State Land Board
Common School Fund
Annual Portfolio Review

Purpose
To provide the State Land Board an update on the performance, structure, and asset allocation of the Common School Fund for periods ended December 31, 2015.

Market Performance Overview
(Provided by Callan Associates, Oregon Investment Council consultant)

Macroeconomic Environment

The 2015 calendar year will be remembered for the long-awaited first Fed hike in nine years as well as a year of disappointing returns across asset classes, with plunging commodity and oil prices and uncertainty over the pace of China's slowdown being key forces. Painfully, no year since 1990 has seen more negative returns across equity and fixed income indices, and declining oil and gold prices. While losses in 2008 were sharper, losses in 2015 were more broad-based. Despite the poor investment results, the US economy remained a relatively bright spot in the global economy.

Real GDP growth in the US for 3Q15 was a reasonable, while not spectacular, +2.0% (annualized). After a slow start to the year (1Q15 real GDP: +0.6%), the 2nd quarter print was more robust (2Q15: +3.9%) as weather-related headwinds abated. However, GDP forecasts from the Fed have been declining given global headwinds and the persistent strength of the US dollar. Fed expectations for growth in 2016 were 2.5% to 3.0% as of December, 2014 and have since been revised downward to 2.3% - 2.5%. Growth outside the US remained stagnant in spite of continued accommodative policies from central banks (Japan 3Q15 GDP +1.6%; Europe 3Q15 GDP +1.6%). While China's growth rate remains high (3Q15: +6.9%), its slowdown has been apparent and weighed on economies elsewhere. China's growth rate was the slowest since the 1st quarter of 2009 and to further highlight the magnitude of the deceleration, its growth averaged 10.88% from 1989 until 2015.

Central banks remained accommodative across the developed world. The "Big 4" central banks (US, UK, Europe, Japan) expanded their collective balance sheet to $11 trillion. Among developed countries, the US stands alone (with the UK close behind) on a path of what are likely to be gradual rate hikes from the current 0.25% to 0.50% Fed Funds target. In December, the US Federal Reserve imposed it first policy rate increase since 2006. Employment, residential investment and auto sales were bright spots in the US while manufacturing continued to contract. Manufacturers, which account for roughly 12% of the US economy, have suffered from weak global demand, a strong dollar and reduced capital spending from the energy sector. Conversely, low gas prices and a strengthening labor market propelled car sales to 17.5 million in 2015, surpassing the peak hit 15 years ago. Unemployment continued to trend lower through 2015 from a 5.7% reading in January to 5.0% in November. Real wages firmed from very weak levels in recent years with year-over-year real wage growth up to nearly 2% as of November, 2015.

Inflation continued to fall short of the Fed's 2% target for the Personal Consumption Expenditures Index (+1.3% 3Q) but trended higher over the course of the year. The trailing 12-month Core CPI was +1.6% in January of 2015 and by November, it had accelerated to +2.0%. Of course, the energy influence was enormous in 2015, as evidenced by the far more muted 0.4% reading for the Headline CPI, which includes food and energy. However, if/when energy prices stabilize, they will cease to have a disinflationary impact and begin to add volatility to Headline CPI. Across the pond, Europe saw more muted inflation with some countries experiencing deflation.

Oil prices continued to play a key role in market sentiment as well as performance. While much of the decline from the $105/barrel level to today's (1/12/16) close at $30.5/barrel (WTI crude) occurred in the 2nd half of 2014, prices continued to fall in 2015. To start the year, spot prices were around $52/barrel and have fallen about 40% to current levels. At this point, oil price forecasts are no more than guesses but the pain felt by the industry is certain and regardless of the path from here, the effects of the decline are readily apparent and will likely be felt for some time.

Equity Results

US equities suffered their worst performance post 2008. News out of China played a pivotal role in stock market performance in 2015. The five worst performing days for the S&P 500 in 2015 came alongside negative news from China. Returns were highly concentrated both among names and by date in 2015. Without the now-famed "FANGNOSH" (Facebook, Amazon, Netflix, Google, Nike, O'Reilly Auto Parts, Starbucks and Home Depot), the S&P 500 would have been down for the year. Amazon and Netflix were the star performers, up more than 120% for the year. This performance belies much weaker results from the broader constituency. The S&P 500 Index declined 0.8% on a price-only basis, up 1.3% with dividends.

Large caps performed best (R1000: +0.9%) and results worsened as one went down the capitalization path (Rmidcap: -2.4%, R2000: -4.4%, Rmicro: -5.2%). Growth outperformed value across capitalization, and in large caps, growth outperformed value by the widest margin since the financial crisis (R1000G: +5.7%, R1000V: -3.8%). High quality outperformed low quality by more than 6% in 2015 (the most since 2011) with the vast majority of the margin coming in the turbulent 3rd quarter. From a sector perspective, Consumer Discretionary (+10.1%) and Health Care (+6.9%) performed best while Energy (-21.1%) and Materials (-8.4%) suffered the most.

Outside of the US, developed markets outperformed domestic by a wide margin when measured in local terms (MSCI EAFE Local: +5.3%); however, the strength of the US dollar pushed returns for unhedged US investors into negative territory (MSCI EAFE US$: -0.8%). As in the US, growth sharply outperformed value in the developed world (MSCI EAFE Growth: +4.1%, Value: -5.7%). Developed markets small cap was the top performer (MSCI EAFE SC: +9.6%). Conversely, emerging markets were a disaster and represented the worst performing area of global equities (MSCI EM US$: -14.6%). EM was also hurt by the US dollar strength (MSCI EM Local: -5.6%).

Fixed Income Results

Yields rose throughout the 4th quarter as investors grew increasingly certain that the Fed would hike rates before year-end. Sentiment proved correct as the Fed raised the fed funds target from its 7-year "near zero" target to 0.25% to 0.50% at its December meeting. The yield on the 10-year Treasury rose 21 bps over the quarter and closed the year at 2.27%, up 11 bps from 12/31/2014. The Barclays Aggregate Index was down modestly for the quarter (-0.6%) but up slightly for the year (+0.6%), thanks to coupon payments. Investment grade credit and mortgages outperformed like-duration US Treasuries for the quarter but underperformed for the full year. Declining commodity prices and negative sentiment continued to take a toll on high yield corporates. The Barclays High Yield Index was down 2.1% for the quarter bringing its 2015 loss to 4.5%. The Energy component, which comprises 11% of the Index, bore the brunt of the pain with returns of -12.9% for the quarter and -23.6% for the full year. Municipal bonds outperformed taxable bonds for the quarter and the year. A favorable technical picture contributed to the results as supply was down 10% from the 3rd quarter while flows into mutual funds attracted inflows for thirteen consecutive weeks. The Barclays Municipal Bond Index returned 1.5% for the quarter bringing the full year return to 3.3%. The shorter duration Barclays 1-10 Year Blend posted a 0.8% 4th quarter return and was up 2.5% for 2015.

Outside of the US, the strength of the US dollar was reflected in the outperformance of hedged indices versus their unhedged counterparts. The US dollar climbed nearly 3% versus the euro and pound with more modest appreciation (+0.4%) relative to the yen. Versus a trade-weighted basket of major currencies, the dollar was up 2.3% for the quarter and 8.2% for the year. Yields dropped in Italy, Spain and Japan but were otherwise flat to modestly higher in other developed markets. The Barclays Global Aggregate Index (unhedged) returned -0.9% in the 4th quarter. Hedged in US dollars, the Index was up 0.1%. Results for the year were +1.0% and -3.2% (hedged and unhedged, respectively). Emerging markets debt staged a comeback in the 4th quarter with the dollar-denominated JPM EMBI Global Diversified Index up 1.3%. The local currency-denominated JPM GBI-EM Global Diversified Index was flat for the quarter but remained down nearly 15% for the year, far worse than the +1.2% return for the dollar-denominated Index.

Other Asset Classes

Commodity returns were no less than terrible in 2015, led lower by the energy complex. Indeed, all major groups suffered substantial declines. The energy-heavy S&P GSCI fell nearly 33% while the more balanced Bloomberg Commodity Index (BCI) slipped 25%. Brent Crude and WTI Crude fell 45.6% and 44.4%, respectively. Cotton was the only contract within the BCI to post a gain in 2015, a muted +3.0%. Gold fell 11% to close the year at around $1,060/oz, near a 6-year low.

Hedge funds failed to provide a bright spot for investors. The HFRI Fund Weighted Composite underperformed both stocks and bonds in 2015 (HFRI FWC: -0.85%). Hedge Fund of Funds performed slightly better; however, still ended the year with a loss (HFRI FoF: -0.36%). Volatility was the year's big winner from a strategy perspective (HFRI RV Volatility: +7.0%) while Yield Alternatives were the worst performers (HFRI RV Yield Alternatives: -16.5%) due in large part to heavy exposure to MLPs.

CSF Performance

The Common School Fund had a calendar year return of 0.46 percent, outperforming the fund's policy benchmark by 1.39 percent (Exhibit 1). Over 10 years period ending 12/31/15, the fund has returned 5.3 percent annually, in line with the CSF policy benchmark albeit lower than the long-term objectives of the fund. For the fiscal year ended June 30, 2015, the CSF's 3.5 percent advance also beat the 2.4 percent (net of fees) return from the 2015 NACUBO[1]-Commonfund Study of Endowments (a composite comprised of 812 U.S. Colleges and Universities). Over the five-year trailing period, the CSF returned 11.5 percent, compared to the average NACUBO endowment return of 9.8 percent.

[1] National Association of College and University Business Officers, a global membership organization representing more than 2,500 colleges, universities, and higher education service providers.

Exhibit 1

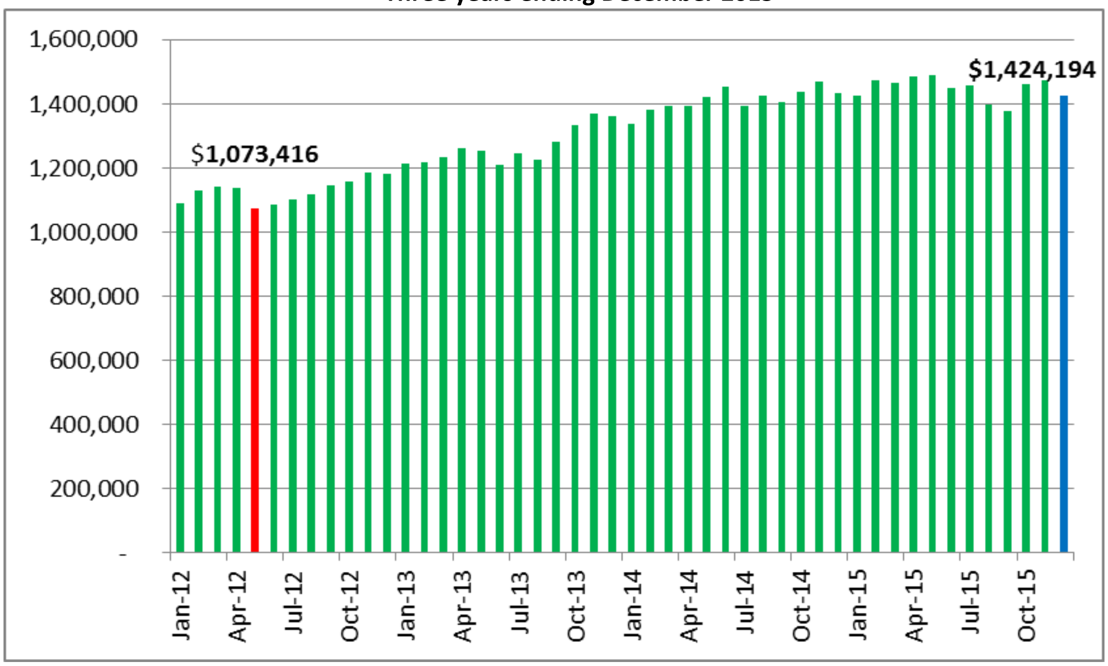
	EMV $(000'S)	%	1 YEAR	3 YEARS	5 YEARS	7 YEARS	10 YEARS
TOTAL COMMON SCHOOL FUND	1,424,195	100.0%	0.46	8.11	7.39	11.22	5.37
OREGON CSF POLICY INDEX			**-0.93**	6.98	6.84	10.16	5.34
TOTAL FIXED INCOME - CSF	417,968	29.3%	**-0.03**	1.74	4.14	7.09	5.16
BC UNIVERSAL			0.43	1.51	3.46	4.71	4.68
WELLINGTON MANAGEMENT	205,846	14.5%	0.19	1.53	4.12	6.91	5.27
WESTERN ASSET MANAGEMENT	212,122	14.9%	-0.20	1.95	4.37	7.43	5.15
TOTAL DOMESTIC EQUITY	383,392	26.9%	1.53	14.76	11.99	14.81	6.70
RUSSELL 3000			0.48	14.74	12.18	15.04	7.36
BLACKROCK S&P 500 INDEX	122,425	8.6%	1.42	15.14	12.61		
S&P 500			1.38	15.13	12.57		
MFS ADVISORS	97,395	6.8%	-0.29	14.68	12.15	13.43	
RUSSELL 1000 VALUE			-3.83	13.08	11.27	13.04	
CLEARBRIDGE INVESTMENTS	31,288	2.2%	2.36				
RUSSELL MIDCAP			-2.44				
BOSTON COMPANY	30,342	2.1%	-5.82	9.67	9.05	13.46	
RUSSELL 2000 VALUE			-7.47	9.06	7.67	0.00	
JACKSON SQUARE PARTNERS	101,942	7.2%	5.57				
RUSSELL 1000 GROWTH			5.67				
TOTAL INTERNATIONAL EQUITY	347,843	24.4%	**-2.24**	5.26	4.05	11.03	4.54
OREGON CSF CUSTOM INTL INDEX			**-5.66**	1.5	1.06	7.48	2.58
PYRAMIS SELECT	137,061	9.6%	-1.42	4.84	3.80	8.42	
MSCI WORLD EX US (NET)			-3.04	3.93	2.79	7.61	
ARROWSTREET	153,082	10.7%	2.57	11.17	8.08	8.20	
MSCI WORLD EX US IMI (NET)			-1.95	4.43	3.00	5.75	
GENESIS ASSET MANAGEMENT	29,024	2.0%	-15.21	-5.54	-2.80	10.79	
MSCI EMERGING MARKETS IMI INDEX (NET)			-13.86	-6.12	-4.59	8.13	
ARROWSTREET EMERGING MARKETS	28,676	2.0%	-13.96	-5.60			
MSCI EMERGING MARKETS			-14.92	-6.76			
BLACKROCK ACWI IMI INDEX	83,758	5.9%	-1.822	8.268	6.495		
MSCI ACWI IMI (NET)			-2.187	7.861	6.111		
CSF PRIVATE EQUITY	167,267	11.7%	7.39	15.70	14.94	11.65	
RUSSELL 3000+300 BPS QTR LAG			2.49	15.87	16.64	13.62	
CSF-CASH INVESTED IN OSTF	23,968		0.50	0.56	0.69	0.95	1.83
91 DAY TREASURY BILL			0.05	0.05	0.08	0.1	1.26

CSF Market Value

Net of contributions and distributions, the fund has grown by 31 percent over the past three years, from $1.09 billion in January 2012, to $1.42 billion at year end 2015 (Exhibit 2). The fund hit its low of $1.07 billion in May 2012 (highlighted in red below) before continuing a steady upward trend.

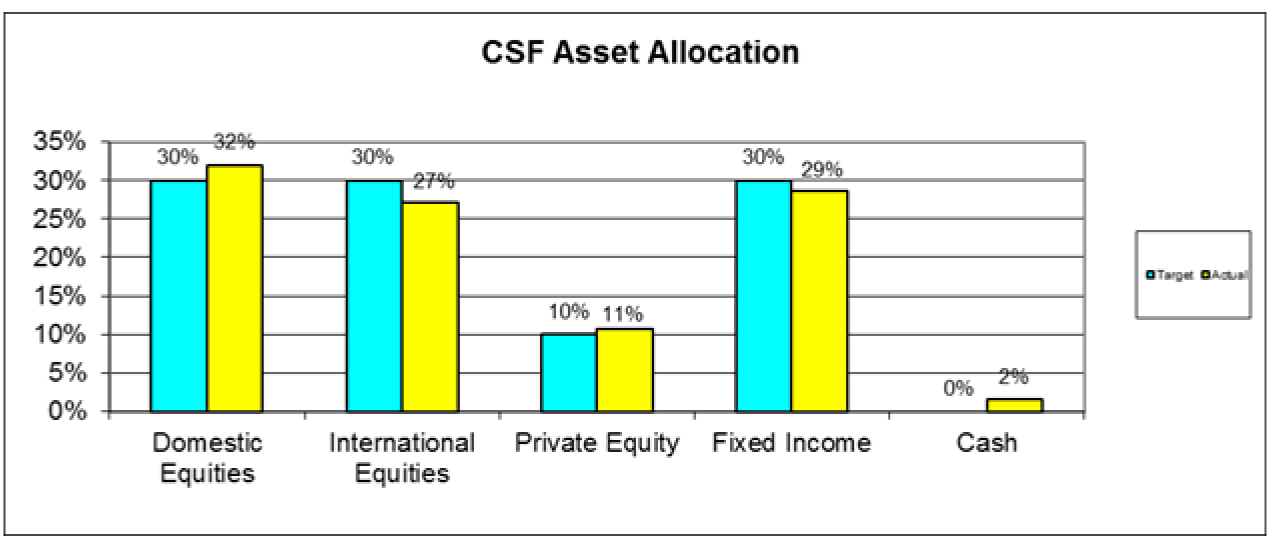
Exhibit 2

CSF NAV
Three years ending December 2015



CSF Asset Allocation

CSF asset allocation is managed relative to a 70/30 equity-to-fixed income target. As of year-end 2015, the CSF's actual allocations relative to established targets were within policy tolerances.



In 2007, OIC approved a target allocation of 10% in private equity for the Common School. The objective was to increase expected returns while simultaneously gaining diversification benefits, and remaining sufficiently liquid in order to meet bi-annual distribution requirements. In 2008, in efforts to further diversify alpha sources, changes to the public equity structure were made. These included moving towards a more global benchmark allocation to reduce home country bias, expanding the manager line-up, and including an allocation to emerging markets.

While the above changes have been additive, staff and the OIC's consultant will continue to monitor the performance and risk of the plan, as well as regularly assess the prudence of CSF's asset allocation with the objective of holding a diversified portfolio aimed at seeking highest returns possible. To this end, a formal asset allocation study is planned for calendar year 2016.

Oregon
Kate Brown, Governor

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State Land Board

Kate Brown
Governor

Jeanne P. Atkins
Secretary of State

Ted Wheeler
State Treasurer

State Land Board

Regular Meeting
April 12, 2016
Agenda Item 5

SUBJECT

2015-17 Common School Fund Distribution

ISSUE

Whether the State Land Board should authorize an increase in the Common School Fund distribution to Oregon's K-12 public schools for the 2015-17 biennium.

AUTHORITY

Section 2(2), Article VIII of the Oregon Constitution; authorizing the CSF to be invested as provided by law; authorizing the Land Board to apply income from the investment of the CSF to its constitutional land management expenses; and directing the remainder of the investment income to be applied to the support of primary and secondary education as prescribed by law.

Section 4, Article VIII of the Oregon Constitution directing that, "Provision shall be made by law for the distribution of the income from the common school fund among several Counties of this state in proportion to the number of children resident therein between the ages, four and twenty years."

ORS 273.105: establishing the Distributable Income Account within the CSF to be administered in accordance with Section 4, Article VIII of the Oregon Constitution and directing what moneys within the CSF shall be credited to the Distributable Income Account.

SUMMARY

The 2015-17 Governor's Balanced Budget assumed a 4% Common School Fund distribution in accordance with the Land Board's current distribution policy (Appendix A). In the budget report for Senate Bill 5507, the 2015 Legislature recognized a need for increased funding for the state school fund. The additional funding was proposed to be met by the Land Board increasing the distribution from 4% to 5% for the 2015-17 biennium, and the legislatively adopted budget reflected that increase.

The draft resolution before the State Land Board today would support the budget report by authorizing the agency to distribute 5% of the three-year rolling average balance for the 2015-17 biennium (Appendix B).

RECOMMENDATION

The Department recommends that the State Land Board determine whether to increase the Common School Fund distribution to 5% for the 2015-17 biennium, and direct the Department to implement their determination.

APPENDICES

A. Common School Fund distribution policy
B. Draft resolution

OREGON STATE LAND BOARD
COMMON SCHOOL FUND DISTRIBUTION POLICY
Adopted April 14, 2009

Effective with the December 31, 2009 distribution, the amount of the distribution shall be equal to 4% of the average balance of the preceding 3 years. If the average balance of the fund has increased by 11% or more, the distribution amount shall be 5% of the average balance of the preceding 3 years.

The average value of the Fund will be determined as of December 31 for the three preceding years (e.g., to determine average value for distributions in FY 2010, average value of the Fund would be determined as of December 31 for the calendar years 2006, 2007, 2008).

Fund growth is determined on the basis of a 3-year rolling average, comparing the most recent 3-year period to the 3-year period ending on the previous December 31 (e.g., to determine the Fund value for distributions in FY 2010, average value of the Fund would be determined as of December 31 for the calendar years 2006, 2007, 2008 and compared to the average value of the Fund for calendar years 2005, 2006, and 2007).

OREGON STATE LAND BOARD RESOLUTION	} } } }	In the matter of the Common School Fund distribution in 2015-17

WHEREAS, the State Land Board recognizes that the approved K-12 education budget does not contain adequate revenue for the desired funding levels in the 2015-17 biennium; and

WHEREAS, the State Land Board desires to demonstrate its commitment to helping reach the funding levels for 2015-17; and

WHEREAS, the State Land Board has the authority to determine the amount of the Common School Fund distribution for Oregon's K-12 public schools; now therefore,

BE IT RESOLVED, THAT THE STATE LAND BOARD DIRECTS:

The 2015-17 Common School Fund distribution be increased by an additional 1% over the policy distribution of 4% of the three-year average balance.

Adopted this ____ day of April 2016.

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Kate Brown
Governor

____

Jeanne P. Atkins
Secretary of State

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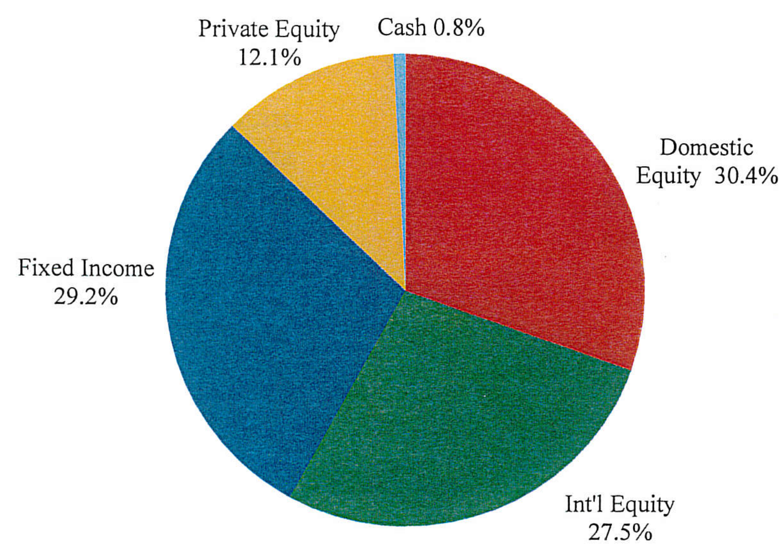
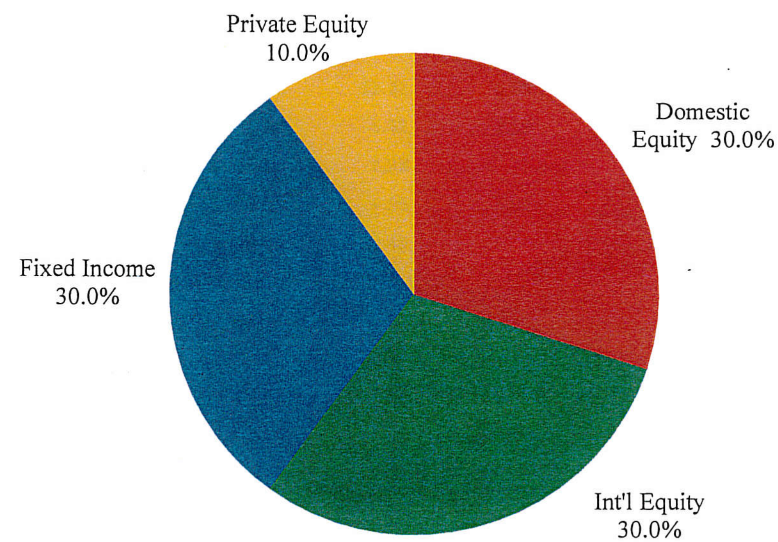
Ted Wheeler
State Treasurer

State of Oregon Common School Fund
Asset Allocation
as of 12/31/2016

Allocation



Policy



Domestic Equity   Int'l Equity   Fixed Income   Private Equity   Cash

BlackRock ACWI IMI's Global Equity Fund is allocated 53.68% to Domestic Equity and 46.32% to International Equity

Oregon Common School Fund
Total Fund Performance vs. Benchmarks
Rates of Return
12/31/2016

	Market Value	% Allocation	Current Quarter	YTD	1 Year	3 Year	5 Year	7 Year	10 Year	Inception to Date	Inception Date
FUNDS											
TOTAL FUND	**1,464,506**	**100.0**	**0.29**	**6.09**	**6.09**	**4.36**	**9.13**	**7.98**	**4.49**	**7.27**	**Jun-01-95**
OREGON CSF POLICY INDEX [1]			0.51	8.01	8.01	4.39	8.85	7.64	4.74	7.21	Jun-01-95
Excess			-0.23	-1.92	-1.92	-0.02	0.29	0.34	-0.25	0.05	
DOMESTIC EQUITY	396,792	27.1	2.97	9.16	9.16	7.21	14.18	12.21	6.05	9.40	Jan-01-95
INTERNATIONAL EQUITY	361,221	24.7	-1.02	3.76	3.76	-0.16	7.92	5.53	2.39	5.28	Mar-01-97
GLOBAL EQUITY	91,078	6.2	1.34	8.75	8.75	3.63	10.03	7.33		1.66	Jun-01-08
FIXED INCOME	427,104	29.2	-2.59	4.07	4.07	3.38	3.61	4.96	5.01	5.98	Jun-01-95
PRIVATE EQUITY	176,642	12.1	4.05	7.99	7.99	11.96	14.68	13.45		6.68	Nov-01-07
INDICES											
RUSSELL 3000			4.21	12.74	12.74	8.43	14.67	12.92	7.07		
OREGON CSF CUSTOM INTL INDX [2]			-1.25	4.50	4.50	-1.78	5.00	2.93	0.66		
BC AGGREGATE			-2.98	2.65	2.65	3.03	2.23	3.63	4.34		
BC UNIVERSAL BLEND [3]			-2.98	3.01	3.01	2.98	2.60	3.92	4.48		
91 DAY TREASURY BILL			0.09	0.33	0.33	0.14	0.12	0.12	0.80		
CPI			0.00	2.07	2.07	1.18	1.36	1.61	1.81		

1 From February 1, 2012 to June 30, 2016, policy benchmark is 30% Russell 3000, 30% MSCI ACWI ex US Net, 30% BC Universal Index, and 10% Russell 3000+300 bps QTR lag. From July 1, 2016 to current, policy benchmark is 30% Russell 3000, 30% MSCI ACWI ex US Net, 30% BC US Aggregate, and 10% Russell 3000+300 bps QTR lag
2 Benchmark performance through April 31, 2008, is MSCI World ex-US Standard Gross index. From May 1, 2008, is MSCI ACWI ex-US Net Index.
3 Prior to November 1, 2005, index is BC Aggregate.From November 1,2015 to June 30,2016 the benchmark was BC Universal Index. From July 1, 2016 to current the benchmark is BC Aggregate