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An Analysis of the Investment of the Common School Permanent Fund in South Dakota

John Edward Keeping

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AN ANALYSIS OF THE INVESTMENT OF THE
COMMON SCHOOL PERMANENT FUND
IN SOUTH DAKOTA

BY

JOHN EDWARD KEEPING

A thesis submitted
in partial fulfillment of the requirements for the
degree Master of Arts, Major in
Economics, South Dakota
State University
1971

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COMMON SCHOOL PERMANENT FUND
IN SOUTH DAKOTA

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Thesis Adviser

Head, Economics Department
ACKNOWLEDGEMENTS

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Additionally, very sincere appreciation is expressed to my wife, Mary Jo, and to a little girl who thought Daddy lived at the "liberry." Without their help and understanding this work would have never been accomplished.

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The return accruing from the prudent investment of these funds is the potential source of this revenue. This thesis will deal with an examination of the investment of one such source of revenue—the Common School Permanent Fund of the State of South Dakota. In this chapter, the history and growth of the Fund will be briefly examined and then the "statement of the problem" will be presented.

### THE HISTORY AND GROWTH OF THE COMMON SCHOOL PERMANENT FUND

The current system of the endowment of the public schools was conceived by Henry VIII. In an attempt to supplement the dwindling coffers of his government, he confiscated all Church property resulting in the collapse of Church-supported education in England. To fill the hiatus caused by the loss of Church financing, various educational institutions throughout the realm were granted tracts of property.

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Chapter 1

A REVIEW OF THE GROWTH OF THE COMMON SCHOOL PERMANENT FUND AND A STATEMENT OF THE PROBLEM

INTRODUCTION

The investment of public monies constitutes a source of revenue independent of State taxes or other non-tax charges on the public. The return accruing from the prudent investment of these funds is the potential source of this revenue. This thesis will deal with an examination of the investment of one such source of revenue—the Common School Permanent Fund of the State of South Dakota. In this Chapter, the history and growth of the Fund will be briefly examined and then the "statement of the problem" will be presented.

THE HISTORY AND GROWTH OF THE COMMON SCHOOL PERMANENT FUND

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1 State of South Dakota, "Investment of the South Dakota Permanent School Fund" (Pierre: State Legislative Research Council, 1969), p. 2. (Mimeographed.)
Specifically designated to be used as a means of financial support, this property formed the nucleus of the non-tax revenue for the emerging schools.

Although the land endowment of public schools was not a new concept in the Americas, the first manifestation of our present system is found in the Northwest Ordinance of 1785. This document laid the governmental and administrative groundwork for the northern portion of the Ohio Valley. The Ordinance established the basic boundaries for Illinois, Indiana, and Ohio and further stipulated the territory be divided into townships providing "...the townships, shall be marked by subdivisions into lots one mile square, or six hundred and forty acres, and numbered from 1 to 36."3

Two years later, the Ordinance of 1787 provided that certain township sections be reserved for certain public institutions and hence, inaugurated the land endowment of our public schools and universities. The South Dakota Enabling Act of 1889 incorporated in its application for Statehood, provisions stating that sections 16 and 36 of each township be set aside for the endowment of the public schools. This resulted in 3,508,734.31 acres4 being set aside for the endowment and maintenance of public schools and various other

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3 Ibid.

public institutions. Certain tracts of this land were specifically designated as the endowment of the public common schools. As this land was sold, the proceeds formed the principal or corpus of the Common School Permanent Fund. The interest income from the prudent investment of this Fund together with interest on deferred payments for land sales, agricultural leasing and mineral rights payments and federal mineral leasing payments were to be annually apportioned on a per-pupil basis to the school districts of all counties in the State of South Dakota.

Originally, the investment of the Fund was accomplished by boards of county commissioners in the organized counties of the State.\(^5\) According to the Fourth Biennial Report of the Commissioner of School and Public Lands, the "...money [will be] distributed to the various organized counties of the State, in proportion to their population to be invested in school bonds or first mortgages on real estate."\(^6\) Apparently, the administration of this money was carried out in an unsatisfactory manner for several years. Subsequent biennial reports called for such innovations as a uniform bookkeeping system\(^7\) and a


requirement that notes, mortgages, and bonds securing mortgages be deposited with the Department of School and Public Lands. In a later report, municipal and county bonds were recommended as allowable investment instruments.  

Reflecting a desire that South Dakota's money should benefit South Dakota agriculture, the largest portion of the Fund was invested through the county commissioners in first mortgages on improved farmland. Crop failures in the twenties coupled with the widespread depression of the thirties resulted in these mortgages being defaulted and foreclosure by the counties on the collateral farmland. The depression saw land prices plummet and there was little chance to sell or rent these land holdings on satisfactory terms.

Since its inception, the Fund had been primarily invested in first mortgages on improved farmland through the counties of the State. Each county would make application to the Department of School and Public Lands for funds to loan. Then, this money would be loaned out in mortgages on farms. The mortgagees in turn would repay the loan and accrued interest through the counties to the Department. The counties

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evidently received no payment for their services as an intermediary agent, but were held responsible for funds for which they had subscribed to the extent they were to make payments of the interest and principal on the mortgages they had made, should these mortgages be defaulted. As crop failures and depression spread in South Dakota, the counties, unable to pay the 5 percent interest rate required by the Constitution on monies entrusted to them for investment, ceased to be a significant source of income to the common schools.

As the demand for funds for first mortgages and municipal bonds diminished in the thirties, idle cash began to accumulate in the Common School Permanent Fund. The 5 percent constitutional interest limitation severely restricted the range of investment instruments since prevailing interest rates were significantly below that. However, a 1935 decision by the Attorney General indicated that this applied only to South Dakota bonds.\(^{11}\) Hence, in that year the Commissioner of School and Public Lands was advised the Fund could be invested in U. S. Securities at less than the 5 percent rate. Under this ruling the Department purchased $3,220,000 of U. S. Government Bonds of various maturities at rates of interest ranging from 2 1/2 percent to 2 3/4 percent.\(^{12}\)

Throughout the thirties additional securities were purchased, sometimes at a premium, such that on May 2, 1939, the Department held

\(^{11}\)Ibid., p. XIX.

\(^{12}\)Ibid.
$3,800,000 in various issues. 13

In June of that year, it became apparent that some low-rate, short-term bonds could be sold at a premium and the proceeds used to acquire a higher return in longer maturity issues. This was accomplished and the Department received $18,782.81 in earned interest plus $3,031.25 in premium on the exchange. 14 Commissioner Hammerquist, however, received somewhat less than widespread acclaim for his innovative action. He notes in the Twenty-Seventh Biennial Report:

Much has been said through the press and otherwise, criticizing the Commissioner for 'speculating' in U.S. Government bonds. In the first place there was no speculation at any time on any issue. Bond experts do not find in the accompanying statement of the detail of all transactions any evidence or incidence of speculation. ... Your Commissioner was charged with the serious crime of accepting bribes in connection with handling some of the transactions mentioned herein. To those charges I pleaded innocent and was wholly vindicated by two juries that heard the evidence. ... Certain interests succeeded in having me erased politically. They have taken from my position and temporarily broken me financially. Nevertheless, I will turn over the Department's affairs to my successor with the gratification of knowing that I have rendered to the people of South Dakota a service never before equalled and perhaps never to be surpassed. 15

In 1941, Legislative action was taken to reduce the rate of interest charged to the counties for funds entrusted to them for investment. This resulted in a massive refunding program being initiated to reimburse the Common School Permanent Fund for money "lost" on defaulted

13 Ibid.
14 Ibid.
15 Ibid., p. XXII.
mortgages made by the counties during the thirties. The proceeds from this program were then invested in 2 1/2 percent United States Treasury Bonds. In 1944 the Commissioner was predicting that eventually 85 percent of the total Permanent School Fund would be invested in United States Government Bonds.

The counties were being eased out of the responsibility for the investment of Common School monies as the Department began to intensify its efforts in the U. S. bond market. In light of the 1935 Attorney General's decision, by 1947 the Common School Permanent Fund totaled $20,818,680.90 with $19,565,210.85 invested in U. S. Bonds and only $1,021,066.43 entrusted to the counties. No legislation was required for this shift in investment emphasis since U. S. Bonds fell within the legal investment instruments already permitted by the Constitution. The implicit philosophy held since the inception of the fund: that this money should serve a dual purpose—that of interest-earning capital and a source of county, municipal and agricultural loans—was being discarded. Now a new set of objectives was being

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17 Ibid., p. IX.

18 See p. 5.

developed. Because of the experience with agricultural loans, "safer" securities were sought to insure the principal would not be lost. Safety of the principal was the primary objective in security selection.

In 1952, Article VIII, Section 11 of the Constitution of the State of South Dakota was amended. The Amendment finally took the "counties out of the loaning business and relieved them from the financial and administrative responsibility for the investment of the Fund." Additionally, this Amendment made the Commissioner of School and Public Lands responsible for the investment of the Fund, eliminated bonds of townships as investment instruments, and indicated the Legislature would be responsible for providing rules to guarantee the highest return.21

In 1951, the Federal Government offered to exchange newly-issued Series B 2 3/4 percent, 1975/80 Bonds for 2 1/2 percent, 1967/72 issues. South Dakota held the lower-maturing issues and since the trade would result in an increase to the Fund by an amount in excess of $58,000 per year in income, the exchange was made.22 The Series B issues, while they bore a higher interest rate, were issued only at


21 Ibid., p. XXVI.

22 State of South Dakota, "Investment of the South Dakota Permanent School Fund" op. cit., p. 12.
par (on a one-for-one basis for the 2 1/2's), registered, and non-negotiable. There was, however, a provision that allowed conversion of these bonds to 1 1/2 percent United States Notes maturing in five years from the date of issue. The five-year notes were wholly marketable. Of course, the length of maturity of the Series B issues was a considerable drawback, but with the convertibility feature, no difficulty was anticipated should their sale, given future events, prove desirable. The Commissioner noted:

The hazard of tying up the funds in these long term 1975/80's which are not negotiable, was carefully considered and the exchange would not have been made had there not been a provision whereby they can be exchanged for short term low rate five year notes which are negotiable. It was determined that, should bonds bearing a rate of interest higher than 2 3/4 percent become available in 'tap' issues, the 1975/80's can be surrendered for the five year notes, the notes sold on the market, and the proceeds invested in the higher rate bonds which may, or may not, be issued.

In 1957, in the face of secularly rising interest rates, the conversion was considered. The action contemplated was to sell the 2 3/4's through the conversion clause the bonds carried, at a slight discount; and purchase Federal Housing Administration 4 1/2's. This would have resulted in an increase in income of approximately $1,600,000 between 1957 and 1980. However, a question arose regarding Article VIII, Section 7 of the South Dakota Constitution. This section states:

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received from the United States...shall be and remain perpetual funds...The principal of every such fund may be increased but shall never be diminished, and the interest and income only shall be used.25

But, because of certain activity carried on in the forties where bonds were bought at a premium, which in a sense depleted the principal, and the recent constitutional Amendment which indicated the Legislature could provide rules to "guarantee the highest return," the Commissioner felt the sale was justified. To insure the exchange was perfectly within the limits of the law, arrangements were made to have the action reviewed by the Supreme Court of South Dakota.

In Schelle vs. Foss (83 N. W. 2d 847),26 the Court ruled that it was illegal to sell these issues at less than cost. This ruling severely restricted the investment of the Fund. It prevented the sale of these low-yield issues and hence "froze" the Fund in a low-income position.

As a result of this case, Commissioner Linn prepared three position papers: "Expand the Field," "Why Amend?," and "Apportion the Net." These papers, obtainable from the Department of School and Public Lands, called for Constitutional amendments to widen the field of investment instruments and authority to take temporary losses on the principal of the Fund to facilitate market operations.


26 State of South Dakota, Thirty-Fifth Biennial Report of the Commissioner of School and Public Lands op. cit., p. XVI.
In November 1968, an amendment to Article VIII, Section 11, was approved by the voters of South Dakota to allow the sale of bonds below cost "to secure the highest income compatible with safe investment." 27

In 1970, the guaranteed portion of Small Business Administration loans was approved as a legal investment. 28

Current activity is concentrated in the field of broadening the range of allowable investment securities to include corporate stocks and bonds.29

A STATEMENT OF THE PROBLEM

As was indicated earlier in the introduction to this Chapter, the investment of public monies constitutes a revenue source independent of taxes or other non-tax charges on the public. As the investment of one such potential source—the Common School Permanent Fund—is examined, an assumption will be made that it is in the best interests of the State of South Dakota to maximize the rate of return from the Common School Permanent Fund considering certain constitutional, statutory, and administrative restraints while providing for the safety and liquidity of the principal of the Fund. However, this assumption is not

27 State of South Dakota, Constitution of the State of South Dakota op. cit., Article VIII, Section 11.


29 State of South Dakota, "Investment of the South Dakota Permanent Fund" op. cit., pp. 50, 51.
of the principal of the Fund. However, this assumption is not meant to preclude the possibility of changing selected constitutional, statutory and administrative restraints.

Currently (September 30, 1969), the Fund returns 3.8 percent on a principal of $44,142,510.87. For comparative purposes the Federal Reserve Bulletin quotes, for the same period, 7.08 percent as the yield on 3-month government bills, 7.58 percent as the yield on certificates and selected note and bond issues (3 to 5 years maturity), and 6.32 percent as the yield on long-term U. S. government bonds (10

30 Objection may be raised to this assumption on the basis that the Fund should provide an opportunity for financing school bonds and other local government funding ventures at lower than market rates of interest. This apparently is not and has not been Department policy for several years. The Thirty-Second Biennial Report states on page XIII, "...these funds should never be used to the disadvantage of the trusts, to 'drive' rates down, or to finance uneconomically constituted or extravagant school districts to the detriment of all school districts." Furthermore, on page 11 of The Thirty-Sixth Biennial Report, Commissioner Linn indicates that Governor Ralph Herseth established a policy of not investing any Permanent Fund monies in city, county, or school district bonds.

31 Based on computations from the September "Quarterly Statements of Condition" issued by the Department of School and Public Lands and the "Sources of Funds Apportioned" Statement from the Biennial Reports. The entire balance of the Interest and Income Fund as of September 30 each year is apportioned to the public schools in January of the following year. All monies earned by the Common School Permanent Fund accrue in the Interest and Income Fund and form a portion of it. The rate of return on the Common School Permanent Fund was determined by dividing the principal available on September 30 of the preceding year into the interest earned on: monies invested in U. S. Bonds and Securities, monies invested through counties, bank balances, and short-term investments.
or more years to maturity). 32 It should be noted this 3.8 percent figure is heavily influenced by $25,784,000 in Series B 1975/80 Bonds drawing 2 3/4 percent. This amount represents 56.98 percent of the total invested assets of the Fund.

Given the initial assumption, this thesis is concerned with attempting to identify some of the factors that give rise to this 3.8 percent figure. The recent and current management and State investment decision framework will be reviewed. Using the annual rate of return as the principal performance criterion, a comparison will be made between the performance of the Common School Permanent Fund and similar funds in certain other selected states. These states shall be selected on the basis of the investment institutions they employ in the handling of State funds and the similarity of the exogenous variables they face to the exogenous variables faced by South Dakota with respect to the investment of its Common School Permanent Fund. Should the performance of the Common School Permanent Fund appear to be below its potential, research will be directed toward the possibility of redefining some investment objectives and redesigning the State government institutional framework within which investment decisions are made. This will be done by applying the experience of other selected states to South Dakota's Common School Permanent Fund investment program.

32 These interest rates were extracted from The Federal Reserve Bulletin, LV, 12, December 1969. The rates of interest for 3-month government bills and selected government note and bond issues were extracted from the table entitled "Money Market Rates," page A 33, and the figure for long-term U. S. government bonds was found on the following page (A 34) in the table entitled "Bond and Stock Yields."
The method of analysis will involve classifying certain endogenous and exogenous variables affecting the investment of the Fund. It is anticipated that the classification will facilitate comparison between South Dakota's Common School Permanent Fund and similar funds in these selected States. Furthermore, it is expected that this classification process will illuminate problem areas and assist in their resolution.

Exogenous Variables

Exogenous variables are those which the Fund managers or State policy makers cannot control or can control only to a small degree. Because of this, little can be done by managers to manipulate these variables. Decisions must be made within the limits or constraints set by these factors. They are mentioned only for sake of completeness. For example, these variables would include both present and future market prices for securities, the range of investment media available for investment at a given point in time and monies available from land sales for investment at a given point in time. Additionally, inflation must be considered as an exogenous factor. To the extent the Fund does or does not earn a rate of return in

33 This last restraint may be controllable to the extent the Department is also responsible for land sales—the primary source of income to the principal—and thus could increase the principal if desired. But land sales are still subject to such exogenous variables as current land prices, condition of the land for sale, and location. With these factors in mind and considering that land sales will not be an endless source of appreciation in the principal, it will be assumed the greater part of the funds available for investment purposes will have to be gained through manipulation of the portfolio (an endogenous variable), and the "new money" from land sales (an exogenous variable) will assume a smaller role in supplying investment capital.
excess of the current rate of inflation, there are or are not real increases to the money available for disbursement to the public schools. Figure 1 compares the annual rate of return earned by the Common School Permanent Fund and the annual rate of increase in the Consumer Price Index. If the annual rate of increase in the Consumer Price Index exceeds the annual rate of return of the Common School Permanent Fund, the Fund bears a smaller and smaller portion of the increasing costs of education because of inflation. Assuming other factors remain unchanged, the quality of public education is likely to be impaired.

A final exogenous variable that must be considered is "past decision." The decisions that were made in the past were made in good faith. If subsequent events show them to be inappropriate, little can be done except to benefit from the experience. Investment policy must be made for the future. Investment policy makers stand at the present and may use the past only as a guide for decisions that are to be made. It does little good to berate past policy makers for decisions they made, since there can be no alteration of those decisions. Attention should be directed, rather, toward avoiding such situations in the future.

**Endogenous variables**

Endogenous variables are those which the Fund managers or State policy makers can control. If these variables or areas can be identified and the adequacy of the present scope of control determined with respect to goal achievement, and there are indications these goals are
Figure 1

A Comparison of the Annual Rate of Return Earned by the Common School Permanent Fund and the Annual Rate of Change in the Consumer Price Index, 1960-1968

Source: Appendix C.
not being achieved, or are too modest, suggestions may be made as how to improve controlling the variables in question to achieve realistic goals. It has been suggested one goal is the attainment of a "high" rate of return on the Common School Permanent Fund. To the extent the endogenous variables that affect the rate of return can be identified, policy makers are in a better position to institute changes that will allow achievement of the stated goals. This section will address itself to attempting to identify some of these variables.

For purposes of clarification the range of endogenous variables is subdivided into three areas: constitutional, statutory and administrative. Constitutional variables are those variables which can be changed by vote of the people. Statutory variables are those variables which can be changed by the Legislature of the State of South Dakota. Administrative variables are those variables that may be changed through revision of administrative rules and regulations, usually within the Department of School and Public Lands.

There exists, however, a certain interrelationship between constitutional and statutory variables. Often, for example, changes in constitutional restraints or variables approved by the people, must be implemented by legislative action. Because of this, the constitutional and statutory variables will be discussed together in this analysis.

Endogenous variables—constitutional and statutory. This section will deal with the constitutional and statutory variables. One
constitutional endogenous variable to be considered is the range of investment instruments. Article VIII, Section 11 of the Constitution of the State of South Dakota limits the investment instruments that the Common School Permanent Fund may utilize to "bonds of the United States, securities guaranteed by the United States, bonds of the State of South Dakota, or ... bonds of any school corporation, organized county, or incorporated city within the State of South Dakota." 34 The problem to be considered here is to determine if this inflexibility with respect to the range of allowable investment instruments results in a rate of return that is below the potential of the Fund ceteris paribus.

A second constitutional endogenous variable to be noted is the inviolate criterion of the corpus of the Fund. Article VIII, Section 7 states, "The principal...may be increased, but never shall be diminished.... Every such fund shall be deemed a trust fund held by the State...." 35 The 1968 Amendment to Article VIII, Section 11 authorizing the "sale of bonds below cost in order to secure the highest income compatible with safe investment" 36 allows the sale of low-yielding securities even though this sale results in a loss to the principal of the Fund. However, in conjunction with this Amendment, the statutes indicate "all losses to the corpus of the fund shall


35 Ibid., Article VIII, Section 7.

36 Ibid., Article VIII, Section 11.
be restored out of the first additional proceeds of the new investment until the entire corpus of the fund has been fully restored."\(^{37}\)

This prevents the return from being maximized to the extent diversions must be made for replenishing the corpus. In other words, the State is attempting to force its Fund manager to control an exogenous variable—past decision. The problem to be considered is to determine if this "inviolate" criterion poses a barrier to Fund operations to the extent Fund managers do not have sufficient latitude in the buying and selling of securities. That is to say, the problem is to determine if the "inviolate" criterion of the principal of the Common School Permanent Fund results in a rate of return that is below the potential of the Fund \textit{ceteris paribus}.

\textbf{Summary.} The reader will note a convenient \textit{ceteris paribus} condition tacked on the end of each of the concluding statements of the preceding section. While it is anticipated that manipulation of each of the variables mentioned would result in a higher rate of return from the Fund "all other factors remaining unchanged," there may be certain complementarities that would result from the manipulation of the two simultaneously that would not be observed if compared to the cumulative effect of the separate manipulation of the variables \textit{ceteris paribus}. Hence, while divided into two cases for purposes of identification, it would appear they should be considered together.

when forwarding suggestions for changes in the State governmental institutional framework for investment.

Endogenous variables—administrative. This category of controllable variables contains those items which are determined by the Department of School and Public Lands either directly or indirectly. Four items appear to be of concern here. They are: 1) the Method of Investment, 2) the Investment Proficiency of the Fund Managers, 3) Investment Timing, and 4) the Investment of the Interest and Income Fund.

1. The Method of Investment. The first of the variables is the actual method of the investment of the Common School Permanent Fund. The "method" is defined as the procedure used in selecting securities for investment. It will be noted in a later Chapter this procedure involves the use of two separate boards of review with eight persons being involved in the decision process. Additionally, this process deals only with funds invested by the Department of School and Public Lands. Since Article VIII, Section 1238 of the Constitution affords the Governor the right to disapprove any investment made by the Department of School and Public Lands, it would appear at a minimum, one man, with judicious and careful review by the executive office, could make and carry out investment decisions. If this were the case, it would appear certain savings of time, effort,

and expense could be made over the present system.

2. Investment Proficiency. A second variable in question is the investment proficiency of the Department itself. While severely restricted in the range of instruments available for investment, nevertheless, a problem may arise with respect to the Department's ability to be continually informed of all the legal instruments for investment activity and their current quotations. In addition to the investment function, the Department is also responsible for school land sales and supervision and control of school land rentals both to agricultural lessees and oil and gas lessees. The Department has also assumed the primary responsibility of "lobbying" for legislation that would release it from various investment constraints to improve its investment record. Acknowledging the complicated and diverse nature of the Department's responsibility, it may be in the best interests of the State of South Dakota to separate the investment function from the Department of School and Public Lands. The alternative would be to place the investment function in the hands of an central agency that can devote its full-time effort to the investment of State funds should investigation show that this centralized method of handling State investments facilitates a higher return.

3. Investment Timing. A third endogenous administrative variable that may be noted is the timing of investment activity. Investment timing deals with the strategy used to insure funds will be available to allow the investor to take advantage of aberrations of the market with respect to his investment objectives. For
It will be hypothesized there are three alternative methods with respect to investment timing. These are: 1) a lump-sum method, 2) a rollover method, and 3) a discretionary method. The lump-sum method is essentially a plan that involves no timing. Funds are invested as they become available. If three-fourths of the total assets of the Fund became available they would be invested immediately at the current rate of return. The rollover method involves some investment planning. Securities are purchased such that there will be a specified amount maturing on a specific date in the future and will be available for reinvestment. The final investment plan is termed the discretionary method. This involves the use of investment analysis and broad discretionary powers with respect to both the types of securities to be purchased and sold and the timing of these purchases and sales.

The problem is to determine if one method is more desirable than the other two to employ in future investment plans. The method of determining this will be to use historical data. Because of the use of historical data, little could be gained of any value from simulating the discretionary method. It would be practically impossible to example, if the investor is attempting to maximize the rate of return on his investments, he will attempt to buy securities when they bear a high rate of return. Because of the "inviolate" nature of the principal of the Common School Permanent Fund, the availability of monies from the sale of low-yielding securities to purchase higher-yielding securities is not always assured. Hence, while considering the return securities may be purchased with an eye toward the date of maturity such that certain issues will always be maturing and therefore, funds will be available to take advantage of increases in the rate of return—the stated investment objective.
determine what decisions would have been made, and any decisions that would be made in the simulation would necessarily be influenced by the knowledge of what was to come. Additionally, since these discretionary powers are not currently available to the Fund manager in toto, this method will not be examined. However, there will be an attempt to evaluate the performance of the Fund under the two remaining methods of investment.

4. Investment of the Common School Interest and Income Fund. A final endogenous administrative variable under scrutiny is the investment of the interest income of the Common School Permanent Fund. At the present time the interest income of the Common School Permanent Fund is invested by the Department of School and Public Lands in short-term government securities through the State Treasurer.40 As the interest income from the Common School Permanent Fund is earned and paid throughout the year, it is credited to the Common School Interest and Income Fund (hereafter referred to as the "Interest and Income Fund"). These balances are, in turn, invested in short-term government securities and the return from this investment ultimately is apportioned to the school districts along with the interest of the Common School Permanent Fund. The statutes governing the investment of such

40 The word "through" is used intentionally. While the Department is responsible for the investment decision and these decisions are made by the Board of School and Public Lands, the actual purchasing of the securities is done by the State Treasurer. The issues purchased must have a maturity such that the principal will be available for apportionment in January of each year.
funds are found in Title 4, Chapter 5. At the present time the investment of the Interest and Income Fund is restricted to securities of the United States and also guaranteed by the United States to be redeemable within 18 months. There may be opportunities available that would substantially increase the money available for distribution to the common schools from the investment of the Interest and Income Fund if the restriction on investment instruments is relaxed.

The preceding section has been devoted primarily to identifying the exogenous and endogenous variables affecting the investment of the Common School Permanent Fund. The next Chapter will be devoted to a definition of permanent funds and an examination of the manner in which the current State government institutional framework for fund investment decisions deals with the constitutional, statutory, and administrative endogenous variables. Next, the State government institutional frameworks and investment objectives found in other certain, selected states will be reviewed. Finally a comparison will be made between South Dakota's State institutional framework for the investment of State funds as it relates to permanent fund investment and these similar frameworks dealing with similar funds found in the other selected states.

41 State of South Dakota, South Dakota Compiled Laws, 1967 op. cit., Title 4, Chapter 5.

42 Ibid., Title 4, Chapter 5, Section 6.
OBJECTIVES

The objectives of this study are:

1. To determine if the exogenous variables set an upper limit on the rate of return on the Common School Permanent Fund.

2. To determine if the current endogenous variables result in a rate of return below the limit imposed by the exogenous variables.

3. To suggest legislation to, if possible, raise the rate of return now experienced as determined by the endogenous variables.

A REVIEW OF THE LITERATURE

The Biennial Reports of the Commissioner of School and Public Lands provide excellent insight with respect to the history and growth of the Common School Permanent Fund. These reports, in addition to stating the financial condition of the Fund, indicate in narrative form the Commissioners' opinions and evaluations of the activity of the Department over the bienniums.

A thesis and dissertation have been written in South Dakota on the Permanent School Fund of which the Common School Permanent Fund is a part. The thesis43 was written by Oral L. Holm on the management of the Permanent School Fund. Since the work was produced in 1940, it did not provide much insight because of the changed nature of the Fund since that time.

A more recent work, "The Derivation and Distribution of the Income from the South Dakota Permanent School Fund and School Lands" was not available. However, much of this dissertation was reproduced in a staff memorandum entitled, "Investment of the South Dakota Permanent School Fund," published by the Legislative Research Council of the State of South Dakota.

There is little written on the investment of permanent school funds per se that is readily available. The Advisory Commission on Intergovernmental Relations suggested as the best and most recent work on permanent fund investment, "State Centralized Investment Process—Structure, Controls, and Operations," a doctoral dissertation by Miles Tommeraasen. This was an excellent source for suggestions as to the methods of consolidating the state investment process.


45 State of South Dakota, "Investment of the South Dakota Permanent School Fund" op. cit.

46 Based on Correspondence with Will S. Myers, Jr., Senior Analyst, Advisory Commission on Intergovernmental Relations, Washington, D. C., May 15, 1970.

The States of New Mexico, Minnesota, Texas and Wisconsin were particularly helpful in submitting various reports on their permanent fund investments. In addition to the published reports, the fund managers of each of these States were also found to be ready and happy to answer individual questions.

Two sources were found to be particularly helpful in the area of security analysis and bond investment. Security Analysis, Principles and Techniques\textsuperscript{48} by Graham, Dodd, and Cottle identified the criteria for sound corporate stock and bond investment. Investment Principles and Practices\textsuperscript{49} by Badger, Torgerson, and Guthmann was strong in pointing out various investment instruments' strengths and weaknesses. Both commented on the philosophy behind the investment process, albeit directed toward the private or corporate investor. Nevertheless, it appears much can be gained from these sources for the public investor.

Other sources of information are the Ford Foundation's Advisory Committee on Endowment Management,\textsuperscript{50} and the Advisory Commission on


Intergovernmental Relations,\textsuperscript{51} a commission of the United States Government.

Finally the Constitution of the State of South Dakota\textsuperscript{52} and the South Dakota Compiled Laws, 1967\textsuperscript{53} provide information with respect to the regulation and restraints on the investment of the Fund.

\textbf{A DEFINITION OF TERMS}

This thesis is concerned with the Common School Permanent Fund, one of the twelve endowed entities that make up the Permanent School Fund. The return accruing from each of these endowment funds is used for the maintenance and support of its respective institution. The balance of the Permanent School Fund and the portfolio of the Common School Permanent School Fund as of June 30, 1969, are depicted in Appendix A and Appendix B respectively. It will be noted the Common School Permanent Fund ($45,413,664.69) makes up approximately 86 percent of the Permanent School Fund ($52,839,873.32). The portfolio of the Common School Permanent Fund is similar to that of the other endowed entities, with the securities held being of the same type.


\textsuperscript{52}State of South Dakota, Constitution of the State of South Dakota op. cit.

although not necessarily in the same proportion or amount. Other terms will be defined throughout the paper.

A STATEMENT OF PROCEDURE

A narrative approach will be followed. Each of the endogenous variables will be examined. If improvements can be made, suggestions will be forwarded. If no improvement is needed, this will be acknowledged.

Two field trips will be conducted to Pierre to question the Commissioner directly on points that need clarification. The resultant information will be so noted.

A computer program will be run to simulate an investment program under two alternative investment plans using two investment instruments that are within the current constitutional and statutory restraints. The objective of this phase of the study will be to provide some insight for future investment decisions with respect to the timing of investment activity.

Little that will be presented here is "new" in the sense of uncovered ground. Rather emphasis will be directed toward applying the experience of other investment programs and fields to South Dakota's investment of the Common School Permanent Fund.
Chapter 2

AN ANALYSIS OF THE ENDOGENOUS AND EXOGENOUS VARIABLES

INTRODUCTION

It is the purpose of this chapter, first, to define the Common School Permanent Fund with respect to the type of fund it is, and then review the constitutional and statutory endogenous variables that are applicable to the Fund. Finally, the endogenous administrative variables will be reviewed and then a portion of the computer program mentioned in Chapter 1 reviewed.

TYPES OF FUNDS

Miles Tommeraasen notes three divisions in the types of funds held by states. These are:

1. Permanent or Trust Funds;
2. Pension and Retirement Funds;
3. Current Operating Balances. 54

Permanent funds are defined as those funds to which cash flow is a relatively unimportant concept. This arises from the idea that the earnings or income of these funds are the only portion generally available for expenditure while the principal usually remains intact. 55

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54 Tommeraasen, op. cit., p. 2.
55 Ibid., p. 124.
Pension and retirement funds, on the other hand, involve the cash flow concept, that is, the monies in these funds are expended and replenished over time. The nature of these funds is to provide a certain income each month for disbursements to pensioners or other recipients. Also, unlike permanent funds, pension and retirement funds receive substantial amounts of income each month from the paying participants. As a rule the principal is not considered inviolate and, hence, capital gains can be distributed and the capital losses absorbed. In general, there is wider latitude in the choice of investment instruments than that found in permanent funds. As can be seen the cash flow concept is very important in the effective management of these funds.\textsuperscript{56}

Finally, current operating balances are temporarily idle funds that are available for short-term investment. These arise because of many circumstances. One such circumstance could be the uneven payments made by taxpayers over a year. For example, on April 15 the Federal Government receives a substantial part of its operating monies for the whole year. Of course, this is not all spent immediately so that certain idle balances exist which diminish over the year as disbursements

\textsuperscript{56}Cash flow is a concept that deals with the funds available to a concern before amortization. In corporate situations, cash flow indicates the total earnings available from the operations of a certain period available for replacements, debt reduction, dividends, etc. In fund management, the idea would apply to the amounts left over after all payments are made to the recipients and hence an optimal objective would be to have a zero cash flow figure. For a more complete discussion of cash flow from a corporate standpoint see Benjamin Graham, David L. Dodd and Sidney Cottle, Security Analysis, Principles and Practices (4th ed.; New York: McGraw-Hill Book Co., 1962), pp. 172 ff.
are made. These idle balances could be made to "work" through short-term investment and provide additional revenue. The time element here is of crucial importance. The Common School Interest and Income Fund and its investment provide a good example of operating-balances investment. Since apportionment is made only once a year, there are at other times positive balances in this Fund. At the present time these balances vary approximately from $200,000 to $2,500,000 throughout the fiscal year. They are currently invested by the Department as explained in Chapter 1.

It can be seen that, in concept, permanent funds are unique in their investment criteria. Furthermore, in addition to the "intact" principal, other restrictions may be applied. These will now be examined.

CONSTITUTIONAL ENDOGENOUS VARIABLES

Article VIII and Article XXVIII of the Constitution of the State of South Dakota are primarily concerned with education and school lands and, as a result, with permanent funds. This section will be concerned with an in-depth review of each of the Articles and their relation to the Common School Permanent Fund. The entirety of Articles VIII and XXVIII is reproduced in Appendix D.

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57 Interview with Commissioner Bernard Linn, Commissioner of School and Public Lands, State Capitol Building, Pierre, South Dakota, August 4, 1970.

58 For a more complete discussion of the investment of operating balances in the State of South Dakota, see Robert L. Johnson, "Investment of State and Local Cash Balances," South Dakota Municipalities, XXXVI (December, 1969), pp. 5 ff.
Article VIII, Section 1 charges the State with the responsibility for the establishment and maintenance of the public schools. It calls for free tuition and non-discrimination.

Section 2 indicates the sources of the principal or corpus of the Fund. The sources of the principal shall be "all proceeds from the sale of public lands" and indemnity lands. Indemnity lands are those lands granted in lieu of lands found to be unacceptable for endowment purposes. A certain portion of the proceeds from the sale of federal lands within the State is also placed in the principal of the Fund. Additional sources of the principal include the proceeds from the sale of property that is escheated to the State and gifts or donations. This Section further establishes the inviolate criterion of the principal of the Fund in that the principal is required to remain "inviolate," that is, it is not to be expended for any purpose. It is noted, however, that this provision was altered by the 1968 Amendment to Section 11 that allows the Fund to take temporary losses to "secure the highest income compatible with safe investment."59

Section 3 specifies the disposition of the interest and income earned by the Common School Permanent Fund. It states the apportionment to the school districts shall be made annually on a per-pupil basis and that all the interest and income will be used for the maintenance and support of the schools. This Section provides, additionally, that the fines collected by the counties for violation of various state laws will also be disbursed to the school districts in a similar manner.

59 State of South Dakota, Constitution of the State of South Dakota op. cit., Article VIII, Section 11.
Sections 4, 5, and 6 deal with the sale of school and State public lands. Section 7 establishes the permanent funds for the endowed institutions other than the common schools. These institutions are noted in Appendix A. Section 8 deals with the sale of public lands set aside by the Enabling Act for these other endowed entities.

Section 9 allows the leasing of school lands for agricultural purposes. The proceeds from the leasing of this land are disbursed to the school districts in the same manner as the interest income of the Common School Permanent Fund. Section 10 makes "squatting" on school and public lands illegal.

Section 11 states the legal instruments for investment purposes. These are, "...bonds of the United States, securities guaranteed by the United States, bonds of the State of South Dakota, or bonds of any school corporation, organized county, or incorporated city within the State of South Dakota." Furthermore, this Section instructs the Legislature to "...provide by law, such rules, regulations and safeguards as it may deem necessary to secure safe and continuous investment of such funds..." Section 11 was amended in the general election of 1968 to allow the sale of securities below cost to facilitate investment operations. The accompanying legislation will be reviewed in a later section of this Chapter.

Section 12 gives the Governor the right to disapprove any sale, lease, or investment made on behalf of the State.

60 State of South Dakota, Constitution of the State of South Dakota op. cit., Article VIII, Section 11.
61 Ibid.
Section 13 states the conditions under which losses to all permanent funds may be taken and how these losses shall be repaid. Sections 14, 15, 16, and 17 deal with land or education provisions and, as such, are not concerned with the investment of the Fund.

Section 18 establishes the apportionment of monies received from the leasing of oil, gas, and mineral rights on Common School Lands. This money is apportioned in proportion to the lands held by each endowed entity. This Section further states that at least 50 percent of the monies received in this manner shall be given to the public schools.

Article XXVIII is somewhat out of date at this time. It sets a limit of $1,000 for loans made to farmers through the counties and allows investment in first mortgages on farms. Since the current rate of interest obtainable for such loans and mortgages is lower than can be secured elsewhere, the Department does not consider these securities as viable investment alternatives at the present time. 62

STATUTORY ENDOGENOUS VARIABLES

This section will review portions of the South Dakota Compiled Laws, 1967 as they apply to the investment of the Common School Permanent Fund. Title 5, Chapter 10 deals with State public school and endowment funds. Much of this Title deals with administrative

62 Interview with Commissioner Bernard Linn, loc. cit.
procedures not concerned with the investment of the Common School
Fund and will not be entertained, however, Chapters of this Title
that deal with the investment of the Fund will be covered.

Title 5, Chapter 10, Section 3 indicates the accounts and records
that will be maintained by the Commissioner of School and Public Lands.

He is instructed to:

...keep an accurate account of all money due or to become due
the state on account of sales and leases of school and public
lands and the interest arising from the loaning of the Permanent
School Fund." 63

Title 5, Chapter 10, Section 18 states the instruments available
for investment of the Common School Permanent Fund 64 pursuant to the
provisions of the Constitution. 65 Additionally, this Section indicates
the minimum interest rate which will be accepted for bonds of counties,
incorporated cities or school corporations.

At the present time investment of the monies of the Common School
Permanent Fund are restricted by statute to:

1. Bonds of the United States; 66

2. Securities guaranteed by the United States, including
Farmer's Home Administration and Federal Housing Administration

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63 State of South Dakota, South Dakota Compiled Laws, 1967 op. cit., Title 5, Chapter 10, Section 3.
64 Ibid., Title 5, Chapter 10, Section 18.
65 State of South Dakota, Constitution of the State of South Dakota op. cit., Article VIII, Section 11.
mortgages\textsuperscript{67} and Small Business Administration loans;\textsuperscript{68}

3. General obligation bonds of the State of South Dakota;\textsuperscript{69}

4. General obligation bonds of any public school corporation of South Dakota;\textsuperscript{70}

5. General obligation bonds of any organized county of South Dakota;\textsuperscript{71}

6. General obligation bonds of any incorporated city within the State of South Dakota;\textsuperscript{72}

7. Loans made under the Federal Higher Education Act of 1965, as amended, provided that "...the owner of such loans shall continue to service such loans, for which servicing the Commissioner shall, by rule, allow a reasonable administrative cost allowance."\textsuperscript{73}

Furthermore, this Section sets the interest rate which will be demanded for bonds of the State of South Dakota, any organized county, incorporated city or school corporation at 6 percent.\textsuperscript{74} The Commissioner

\textsuperscript{67} Ibid.

\textsuperscript{68} State of South Dakota, "H. B. 612" op. cit.

\textsuperscript{69} State of South Dakota, \textit{South Dakota Compiled Laws, 1967} loc. cit.

\textsuperscript{70} Ibid.

\textsuperscript{71} Ibid.

\textsuperscript{72} Ibid.

\textsuperscript{73} State of South Dakota, Forty-Fifth Session of the South Dakota State Legislature, "H. B. 858" (Pierre: February 24, 1970).

\textsuperscript{74} State of South Dakota, \textit{South Dakota Compiled Laws, 1967} loc. cit.
stated because of the 6 percent rate of interest set by the Legislature with respect to items 3, 4, and 5, and because of the rate of interest (7 percent) stipulated by the Federal Higher Education Act of 1965, these instruments were not currently being sought by the Department as investment media. 75

Additionally, the Commissioner of School and Public Lands has indicated that since Small Business Administration loans are only 90 percent guaranteed,76 these do not fall within the "letter of the law" noted in item 2 above. That is to say, he feels the term "guaranteed" infers fully guaranteed. 77 He indicated, for purposes of illustration, that a circle cannot be "rounder" than round. The same absolute interpretation of the word applies to the word, "guaranteed." A security cannot be more or less "guaranteed."

Therefore, there is a de facto restriction on the investment of the Common School Permanent Fund to:

1. Bonds of the United States;
2. Farmer's Home Administration mortgages;
3. Federal Housing Administration mortgages.

From the portfolio display in Appendix B, it can be seen that these types of securities encompass the major portion of the Fund. The

75 Interview with Commissioner Bernard Linn, loc. cit.
76 State of South Dakota, "Investment of the South Dakota Permanent School Fund" op. cit., p. 51.
77 Interview with Commissioner Linn, loc. cit.
old 5 percent farm loans are "holdovers" from the refunding operation of the early forties. The county general obligation bonds are being held to maturity and will be retired by 1975. 78 Again, because of the low rate of interest set by the Legislature, 79 no new activity is anticipated in this field.

Title 5, Chapter 10, Section 18 was amended in 1969 to provide the legal framework to incorporate the 1968 Constitutional Amendment that provided for temporary losses to the principal of the Fund. 80 Now, the statutes and Constitution permit low-yield bonds to be sold or exchanged below cost. Also, this Section provides that the loss shall be restored out of the first additional interest income until the principal is fully restored. In the event the loss exceeds $100,000, it may be amortized.

Title 5, Chapter 10, Sections 20, 21 and 22 deal with investments made through the county treasurers and, hence, are not of importance since investments are no longer made through this medium.

The remainder of this Title can be inspected in Appendix E.

Relating to the above provisions: 1) the range of investment securities is limited to U. S. Bonds, Farmer's Home Administration

78 Based on Correspondence with Commissioner Bernard Linn, Commissioner of School and Public Lands, Department of School and Public Lands, State Capitol Building, Pierre, South Dakota, August 25, 1970.

79 State of South Dakota, South Dakota Compiled Laws, 1967 op. cit., Title 5, Chapter 10, Section 18.

80 Ibid., Title 5, Chapter 10, Section 18.1.
and Federal Housing Administration mortgages and 2) the inviolate
criterion of the principal has been circumvented in part by recent
amendment to the Constitution, but that loss must still be restored
to the corpus.

ADMINISTRATIVE ENDOGENOUS VARIABLES

Method of Investment

This section will be devoted to a detailed discussion of the
administrative endogenous variables mentioned in Chapter 1. The
first of the variables is the method of investment of the Fund.
Currently, the procedure is as follows:

1. The Commissioner recommends an investment to the Board of
School and Public Lands.81

2. If approved the resolution of the Board of School and
Public Lands is submitted to the Board of Finance82 for review
and approval.

3. The State Treasurer at the direction of the Board of
School and Public Lands, approved by the Board of Finance, makes
the ordered investment.

4. The Commissioner draws the vouchers for the warrants to
pay the cost of the investment. The Comptroller and the State
Auditor both audit and record the voucher and the auditor writes
the warrants which are delivered to the Treasurer or the
Comptroller.

5. The Treasurer makes a full and complete report of the
entire transaction to the Board of Finance. His report is

81 The Board of School and Public Lands consists of three
members, all ex officio--the Commissioner of School and Public
Lands, the Governor and the State Auditor.

82 The Board of Finance consists of eight members, all ex
officio--the Governor, State Treasurer, Secretary of State, State
approved, filed and recorded.

6. Two photostatic copies of the trust receipt held by the Treasurer are made and after comparison, one is filed with the Secretary of State and the other with the Department.

Salient points to be noted here are: 1) The Commissioner is the only source of recommendation, 2) two boards composed of a total of eight different persons are needed for approval of an investment, and 3) this procedure applies only to funds invested by the Department of School and Public Lands.

Investment Proficiency

Under this arrangement the members of the two boards deal with the investment of funds in excess of $50 million. However, apparently none of these individuals are trained financial analysts. Furthermore, all the members of the Board of School and Public Lands are members of the Board of Finance, resulting in an apparent redundancy. The Commissioner has indicated that occasionally he consults with investment personnel of the State Investment Board of Minnesota, but with this exception; no other trained investment personnel are involved at any level of this decision process. Hence, it would appear there is a lack of technical analysis in a decision-making position under

Auditor, Attorney General, Commissioner of School and Public Lands, Superintendent of Banks, and the Commissioner of Education.


84 Interview with Commissioner Bernard Linn, Commissioner of School and Public Lands, State Capitol Building, Pierre, South Dakota, June 18, 1970.
this method of organization.

Miles Tommeraasen notes that because of the peculiar nature of permanent funds—that is the inviolate principal—the more technical analysis to assure cash flow is not the problem that it is in the funds where cash flow is a primary concern. He states:

No detailed analysis is required to assure that fund balances will be available to meet expenditures. Additions to the Fund may be regular or sporadic, but are no problem since they become a permanent part of the principal and will not be expended. For these funds decisions concerning balances and cash flow can be based on experience with the funds with little attention to more technical analysis.85

At first glance, this last sentence may seem to indicate the method of handling Fund investment in South Dakota—that is, principally by experience—is in consonance with the opinion of a leading authority. However, it should be noted the quote deals with cash flow, not security selection. It is one thing to have technical analysis to assure cash flow and another thing to have technical analysis to insure the proper selection of securities to provide for the highest return possible under the exogenous variables.

Additionally, the mere size of the Fund may warrant the need for trained investment counsel. The Ford Foundation Advisory Committee on Endowment Management indicates that some experts suggest that proper management of endowment funds of $50 million in size would necessitate the hiring of a full-time investment manager and several assistants. But this figure is arbitrary and the report suggests some would feel

85 Tommeraasen, op. cit. p. 136.
the proper minimum would be twice that amount. 86

Commissioner Linn has indicated he does not feel the size of the Permanent Fund warrants the hiring of full-time professional help. 87

However, as of June 30, 1969, there were ten different funds in the State having a combined balance of $117,400,550.98 (see Table 1). It should be noted this amount includes funds of all types: permanent, pension, and operating balances. At the present time the investment of these funds is carried on either by the State Treasurer or by the office to which the fund is entrusted.

It is suggested that the size of this aggregate amount ($117 million) would merit the consideration of some type of state-centralized investment process. In response to two of the three administrative endogenous variables mentioned in Chapter 1 the centralized process offers an alternative to the method of investment discussed on page 40. Secondly, the centralized process places a trained investment officer in a decision-making position that deals with all State funds.

Investment Timing

The third endogenous administrative variable mentioned in Chapter 1 was the timing of investment activity. It was anticipated that a methodical plan of investment would result in a higher total income.


87 Interview with Commissioner Bernard Linn, op. cit., August 4, 1970.
Table 1

State Funds and Balances June 30, 1969

<table>
<thead>
<tr>
<th>Fund</th>
<th>Cash and/or investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Fund</td>
<td>$ 4,020,926.01</td>
</tr>
<tr>
<td>Special Revenue Funds</td>
<td>19,368,920.39</td>
</tr>
<tr>
<td>Bond Funds</td>
<td>1,885,879.16</td>
</tr>
<tr>
<td>Sinking Funds</td>
<td>1,484,111.99</td>
</tr>
<tr>
<td>Working Capital or Revolving Funds</td>
<td>635,823.63</td>
</tr>
<tr>
<td>Trust and Agency Funds</td>
<td>31,061,949.32</td>
</tr>
<tr>
<td>Public Service Funds</td>
<td>2,198,262.94</td>
</tr>
<tr>
<td>Clearing and Other Funds</td>
<td>4,103,907.19</td>
</tr>
<tr>
<td>Permanent Funds</td>
<td>52,640,770.35</td>
</tr>
<tr>
<td><strong>Total State Funds and Balances</strong></td>
<td><strong>$117,400,550.98</strong></td>
</tr>
</tbody>
</table>

Over a given period of time interest rates fluctuate such that the pattern is composed of a series of peaks and troughs (see Figure 2). Prices of debt move counter to this pattern, hence, as interest rates increase, debt prices decrease and vice-versa.

This occurs because of the nature of a debt issue. Most debt obligations carry a specified rate of interest. This is generally designated as a percentage of the face value of the obligation. Hence, on a regular basis a certain constant sum of money is paid to the holder of the debt as long as the debtor remains solvent. Hence, the money lent "buys" a regular income plus the promise to pay the face amount of the debt upon maturity.

Thus, at a given rate of interest, say 8 percent per annum, $8 buys the use of $100 for one year. Now, assume that other bidders in the money market are willing to pay 10 percent per annum or $10 for the use of $100 for a year. Formerly, the lender could buy $108 a year hence, for $100 at the present. Now, he can purchase $110 one year hence for $100. Clearly, if the $108 promise to pay is to be sold on the open market, it must be sold for something less than $100. At 10 percent, in fact, the $108 debt would only be worth $98.18. Hence, the price of the $100, 8 percent security must fall to make it yield 10 percent, the going market rate, as interest rates rise.

The investor is faced with two options. He can invest for capital appreciation (an increase in the value of his security as interest rates fall), or he can buy a security for its income. If he is looking for capital appreciation, he will buy when interest rates
Figure 2

Interest Rate Patterns
are high (prices low) and sell when interest rates fall (prices rise). Should he fail to realize his expectations of a falling interest rate he still has a high-yielding security which will pay its face value at maturity. On the other hand, if the investor desires a high income, he will attempt to buy debt when interest rates are high and hold the security to maturity regardless of price fluctuations.

After insuring the safety of the principal by purchasing only fully-guaranteed government debt, the Department attempts to realize the highest income or, in other words, follows the second course of action.

**Hypothesis.** A hypothesis was forwarded that an investment strategy that involved investing a portion of the Fund at fairly short, regular intervals would, given a long-term upward trend in interest rates, result in a higher total income than an investment strategy that involved investing the whole principal and holding it for a longer period of time. This assumed that the investor was predisposed to hold his securities to maturity. This first strategy is a variation of the "dollar cost averaging" strategy, a fairly well-known investment technique when an investor is trying to minimize his average equity price per share in a falling stock market. 88 It was anticipated the process would work in the same manner if the investor was trying to increase his average return in a debt market.

Investment strategies. Two investment strategies were devised. Strategy I, referred to as "Lump-sum" dealt with investing the entire principal at one time and holding the debt purchased to maturity. Upon maturity the earned interest was calculated, totaled, and the principal less the earned interest was reinvested.

Strategy II involved dividing the principal into smaller amounts. These smaller amounts were to be invested at equal intervals, that is "rolled-over," regardless of any interest rate fluctuations. As each increment matured, the earned interest was calculated, totaled, and the increment less earned interest reinvested. As was indicated earlier, it was anticipated this "rolling-over" of the principal would result in a higher income.

Investment instruments. Two media for investment were considered. One potential medium was government notes. These are medium-term government debt issues having maturities from one to five years. The other source was long-term bonds. These are long-term government debt issues with maturities ranging from ten to twenty years.

Each investment strategy was applied to each type of investment instrument making a total of four outcomes. Figure 3 shows these strategies in schematic form.

The results of each strategy as applied to each type of investment security are presented in Tables 3 through 6. Table 2 is presented as a "bench-mark" for the two investment strategies. This is the result of continuously investing the principal in short-term (3-month) bills. This was assumed to be the easiest and most elementary type of investment timing procedure.
Figure 3

Alternative Investment Strategies
Table 2
Investment in 3 Month Bills--"Benchmark," 1941 to 1970

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal (1)</th>
<th>Interest rate (3)</th>
<th>Interest income (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$50,000,000</td>
<td>0.097%</td>
<td>$48,500</td>
</tr>
<tr>
<td>2</td>
<td>50,000,000</td>
<td>0.368</td>
<td>184,000</td>
</tr>
<tr>
<td>3</td>
<td>50,000,000</td>
<td>0.374</td>
<td>187,000</td>
</tr>
<tr>
<td>4</td>
<td>50,000,000</td>
<td>0.375</td>
<td>187,500</td>
</tr>
<tr>
<td>5</td>
<td>50,000,000</td>
<td>0.375</td>
<td>187,500</td>
</tr>
<tr>
<td>6</td>
<td>50,000,000</td>
<td>0.375</td>
<td>187,500</td>
</tr>
<tr>
<td>7</td>
<td>50,000,000</td>
<td>0.703</td>
<td>351,500</td>
</tr>
<tr>
<td>8</td>
<td>50,000,000</td>
<td>0.997</td>
<td>498,500</td>
</tr>
<tr>
<td>9</td>
<td>50,000,000</td>
<td>0.990</td>
<td>495,000</td>
</tr>
<tr>
<td>10</td>
<td>50,000,000</td>
<td>1.172</td>
<td>586,000</td>
</tr>
<tr>
<td>11</td>
<td>50,000,000</td>
<td>1.593</td>
<td>796,000</td>
</tr>
<tr>
<td>12</td>
<td>50,000,000</td>
<td>1.824</td>
<td>912,000</td>
</tr>
<tr>
<td>13</td>
<td>50,000,000</td>
<td>2.040</td>
<td>1,020,000</td>
</tr>
<tr>
<td>14</td>
<td>50,000,000</td>
<td>0.710</td>
<td>355,000</td>
</tr>
<tr>
<td>15</td>
<td>50,000,000</td>
<td>1.622</td>
<td>811,000</td>
</tr>
<tr>
<td>16</td>
<td>50,000,000</td>
<td>2.334</td>
<td>1,167,000</td>
</tr>
<tr>
<td>17</td>
<td>50,000,000</td>
<td>3.165</td>
<td>1,582,500</td>
</tr>
<tr>
<td>18</td>
<td>50,000,000</td>
<td>0.962</td>
<td>481,000</td>
</tr>
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<td>1,621,500</td>
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<td>1,198,000</td>
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<td>50,000,000</td>
<td>2.268</td>
<td>1,134,000</td>
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<td>22</td>
<td>50,000,000</td>
<td>2.945</td>
<td>1,472,500</td>
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<td>23</td>
<td>50,000,000</td>
<td>3.143</td>
<td>1,571,500</td>
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<td>24</td>
<td>50,000,000</td>
<td>3.479</td>
<td>1,739,500</td>
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<td>50,000,000</td>
<td>3.831</td>
<td>1,915,500</td>
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<td>4.855</td>
<td>2,427,500</td>
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<tr>
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<td>4.308</td>
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<td>50,000,000</td>
<td>5.382</td>
<td>2,691,000</td>
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<td>50,000,000</td>
<td>7.004</td>
<td>3,502,000</td>
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<tr>
<td>30</td>
<td>50,000,000</td>
<td>6.480</td>
<td>3,240,000</td>
</tr>
</tbody>
</table>

Total Interest Income: $34,704,500


Column 4: The interest income was calculated by multiplying $50,000,000 by the interest rate given for 3 month bills for each year.
Table 3

Strategy I (Lump-sum) Medium-Term Notes,
3 to 5 Year Maturity, 1941-1970

<table>
<thead>
<tr>
<th>Years</th>
<th>Principal</th>
<th>Interest rate</th>
<th>Interest income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-5</td>
<td>$50,000,000</td>
<td>0.67%</td>
<td>$1,675,000</td>
</tr>
<tr>
<td>6-10</td>
<td>50,000,000</td>
<td>1.13</td>
<td>2,825,000</td>
</tr>
<tr>
<td>11-15</td>
<td>50,000,000</td>
<td>1.94</td>
<td>4,850,000</td>
</tr>
<tr>
<td>16-20</td>
<td>50,000,000</td>
<td>2.97</td>
<td>7,425,000</td>
</tr>
<tr>
<td>21-25</td>
<td>50,000,000</td>
<td>3.69</td>
<td>9,225,000</td>
</tr>
<tr>
<td>26-30</td>
<td>50,000,000</td>
<td>5.22</td>
<td>13,050,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Total Interest Income</strong> $39,050,000</td>
</tr>
</tbody>
</table>


Column 4: The interest income was calculated by multiplying $50,000,000 by the interest rate given for medium-term notes for years 1, 6, 11, 16, 21, and 26. The product of each of these calculations was multiplied by 5 to determine the interest income for each 5 year period.
Table 4
Strategy I (Lump-sum) Long-Term Bonds,
10 to 20 Year Maturity, 1941-1970

<table>
<thead>
<tr>
<th>Years</th>
<th>Principal</th>
<th>Interest rate</th>
<th>Interest income</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
</tr>
<tr>
<td>1-10</td>
<td>$50,000,000</td>
<td>1.90%</td>
<td>$9,500,000</td>
</tr>
<tr>
<td>11-30</td>
<td>50,000,000</td>
<td>2.63</td>
<td>26,300,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Total Interest Income</strong> $35,800,000</td>
</tr>
</tbody>
</table>


Column 4: The interest income was calculated by multiplying $50,000,000 by the interest rate given for long-term bonds for years 1 and 11. The product of each of these calculations was multiplied by 10 and 20 respectively to determine the interest income for the 10 and 20 year period.
### Table 5
Strategy II (Roll-over) Medium-Term Notes, 3 to 5 Year Maturity, 1941-1970

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal</th>
<th>Interest rate</th>
<th>Years invested</th>
<th>Interest income</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
</tr>
<tr>
<td>1</td>
<td>$10,000,000</td>
<td>0.67 %</td>
<td>5</td>
<td>$335,000</td>
</tr>
<tr>
<td>2</td>
<td>10,000,000</td>
<td>1.20</td>
<td>5</td>
<td>600,000</td>
</tr>
<tr>
<td>3</td>
<td>10,000,000</td>
<td>1.30</td>
<td>5</td>
<td>650,000</td>
</tr>
<tr>
<td>4</td>
<td>10,000,000</td>
<td>1.31</td>
<td>5</td>
<td>655,000</td>
</tr>
<tr>
<td>5</td>
<td>10,000,000</td>
<td>1.16</td>
<td>5</td>
<td>580,000</td>
</tr>
<tr>
<td>6</td>
<td>10,000,000</td>
<td>1.13</td>
<td>5</td>
<td>565,000</td>
</tr>
<tr>
<td>7</td>
<td>10,000,000</td>
<td>1.33</td>
<td>5</td>
<td>665,000</td>
</tr>
<tr>
<td>8</td>
<td>10,000,000</td>
<td>1.56</td>
<td>5</td>
<td>780,000</td>
</tr>
<tr>
<td>9</td>
<td>10,000,000</td>
<td>1.26</td>
<td>5</td>
<td>630,000</td>
</tr>
<tr>
<td>10</td>
<td>10,000,000</td>
<td>1.45</td>
<td>5</td>
<td>725,000</td>
</tr>
<tr>
<td>11</td>
<td>10,000,000</td>
<td>1.94</td>
<td>5</td>
<td>970,000</td>
</tr>
<tr>
<td>12</td>
<td>10,000,000</td>
<td>2.14</td>
<td>5</td>
<td>1,070,000</td>
</tr>
<tr>
<td>13</td>
<td>10,000,000</td>
<td>2.72</td>
<td>5</td>
<td>1,360,000</td>
</tr>
<tr>
<td>14</td>
<td>10,000,000</td>
<td>1.71</td>
<td>5</td>
<td>845,000</td>
</tr>
<tr>
<td>15</td>
<td>10,000,000</td>
<td>2.54</td>
<td>5</td>
<td>1,270,000</td>
</tr>
<tr>
<td>16</td>
<td>10,000,000</td>
<td>2.97</td>
<td>5</td>
<td>1,485,000</td>
</tr>
<tr>
<td>17</td>
<td>10,000,000</td>
<td>3.89</td>
<td>5</td>
<td>1,945,000</td>
</tr>
<tr>
<td>18</td>
<td>10,000,000</td>
<td>2.54</td>
<td>5</td>
<td>1,250,000</td>
</tr>
<tr>
<td>19</td>
<td>10,000,000</td>
<td>4.40</td>
<td>5</td>
<td>2,200,000</td>
</tr>
<tr>
<td>20</td>
<td>10,000,000</td>
<td>3.71</td>
<td>5</td>
<td>1,855,000</td>
</tr>
<tr>
<td>21</td>
<td>10,000,000</td>
<td>3.69</td>
<td>5</td>
<td>1,845,000</td>
</tr>
<tr>
<td>22</td>
<td>10,000,000</td>
<td>3.71</td>
<td>5</td>
<td>1,855,000</td>
</tr>
<tr>
<td>23</td>
<td>10,000,000</td>
<td>3.78</td>
<td>5</td>
<td>1,890,000</td>
</tr>
<tr>
<td>24</td>
<td>10,000,000</td>
<td>3.99</td>
<td>5</td>
<td>1,995,000</td>
</tr>
</tbody>
</table>
Table 5 (Continued)

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal</th>
<th>Interest rate</th>
<th>Years invested</th>
<th>Interest income</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
</tr>
<tr>
<td>25</td>
<td>$10,000,000</td>
<td>4.10 %</td>
<td>5</td>
<td>$ 2,050,000</td>
</tr>
<tr>
<td>26</td>
<td>10,000,000</td>
<td>5.22</td>
<td>5</td>
<td>2,610,000</td>
</tr>
<tr>
<td>27</td>
<td>10,000,000</td>
<td>5.17</td>
<td>4</td>
<td>2,068,000</td>
</tr>
<tr>
<td>28</td>
<td>10,000,000</td>
<td>5.44</td>
<td>3</td>
<td>1,632,000</td>
</tr>
<tr>
<td>29</td>
<td>10,000,000</td>
<td>7.004&lt;sup&gt;a&lt;/sup&gt;</td>
<td>2</td>
<td>700,400</td>
</tr>
<tr>
<td>30</td>
<td>20,000,000&lt;sup&gt;b&lt;/sup&gt;</td>
<td>6.480&lt;sup&gt;a&lt;/sup&gt;</td>
<td>1</td>
<td>1,296,000</td>
</tr>
</tbody>
</table>

**Idle Balances Invested at Short-Term Rates**

Total Interest Income: $37,005,900

<sup>a</sup>Since the maturity on the notes is not of sufficient time, the principal invested in years 24 and 25 is invested in short term bills.

<sup>b</sup>This amount includes the reinvestment of $10,000,000 invested in year 29 at short-term rates and the principal maturing at the beginning of year 30--total $20,000,000.


Column 5: Each $10,000,000 increment is invested at the beginning of the year for the next five years. For example $10,000,000 is invested in Year 1 to mature in Year 5 and then is reinvested in Year 6 to mature in Year 10. The increments for Years 27 and 28 are invested to mature in Year 30. Initial idle balances are invested at short-term rates.
Table 6
Strategy II (Lump-sum) Long-Term Bonds,
10 to 20 Year Maturity, 1941-1970

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal</th>
<th>Interest rate</th>
<th>Years invested</th>
<th>Interest income</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
</tr>
<tr>
<td>1</td>
<td>$5,000,000</td>
<td>1.90%</td>
<td>10</td>
<td>$ 950,000</td>
</tr>
<tr>
<td>2</td>
<td>5,000,000</td>
<td>2.34</td>
<td>10</td>
<td>1,167,000</td>
</tr>
<tr>
<td>3</td>
<td>5,000,000</td>
<td>2.27</td>
<td>10</td>
<td>1,135,000</td>
</tr>
<tr>
<td>4</td>
<td>5,000,000</td>
<td>2.49</td>
<td>10</td>
<td>1,145,000</td>
</tr>
<tr>
<td>5</td>
<td>5,000,000</td>
<td>2.34</td>
<td>10</td>
<td>1,170,000</td>
</tr>
<tr>
<td>6</td>
<td>5,000,000</td>
<td>2.18</td>
<td>10</td>
<td>1,090,000</td>
</tr>
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<td>5,000,000</td>
<td>2.25</td>
<td>10</td>
<td>1,125,000</td>
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<td>5,000,000</td>
<td>2.44</td>
<td>10</td>
<td>1,220,000</td>
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<td>5,000,000</td>
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<td>10</td>
<td>1,135,000</td>
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<tr>
<td>10</td>
<td>5,000,000</td>
<td>2.34</td>
<td>20</td>
<td>2,340,000</td>
</tr>
<tr>
<td>11</td>
<td>5,000,000</td>
<td>2.63</td>
<td>19</td>
<td>2,985,000</td>
</tr>
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<td>18</td>
<td>2,349,000</td>
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<td>17</td>
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<td>1,976,000</td>
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<td>3.60</td>
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<td>11</td>
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<td>10a</td>
<td>1,930,000</td>
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<td></td>
<td></td>
<td></td>
<td>-0-</td>
</tr>
<tr>
<td>22</td>
<td></td>
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</tr>
<tr>
<td>24</td>
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<td>-0-</td>
</tr>
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</table>
Table 6 (Continued)

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal</th>
<th>Interest rate</th>
<th>Years invested</th>
<th>Interest income</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
</tr>
<tr>
<td>25</td>
<td></td>
<td></td>
<td></td>
<td>-0-</td>
</tr>
<tr>
<td>26</td>
<td></td>
<td></td>
<td></td>
<td>-0-</td>
</tr>
<tr>
<td>27</td>
<td></td>
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<td></td>
<td></td>
<td>-0-</td>
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<tr>
<td>30</td>
<td></td>
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<td></td>
<td>-0-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$35,106,500</td>
</tr>
</tbody>
</table>

Idle Balances Invested at Short-Term Rates

<table>
<thead>
<tr>
<th>Total Interest Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$35,964,150</td>
</tr>
</tbody>
</table>

The issues used for this strategy have an insufficient maturity to reinvest here.


Column 5: Here $5,000,000 increments were used. The interest income was calculated by multiplying the interest rate by the $5,000,000 increment. The product was then multiplied by the number of years indicated in Column 4. Initially each increment was invested for 10 years. As each increment matured it was reinvested to mature in Year 30. Because of this aspect, there were no monies available from Year 20 on to invest. This presents an interesting "liquidity" problem the Department of School and Public Lands has encountered in reality.
Various assumptions were made to establish the "ground rules" for the investment strategies. First, a nominal principal of $50,000,000 was used and this was not increased or decreased. Secondly, the interest income was not compounded; rather, in light of the fact that earnings are apportioned to the school districts each year, the income was totaled to indicate the success of each plan and not invested. Thirdly, idle balances that arose under Strategy II (Roll-over plan), were "invested" at the prevailing short-term rate. A fourth assumption involved the use of interest rates. These rates were the rates quoted each year for July by the Federal Reserve Bulletin. It should be noted that each year saw a range of interest rates and it is not implied that the rate used is an average. Additionally, it was assumed that the long-term bonds under the "Lump-sum" strategy were invested for 10 years, then reinvested for 20 years or shorter such that the issues would mature in year 30. An alternative to this procedure that would have more closely replicated the procedure used for notes, would have been to invest every 10th year. However, it was felt that the 10/20 year strategy more closely approximated the activity of the Department in light of the historical evidence that a major portion of the Fund ($26 million) was invested in 1951 for approximately 20 years.

Results. Again, the working hypothesis was that "rolling-over" the principal would result in a higher total income. As explained above, since the long-term trend in interest was upward, it was felt the peaks of the cyclical variations would more than compensate for
the troughs. Hence, by "rolling-over" the principal, it was antici-
pated the Fund would benefit from both the long-term trend and the
cyclical variation. Comparing Tables 4 and 6 for the "Lump-sum"
verses "Roll-over" strategy using long-term bonds, "rolling-over" the
principal resulted in a higher return. However, the difference
($164,150) is so small relative to the totals involved, it should
not be considered conclusive. Additionally, when the results from
Tables 3 and 5 are compared, Strategy I (Lump-sum), actually had a
higher total income by $2,044,100 when invested in medium-term issues.
From these results in was concluded that in all probability, little
advantage can be gained by "rolling-over" the principal under the
specified assumptions.

One point of interest, however, should be noted. Strategy I,
involving the use of five-year medium-term notes, resulted in the
highest total income. Traditionally, interest rates are higher, the
longer the term of the security. However, under each strategy, the
3 to 5 year issues had a higher total return. As expected, the
program that involved only investment in short-term bills resulted
in the lowest return (Table 2). This indicates that such an
investment program would result in a less satisfactory return
than the two strategies utilized.

Because of the assumptions involved and with respect to the
arbitrary nature of the various investment plans, this type of
simulation is only a very rough approximation of reality. Faced with
a similar set of circumstances, the rational investor may wish,
sometimes, to deviate from the arbitrary decision strategy. This would be operating under a discretionary strategy mentioned in Chapter 1. With this in mind then, these results are not offered as conclusive evidence that would support or deny the hypothesis mentioned. Rather, it is felt that the timing of investment activity and the type of security that should be purchased would best be determined by qualified investment counsel.

**Investment of the Interest and Income Fund**

The investment of the Interest and Income Fund is provided for in Title 4, Chapter 5, South Dakota Compiled Laws, 1967. As indicated in Chapter 1 the range of allowable investment instruments is restricted to securities of the United States such that they are guaranteed by the United States, redeemable in 18 months or less. The Interest and Income Fund is not a permanent fund. The Constitution states the interest and income from the Common School Permanent Fund shall be apportioned each year to the school districts of the state. While awaiting apportionment, this money is invested in short-term government securities as provided for in The Compiled Laws. The statutes further indicate the Board of School and Public Lands

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89 State of South Dakota, South Dakota Compiled Laws, 1967 op. cit., Title 4, Chapter 5, Sections 5 through 7.

90 State of South Dakota, Constitution of the State of South Dakota op. cit., Article VIII, Section 3.

91 State of South Dakota, South Dakota Compiled Laws, 1967 op. cit., Title 4, Chapter 5, Section 6.
is responsible for the investment of this Fund.\footnote{Ibid., Section 7.}
Chapter 3

A REVIEW OF THE INSTITUTIONAL INVESTMENT FRAMEWORKS OF SELECTED STATES AS THEY RELATE TO THE INVESTMENT OF THE SOUTH DAKOTA COMMON SCHOOL PERMANENT FUND

INTRODUCTION

The purpose of this chapter will be to examine the investment activity of certain selected states as it relates to the investment of common school permanent funds. This technique may show some similar characteristics and procedures that would be beneficial to South Dakota. Also, it is felt that the experience of other states would be helpful in redesigning South Dakota's state institutional framework for the investment of State funds.

STATES REVIEWED

The Advisory Commission on Intergovernmental Relations Report, "Investment of Idle Cash Balances by State and Local Governments," indicates the States of Kentucky, Minnesota, New Jersey, and Wisconsin are particularly progressive with respect to the investment of public funds. Further investigation revealed that Texas and New Mexico should be added to this list. Inquiries sent to these States resulted in replies and information from Minnesota, Wisconsin, Texas, and New Mexico.

93 Advisory Commission on Intergovernmental Relations, op. cit., p. 17.
The information received from the State of Wisconsin, however, dealt with the State Investment Board of that State. From the correspondence it could be inferred that the Board handles Permanent Common School Fund investment but since this was not stated specifically, hence, this State will not be reviewed in this context.

For purposes of comparison, therefore, attention will be directed toward the remaining three states. The discussion will revolve around the exogenous and endogenous variables mentioned in Chapter 1. By definition, there is little that can be done with respect to the exogenous variables. It is fairly safe to assume that most states face somewhat similar exogenous factors. The incidence of present and future security prices and inflation are somewhat similar in all states. "Past decision" may cause varying situations with respect to individual states, but each state copes with this exogenous variable in some way.

Because this thesis is concerned with positive action that can be taken, concern will be directed toward the endogenous variables with respect to permanent fund investment. The approach of each state to each variable will be examined and then perhaps the insight gained will be applicable to South Dakota's activity.

CONSTITUTIONAL AND STATUTORY ENDOGENOUS VARIABLES

The Range of Investment Instruments

Minnesota. Article VIII, Section 4 of the Constitution of the State of Minnesota delineates the range of investment instruments
for the Permanent School Funds. These include:

1. Fully-guaranteed, interest-bearing, fixed-income securities of the United States and its agencies;

2. Bonds of the State of Minnesota or its political subdivisions, or agencies;

3. Bonds of other States;

4. Stocks of corporations on which cash dividends from earnings have been paid from earnings for five consecutive years or longer immediately prior to purchase;

5. Bonds of corporations whose earnings have been at least three times the interest requirements on outstanding bonds for five consecutive years or longer prior to purchase.

Additionally, restrictions are placed on the percentage of the Fund that may be invested in the various instruments, and the Fund may not own more than five percent of the voting stock of any one corporation.

New Mexico. The range of allowable investment instruments with respect to the New Mexico Permanent School Fund includes:

1. Bonds or other obligations of the United States, or other obligations guaranteed by the United States as to payment of principal and interest.

2. Bonds or other obligations issued by such Federal agencies as a Federal Intermediate Credit Bank, Federal Land Bank,

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Based on Correspondence with Robert E. Blixt, Executive Secretary, Minnesota State Board of Investment, Saint Paul, Minnesota, July 7, 1970.
Federal National Mortgage Association, and Banks for Co-ops.

3. Bonds or other obligations of a municipal or political subdivision of the State of New Mexico, including districts.

4. Bonds or other obligations, as well as common and preferred stocks of corporations organized and operating within the United States, provided that each shall have minimum net assets of ten million dollars, and provided that stocks are listed on a national stock exchange and have paid dividends for at least 10 consecutive years immediately preceding such purchase, provided further that the combined funds of the State shall not at any one time own more than 10 percent of the voting stock of any corporation, and provided further that not more than 50 percent of the total fund shall at any time be invested in securities of the class.

5. Obligations secured by mortgages constituting a first lien upon real estate situated within the State of New Mexico, which are fully insured or guaranteed as to payment of principal and interest by the United States or an authorized agency thereof, including mortgages securing loans insured under the National Housing Act or the Farmers Home Administration Act.  

Texas. Article 2669, Vernon's Collected Statutes for the State of Texas authorizes the State Board of Education to invest the Permanent School Fund in:

1. Securities, bonds, or other obligations insured or guaranteed in any manner by the United States Government, or any of its agencies.

2. Bonds issued by the State of Texas, or any county thereof, and the independent or Common School Districts, ward precinct, drainage, irrigation, navigation, and levee districts in this State.

95 State of New Mexico, This is Your Permanent Fund (Santa Fe: New Mexico State Investment Council, 1969), pp. 2-3.

96 Based on Correspondence with Mr. Vane C. Burnett, Investment Officer, State Permanent School Fund, Texas Education Agency, Austin, Texas, July 9, 1970.
3. Bonds of incorporated cities or towns.
4. Obligations and pledges of the University of Texas.
5. Corporate bonds of United States corporations of at least "A" rating.
7. Corporation bonds, preferred and common stocks as the State Board of Education may deem to be proper investments for said Fund.

Summary. The previous section, devoted to the range of investment instruments, should provide some insight into the latitude provided Fund managers in these selected states with respect to the choice of investment media. Should subsequent investigation reveal that these state funds possess a higher rate of return than the Common School Permanent Fund, it may be inferred the endogenous variable dealing with the range of investment instruments facilitates this rate of return. It can be seen that with some variation the range of investment instruments of each of the three states mentioned includes:

3. State bonds and obligations.
4. Municipals
5. Corporate equities.
6. Corporate bonds.

As indicated in Chapter 2, items 5 and 6 are not included in the list of viable investment instruments authorized for investment of the South Dakota Common School Permanent Fund.

Inviolate Criterion of the Principal

Minnesota. Article VIII, Section 4 of the Constitution of the State of Minnesota states that the principal of the Permanent School Fund "shall be perpetual and inviolate." However, this provision does not prevent the sale of private or public stocks or bonds at less than cost. This Section further states that if it becomes necessary to sell at a "loss," all losses not offset by gains shall be repaid from the interest and dividends subsequently earned.

New Mexico. Article XII, Section 7 of the New Mexico State Constitution indicates that losses taken by the Permanent School Fund from interest-bearing notes or securities shall be reimbursed by the State.

Texas. The State of Texas provides for the contingent possibility of loss to the extent that losses are merely charged to the principal

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98 Ibid.

99 Ibid., State Constitution of New Mexico, p. 37.
of the State Permanent School Fund. It would appear this procedure facilitates investment activity with the least restriction.

South Dakota. The 1968 Amendment to the Constitution of the State of South Dakota permits temporary losses to be taken by the principal. The procedure is similar to that for the State of Minnesota. This gives South Dakota some similar flexibility in conducting its Common School Permanent Fund investment operations.

ADMINISTRATIVE ENDOGENOUS VARIABLES

The endogenous variables dealing with the method of investment, proficiency of the investment agency, the timing of investment activity, and the short-term investment of the interest and income are handled in a similar manner by the three states examined. In all cases the investment of permanent school funds is handled by a state investment officer appointed specifically for that purpose. In all cases a board or advisory committee of state officers has some review capability, but the actual investment decisions are made by the state investment officer.

With respect to professional ability, the Executive Secretary of the Minnesota State Board of Investment, for example, is a certified


101 State of South Dakota, Constitution of the State of South Dakota op. cit., Article VIII, Section 11.
investment analyst. The State of Texas employs professional investment counsel. The State Investment Council of New Mexico is required to have its four public members to be "qualified by competence and experience in the field of investment or finance." Additionally, New Mexico employs at the present time The First National City Bank of New York as professional investment consultant. Wisconsin employs qualified investment counsel "to guide and assist the Trustees and Staff in equity investments."

Presumably, with the indicated proficiency of each of the states mentioned with respect to the ability of the personnel employed by the state investment entities, the handling of investment activity is done with the highest professional competence. Since it is not the purpose of this paper to pass judgment on the technical aspects of the investment process, it will be assumed that the training, and investment education of the various officers and staff members of these state investment entities operating under a centralized process, results in competent technical advice being available with respect to the method and timing of investment activity.

102 Based on Correspondence with Robert E. Blixt, loc. cit.
103 Texas Education Agency, op. cit., p. 16.
104 State of New Mexico, op. cit., p. 4.
105 Ibid.
The endogenous variable dealing with the investment of the interest income is apparently handled by all three states as a short-term investment. Investigation has revealed that the investment of the South Dakota Common School Permanent Interest and Income Fund is restricted to securities of the United States and securities fully-guaranteed by the United States government redeemable in 18 months or less. With respect to the other States examined, in all cases, they attempt to maximize the return within given liquidity and risk requirements. In some states this involves the use of commercial paper and banker's acceptances—an instrument not currently permitted in South Dakota.

An example of short-term investment is The State Investment Fund managed by Wisconsin's Investment Board. Short-term monies from approximately 26 different state accounts are pooled into a State Investment Fund. The permissible investment instruments include U. S. Government obligations of less than 5 years maturity and corporate obligations of less than 12 months which are rated "A" or better. Also, provision is made to lend to responsible dealers on the collateral of short-term government securities up to 98 percent of the market value of these securities. Presumably this procedure results in


108 Based on Correspondence with John R. Pike, Executive Director, State of Wisconsin, Investment Board, Madison, Wisconsin, June 11, 1970.
temporarily idle funds being put to work at a high rate of return.

In conclusion, some attempt should be made to compare the performance of South Dakota's Common School Permanent Fund to the performance of similar funds managed by these state investment entities. If there is a difference in the performance, this could be inferred to be the result of the difference in the endogenous variables assuming the exogenous environment is essentially the same for all the states examined.

Table 7 compares the annual rate of return earned by the South Dakota Common School Permanent Fund, the New Mexico Common School Permanent Fund, the Minnesota Permanent Trust Funds and the State Investment Fund of Wisconsin. This section concludes the discussion of the institutional framework for the investment of state funds.
Table 7

A Comparison of the Annual Rate of Return of the Common
School Permanent Fund and the Annual Rates of Return
of Other States' Selected Funds

<table>
<thead>
<tr>
<th>Fund</th>
<th>Rate of Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minnesota Permanent Trust Fund (1968)</td>
<td>3.59%&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>South Dakota Common School Permanent Fund (1968)</td>
<td>3.80%&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td>New Mexico Common School Permanent Fund (1968)</td>
<td>4.51%&lt;sup&gt;c&lt;/sup&gt;</td>
</tr>
<tr>
<td>South Dakota Common School Permanent Fund (1968)</td>
<td>3.80%&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td>Wisconsin State Investment Fund (1969)</td>
<td>5.52%&lt;sup&gt;d&lt;/sup&gt;</td>
</tr>
<tr>
<td>South Dakota Common School Permanent Fund (1968)</td>
<td>3.80%&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

Sources:  

<sup>a</sup> South Dakota data obtained from the applicable "Quarterly Reports" published by the Department of School and Public Lands.  
<sup>b</sup> State of Minnesota, 1968 Report of the Executive Secretary (Saint Paul: State of Minnesota State Board of Investment, 1969), Schedule III.  
Chapter 4

AN APPLICATION OF THE STATE-CENTRALIZED INVESTMENT PROCESS AND SOME CONSIDERATIONS FOR FUTURE INVESTMENT

INTRODUCTION

Graham, Dodd and Cottle define analysis as "the careful study of available facts with the attempt to draw conclusions therefrom based on established principles and sound logic." With this in mind, an attempt has been made to examine the past and present investment of South Dakota's Common School Permanent Fund.

This Chapter will be devoted to some considerations that perhaps should affect the future of the Fund. Initially, a presentation of the advantages of a state-centralized investment process will be forwarded. Following this, some factors that could be considered in the scope of activity of a state investment officer will be entertained.

STATE-CENTRALIZED INVESTMENT PROCESS

Advantages

The Advisory Commission on Intergovernmental Relations indicates that Miles Tommeraasen's Ph. D. dissertation, "State Centralized Investment--Structure, Controls, and Operation," is the most definitive publication available on the state-centralized investment process.

The concept involves the centralization of the investment of all state funds. Tommeraasen mentions several advantages of this system:

1. Small balances are to be combined for investment purposes. Many departments and agencies within the State of South Dakota, for example, may maintain small balances in operating accounts. The small size of these accounts discourages their investment since the return would probably not justify the expense or effort. Additionally, the investment of these funds would be another burden on a staff which in all probability does not have the experience or time to become involved. The centralization process combines these small balances into a substantial amount and places the responsibility for investment of these funds into qualified, capable hands whose primary duty is fund investment.

2. It has been shown that certain State funds other than the Common School Permanent Fund are invested by the State (see Table, p. 44). The centralized investment process would eliminate duplication of effort in research, approval, and paper work now found with respect to the various investing entities. The process would also reduce the meeting time necessary to determine the courses of investment activity for each investment fund. The centralized investment agency would be able to take into account the various investment criteria and restrictions, and provide professional investment counsel and guidance.

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110 Tommeraasen, op. cit., pp. 59-70.
3. The Department of School and Public Lands is involved in many activities. Land lease and sales, mineral leasing, equalization, apportionment, and investment of school funds all fall within its scope of activity. It can be assumed that in a similar manner, the other investing entities within the State are also engaged in other activity and perhaps the investment of funds entrusted to them assumes a secondary role. The state-centralized investment process by collectivizing the investment responsibility and function would remove this burden from the various investing entities and place it in an agency whose primary responsibility would be the wise and prudent investment of State funds.

4. As the process of consolidation eliminates duplication, it would also reduce the expense involved in current investment procedures. While the apparent investment cost would increase because the hiring of a special staff and investment officer, hopefully economies could be realized from the time- and effort-saving aspects mentioned above. Additionally, the process apparently results in a significant increase in return as evidenced by the experience of New Mexico and Wisconsin.

Alternatives

Several alternative institutional frameworks for the investment of state funds are presented here. They are:

1. Do nothing. Funds are not set to "work." This course of action is not an acceptable alternative since the concept of

111 Tommeraasen, op. cit., p. 32.
working balances has been assumed to be a desirable revenue-gaining function. Another assumption here is the State is desirous of minimizing its tax requirements while providing an acceptable level of public services.

2. Separate investment by each fund. This alternative would involve the employment of an investment officer and staff by each investing entity. While some agencies or departments in the State may have funds of sufficient size to warrant this type of treatment, in most cases the inefficiency, duplicity of effort, expenses, and other diseconomies of operation would render this alternative infeasible.

3. Use of an advisory group. This course of action has been suggested as an acceptable alternative. Commissioner Linn has indicated\footnote{Interview with Commissioner Linn, loc. cit.} that the employment of investment counsel would be a wise step to take with respect to the Common School Permanent Fund.

4. Investment by State officers. This is the current method of handling the State's investment. Each office in charge of funds invests these funds either individually or through the State Treasurer. While many of the people have gained experience in the investing of the fund for which they assume the responsibility and many seek professional counsel and advice, it is felt that trained investment personnel in a decision-making
capacity would be in a better position to handle those matters.

5. The state-centralized investment process. This is the course of action suggested for application in the State of South Dakota. It employs the use of trained investment personnel who assume the responsibility for investment of funds entrusted to them.

An argument that may be raised is that a centralized process removes a certain control of funds from the office that originally invested them. It should be understood that the centralized process consolidates only the investment function. The amount to be invested and the disposal of the return would still be handled by the entity from whence the funds came. The centralized investment process requires that only the investment function be placed in a central agency, thus, insuring the investment of state funds by trained, competent personnel whose only responsibility is the prudent investment of such funds.

The implementation of a state-centralized investment process in the State of South Dakota would require amendment of the Constitution and changes in current statutes. Of course, any plan of this nature should be tailored by people completely familiar with the legal framework and investment requirements of each state agency. However, the Advisory Commission on Intergovernmental Relations has prepared a Model Investment of State Funds Law to be used as a guide by states contemplating such a move. This is presented in Appendix F.

The Model Investment of State Funds Law utilizes a state investment council (Article I) and provides for a state investment officer.
In addition, Article V, if incorporated into South Dakota Law, would broaden the range of permissible investment instruments. While it is not suggested that this should be accepted in toto, the Model Investment for State Funds Law does provide a basis from which South Dakota could design and institute a centralized investment process to handle the investment of all State funds.113

INVESTMENT OBJECTIVES

Risk

It has been shown that the explicit objective of the Common School Permanent Fund's investment has been to maintain the "inviolate" nature of the principal. While attempts have been made to periodically increase the rate of return from the Fund, the overriding consideration has been to maintain the principal intact—to avoid "speculation." This has led to the exclusion, either explicitly or implicitly, of government securities which are not fully-guaranteed, out-of-state municipals, federal agencies, common and preferred equities and corporate debt. The reason for the exclusion of these instruments is the "risk" involved in holding these securities. Rather than some vague notion regarding the "loss" of the principal, it may be edifying to pause and define the term "risk."

113Although not within the scope of this thesis, the state-centralized investment process can be utilized to handle the investment of local government monies in addition to State monies.
Badger, Torgerson, and Guthmann use the word "risk" to denote the "twofold possibility of loss or gain."\textsuperscript{114} They further define four major risks or uncertainties facing investors.\textsuperscript{115} These are: 1) business risk, 2) interest-rate risk, 3) market risk, and 4) purchasing-power risk. Business risk is defined as that risk the investor takes when he purchases ownership of a business firm. As an example, the choice of securities ranges from securities of stable industries with an upward growth trend, such as power and light companies, to securities of concerns with cyclical trends such as construction companies. This risk is not taken by the investors of the Common School Permanent Fund since, by the Constitution and statute, investment in corporate debt or equity is not permitted.

Interest-rate risk is defined as the risk of fluctuation in the market price of fixed income securities that affect the yield to maturity of the obligation. For a more complete discussion of this phenomenon, see page 45. Since the Department concentrates on the coupon rate of the obligation rather than its yield to maturity and holds most obligations to maturity, it would appear that essentially this risk is avoided.

Market risk is that risk associated with the fluctuating prices of securities. A security purchased today may or may not be worth as much as tomorrow. This is the risk most commonly referred to in investment operations. By holding the debt obligations to maturity and purchasing a significant portion of the portfolio at par, it would

\textsuperscript{114}Badger, Torgerson and Guthmann, op. cit., p. 6.

\textsuperscript{115}Ibid., pp. 7-10.
appear that this type of risk is also avoided by the Department.

The final risk noted is purchasing-power risk. As alluded to in Chapter 1 to the extent the Fund does not keep pace with an inflating dollar, the corpus itself becomes worth less and less in real terms. Similarly the real rate of return is eroded. Any investor must concern himself with these aspects. Inflation is an exogenous variable over which he has little control and, hence, the investor is forced to attempt to minimize this risk through the selection of securities that will provide this protection.

Elimination or minimization? The question that arises with respect to the investment of the Common School Permanent Fund is one of determining how the Fund manager will cope with risk. That is, is an investment objective to eliminate risk or to minimize risk? It would appear that a rising rate of inflation, an exogenous variable, precludes the possibility of eliminating risk in that purchasing-power risk is experienced, as has been shown in Chapter 1 (Figure 1) and Appendix C. Hence, it is posited that minimization of risk is a proper investment objective. This is more than a play on words—this idea of minimization or elimination of risk—indeed that minimization implies degree. And if degree is a question, some fundamental changes in investment policy may be contemplated. For example, the business risk and/or market risk of an equity investment may not be as great as the purchasing-power risk of a fully-guaranteed government security.

Another investment goal of the Department is the maintenance of the "inviolate" criterion of the principal of the Common School
Permanent Fund. Consideration of the implications of purchasing-power risk, however, may justify examination of the accomplishment of this goal in detail.

The inviolate criterion. The primary source of increases to the principal of the Common School Permanent Fund has been cash capital accumulated from the sale of school lands. Over the years, increases to the Fund have been "appreciating" the corpus faster than the rate of inflation has been depleting it in real terms.\(^{116}\) However, it can be anticipated that eventually the main source of capital appreciation, land sales, will be depleted and some attention will have to be directed toward alternative methods of increasing the principal to match the pace of the inflating dollar. The nature of the Common School Permanent Fund itself, presents some difficulty with respect to capital appreciation. A trust fund, for example, may reinvest all earnings not disbursed over a certain period. However, a permanent fund does not have that option. All earnings of a permanent fund must be paid out. Hence, when land sales play out, the Fund will have to look elsewhere for new sources of investment capital.

No doubt the per centum from Federal land sales may be a possible source, but it may be assumed this will eventually be depleted. Additionally, gifts and escheated property may provide some

\(^{116}\) For example, since 1960 the principal has increased 28 percent from approximately $35 million to around $45 million. For the same period the Consumer Price Index rose 24 percent. This means there has been approximately a 4 percent increase in the principal of the Fund in constant 1960 dollars.
capital, but this will be admittedly small. The most probable source, aside from the taxpayer, could be the capital appreciation of such securities as purchased by the Department. A telephone conversation with the Department\textsuperscript{117} indicated at the present time any capital gains—that is, the difference between the purchase price and selling price of a security—are apportioned. However, the statutes indicate only "the accrued interest on invested funds,"\textsuperscript{118} shall be apportioned. This may mean that, the current procedure notwithstanding, capital appreciation may be applied to the principal of the Fund, thereby increasing the size of the Fund.

If it should then be decided that capital appreciation is a legal source of investment capital, it would appear that certain fundamental changes should be made with respect to the choice of investment instruments. With respect to investment objectives, this could mean sacrificing the inviolate criterion of the principal in favor of a plan that would allow investment in securities that possess better capital appreciation qualities than those now legal. This is not to suggest in any way that the Fund be managed in a speculative manner.

At the present time, the inviolate criterion of the principal is the primary consideration with respect to the choice of investment

\textsuperscript{117}Telephone conversation with Mr. Jacob H. Burg, Accountant I, Department of School and Public Lands, Pierre, South Dakota, September 17, 1970.

\textsuperscript{118}State of South Dakota, South Dakota Compiled Laws, 1967, Vol. V, op. cit., Title 13, Chapter 13, Section 1.
instruments. The Commissioner is then charged with finding the highest interest income available within the scope of the legal possibilities for investment. As the rate of inflation continues, it may be necessary to sacrifice some of this interest income for capital appreciation to maintain the relative earning power of the principal. In a sense, what is suggested is an attempt in fact to maintain the "inviolate" criterion of the principal in real terms, that is to insure that in years to come the corpus of the Common School Permanent Fund will have at least the real value it has today.

Some Implications

It is suggested, therefore, that one source of additions to investment capital may be found in corporate equities. The capital appreciation of properly managed, certain investment-grade corporate equities could provide a sufficient hedge against the inflating dollar. Additional income could be earned on corporate debt. Also, corporate debt provides an opportunity for capital appreciation in that decreases in interest rates result in an appreciation in the price of debt.119 Corporate bonds are not unknown even within the State of South Dakota as a legal investment instrument for certain state monies. Various retirement funds maintained by the state hold a significant position in corporate debt.120

119 See page 45.

Little argument can be raised that such a course of action places more business and/or market risk on the principal, risking possible capital loss. It is an axiom in investment circles that the greater the possible rate of return, the greater the risk, but to continue the present philosophy is to invite an eroding of the principal through the eroding dollar. The inclusion of corporate equity and debt as allowable investment instruments should be accompanied by some provision for professional technical management either through a state investment officer or consulting service. Additionally, it is further suggested that the scope of government securities be enlarged to include other than fully-insured issues. Again, the reasoning being that with a portion of the Fund portfolio used primarily for capital appreciation, the remainder of the portfolio should be put to use securing the highest income available compatible with sound investment principles.

These suggestions would necessitate changes to the Constitution and applicable statutes to provide the state investment officer with sufficient latitude in choosing investment securities. For example, he should be allowed to take temporary losses to the principal both from decreases in equity prices and losses due to bond price depreciation. This is now possible in light of the 1968 Constitutional Amendment under which the Commissioner is allowed to sell certain low-yield government bonds. Again, the Model Investment of State Funds Law in Appendix F provides a guide for considerations along this line.
At this point, it would appear that the proper course of action would be to suggest some ideas of the securities to carry in a future Common School Permanent Fund portfolio. As was mentioned in the introduction to this Chapter, this would properly be the job of the state investment officer or the investment counsel. The process involves considering some carefully-defined investment objectives, exogenous and endogenous variables and the range of investment instruments. Also, changing conditions in the nation's economy and financial markets are factors to be considered. An appropriate current portfolio for the Fund may or may not be advisable at a future date. Hence, it is anticipated that, with clearly defined investment objectives, investment knowledge and experience, the centralized investment process would permit the Common School Permanent Fund to realize its greatest potential for the children of the State of South Dakota.

Cost

Another consideration that could be investigated is that of the cost of a centralized investment program. It should be noted that any comparison of costs can only be very rough. While it may be relatively simple to determine the cost associated with the investment of state funds where it is accomplished under a state-centralized process, it is somewhat more complex to determine what portion of the operating cost of the Department of School and Public Lands is attributable to the investment function. To determine the present cost of the investment of State funds it would be necessary to determine exactly what each of several investing entities in State
government spends on its investment activity alone. It is highly
doubtful that this could be determined with any precision.

However, for purposes of comparison let it be assumed that
the Department devotes say, one-fourth of its expenditures for
investment activity. In 1969, the Department spent $101,155.55\textsuperscript{121}
on administration, personnel services, etc. Based on the assumption
this means that about $25,288 would have been the cost of the invest­
ment of all Permanent Funds or in relative terms about $0.48 per
thousand invested. Total operating expenses for the centralized
investment board in New Mexico were $136,209.02\textsuperscript{122} or about $0.37 per
thousand invested. It would appear certain economies do exist in
the centralized process.

\textsuperscript{121} State of South Dakota, Annual Report of the State Treasurer

\textsuperscript{122} State of New Mexico, 11th Annual Report on the State
Permanent Funds for the Period, July 1, 1968 to June 30, 1969
loc. cit., p. 8.
Chapter 5

SUMMARY AND CONCLUSIONS

The Common School Permanent Fund is 73 percent less effective in supporting the education process in the State of South Dakota than it was 12 years ago.\textsuperscript{123} This thesis has been concerned with presenting suggestions that will improve its effectiveness.

In Chapter 1 it was assumed that it is in the best interests of the State of South Dakota to maximize the annual rate of return from the Common School Permanent Fund. Some variables affecting the rate of return on investment were defined in Chapter 2, and these were classified as to the State's ability to control them. Those which were felt to be beyond the State's ability to affect were termed exogenous and those under the State's influence--endogenous. It was indicated that the manipulation of the endogenous variables will affect the rate of return earned by the Fund.

In Chapter 3, other states were reviewed to determine if similar funds had similar returns. Table 7 indicated that both New Mexico and Wisconsin were able to realize a higher rate of return than the State of South Dakota with similar funds. An attempt was made to determine the institutional frameworks dealing with the investment of State funds that affected these rates of return.

Chapter 4 dealt with the State-centralized investment process and presented considerations for a redefinition of some investment

\textsuperscript{123}\textsuperscript{See Appendix G.}
objectives. These objectives primarily dealt with policy changes under a redefinition of the term, "risk."

In response to the objectives of this thesis mentioned on page 25, it is suggested that the exogenous variables limit the rate of return on invested funds and this is the upper limit of the possible rate of return. Additionally, it should be mentioned that all public investors face similar exogenous variables. The endogenous variables determine the present rate of return on investment. If there is a discrepancy between the two, it is anticipated the manipulation of the endogenous variables will result in a return closer to the upper limit set by forces outside the scope of control of the fund managers. It has been shown that the rate of return of South Dakota's Common School Permanent Fund is below that of two other States pursuing a more aggressive investment policy.

**CHANGES IN THE STATE GOVERNMENT INSTITUTIONAL FRAMEWORK**

**DEALING WITH INVESTMENT OF STATE FUNDS**

The following suggestions are presented to supplement or supplant certain aspects of the present State government institutional framework for investing Common School Permanent Fund monies. The altering of the State government institutional framework involves the manipulation of the endogenous variables defined in Chapter 1 and explained in Chapter 2.

1. It is suggested a broader range of legal investments may increase South Dakota's return from its Common School Permanent Fund. The examination of other States has shown corporate debt
and equity and a broader range of government securities are found in the portfolios of comparable funds earning higher rates of return. The range of possible investment instruments should include, but not be limited to, those found in Article V, Model Investment of State Fund Law (Appendix F).

2. The principal of all the funds examined in other selected States is not required by law to remain "inviolate." It is suggested that a similar flexibility with respect to South Dakota's Permanent Fund would facilitate operations that would increase the rate of return. Article V, Section 3 of the Model Investment of State Fund Law provides some guidance in this respect. As indicated in Chapter 1, there may be certain complementarities that arise with the concurrent implementation of these two suggestions.

3. The Interest and Income Fund is invested at the present time in short-term government securities. It is suggested that higher returning securities such as commercial paper or banker's acceptances be permitted as possible short-term instruments.

4. Finally, the State-centralized investment process is offered as an alternative to the present institutional framework for the administration of the Fund. The advantages of this process were pointed out in Chapter 4. It is also noted, that in each of the selected States earning a higher rate of return, the State-centralized investment process was employed.
CHANGES IN INVESTMENT OBJECTIVES

In Chapter 4 some types of risk were presented. These were: 1) business risk, 2) interest-rate risk, 3) market risk, and 4) purchasing-power risk. At the present time an implicit objective found in the investment process with respect to the Common School Permanent Fund is the elimination of "risk." However, it is suggested that this is based on an incomplete definition of the term. While little argument can be raised in opposition to the fact that business risk, interest-rate risk, and market risk are all but circumvented by statutory or administrative design, it is suggested that the current investment philosophy is vulnerable to purchasing-power risk. It has been forwarded that this risk must be dealt with if the Fund is to realize, in real terms, the maintenance of its inviolate criterion.

In light of this redefinition of risk, two suggestions are forwarded with respect to investment objectives.

1. Income and capital appreciation should assume a greater role in choosing a security for investment. The primary requirement heretofore, in choosing investment instruments has been the element of safety of the principal. The maximization of income and capital appreciation should assume the role of being the primary requirement. In light of the 1968 Amendment to the Constitution, it appears the people are willing to assume temporary loss to increase the income from the Fund. Perhaps they are willing to extend this philosophy to allow the investment in corporate debt and equity to maximize income and provide opportunity for capital appreciation.
2. Investment should be made with consideration for minimizing all four forms of risk rather than the eliminating of three forms of risk and allowing the Fund to remain completely vulnerable to purchasing-power risk.

It is suggested, then, that the incorporation of the State-centralized investment process with a broader latitude in the choice of investments and elimination of the "inviolate" criterion of the principal will result in a higher return from the investment of the Common School Permanent Fund.

As a final consideration, it should be noted that each one percent increase in the annual rate of return on an invested principal of $48 million will result in an annual increase of $480 thousand in interest income. Assuming that an interest income of this amount were invested in short-term securities at current short-term rates, it is conceivable that well in excess of $1/2 million would be available from each additional one percent increase in the annual rate of return to support the public education of the children of the State of South Dakota.

NEED FOR FURTHER RESEARCH

Further attention should be directed toward determining the cost of such a venture as the centralized investment of State funds. Additionally, study should be initiated in the area of the Interest and Income Fund investment. This Fund presents a substantial source of interest revenue that may be earned. Finally, other South Dakota
state and local government funds should be examined to determine their potential for incorporation into the centralized investment process.

There are unlimited possibilities for a more technical analysis of potential investment instruments. It is felt, however, that this undertaking should be pursued by individuals thoroughly familiar with, and formally trained in investment analysis and counseling. Work of this nature has been done, but little attention has been directed to it because the inclusion of corporate debt and equity as allowable investment instruments has not been seriously considered. It is felt that a renewed effort should be made at this point, with the intention of presenting to the people of the State of South Dakota some form of a centralized investment process for their approval.
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SELECTED BIBLIOGRAPHY

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This is Your Permanent Fund. Santa Fe: New Mexico State Investment Council, 1969.


4. Miscellaneous


APPENDIXES
APPENDIX A

PERMANENT FUND BALANCE AS OF JUNE 30, 1969
APPENDIX A

Table 8
Permanent Fund Balance as of June 30, 1969

<table>
<thead>
<tr>
<th>Endowed entity</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common School</td>
<td>$45,413,664.69</td>
</tr>
<tr>
<td>College of Agriculture</td>
<td>2,035,120.78</td>
</tr>
<tr>
<td>University</td>
<td>1,357,362.48</td>
</tr>
<tr>
<td>Educational and Charitable</td>
<td>256,669.08</td>
</tr>
<tr>
<td>Training School</td>
<td>585,172.29</td>
</tr>
<tr>
<td>School for Deaf</td>
<td>474,471.11</td>
</tr>
<tr>
<td>School for the Blind</td>
<td>271,255.11</td>
</tr>
<tr>
<td>School for the Feeble Minded</td>
<td>263,511.19</td>
</tr>
<tr>
<td>School of Mines</td>
<td>347,811.17</td>
</tr>
<tr>
<td>Normal Schools</td>
<td>871,971.78</td>
</tr>
<tr>
<td>Southern Normal</td>
<td>499,172.27</td>
</tr>
<tr>
<td>Northern Normal</td>
<td>463,691.37</td>
</tr>
<tr>
<td><strong>Total Permanent Fund</strong></td>
<td><strong>$52,839,873.32</strong></td>
</tr>
<tr>
<td><strong>Less: Unencumbered</strong></td>
<td><strong>(199,102.97)</strong></td>
</tr>
<tr>
<td><strong>Total Permanent Funds Invested</strong></td>
<td><strong>$52,640,770.35</strong></td>
</tr>
</tbody>
</table>

APPENDIX B

COMMON SCHOOL PERMANENT FUND PORTFOLIO AS OF JUNE 30, 1969
APPENDIX B

Table 9
Common School Permanent Fund Portfolio as of June 30, 1969

<table>
<thead>
<tr>
<th>Type of security</th>
<th>Maturity and/or coupon rate</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>U. S. Bonds:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U. S. Bonds Series B.</td>
<td>1975/80</td>
<td>2 3/4%</td>
</tr>
<tr>
<td>U. S. Bonds</td>
<td>1974</td>
<td>4 1/4</td>
</tr>
<tr>
<td>U. S. Bonds</td>
<td>1975/85</td>
<td>4 1/4</td>
</tr>
<tr>
<td>U. S. Bonds</td>
<td>1990</td>
<td>3 1/2</td>
</tr>
<tr>
<td>U. S. Bonds</td>
<td>1993/88</td>
<td>4</td>
</tr>
<tr>
<td>U. S. Bonds</td>
<td>1973</td>
<td>4 1/8</td>
</tr>
<tr>
<td>U. S. Bonds</td>
<td>1969</td>
<td>4</td>
</tr>
<tr>
<td>U. S. Bonds</td>
<td>1972</td>
<td>4</td>
</tr>
<tr>
<td>U. S. Bonds</td>
<td>1974</td>
<td>4 1/8</td>
</tr>
<tr>
<td>U. S. Bonds</td>
<td>1975</td>
<td>6</td>
</tr>
</tbody>
</table>

(Face) $32,177,000.00 (Cost) $32,062,801.74

<table>
<thead>
<tr>
<th><strong>F. H. A. Investments:</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Housing Administration</td>
<td>4 %</td>
</tr>
<tr>
<td></td>
<td>4 3/4</td>
</tr>
</tbody>
</table>

(Face) $ 518,312.98 (Cost) $ 461,722.15

<p>| Farmer's Home Administration | 4 % | $ 935,082.45 |
|                              | 4 1/4 | $ 695,757.91 |
|                              | 4 1/2 | $ 1,263,987.09 |</p>
<table>
<thead>
<tr>
<th>Type of security (Continued)</th>
<th>Maturity and/or coupon rate</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>F. H. A. Investments</td>
<td>4 1/2%</td>
<td>$1,263,987.09</td>
</tr>
<tr>
<td></td>
<td>5 1/8</td>
<td>1,209,990.55</td>
</tr>
<tr>
<td></td>
<td>5 2/5</td>
<td>1,154,618.48</td>
</tr>
<tr>
<td></td>
<td>5 3/4</td>
<td>31,550.51</td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>22,334.48</td>
</tr>
<tr>
<td></td>
<td>6 1/4</td>
<td>972,570.65</td>
</tr>
<tr>
<td></td>
<td>6.375</td>
<td>198,329.79</td>
</tr>
<tr>
<td></td>
<td>6 1/2</td>
<td>1,259,369.93</td>
</tr>
<tr>
<td></td>
<td>6.875</td>
<td>499,940.00</td>
</tr>
<tr>
<td></td>
<td>7 1/4</td>
<td>2,200,401.56</td>
</tr>
<tr>
<td></td>
<td>7 3/4</td>
<td>200,000.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$10,643,933.40</td>
</tr>
<tr>
<td>Old 5% Farm Loans</td>
<td></td>
<td>7,174.70</td>
</tr>
<tr>
<td>4% General Obligation Bonds</td>
<td></td>
<td>592,200.00</td>
</tr>
<tr>
<td>3% General Obligation Bonds</td>
<td></td>
<td>1,478,100.00</td>
</tr>
<tr>
<td>Total Common School Permanent Fund (Invested)</td>
<td></td>
<td>$45,245,931.99</td>
</tr>
<tr>
<td>Uninvested</td>
<td></td>
<td>167,732.70</td>
</tr>
<tr>
<td>Total Common School Permanent Fund</td>
<td></td>
<td>$45,413,664.69</td>
</tr>
</tbody>
</table>

APPENDIX C

A COMPARISON OF THE ANNUAL RATE OF RETURN

EARNED BY THE COMMON SCHOOL PERMANENT FUND AND THE

ANNUAL RATE OF CHANGE IN THE CONSUMER PRICE INDEX, 1960-1968
APPENDIX C

Table 10

A Comparison of the Annual Rate of Return Earned by the Common School Permanent Fund and the Annual Rate of Change in the Consumer Price Index, 1960-1968

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal</th>
<th>Interest income</th>
<th>Return in %</th>
<th>Annual rate of change in the C. P. I. (1960)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
</tr>
<tr>
<td>1960</td>
<td>$35,142,443.50</td>
<td>$1,043,032.37</td>
<td>2.97</td>
<td>-0-</td>
</tr>
<tr>
<td>1961</td>
<td>36,156,676.20</td>
<td>1,080,633.55</td>
<td>2.99</td>
<td>1.06</td>
</tr>
<tr>
<td>1962</td>
<td>36,933,275.58</td>
<td>1,141,684.09</td>
<td>3.10</td>
<td>1.16</td>
</tr>
<tr>
<td>1963</td>
<td>38,244,812.33</td>
<td>1,184,337.60</td>
<td>3.10</td>
<td>1.26</td>
</tr>
<tr>
<td>1964</td>
<td>39,268,095.02</td>
<td>1,227,534.03</td>
<td>3.13</td>
<td>1.35</td>
</tr>
<tr>
<td>1965</td>
<td>40,387,972.54</td>
<td>1,350,366.24</td>
<td>3.34</td>
<td>1.74</td>
</tr>
<tr>
<td>1966</td>
<td>41,465,747.15</td>
<td>1,419,290.74</td>
<td>3.42</td>
<td>3.10</td>
</tr>
<tr>
<td>1967</td>
<td>42,597,209.10</td>
<td>1,470,807.50</td>
<td>3.45</td>
<td>3.10</td>
</tr>
<tr>
<td>1968</td>
<td>44,142,510.87</td>
<td>1,678,956.26</td>
<td>3.80</td>
<td>4.75</td>
</tr>
</tbody>
</table>

Sources: Column 2: State of South Dakota, "Quarterly Statements of Condition of the Permanent School Funds, State of South Dakota" (Pierre: Department of School and Public Lands, 1960-1968), September Quarter.


Column 4: Calculated from Columns 1 and 2.

Column 5: 91st Congress, 2nd Session, "Economic Indicators, August 1970" (Washington: Government Printing Office, 1970), p. 26. This index is spliced from an index whose base is 1957-59. The figures in this column indicate the increase in the Consumer Price Index over the preceding year in constant 1960 dollars.
APPENDIX D

ARTICLE VIII AND ARTICLE XXVIII OF THE CONSTITUTION OF THE
STATE OF SOUTH DAKOTA
APPENDIX D

ARTICLE VIII

EDUCATION AND SCHOOL LANDS

Section 1. The stability of a republican form of government depending on the morality and intelligence of the people, it shall be the duty of the legislature to establish and maintain a general and uniform system of public schools wherein tuition shall be without charge, and equally open to all; and to adopt all suitable means to secure to the people the advantages and opportunities of education.

Section 2. All proceeds of the sale of public lands that have heretofore been or may hereafter be given by the United States for the use of public schools in the state; all such per centum as may be granted by the United States on the sales of public lands; the proceeds of all property that shall fall to the state by escheat; the proceeds of all gifts or donations to the state for public schools or not otherwise appropriated by the terms of the gift; and all property otherwise acquired for public schools, shall be and remain a perpetual fund, for the maintenance of public schools in the 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.

Section 3. The interest and income of this fund together with all other sums which may be added thereto by law, shall be faithfully used and applied each year for the benefit of the public schools of the state, and shall be for this purpose apportioned among and between all the several public school corporations of the state in proportion to the number of children in each, of school age, as may be fixed by law; and no part of the fund either principal or interest, shall ever be diverted, even temporarily, from this purpose or used for any other purpose whatever than the maintenance of public schools for the equal benefit of all the people of the state.

That the proceeds of all fines collected from violations of state laws shall be paid to the County Treasurer of the county in which said fine shall have been imposed, and by him remitted to the State Treasurer and apportioned by the Commissioner of School and Public Lands back to the county from which such moneys were collected to be distributed among and between all the several public schools incorporated in such county in proportion to the number of children in each, of school age, as may be fixed by law. (As amended November, 1930, pursuant to Ch. 84, 1929.)
Section 4. After one year from the assembling of the first legislature, the lands granted to the state by the United States for the use of public schools may be sold upon the following conditions and no other: Not more than one-third of all such lands shall be sold within the first five years, and no more than two-thirds within the first fifteen years after the title thereto is vested in the state, and the legislature shall, subject to the provisions of this article, provide for the sale of the same.

The commissioner of school and public lands, the state auditor and the county superintendent of schools of the counties severally, shall constitute boards of appraisal and shall appraise all school lands within the several counties which they may from time to time select and designate for sale, at their actual value under the terms of sale.

They shall take care to first select and designate for sale the most valuable lands; and they shall ascertain all such lands as may be of special and peculiar value, other than agricultural, and cause the proper subdivision of the same in order that the largest price may be obtained therefor.

Section 5. No land shall be sold for less than the appraised value, and in no case for less than ten dollars ($10.00) per acre. The purchaser shall pay at least one-tenth of the purchase price in cash. The legislature shall provide by general law for payment of the balance which shall be made in partial payments and must be fully paid up within thirty (30) years. Interest shall be five (5) per cent annually. All lands may be sold for cash, provided further, that the purchaser or purchasers shall have the right or option of paying the balance in whole or in part on any interest paying date, under such rules as the legislature may provide. No land shall be sold until appraised and advertised and offered for sale at public auction after sixty (60) days advertisement of the same in at least three newspapers of general circulation, two of which shall be located in the vicinity of the lands to be sold, and one at the seat of government. No land can be sold except at public sale.

Such lands as shall not have been specially subdivided shall be offered in tracts of not more than eighty (80) acres and these subdivided into the smallest division of the lands designated for sale and not sold within two (2) years after their appraisal shall be reappraised by the board of appraisers as hereinafter provided before they are sold.

Section 6. All sales shall be conducted through the office of the commissioner of school and public lands as may be prescribed by law, and returns of all appraisals and sales shall be made to said office. No sale shall operate to convey any right or title to any lands for sixty days after the date thereof, nor until the same shall have received the approval of the governor in such form as may
be provided by law. No grant or patent for any such lands shall issue until final payment be made.

Section 7. All lands, money or other property donated, granted or received from the United States or any other source for a university, agricultural college, normal schools or other educational or charitable institution or purpose, and the proceeds of all such lands and other property so received from any source, shall be and remain perpetual funds, the interest and income of which, together with the rents of all such lands as may remain unsold, shall be inviolably appropriated and applied to the specific objects of the original grants or gifts. 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.

Section 8. All lands mentioned in the preceding section shall be appraised and sold in the same manner and by the same officers and boards under the same limitations, and subject to all the conditions as to price, sale and approval, provided above for the appraisal and sale of lands for the benefit of public schools, but a distinct and separate account shall be kept by the proper officers of each of such funds.

Section 9. The lands mentioned in this article shall be leased for pasturage, meadow, farming, the growing of crops of grain and general agricultural purposes, and at public auction after notice as hereinbefore provided in case of sale and shall be offered in tracts not greater than one section. All rents shall be payable annually in advance, and no term of lease shall exceed five years, nor shall any lease be valid until it receives the approval of the governor.

Provided, that any lessee of School and Public Lands shall at the expiration of a five year lease, be entitled, at his option, to a new lease for the land included in his original lease, for a period of time not exceeding five years, without public advertising, at the current rental prevailing in the county in which such land is situated, at the time of the issuance of the new lease. The Commissioner of School and Public Lands shall notify by registered mail each lessee or assignee on or before the first day of November first preceding the expiration of his lease that such lease will expire.

Such option shall be exercised by the lessee by notifying the Commissioner of School and Public Lands by registered mail, on or before the first day of December first preceding the expiration of his lease describing the lands for which he desires a new lease, in the same manner as the same is described in his original lease. (As adopted November 1948, pursuant to Ch. 252, Laws of 1947.)

Section 10. No claim to any public lands by any trespasser thereon by reason of occupancy, cultivation or improvement thereof,
Section 11. The moneys of the permanent school and other educational funds shall be invested by the Commissioner of School and Public Lands only in bonds of the United States, securities guaranteed by the United States, bonds of the State of South Dakota, or in bonds of any school corporation, organized county, or incorporated city within the State of South Dakota, and at such rates of interest as the Legislature shall, from time to time determine.

The Legislature shall provide by law, such rules, regulations and safeguards as it may deem necessary to secure safe and continuous investment of such funds as far as possible, and notwithstanding other provisions of this article, may authorize the sale of bonds of the United States below cost in order to secure the highest income compatible with safe investment. (As adopted November 1968, pursuant to Ch. 225, Laws of 1968.)

Section 12. The governor may disapprove any sale, lease or investment other than such as are intrusted to the counties.

Section 13. All losses to the permanent school or other educational funds of this state which shall have been occasioned by the defalcation, negligence, mismanagement or fraud of the agents or officers controlling and managing the same shall be audited by the proper authorities of the state. The amount so audited shall be a permanent funded debt against the state in favor of the fund sustaining the loss upon which not less than six per centum of annual interest shall be paid. The amount of indebtedness so created shall not be counted as a part of the indebtedness mentioned in article XIII, section 2.

Section 14. The legislature shall provide by law for the protection of the school lands from trespass or unlawful appropriation, and for their defense against all unauthorized claims or efforts to divert them from the school fund.

Section 15. The Legislature shall make such provision by general taxation and by authorizing the school corporations to levy such additional taxes as with the income from the permanent school fund shall secure a thorough and efficient system of common schools throughout the state. The Legislature is empowered to classify properties within school districts for purposes of school taxation, and may constitute agricultural property a separate class. Taxes shall be uniform on all property in the same class. (As adopted November 1966, pursuant to Ch. 275, Laws of 1965.)

Section 16. No appropriation of lands, money or other property or credits to aid any sectarian school shall ever be made by the
or credits to aid any sectarian school shall ever be made by the state, or any county or municipality within the state, nor shall the state or any county or municipality within the state accept any grant, conveyance, gift or bequest of lands, money or other property to be used for sectarian purposes, and no sectarian instruction shall be allowed in any school or institution aided or supported by the state.

Section 17. No teacher, state, county, township or district school officer shall be interested in the sale, proceeds or profits of any book, apparatus or furniture used or to be used in any school in this state, under such penalties as shall be provided by law.

Section 18. Notwithstanding the provisions of sections two, three and seven of Article VIII of this Constitution, moneys received from the leasing of all common school, indemnity, and endowment lands for oil and gas and other mineral leasing of said lands shall be apportioned among the public schools and the various state institutions in such manner that the public schools and each of such institutions shall receive an amount which bears the same ratio to the total amount apportioned as the number of acres (including any that may have been disposed of) granted for such public schools or for such institutions bears to the total number of acres (including any that may have been disposed of) granted in trust to the state by the Enabling Act approved February 22, 1889, as amended, and allocations authorized pursuant to the provisions of section 17 of such Enabling Act; and further that not less than fifty per cent of each such amount so allocated shall be covered into the permanent fund of the public schools and each of such institutions. (As adopted November 1954, pursuant to Ch. 310, Laws of 1953.)

ARTICLE XXVIII

Section 1. The several counties of the state shall invest the moneys of the permanent school and endowment funds in bonds of school corporations, state, county and municipal bonds or in first mortgages upon good improved farm lands within the limits respectively, under such regulations as the legislature may provide, but no farm loan shall exceed one thousand dollars to any one person, firm or corporation.

APPENDIX E

TITLE 5, CHAPTER 10, SOUTH DAKOTA COMPILED LAWS, 1967
5-10-1. Assignment of receipts from leases, interest and land sales to income and permanent funds.--The income from the leased lands of each class of school and public lands and the interest on the permanent fund of that class shall be assigned by the state treasurer to a fund to be known as the interest and income fund of such class. The principal of money derived from the sale of each class of lands granted to the state for educational and charitable purposes shall be assigned by the state treasurer to a fund to be known as the permanent fund of such class.

5-10-2. Annual certification of fund balances and receipts to commissioner of school and public lands.--It shall be the duty of the state treasurer on or before the fifteenth day of June of each year to certify to the commissioner of school and public lands the amount of funds in his possession to the credit of the interest fund of each class of lands, the interest fund of the five per cent paid by the United States to the state of South Dakota on sales of public lands within the state, and also the amount received by him for leases on each class of lands.

5-10-3. Accounts and records maintained by commissioner--Accounts with state treasurer and counties.--The commissioner shall keep an accurate account of all money due or to become due the state on account of sales and leases of school and public lands and the interest arising from the loaning of the permanent school fund. He shall keep accurate accounts with the state treasurer in which he shall charge such treasurer with all money received by him and credit him with all sums paid out according to law, showing separately the amounts received and paid out for the various purposes provided by law. He shall also keep separate accounts between the state and each county, which shall show the receipts and payments for each purpose herein named.

5-10-4. Supervision by commissioner of collections, apportionment and distribution of funds.--The commissioner shall have supervision of the collection of all money due the state for the purposes aforesaid, and of the apportionment and distribution of such funds to the several counties and public institutions of the state.

5-10-5. Annual statement to counties of sale and lease payments coming due--Semianual statement of interest due from counties.--The commissioner shall on or before the fifteenth day of December of each year furnish to the treasurer of each county a full statement of the principal and interest on sales and rental on term leases falling due in such county on the first day of January following; and
on or before the first day of February and August in each year he shall furnish each county treasurer with a statement of the amount of interest on permanent school and endowment funds which was due from the county to the state on the first day of January and July preceding.

5-10-6. Apportionment among counties and institutions of income from school lands and funds.--The commissioner shall make a division and apportionment of all funds derived from the leasing of school and public lands, from accrued interest on all invested funds derived from the sale of school and public lands, and from accrued interest on invested funds derived from the five per cent paid to the state by the United States on sales of public lands within the state, such apportionment to be made among the counties, and the educational, penal, and charitable institutions, as provided by law.

5-10-7. County treasurer's receipts for payments by lessees and purchasers--Disposition of copies.--The county treasurer shall, for all money paid to him by any lessee or purchaser, execute triplicate receipts, and shall deliver one to the person paying the same, transmit one to the commissioner, and file the other in his office.

5-10-8. Duplicate receipt filed by county treasurer with commissioner--Time of forwarding.--Each county treasurer shall on the first day of each month forward to the commissioner a duplicate of each receipt issued by him during the preceding month for any of the purposes herein named except in case of full payment of principal and interest upon sales of school and public lands, in which case he shall forward such duplicate receipts on the date issued.

5-10-9. Quarterly county report on school lands and funds--Contents and time of filing.--It shall be the duty of the several county treasurers to furnish the commissioner with a statement, attested by the county auditor, on the first day of March, June, September, and December of each year, and at such other times as the commissioner may deem expedient, upon blanks furnished by the commissioner.

Each statement shall show the amount of money on hand arising from the sale of school and public lands, deferred payments, full payments, interest on deferred payments, leases of school lands, leases of endowment lands, term leases of each class of lands, and interest on the permanent school fund due from the county to the state; provided, that treasurers and auditors shall not include in such statements any money received upon leases or sales of land not yet approved by the governor and the commissioner.
Each statement shall also show the amount of money on hand arising from fines, forfeitures, and pecuniary penalties for violation of state laws and shall state the title and venue of each case collected, and paid, the amount of costs taxed, whether such costs have been collected, the net proceeds paid into the county treasury, and the date of such payment.

Such statement shall be forwarded to the commissioner within five days after the dates herein provided, and in respect to other statements called for by the commissioner within five days after demand.

5-10-10. Annual and special county reports on school fund investments and mortgages. -- It shall also be the duty of the several county treasurers to furnish the commissioner with a statement, attested by the county auditor, on or before the thirty-first day of December of each year, and at such other times as the commissioner may require, upon blanks furnished by the commissioner, showing the character and status of the county's obligation to the school fund; the status of all permanent school fund loan mortgages, whether past due, foreclosed or delinquent; and the status of all county, municipal and school corporation bonds, whether current, delinquent in either principal or interest, levies for necessary sinking funds and such other information as the commissioner may require.

5-10-11. Drafts on counties for school funds due state. -- The commissioner shall, immediately after receiving such statements provided for herein, draw and deliver to the state treasurer a draft on each county treasurer for the full amount shown to be due the state. Such draft shall specify the various funds to which the money belongs, and he shall at the same time send the county auditor of each county a duplicate of such draft.

5-10-12. Counties to forward funds only on commissioner's draft. -- No money belonging to any of the funds herein specified shall be forwarded to the commissioner by any county treasurer, except upon the draft of the commissioner as herein provided.

5-10-13. County treasurer to remit on receipt of copy of draft. -- The county treasurer, immediately after receiving a copy of such draft, shall forward to the commissioner the total amount specified therein.

5-10-14. County checks forwarded to commissioner--Transmittal report and record. -- All moneys received by a county treasurer belonging to any fund or funds administered by the commissioner of school and public lands, when required by law to be remitted to the state treasurer, shall be forwarded to the commissioner by check payable to the state treasurer of South Dakota and signed by the county treasurer; and each such remittance shall be accompanied by the transmittal report and record hereinafter provided for.
5-10-15. Forms for county transmittal records and reports--
Disposition of copies.--The commissioner shall furnish to each
county treasurer forms bound in book form for making such transmit­
tal records and reports, which shall be in triplicate, each of which
shall be prepared and signed by the county treasurer; one counter­
part of which, as indicated on the lower margin thereof, shall
accompany any such remittance; and the same, when received, shall
be filed in the office of the commissioner as a permanent record
of his office; one counterpart, as indicated on the lower margin
thereof, shall by the county treasurer be used as a voucher and
delivered by him to the county auditor; one counterpart, as indicated
on the lower margin thereof, shall be retained by the county treasur­
er as a permanent record of his office.

5-10-16. Delivery of county check to state treasurer.--Upon re­
ceipt of such check, if remitted in the proper form and in the
proper amount, the commissioner shall forthwith deliver the same to
the state treasurer with instructions as to the fund or funds to
be credited therewith.

5-10-17. Monthly settlements between commissioner and state
treasurer.--The commissioner and the state treasurer shall, on the
first day of each month, have a full settlement of the business of
the preceding month.

5-10-18. Investment of permanent school funds--Types of se­
curities permitted--Interest rate.--The moneys of the common
school permanent fund and other educational funds shall be invested
only in:

(1) Bonds of the United States;
(2) Securities fully guaranteed by the United States, including
    farmer's home administration and federal housing administra­
tion mortgages;
(3) General obligation bonds of the state of South Dakota;
(4) General obligation bonds of any public school corporation
    of South Dakota;
(5) General obligation bonds of any organized county of South
    Dakota;
(6) General obligation bonds of any incorporated city within the
    state of South Dakota.

The rate of interest at which such funds shall be invested in
bonds of the state of South Dakota, and bonds of any school corporation,
organized county, or incorporated city shall be six per cent.

5-10-18.1. Reinvestment of permanent school fund--Sales or ex­
change of low yield United States bonds authorized.--Whenever in the
carefully considered judgment of the commissioner of school and public
lands and the board of school and public lands, comprised of the
Governor, the state auditor and the commissioner of school and public
lands, low yield bonds of the United States held in trust by the state
as a part of the permanent school fund bond portfolio, can be sold
below their cost, or exchanged at less than their purchase price, in order to secure the highest income compatible with safe investment, such commissioner and such board, with the approval of the Governor as provided in section 12 of article VIII of the Constitution of South Dakota, are hereby authorized by this legislation so to do.

5-10-18.2. Restoration of losses to corpus of permanent school fund from sale or exchange of bonds.--Where exchange or sale and repurchase as provided in Section 5-10-18.1 is made, all losses to the corpus of the fund shall be restored out of the first additional proceeds of the new investment until the entire corpus of the fund has been fully restored.

If the amount so to be restored shall exceed one hundred thousand dollars such restoration may be amortized over the period between the sale of the securities at a discount and the date of their maturity.

5-10-19. Board of finance supervision of investments--Grounds for disapproval--Disbursement of funds to be invested.--Such investments shall be subject to the advisory supervision of the board of finance, as provided in chapter 4-1, but the board of finance shall not have the power to make any investment of such funds, nor to disapprove any investment made in the manner herein provided except upon the grounds of improper procedure upon the part of the board of school and public lands or the commissioner of school and public lands. Disbursement of funds to be invested shall be made by the state treasurer on warrants drawn by the state auditor on vouchers prepared and approved by the commissioner.

5-10-20. Application for investment funds.--All applications for such funds shall be made to the commissioner of school and public lands who shall submit the same to the board of school and public lands and to the Governor for approval.

5-10-21. Delivery of investment funds to county treasurer--Filing of receipts.--All money sent by the commissioner to the several counties shall be delivered to the county treasurer, who shall execute triplicate receipts therefor, one to be filed with the county auditor, one with the commissioner, retaining one as a record of his office.

5-10-22. County treasurer to pay warrants on school fund and retain bonds.--It shall be the duty of the county treasurer to pay all warrants issued on the permanent school fund by the county auditor on presentation of the same, when accompanied by the bonds given to secure the loan; such bonds to remain in possession of the county treasurer until fully paid.

5-10-23. Bidding and purchase by state at judgment sale of school and public lands.--Whenever any real property is sold to satisfy a judgment in favor of the state in any action relating to the school and public lands, it shall be the duty of the commissioner to represent the state as a bidder at such sale and, if he shall purchase such property, the certificate of sale and sheriff's deed, if one be issued, shall be made to the state.
5-10-24. **Maximum price bid by state--Allowance for prior encumbrances.**--The maximum price which the commissioner shall bid for any such property at any such sale shall be determined by an appraisement, to be made in the same manner that the school and public lands of the state are by law required to be appraised, but such price shall never exceed the amount of prior encumbrances, judgments, interest, and costs.

5-10-25. **Disposition of proceeds of judgment.**--All money received as the proceeds of any such sales, or in satisfaction of any judgment obtained in favor of the state in any such action shall be paid to the state treasurer and by him be divided and apportioned according to law.

5-10-26. **Quitclaim to county of land acquired by state through school fund mortgages.**--In any case where the state of South Dakota has or may hereafter acquire any apparent right, title or interest in or to any real estate through foreclosure of a permanent school fund mortgage or through deed of conveyance of the real estate covered by such mortgage, the Governor is hereby authorized to convey such interest on behalf of the state by quitclaim deed to the county in which such real estate is situated or to the grantee of such county if such real estate has been sold and conveyed by it.

5-10-27. **Default on school fund mortgage held by county--Proceedings instituted by state's attorney.**--In case of default in the conditions of any mortgage taken by any county pursuant to the provisions of this chapter; by reason of which the right to foreclose the same shall accrue, the county treasurer shall notify the state's attorney of such default and the state's attorney shall foreclose such mortgage by action or by advertisement in the manner provided by law for the foreclosure sale of mortgages on real property.

5-10-28. **Bidding and purchase by county at mortgage foreclosure sale.**--If no other person shall bid the full amount due upon such mortgage upon the foreclosure sale, with the costs and expenses of the foreclosure and sale, the state's attorney or county auditor shall bid in the land in the name of the county and, if the same is not redeemed as provided by law, the sheriff's deed shall be made to the county and the county shall thereby become the owner of the land.

5-10-29. **Conveyance to county accepted in lieu of mortgage foreclosure--Abstract of title.**--In lieu of foreclosure as provided in section 5-10-27, the county commissioners may, if they deem it for the benefit of the county, by resolution duly made and entered of record, authorize the state's attorney of the county to take a warranty deed running to the county from the owner of said mortgaged property in full satisfaction of any such loan, provided that at the time of delivery of said warranty deed good title can be conveyed by said owner free and clear of all encumbrances and liens, except liens for taxes. An abstract of title to said property must be furnished to the county by the owner of said property at the time of delivery of the deed.
Provided, however, that in all cases where the county holds an abstract of title in connection with said mortgage loan that the county may have such abstract continued at its expense for the purpose of ascertaining whether good title can be conveyed by said owner free and clear of all encumbrances as above provided. Upon the delivery of such deed the county treasurer and county auditor shall satisfy such mortgage in the manner provided in section 5-10-31.

5-10-30. Alternative remedies against absconding or nonresident mortgagors.--In case any of such mortgages shall be held by the county against any person, firm, corporation, or association of persons who are nonresidents of the state of South Dakota, or in case any mortgage debtor shall have absconded taking his family with him, the county treasurer or the state's attorney shall have the right to elect to pursue any other remedy at law or in equity for the purpose of satisfying the mortgage indebtedness of the county against such nonresidents and such absconding debtors.

5-10-31. Mortgage cancellation and release by county on full payment.--Upon full payment of any school fund mortgage, it shall be the duty of the county treasurer of the county in which such school fund mortgage was recorded to cancel the notes and mortgage by stamping them as paid and to deliver to the person paying the same a certificate of the payment thereof, which certificate shall be presented to the auditor of such county and filed by him in his office, whose duty it shall then be to execute a full release and satisfaction thereof.

5-10-32. Violation of investment laws by county officer as misdemeanor--Penalty--Disposition of fines.--Any county treasurer or county auditor in this state who shall fail or neglect to perform any act required to be performed by him under the provisions of the statutes relating to the loaning and investment of the state permanent school and educational funds, shall be guilty of a misdemeanor, and upon conviction thereof shall be fined not less than fifty dollars nor more than one hundred dollars.

The state's attorney of the county shall prosecute such treasurer or auditor upon information of the state commissioner of school and public lands. All fines collected from such prosecution shall be paid into the county treasury and placed to the credit of the interest and income fund, and shall be reported to the commissioner upon the statements provided by law.

5-10-33. Civil liability of county officer for failure to perform duty required by chapter.--Any county auditor, county treasurer, or state's attorney failing, refusing, or neglecting to perform any duty required by him in any of the provisions of this chapter, and at the time required, shall be liable to a fine of not less than fifty dollars nor more than two hundred dollars, to be recovered in a civil action in the circuit court against him and his bondsmen.
APPENDIX F

MODEL INVESTMENT OF STATE FUNDS LAW
APPENDIX F

Model Investment of State Law

AN ACT relating to the establishing and concerning a State Investment Council and a Division of Investment within the State Department of Finance; the centralization of the investment function; and prescribing the classes of securities and other assets in which state funds may be invested.

Be it enacted . . .

ARTICLE I

STATE INVESTMENT COUNCIL

Establishment

1. There is hereby established in the state department of finance a state investment council.

Membership

2. The state investment council shall consist of six voting members: three public members appointed by the governor, two representatives of state funds which own the largest total investment assets, and the state treasurer who shall, however, vote only in case of a tie. The state investment officer shall be a non-voting member of the council. Actions shall be by majority.

Term of appointments

3. Each of the public members of the council shall be appointed by the governor for a term of five years; except that for the first appointments the terms shall be for three, four, and five years respectively. The governor shall also appoint the state fund representatives, but from the membership of the fund governing bodies, and for a term of five years, except the first terms shall be for one and two years respectively. All members shall serve until their respective successors are appointed and have qualified.
Qualifications

4. The public members of the council shall be qualified by training and experience in the field of investment or finance. During his tenure, a member of the council or his firm shall not be engaged in the sale of securities to the state or to any fund thereof; nor shall any such member benefit directly or indirectly from any transaction made by the state investment officer; nor shall he hold any office, position, or employment in any political party.

Removal; vacancy

5. A public or fund member of the council may be removed from office by the governor, for cause, upon notice and opportunity to be heard at a public hearing. Any vacancy in the membership of the council occurring other than by expiration of term shall be filled in the same manner as the original appointment, but for the unexpired term only.

Chairman

6. The chairman and presiding officer of the council shall be the state treasurer.

Necessary expenses

7. The members of the council shall serve without compensation but shall be reimbursed for necessary expenses incurred in the performance of their duties as approved by the council.

ARTICLE II

DIVISION OF INVESTMENT: STATE INVESTMENT OFFICER

Establishment

1. There is hereby established in the state department of finance a division of investment, which shall be under the
immediate supervision and direction of a person who shall be designated the "state investment officer."

State investment officer

2. The state investment officer shall devote his entire time and attention to the duties of his office, shall not be engaged in any other occupation or profession, nor shall he hold any other public office, appointive or elective. He shall be a person qualified, by training and investment experience, to direct the work of such division. He shall receive a salary of not less than _______ thousand dollars (§_______) annually.

Appointment

3. The state investment officer shall be appointed by the state director of finance with the approval of the governor. Recommendations as to appointments shall be made to the director of finance and to the governor by the investment council together with the detailed qualifications of each person recommended. If within sixty (60) days after the effective date of this act, or after any vacancy, an appointment has not been made, the power of appointment shall vest in the council.

Term; removal from office

4. The investment officer so appointed shall serve without term but may be removed from office for cause, upon notice and opportunity to be heard at a public hearing: (a) by the state director of finance; or (b) by the governor, if a majority of the investment council recommends his removal.

Bonding for protection to state

5. Before the state investment officer, or other responsible employee of the division of investment shall enter upon his duties, the state director of finance shall require an individual bond, or shall include him under a blanket bond, for such an amount and for such coverage as deemed best to protect the state's interest. The premium thereon shall not be chargeable to such officer or employee.
Staff and budget

6. The state investment officer shall annually prepare a budget which shall be reviewed by the council; and, subject to civil service regulations of the state, shall appoint all employees of the division.

ARTICLE III

CENTRALIZATION OF THE INVESTMENT FUNCTION

Transfer of investment powers, functions and duties

1. The functions, powers, and duties vested by law in the following enumerated agencies: (list such agencies) relating to investment or reinvestment of moneys and purchase, sale, or exchange of any investments or securities of or for any funds or accounts under the control and management of such agencies, are hereby transferred to and shall be exercised and performed for such agencies by the state investment officer under the supervision of the state director of finance as herein provided.

Ex-officio memberships

2. From and after the effective date of this act, any provision of existing law requiring or designating the state director of finance or the state treasurer to serve, by virtue of his state office, as a member of any of the respective agencies enumerated in Section 1 of this Article shall be and become inoperative, and the ex-officio membership in such agencies shall thereupon terminate.

Boards, commissions and fund trustees to continue

3. Except as otherwise provided in this act:

(1) Each of the respective agencies enumerated in Section 1 of this Article shall continue to have all of the powers and shall exercise all the functions and duties vested in, or imposed upon, it by law;

(2) This act shall not affect the terms of office of the present members of such agencies;
(3) Such agencies shall continue to be constituted as provided by existing law; and

(4) This act shall not operate to limit or restrict the members of any such agency, remaining after application of the provisions of Section 2 of this Article, from exercising or performing the functions, powers and duties of such agency.

ARTICLE IV

INVESTMENT POWERS AND DUTIES

Powers and duties of investment officer

1. Subject to any limitations, conditions, and restrictions contained in policy-making resolutions or regulations approved by the state director of finance, the state investment officer shall have the power to make purchases, sales, exchanges, investments, and re-investments, for or on behalf of any of the funds or accounts referred to herein; and it shall be his duty to see that moneys invested under the provisions of this act are at all times handled to the best interest of the state.

Sales or exchanges of investments

2. Securities or investments purchased or held under the provisions of this act may be sold or exchanged for other securities or investments; provided, however, that no sale or exchange shall be at a price less than the market price of the securities or investments to be sold or exchanged.

Legal opinions

3. In the purchase of bonds with which approving legal opinions ordinarily are furnished, the state investment officer may require an original or certified copy of the written opinion of a reputable bond attorney or attorneys, or the written opinion of the attorney-general, certifying to the legality of such bonds.

Powers and duties of investment council

4. The state investment council shall formulate and recommend to the state director of finance for his approval any investment
policy regulations or resolutions pertaining to the kind of nature of investment of any of the moneys, and any limitations, conditions, or restrictions upon the methods, practices, or procedures for investment, reinvestment, purchase, sale, or exchange transactions which, in the majority opinion of the council, should govern the state investment officer.

Same; consultation and post review

5. The council shall meet at least once each month to consult with the state investment officer with respect to the work of the division, and, when required, with the state director of finance. It shall have access to all files and records of the division and may require any officer or employee therein to provide such information as it may deem necessary in the performance of its functions. The council shall inspect and review the respective accounts and funds administered through the division.

Defaults; power to compromise

6. In the event of default in the payment of principal of, or interest on, any investments made, the state treasurer is authorized to institute the proper proceedings to collect such matured principal or interest, and may, with the approval of the state director of finance, after consultation with the investment council, accept for exchange purposes refunding bonds or other evidences of indebtedness at interest rates to be agreed upon with the obligor.

The state treasurer, with the approval of the state director of finance, after consultation with the investment council, is further authorized to make such compromises, adjustments, or disposition of the past-due interest or principal as are in default, or to make such compromises or adjustments as to future payments of interest or principal as deemed advisable for the purpose of protecting the funds invested; and such adjustments or compromises made and approved are hereby ratified and confirmed.
ARTICLE V

ELIGIBILITY OF SECURITIES AND OTHER ASSETS FOR INVESTMENT

Classes of securities and investments

1. Moneys made available for investment for a period in excess of one year may be invested in the following classes of securities and investments, and not otherwise:

   (1) Bonds, notes, or other obligations of the United States, or those guaranteed by, or for which the credit of the United States is pledged for the payment of the principal and interest or dividends thereof;

   (2) Bonds or other evidences of indebtedness of this state; and full faith and credit obligations of, or obligations unconditionally guaranteed as to principal and interest by an other state of the United States, the Territories of Hawaii and of Alaska, and the Commonwealth of Puerto Rico;

   (3) Bonds, debentures, notes, or other full faith and credit obligations issued, guaranteed, or assumed as to both principal and interest by the government of the Dominion of Canada, or by any province of Canada; provided that the principal and interest thereof shall be payable in United States funds, either unconditionally or at the option of the holder;

   (4) Bonds, notes, or obligations of any municipal or political subdivision of this state, issued pursuant to a law of this state; provided that the issuer has not, within ten years prior to the making of the investment, been in default for more than three months in the payment of any part of the principal or interest on any debt evidenced by its bonds, notes, or obligations; and provided further, if the bonds are city or county utility, or utility-district revenue bonds, the revenues of such utility, other than for payment of operation and maintenance expenses, are pledged wholly to the payment of the interest on and principal of such indebtedness, and the utility project has been completely self-supporting for a period of five years next preceding the date of investment;

   (5) Bonds, notes, or other obligations issued, guaranteed, or assumed by any municipal or political subdivision of any other state of the United States; provided, (a) that any such municipal or political subdivision, or the total of its component parts, shall have a population as shown by the last preceding federal census of not less than 10,000; and (b) the issuer, guarantor, or assume of such bonds, notes, or other obligations: (i) shall have pledged its faith and credit for the payment of the principal and interest of such bonds, notes, or other obligations; (ii) shall have the power to levy taxes on the taxable real property therein for the payment of both principal and interest of such bonds, notes or other obligations.
without limitation of rate or amount; (iii) shall not within ten years prior to the making of the investment have defaulted in payment of principal or interest of any debt evidenced by its bonds, notes or other obligations for more than 90 days;

(6) Bonds, debentures, notes, or other obligations issued, guaranteed, or assumed as to both principal and interest by any city of Canada which has a population of not less than 100,000 inhabitants; provided that the principal and interest thereof shall be payable in United States funds, either unconditionally or at the option of the holder; and provided further that all the conditions as prescribed in subsection (5b) of this Article have likewise been met;

(7) Bonds, notes, or other obligations issued, assumed, or unconditionally guaranteed by the International Bank for Reconstruction and Development;

(8) Bonds, debentures, or other obligations issued by a federal land bank, or by a federal intermediate credit bank, under the Act of Congress of July 17, 1916, known as the "Federal Farm Loan Act," as amended or supplemented from time to time;

(9) Bonds, debentures, or other obligations issued by any national mortgage association under the Act of Congress of June 27, 1934, known as the "National Housing Act," as amended or supplemented from time to time;

(10) Bonds, notes, or other obligations issued, amended, or unconditionally guaranteed by The Port of New York Authority;

(11) Obligations of any public housing authority or urban redevelopment authority issued pursuant to the laws of this state relating to the creation or operation of a public housing or urban redevelopment authority;

(12) Obligations of any state or municipal authority issued pursuant to the laws of this state; provided that for each of the five years next preceding the date of investment the income of such authority available for fixed charges shall have been not less than one and one-fifth times its average annual fixed charges requirements over the life of such obligations;

(13) First mortgages on unencumbered real property when such mortgages are guaranteed or insured in the amount of fifty (50) per cent or more of the loan made, in the event of default, by the United States or any agency of the United States government;

(14) Bonds, notes, debentures, car-trust certificates, preferred stock, or common stock of any corporation organized and operating within the United States; provided that it shall have minimum assets of ten million dollars ($10 million) and securities listed on one or more national stock exchanges; provided further that the combined funds of the state shall not at any one time own more than ten (10) per cent of the voting stock of any such company; and provided further that in the investment of the moneys of any one state fund or account, not more than twenty-five (25) per cent of the total of such fund or account shall at any time be invested in the securities of this class (subsection);

(15) Other investments hereafter from time to time authorized by law as legal for investment by insurance companies of this state.
Investment for short-term periods

2. All surplus cash certified by the state treasurer for short-term investment (one year or less), or other moneys the principal of which shall be required within a twelve-month period, may be invested in the following classes of securities, and not otherwise:

   (1) Certificates or other obligations of the United States, or for which the full faith and credit of the United States is pledged, which mature on such dates as will make available such amount of cash as required;
   (2) Any certificates or other evidences of indebtedness in which savings banks may legally invest; provided that such obligations mature on such dates as will make available without discount such amounts of cash as required;
   (3) Obligations of the United States which are redeemable by the United States Treasury at the owner's option at fixed redemption values within one year from the date of such investment;
   (4) Evidences of indebtedness issued by any corporation which meet the requirements of Article V, Section 1, Item 14; provided that such obligations are not in default as to either principal or interest when acquired, and have a maturity of not more than twelve months from the date of purchase.

General Proviso

3. Be it further provided, however, that any investments under this Article V shall be made with the exercise of that degree of judgment and care, under circumstances then prevailing, which men of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation but for investment, considering the probable safety of their capital as well as the probable income to be derived.

ARTICLE VI

AVAILABLE FUNDS; CUSTODY OF SECURITIES; COLLECTIONS

Funds for investment

1. It shall be the duty of each board, commission, department, official, or agency charged with the custody or administration of any state fund to make moneys available for investment as fully as is consistent with the cash requirements of said fund. Monthly, and
more often as circumstances require, such official or agency shall notify the state investment officer of the amount available for investment, and the investment shall be made and paid for by warrant drawn by said officer against such fund. Such notification shall include the name and number of the fund for which the investments are to be made, and of the life of the investment if the principal sum is subsequently to be required for meeting obligations.

**Surplus cash in the treasury**

2. The state treasurer shall likewise declare as funds available for investment any money in the general fund or special funds of the treasury deemed unnecessary for operating purposes during the next succeeding three or more months.

**Custody of securities**

3. All securities purchased or held shall be in the physical custody of the state treasurer who may, with the approval of the state director of finance, deposit with a fiscal agent in any of the financial centers, or with a local bank or trust company, such of said securities as he shall consider advisable to be held in safekeeping by said agent or bank for collection of principal and interest, or of the proceeds of sale thereof.

**Collection of income and principal**

4. It shall be the duty of the state treasurer to collect the interest, or other income on, and the principal of such securities in his custody as the said sums become due and payable, and to pay the same, when so collected, into the fund to which the investments belong.

**Availability of income for investment**

5. Interest or other income received from the investment of surplus cash in the treasury shall be transferred for credit to the general fund, or the appropriate special fund. All other interest, premium, and income in any form derived from investments, shall be retained by the state treasurer and currently reinvested by the state investment officer on behalf of the fund holding said investments, unless and until the appropriate fund administrative board or head shall issue instruction to the state treasurer as to the transfer or
other disposition of such income receipts. Whenever a given investment is owned by two or more funds, the income received shall be prorated in accordance with the ownership of the respective funds.

ARTICLE VII

RECORDS AND REPORTS

Records of investments

1. The division of investments shall keep, for each fund for which investments are made, a separate account, to be designated by name and number, which shall record the individual amounts and the totals of all investments belonging to such fund. Every receipt and collection or disbursement when received or made shall be immediately notified to the division for recording to the particular fund to which it belongs.

Notification of investments made

2. The division of investments shall report monthly to each and every interested state official or agency the changes in investments made during the preceding month for their respective fund or funds, and, in addition, shall furnish the details on the investment transactions of any fund as requested by the administrative body or head thereof.

Monthly reports

3. Not later than fifteen (15) days after the close of each month, the state investment officer shall submit to the state director of finance and the state investment council a report of the operations of the division of investments during said month. Each report shall include a detailed summary of investment, reinvestment, purchase, sale, and exchange transactions, setting forth, among other things, the investments bought, sold, and exchanged, the dates thereof, the prices paid and obtained, the names of the dealers involved, and a statement of the funds or accounts referred to herein. Such reports shall also be circulated to a mailing list of investment bankers and brokers recommended by the council, and shall, in addition, be open for inspection to the public and the press in the office of the state investment officer.
ARTICLE VIII

AUDIT AND REVIEW

Post-audit

1. The state auditor shall be responsible for conducting a continuous post-audit of the investment transactions of the state, and shall submit annually a special report on his findings to the investment council, the governor, and to the appropriate legislative committee.

Annual report

2. On or before January first of each year, and at such other times as it may deem in the public interest, the investment council shall report to the governor and to the legislature with respect to its review of the work of the division of investment.

ARTICLE IX

GENERAL PROVISIONS

Act controlling

1. To the extent that the provisions of this act are inconsistent with the provisions of any other law, the provisions of this act shall be controlling.

Severability of provisions

2. If any provision of this act, or the applicability thereof to any person or circumstances, is held invalid, the remainder of this act and the applicability thereof and of such provision to other persons or circumstances shall not be affected thereby.
3. This act may be cited as the "Investment of State Funds Law."

Effective date

4. This act shall take effect immediately.

APPENDIX G

A COMPARISON OF THE INCREASE IN THE COST OF EDUCATION INDEX
AND THE INCREASE IN THE ANNUAL RATE OF RETURN
OF THE COMMON SCHOOL PERMANENT FUND
1957-59 TO 1968
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One measure of the performance of the Common School Permanent Fund was a comparison of the annual rate of return to the annual rate of increase in the Consumer Price Index. Another comparison can be made between the rising cost of education and the increase in the rate of return of the Common School Permanent Fund. To the extent the increase in the rate of return of the Common School Fund does not equal at least the increase in the Cost of Education Index, the earnings of the Fund are assuming successively smaller portions of the cost of education. The Cost of Education Index of the School Management magazine is regarded as a "...valued yardstick for comparing and analyzing today's school expenditures..."\textsuperscript{a} measuring the "...cost of an educational market basket..."\textsuperscript{b} of goods and services given the amount and quality of these goods and services remain constant.

\textsuperscript{a}"Background for the Cost of Education Index," School Management, XIII (January, 1968), p. 129.

\textsuperscript{b}Ibid., p. 132.
The increase in the rate of return of the Common School Permanent Fund from 1957-59 to 1968 was computed to be 128 percent. The increase in the Cost of Education Index for the same period was 201.8 percent. Both figures include the increase in real terms as well as increases due to inflation.

These figures suggest that the Common School Permanent Fund is less effective in supporting the cost of education than it was in the 1957-59 base period.

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\( ^c \) Based on the geometric mean of the annual rates of return of 1957-59 and the rate of return for 1968 from the "Quarterly Statements of Condition" published by the Department of School and Public Lands, Pierre, South Dakota.