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

Introduction

The 1998 Legislature, with the support of the Commissioner of School and Public Lands, passed Senate Joint Resolution 2, which provides the citizens of the state an opportunity to amend sections 2, 3, 7, 11, and 13 of Article VIII of the State Constitution. The voters in the 1994 general election, with 130,785 votes for and 168,232 votes against, defeated a somewhat similar proposal (see Issue Memorandum 94-25). Also by way of background, in 1996, the voters approved a measure that provided for the investment of the permanent school fund by the South Dakota Investment Council. Prior to the adoption of the 1996 change, the Commissioner of School and Public Lands was responsible for the investment of the assets. The proposal put forth in Amendment G would allow the assets of the permanent school fund to be invested in stocks, bonds, mutual funds, and other financial instruments under guidelines set by the Legislature. Currently, and unless Amendment G passes, the assets of the permanent school fund may be invested only in bonds of the United States, securities guaranteed by the United States, and bonds of local school districts, organized counties, or incorporated cities in South Dakota.

The Framers of the Constitution and the Permanent School Fund

It is clear that the framers of the Constitution had in mind a permanent school fund that was to be a trust fund, and the earnings on the fund were to be used to provide income to the common schools of the state. They also wanted to ensure that the fund would remain whole, and as such specified that the assets of the fund could be invested only in instruments that would hold their value, thus preserving the integrity of the fund. The framers probably did not have in mind financial markets and changing interest rates that could change the price of a bond (again see Issue Memorandum 94-25). The framers of the Constitution would not recognize today’s investment markets and the way in which the assets of the permanent school fund may be invested.

The Permanent School Fund Portfolio

As of June 30, 1997, the market value of the permanent school fund was $117 million. Of that amount, 3.4% was in cash or cash equivalents; 44.6% was in U. S. Treasury notes; 35.2% was in mortgage-backed securities; 10.0% was in corporate notes; and 6.8% was in other assets.

In fiscal year 1997, earnings on the permanent school fund allowed for the distribution of $10,198,483 to local school districts. This amount was distributed on a per student basis, at $67.05 per student.

Amendment G

Amendment G has two main provisions. First, it allows the assets of the permanent school fund to be invested in a wider array of investments, particularly common stock.
The first main provision would allow for the assets of the permanent school fund to be invested in a more diverse manner, thereby allowing for a contemporary mix of the investment portfolio. In other words, the portfolio would consist of some financial instruments with a higher risk/higher reward profile, and some safer instruments with a lower risk/lower return profile. Second, it provides that any losses that may result from an unconstitutional act need to be made good through a legislative special appropriation. The implication of the second provision is that the value of the permanent school fund may fluctuate and possibly decline as a result of conditions in the financial markets. Amendment G allows the investment council to invest the assets of the permanent school fund in a more diverse manner. It must, however, be kept in mind that the passage of Amendment G will allow the assets of the permanent school fund to be invested in financial instruments that allow for a higher return, but that higher return is at the expense of higher risk. It is up to the South Dakota Investment Council to weigh the return against the risk, and invest accordingly. Obviously, there is no guarantee, but given the investment council’s track record, a more diverse portfolio should result in greater earnings for the permanent school fund.

Amendment G does not change the requirement that only income generated by the assets of the fund may be distributed to the common school districts. In the case of common stock, dividends would be distributed to the common school districts. However, any capital gains resulting from the sale of stock would be added to the permanent school fund.

One major issue raised by Issue Memorandum 94-25 was that the 1994 proposal may have required the Legislature to make good any loss in any part of the assets of the permanent school fund that may have diminished due to minor (or major) fluctuations in the financial markets. Amendment G, through the earlier mentioned second main provision, addresses that issue by specifying that the Legislature is responsible for making good, through a special appropriation, any losses to the permanent school fund resulting from an unconstitutional act. In other words, the permanent school fund is still protected from fraud, theft, embezzlement, etc. However, the permanent school fund may suffer losses through the process of investing in financial instruments where the value of the financial instrument may diminish. The Legislature would not be required to make good those kinds of losses.

Summary, the Pros and Cons

The points in favor of Amendment G are: 1) it allows for a more diverse portfolio which is less subject to fluctuations in the investment markets; 2) diversification away from more conservative fixed income assets allows for the accumulation of capital gains during inflationary times; and 3) at least with respect to recent history, diversification of the portfolio to include common stock would increase the earnings of the portfolio. The point against Amendment G is that a greater element of risk is introduced as the assets of the permanent school fund are invested in financial instruments that have a higher potential for return.

The voters will decide by voting on Amendment G how the framers of the Constitution might have acted had current financial instruments and markets been in place in 1889.
This issue memorandum was written by Dale Bertsch, Chief Analyst for 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.