South Dakota Legislative Research Council

Issue Memorandum 94-25

AMENDMENT C
Proposed Change to the Investment Restrictions of the Permanent School Fund

Introduction

The 1993 Legislature, with the support of the Commissioner of the Department of School and Public Lands, passed Senate Joint Resolution 2, which provides the citizens of South Dakota an opportunity to amend Section 11, Article VIII of the State Constitution. This amendment would allow the Commissioner of the department to invest the assets of the Permanent School Fund in a greater variety of investment instruments than is currently allowed by the State Constitution. The following table shows the change in lawful investments of the Permanent School Fund that would be authorized by Amendment C.

Comparison of Investment Provisions

CURRENT CONSTITUTION	AMENDMENT C
1. Bonds of the United States	1. Certificates of Deposit or like obligations of South Dakota banks
2. Securities guaranteed by the United States	2. Bonds of the State of South Dakota or any school corporation
3. Bonds of any school corporation, organized county, or incorporated city in South Dakota	3. One hundred percent United States government guaranteed bonds
	4. Agencies guaranteed by the United States
	5. Investment grade corporate debt and in common stocks up to fifty percent of the assets of the permanent school fund
	All the above consistent with the Prudent Man Rule

Webster's Third New International Dictionary, Unabridged defines the prudent man rule as, "a rule that gives a large measure of discretion to trustees in selecting investments for trust funds where the trust agreement calls for purchase of legal investments and that allows stocks to be purchased as well as bonds though in some states only up to a specified limit."

The Permanent School Fund Portfolio

As of July 31, 1994, the market value of the portfolio was $120.5 million. Of that amount, $76.6 million (63%) was fixed income assets (government bond, treasury bills, etc.); $9.5 million (7.9%) was in cash equivalents (money market fund treasury securities); $1.1 million (0.9%) was in cash assets; and $33.3 million (27.6%) was in government national mortgage association bonds (GNMA's). It is necessary to have the short-term cash equivalents and cash to meet the obligation of apportionment to common schools. Amendment C would allow more diversification of the Permanent School Fund Portfolio.

Current Investment Risk

Much has been written about the nature of investments and the factors that put investments at risk. There are various elements of risk associated with all investments, even guaranteed United States bonds. For example, a $1,000 bond maturing in 10 years paying a yield of 7% would pay the bearer $70 interest per year and be redeemed for $1,000 at the end of the 10-year term. However, if interest rates should rise, the bond would have a selling price less than $1,000. This is because $1,000 could then be invested at a higher rate and receive a greater return. To compensate for this the price of the bond would be lower.

Consider the following example. A $1,000 bond at 7.5% pays $75 per year. If interest rates rise and a similar bond is paying 9%, the interest would be $90 per year. In order for a $75 return per year to be worth 9%, the price of the bond would be $833. In other words, when the prevailing rate of interest is 9%, an investment (bond price) of $833 would generate a yield of $75 per year. With respect to a guaranteed government bond, the only sure way not to lose money is to hold the bond until maturity.

Stocks vs. Bonds

Empirical evidence shows that over the past 21 years, stocks (as measured by the Standard and Poors 500) have had returns averaging 11.6%, whereas the bond market returns have had a return averaging 9.3% (a 2.3% differential). For two reasons, stocks have a greater element of risk than bonds. First, with a bond the return is fixed, whereas with stocks the return (dividends) are measured by the profitability of the corporation issuing the stock. Second, a bond, at the end of its term, is redeemed at face value whereas the selling price of a share of stock will fluctuate based on factors far too numerous to be considered in this memorandum.

Amendment C and the Permanent School Fund Portfolio

The major impact of Amendment C is to allow half of the portfolio to be invested in common stock. If $55 million were invested in common stock and the return on the common stock was 2.3% greater than the return on the government bonds, approximately $1.3 million additional would be available to distribute to the common schools and other institutions in South Dakota. In terms of the common schools, this would mean approximately an additional $8.13 per student. It is important to note that the additional 2.3% is based on long-term averages. In one single year the bond portfolio may outperform the stock portfolio. Amendment C would allow the Permanent School Fund Portfolio to be invested in a more diverse manner, which should result in a more stable portfolio.

The Implications of Other Sections of the

Constitution on Amendment C

Article VIII, §2 speaks to the maintenance of a perpetual fund, the proceeds arising from the sale of public lands, property falling to the state by escheat, or gifts or donations for public school purposes. Article VIII, §2 clearly states how this perpetual fund (known as the Permanent School Fund) is to be maintained. The last two sentences of Article VIII, §2 state: "It shall be deemed a trust fund held by the state. The principal shall forever remain inviolate, and may be increased, but shall never be diminished, and the state shall make good all losses thereof which may in any manner occur." Article VIII, §7 similarly speaks to the maintenance of a perpetual fund, the proceeds coming from land, money, or property donated for a university, agricultural college, normal schools, or other educational or charitable institution. Article VIII, §7 contains similar language: "The principal of every such fund may be increased, but shall never be diminished, and the interest and income only shall be used. Every such fund shall be deemed a trust fund held by the state, and the state shall make good all losses therefrom that shall in any manner occur."

These two sections of the Constitution clearly indicate that the Permanent School Fund is to be invested in instruments whose value is guaranteed (as specified in Article VIII, §11 as it is currently written); and should that value decline, the Legislature has the responsibility to replace any losses to the Permanent School Fund.

Investing part of the Permanent School Fund in common stock raises some questions which are not clearly answered in the Constitution or Amendment C.

First, how are losses to the Permanent School Fund defined? Does the term "never shall be diminished" apply to the entire fund, or to individual components of the Permanent School Fund portfolio? For example, if the value of the bond portfolio increases by $5 million and the value of the stock portfolio decreases by $2 million, has a loss occurred?

Second, how is the value of the portfolio determined? In the case of bonds, is the value the face value of the bond or is it the current market value of the bond? In the case of the common stock portfolio, the current market price of the portfolio seems to be the only reasonable method to measure the value of the portfolio.

Third, over what time frame are losses or gains measured? The value of each portfolio of the Permanent School Fund, and the value of the Permanent School Fund will fluctuate daily, according to the financial markets. The language "never be diminished" is quite strong and would suggest the impractical notion that the Legislature would need to make up losses to the Permanent School Fund on a daily basis. This conclusion is based on the word "never" in the Constitution. A July 1 to June 30 fiscal year measure of gains or losses would seem to be the most practical time frame.

Amendment C is not solely responsible for these questions, but the inclusion of common stock in the Permanent School Fund portfolio certainly makes these questions important. Given the Legislature's immense responsibility to make good any losses to the Permanent School Fund, the Legislature may want to define answers to the above questions through the passage of legislation.

Summary, the Pros and Cons

The points in favor of Amendment C are: 1) it allows for a more diverse portfolio which is less subject to fluctuations in the investment markets; 2) diversification away from bonds allows for the accumulation of capital gains during inflationary times; 3) diversification to include common stock would, over the long term, increase the earning of the portfolio.

The only apparent point against Amendment C is that a stock market crash would result in substantial losses to the Permanent School Fund which would need to be restored by the Legislature.

This issue memorandum was written by Dale Bertsch, Chief Analyst of Fiscal Research and Budget Analysis for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.