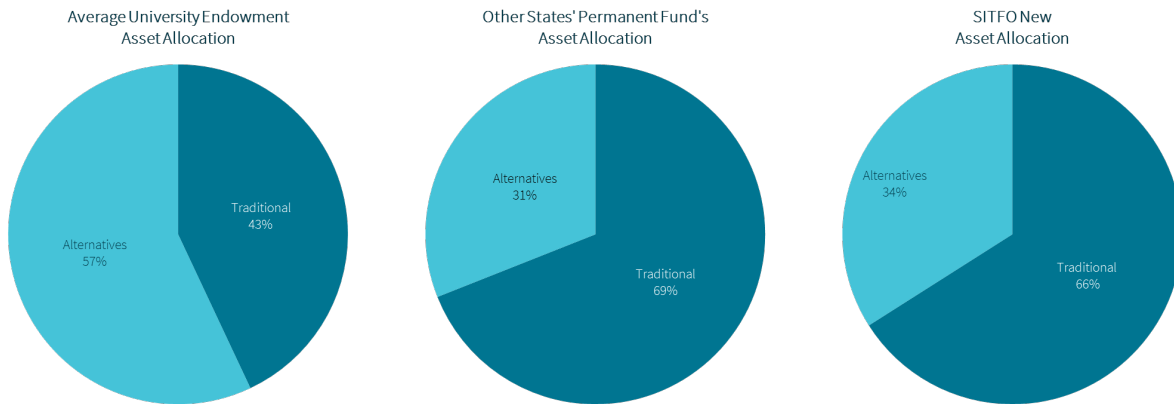
The categories used for framing the asset allocation are as follows:

- **Growth:** Expected to provide the strongest positive returns during periods of sustained economic growth, as well as presenting the highest expected risk (e.g. stocks, private equity).
- **Real Assets (inflation oriented):** Investments that have the advantage of being linked to inflation and typically backed by hard assets such as real estate, infrastructure, commodities, etc. Real Asset investments present characteristics of income as well as price appreciation and thus have a moderate risk profile (e.g. commercial real estate, natural resources).
- **Income:** Like Growth, Income is expected to generate positive returns during economic growth scenarios through an income stream – an important component of total return for the overall portfolio in periods of less robust economic growth – and does not present as much risk as Growth although is still considered a risk-taking investment (e.g. corporate bonds, asset backed securities).
- **Defensive:** The investments in this grouping are intended to do well in negative economic scenarios or periods of market stress. We do not categorize corporate bonds, or other assets that rely on economic growth, as defensive (e.g. cash, government bonds, hedging strategies).

The previous asset allocation had a large holding of US stocks for growth, an income holding of US bonds, and private real estate for a link to inflation. The new asset allocation seeks to diversify further by not only adding new asset classes, but also adding less correlated asset classes and strategies with higher expected returns.

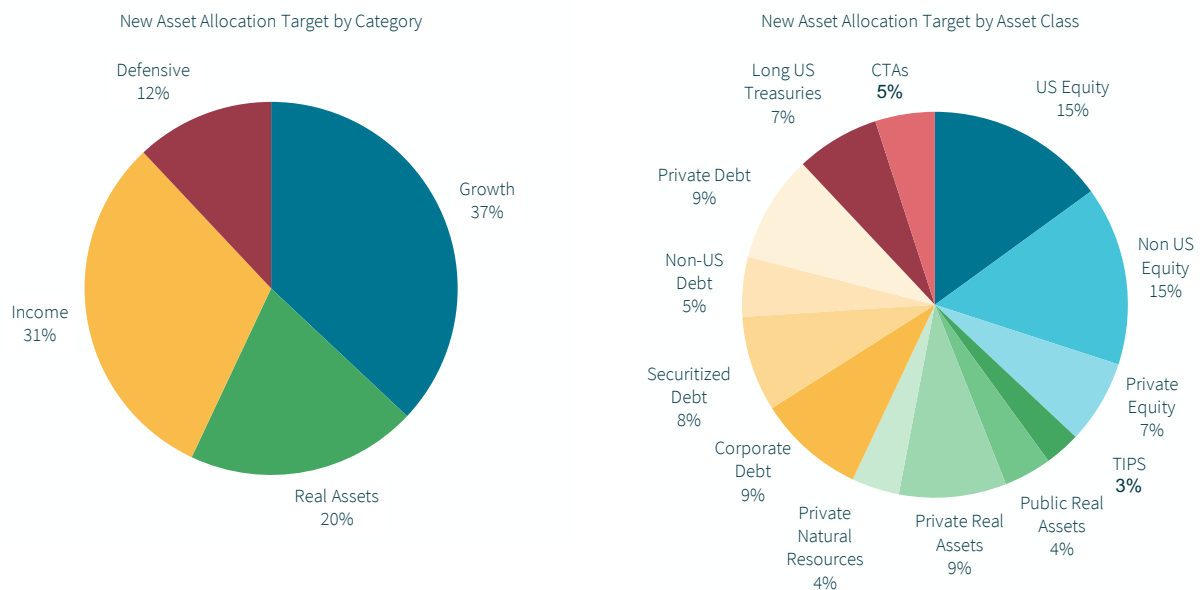


The new asset allocation targets a similar or higher level of return as the previous, but attempts to do so with greater diversification and lower volatility. This is accomplished primarily through introducing “alternative” investments. Alternatives is a broad term used to describe less common investments that present lower correlations and generally have lower liquidity. While these investments may not be familiar to the layperson, they are found within many institutional portfolios such as pension funds, university endowments, sovereign wealth, and other permanent funds.



The charts above show the allocation to alternatives versus traditional asset classes across a sample set of similar portfolios. University endowments are among the most sophisticated and successful institutional investors. As can be seen above, the average allocation to alternatives represents the majority of an endowment’s portfolio. In addition, data we collected from a peer group of permanent funds from other states show that these funds allocate nearly 1/3 of their total portfolio to alternatives. SITFO’s new asset allocation target is substantially similar to other diversified state permanent funds with a greater allocation to traditional assets than university endowments.

A detailed breakout of the new asset allocation is shown below. On the left, is the asset allocation by category. On the right is the mapping of the underlying asset classes color coded to their respective categories.



In summary, we have introduced new asset classes to avoid concentration of risks. We also want to avail ourselves of all worthy opportunities to generate returns and to reduce risk. To simplify communication, we will report on the portfolio at the asset class category level as described previously. We will report on portfolio activities on a regular basis and make these reports available on our website.

**Independent Custodian:**

To facilitate the pooling of resources and to keep an independent verifiable record of history, it is important that the investments be held and serviced by an institutional quality custodian bank. The additional advantages to having an institutional custodian, aside from the independent accounting of the trusts, are the operational efficiency and additional portfolio support provided by a large institutional bank.

To achieve and maintain consistency across the eleven trusts, the assets will continue to be commingled in a pooled accounting structure. This provides for uniform treatment and access to the complete asset allocation framework, which was not always available to the smaller trusts. It is important to note that although the assets are pooled, the trusts will remain independent entities.

In consultation with an outside investment operations consultant, RVK Inc., and a methodical RFP process, the Board has selected Northern Trust as the independent custodian of trust fund investments. We have started the transition process and will begin implementation on November 1, 2016.

**Finally**

We are grateful to all those who have put in significant work to support the success of SITFO. There are too many to name individually, but they include the Board of Trustees, the State Treasurer's Office, the School Children's Trust Section, and other professionals within state government and education. To you who have been instrumental, we appreciate your patience and contributions. We look forward to continuing to work with you to build the trusts, for and on behalf of the beneficiaries.

Kind regards from the team at SITFO.