Department of Natural Resources Investments
Questions and Answers
June 4, 2009

Q1. Where does the investment money come from and how much is there?

A1**.** Most Department of Natural Resources (DNR) investment funds come from non renewable mineral related revenue sources, such as natural gas and oil production from state owned DNR managed lands. Currently the principal of these funds is approximately $630 million.

Q2. How are earnings on investments used?

A2. Earnings are used to support the following programs: Michigan Natural Resources Trust Fund grants for land acquisition and recreational development; State Park Endowment Fund for state parks; Game and Fish Fund programs; and the Non Game Fish and Wildlife Fund activities.

Q3. Rather than investing these funds, could they be spent?

A3. The corpus, or investment principal, of these funds is restricted by State Constitution and/or statute and can not be spent without amendment.

Q4. Why were these funds created?

A4. The funds were created to provide long-term sustainable funding for DNR programs using "one-time" revenue sources that are not considered permanent.

Q5. Can these funds be "raided?"

A5. For most, the answer is: "Not without a Constitutional Amendment." In the past, revenues restricted only by statute have by been used for other purposes, with the most recent being the removal of the $20 million from the Michigan Civilian Conservation Corps Endowment Fund in Fiscal Year 2007.

Q6. Who manages the investments?

A6. The State Treasurer manages all investments, but consults with the DNR, the Natural Resources Commission (NRC), and the Natural Resources Trust Fund Board (Trust Fund Board) to obtain asset allocation recommendations. Policy reports and discussions with the NRC have been primarily through its Policy Committee on Finance and Administration. The Treasurer also works closely with the DNR Office of Financial Services in the accounting for and management of these funds, providing both monthly and quarterly reports on transactions.

Q7. How are the funds invested?

A7. At this time, most investment holdings are in the form of high grade fixed income investments (bonds.) Because there currently is a wide interest rate spread between governmental agency bonds and high quality private sector bonds, the Treasurer currently has most fixed income investments in investment quality corporate bonds.

Other funds are invested in the stock market ("equities"), currently in the form of Institutional Index Mutual Funds (Vanguard S&P 500 and Mid-cap funds.)

Investment reserves may also be held as part of the State Common Cash pool, which is largely made up of prime commercial paper. This serves as the temporary "cash" portion of the portfolio.

Q8. How much of the interest and earnings can be spent.

A8. All interest and earnings, including unrealized market value gains, can be appropriated and spent, with one future exception. The State Park Endowment Fund's principal is to be adjusted for inflation once it reaches the $800 million level, but that is not expected for many years.

Q9. What are revenue stabilization reserves? Why do they exist and how can they be used?

A9. The stabilization reserves were established for a number of reasons, including the need or desire to:
a) spend a portion of market value gains, rather than just dividends, interest, and gains on sales.
b) protect principal from loss should market value decreases occur.
c) stabilize spending so that it does not fluctuate unpredictably with market value changes.
d) generate additional investment income on the retained balances.

These stabilization reserves and related "distribution policies" have been established by policy of the DNR, the NRC, and Trust Fund Board and have been consistently followed since their adoption. The State Budget Office's, Office of Financial Management and the State Legislative Auditor General have reviewed and accepted these policies as well.

Q10 What if it was decided to spend these reserves? What if market value losses exceed reserves?

A10 If it was decided to spend or significantly reduce the stabilization reserves, the DNR and Treasury would likely chose to significantly reduce or eliminate our investments in the stock market. In the long run, this would very significantly reduce the future amount of investment earnings and future program spending, assuming that over time equity returns exceed more conservative bond investments.
Through Fiscal Year 2008, the DNR has not experienced a situation where losses exceeded equity income and reserves, so there is no precedent for such an occurrence. The impact on principal caused by market value losses is not explicitly provided for in

statutes. Should such losses occur, however, spending (i.e., appropriation requests) from earnings and gains would be halted until such time as accumulated losses were recovered. In other words, program reductions would occur so as to maintain investment principal.

Q11 Why invest in stocks at all?

A11 Equity investing is a key element in investment portfolio management. Historically, although returns fluctuate considerably, the rate of return on equity funds over time is much higher than interest only investments. A portfolio which includes a diversification of asset types, including equities, is widely considered the best approach for long-term investment management.

Q12 When did the DNR and Treasury start investing in stocks?

A12 A Constitutional Amendment was sought and passed in 2002 to allow these funds to be invested in the stock market. This change was recommended by the Auditor General and endorsed by the DNR, the NRC, the Trust Fund Board and many constituent groups because historically, stock market investing significantly generates more investment income. Mutual fund purchases began in 2003, following discussions with Treasury.

Q13 What has been the result of the decision to invest in equities?

A13 The decision to invest in equities came at a good time from the perspective of market performance. Between 2003 and 2007 the mutual fund holdings performance was outstanding and a huge success. Some of these investment gains have been used to increase program support and some have been used to build up additional investment reserves.

Since the summer of 2008, major equity market declines have occurred. Fiscal year 2008 market value declines reduced accumulated undistributed gains greatly. Market value losses in the first half of Fiscal Year 2009 have caused projected reserve balances to go negative, unless a major recovery occurs before September 30, 2009.

Q14 How have the equity fund investments been impacted by the stock market decline?

A14 The US stock market lost significant value in the first six months of the 2007-2008 fiscal year. The Treasurer, however, had liquidated all mutual fund holdings in June of 2007 when the S&P 500 index was approximately at 1,500, so a significant portion of those market losses was avoided. The Treasurer “dollar cost averaged” back into the market beginning in November 2007 and the total “cost” of our holdings was approximately 1,400 using S&P as of May 1, 2008.

At its low point, the S&P 500 was at 677 in early March 2009, so at its worst, our declines approximated 50% of our cost basis. As of April 30, 2009, the S&P 500 index had risen significantly and was approximately at 873. The cost of our equities in dollars is approximately $170 million and the market value is approximately $103 million at the April 30 level.

Q15 How will the DNR spending be impacted by these losses?

A15 If the stock market does not recover a significant portion of its early losses during the rest of the year, the amount we will have available to appropriate will be reduced, other things being equal. The situation varies for each fund and program, depending upon their reserve levels at the beginning of the year and the level of stock market exposure. (See also answer to Question 10, above.)

Q16 What will be the impact on future investment asset allocation due to these recent losses?

A16 It is impossible to know with certainty whether additional losses will be incurred through the rest of the fiscal year or if some or all of the losses will be recovered. Should stabilization reserves fall further, adding to equity investments could be delayed, as our tolerance for risking spending is reduced by low program fund balances.

Reducing equity targets at this point would run contrary to the concept of keeping a consistent investment policy, which theoretically encourages you to buy at market lows and reduce equities during highs. If we maintain current asset allocation plans (such as a 25% equity target) Treasury could add significant mutual fund holdings to offset recent losses. (In other words, the current values of the equity holdings are below target levels.)

Given the depletion of reserves and high level of uncertainty in the markets, this might be more “aggressive” than some would be comfortable with for these funds. The options and actions that would occur should the market decline further, rather than recover, would need to be considered. At this point, the State Treasurer is monitoring the markets to determine if and when to adjust our stock market investments.

With the exception of the Game and Fish Trust Fund, no changes in asset allocation targets have been made. For the Game and Fish Trust Fund, which is the most aggressively invested fund, a decision was made to decrease the target equity allocation from 50% to 30%. This was done because of the depletion of reserves in that fund and also because of the decrease in fund balance in the program fund, which increased the need for reliable income to support appropriations.

Q17 Does the State Treasurer do “market timing” selling and buying?

A17 Generally speaking, the practice and long-range strategy of the State Treasurer is to “buy and hold” for both the fixed income and equity holdings in our portfolio. This does not preclude the Treasurer from selling investments and this has been done occasionally in the past. The Treasurer has in the past also invested in variable rate, rather than fixed rate, debt instruments, particularly when yields are low.

Q18 Does the State Treasurer manage investments for other State funds? And, what does their investment management cost?

A18 Yes, the State Treasurer manages the investments of most State agencies, including the multi-billion dollar pension funds, other trust funds, and the common cash fund. The State Treasurer spreads the costs of managing the State's investments and short-term cash to various State funds and agencies by using cost allocation techniques. For fiscal year 2009, the fees allocated to DNR funds totaled approximately $400,000. The fees are appropriated by the Legislature for Treasury operations as part of the annual budget process.

Q19 Could the DNR manage its own investments, or hire private firms to do so?

A19 By law, the State Treasurer is responsible for the investment and management of all these State funds. Given the amounts involved, the cost of using outside private firms would almost certainly be much higher. Moreover, the investment performance of the State Treasurer has been excellent.

Q20 I have additional questions about these investments. Who can I contact and how.

A20 Questions can be directed to the DNR Chief of Financial Services, Mr. Joseph Frick, at 517-321-0856 or by emailing to frickj@michigan.gov.