

Foundation & Endowment Money Management

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Arizona Permanent Land Trust Ponders Real Assets, External Managers

Arizona's \$4.7 billion **Permanent State Land Endowment Trust Fund** is modernizing and diversifying its highly conservative, bond-heavy portfolio. According to State Treasurer **Doug Ducey**, the fund has added small-cap equity and is considering adding an allocation to real assets such as **Treasury Inflation-Protected Securities (TIPS)**, real estate investment trusts (REITs) and natural resources. In addition, the



Doug Ducey

endowment continues to study further diversification into global equities and bonds.

The changes stem from Ducey's arrival at the treasurer's desk in the winter of 2011 and execution of an asset class study. Ducey could not say when the additions might be made, or their size, but noted that external managers will be considered for future asset classes where it proves most effective and cost efficient. The fund does not currently use external managers.

Asset Allocation

As of March 31, the endowment invested 38.5% in fixed income, 35.9% in **Standard & Poor's** 500 equity, 15.4% in S&P 400 equity and 10.2% in S&P 600 equity.

The endowment has had the ability to invest in equity only since 1998, when Arizonans voted to allow the fund to hold stock. "When I took office in January 2011, the assets were split evenly at 50% in equities and 50% in fixed income," Ducey said. "This was a very conservative allocation. There was an opportunity to maximize additional returns on behalf of Arizona taxpayers and the endowment's beneficiaries. One of the first changes I made was having the endowment begin investing in the S&P small-cap 600." Arizona made its first small-cap S&P 600 investment in February 2011. To date, that investment has yielded 16.58%, Ducey said.

The fund's overall performance stands at 13.43% for the year ending March 31. Three-year returns are 10.32% and five-year returns 13.16% through March.

"Something else that I was shocked to learn was that an asset allocation study had never been conducted on the fund," Ducey said. "That became a top priority for the entire office. We partnered with **Meketa Investment Group** to complete the analysis in early 2012."

The study showed the fund had been performing well, but provided guidance on how to better protect and diversify assets, such as adding real assets including REITs, TIPS and natural resources, as well as diversifying further into global equities and bonds.

The fund moves carefully by design. "When it comes to public funds, a dollar lost is not measured the same way as a dollar earned," Ducey said. "Going from two asset classes to five or ten requires a great deal of thought, planning and research—the most important thing is to make sure we execute changes correctly."

The study also uncovered a flaw with the formula used to distribute earnings to beneficiaries. "When voters gave the fund the ability to invest in equities, an overly complicated formula was designed to protect the principal of the trust, adjust for inflation, and smooth out distributions due to the inherent volatility of the stock market," Ducey said. "The formula did not smooth out distributions and in fact had quite the opposite effect, resulting in zero dollars being distributed to public education in 2010. Twenty-year projections using five different economic scenarios indicated that the formula would continue to produce very inconsistent distributions, making it difficult for educators to budget accordingly. Armed with this information, a simpler formula was designed that would protect the fund from the effects of inflation, avoid zero-dollar years, and maximize distributions." Arizona voters approved the new formula in November 2012.

The office has historically managed all investments internally, which Ducey notes is much less costly than hiring external managers. Senior Portfolio Manager **Tim White** executes an index strategy for the 1,500 stocks Arizona holds in its three equity portfolios, and actively manages the fixed-income portion of the fund. He is part of a four-member investment staff, headed by Chief Investment Officer **Patty Humbert**. Together, the staff constitutes the investment risk management committee, which reviews investment strategy and monitors risk.

"Our investment philosophy is safety above all else," Ducey said. "Risk-adjusted performance is a driving [criterion] for our internal investment staff. With interest rates at historically low levels, we are currently investing all of our fixed-income assets short of their duration benchmarks to protect against rising interest rates."

In addition to the endowment, the **Arizona Treasurer's Office** also manages \$5.8 billion in short-term fixed income funds for state agencies and operating cash, and another \$2.8 billion in four local government investment pools. Meketa remains on retainer and is used by the treasurer's office as needed.

Ducey chairs Arizona's five-member board of investment, which meets monthly to review performance of the endowment and the state's other funds. Pima County Treasurer **Beth Ford**, Director of the Arizona Department of Administration **Brian McNeil**, Arizona Superintendent of Financial Institutions **Lauren Kingry** and **Harry Papp**, managing partner of **L. Roy Papp & Associates** serve under Ducey on the board.

—Joe D'Allegro