THE STATE
of ALASKA

GOVERNOR BILL WALKER

Department of Revenue

COMMISSIONER'S OFFICE

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February 3, 2018

The Honorable Neal Foster and the Honorable Paul Seaton
Alaska State Representatives
Co-chairs, House Finance Committee
State Capitol Rooms 410 and 505
Juneau, AK 99801

Re: Committee Member Questions re HB 213

Dear Co-Chairs Foster and Seaton:

At the House Finance hearing on January 30, 2018, a number of questions were raised by committee members.

1. *Please provide additional averaging scenarios for 6, 7, and 8-year averaging periods.* We are awaiting updated capital market projections from Callan Associates. When we get the data, we will be able to provide both 10-year and 20-year projections. This will illustrate the impact of Callan's relatively conservative investment return projections over the next 10 years, and how they normalize over a longer 20-year horizon. We expect that maintaining the inflation adjusted value of an endowment is more of a challenge in the mid-term (10-year horizon) with shorter averaging periods (i.e., 5-year lookback). Over a longer horizon (20-year horizon), as the projection for investment returns increases, a 5-year lookback is more likely to be successful in preserving the inflation adjusted value of an endowment.

   We should be able to provide these projections mid-week.

2. *What are the Public School Trust's 1, 5, and 10 year returns?* The returns, as of 12/31/2017, are attached.

3. *Please provide information on spending from an "underwater" endowment (value is less than principal historic dollar value).* Attached is the Uniform Law Commission's summary of the Uniform Prudent Management of Institutional Funds Act (codified in Alaska at AS 13.65). It describes the prudent expenditure rule, which eliminates the bar against spending when an endowment is below historic dollar value. Expenditures from an endowment must be prudent and consistent with a number of factors, including maintaining the permanent duration of the endowment.

   If the committee is interested in pursuing this approach, in addition to repealing the distinction between principal and income (i.e., repeal AS 37.14.110(c)), the committee could also consider adding the words "up to" prior to the 4.75% distribution percentage in section 3. This would give the Treasury Division and the Legislature the ability to course-correct in various market environments and appropriate less than 4.75% of the average market value of the trust in order to better preserve the inflation adjusted value of the public school trust over extended periods of time.

Sincerely,

Mike Barnhill

Michael A. Barnhill
Deputy Commissioner

c: Sheldon Fisher, Commissioner
Genevieve Wojtusik
Rep. Justin Parish

State of Alaska

Rates of Return

AY08: Public School - Principal
December 31, 2017

THE STATE of ALASKA

Investment Type	NAV	Actual	Target	Min	Max
Cash & Cash Equivalents	$310,595	0.05%	0.00%	0.00%	5.00%
Broad Market Fixed Income	$256,620,350	39.01%	40.00%	35.00%	45.00%
High Yield	$31,119,915	4.73%	5.00%	0.00%	10.00%
Domestic Equity	$210,880,598	32.06%	32.00%	27.00%	37.00%
International Equity	$130,490,397	19.84%	19.00%	14.00%	24.00%
Internally Managed REITs	$28,367,654	4.31%	4.00%	0.00%	9.00%
Total	**$657,789,508**	**100.00%**	**100.00%**		

	NAV	1 Month	3 Month	FYTD	1 Year	3 Year	5 Year	10 Year	ITD	Inception
AY08: PUBLIC SCHOOL - PRINCIPAL	$657,789,508	0.95%	3.26%	6.41%	13.79%	6.74%	7.36%	6.23%	7.00%	Apr-91
INDEX		0.92%	3.24%	6.46%	13.93%	6.56%	7.21%	6.06%	7.84%	
EXCESS		0.03%	0.02%	-0.05%	-0.14%	0.18%	0.15%	0.17%	-0.84%	

Prudent Management of Institutional Funds Act Summary

At its annual meeting in July 2006, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Prudent Management of Institutional Funds Act (UPMIFA) and recommended it for enactment by the legislatures of the various states. UPMIFA is designed to replace the existing Uniform Management of Institutional Funds Act (UMIFA), which was approved by NCCUSL in 1972 and has since been enacted in 47 states. UMIFA was a pioneering statute, providing uniform and fundamental rules for the investment of funds held by charitable institutions and the expenditure of funds donated as "endowments" to those institutions. Those rules supported two general principles: 1) that assets would be invested prudently in diversified investments that sought growth as well as income, and 2) that appreciation of assets could prudently be spent for the purposes of any endowment fund held by a charitable institution. These two principles have been the twin lodestars of asset management for endowments since UMIFA became the law of the land in nearly all U.S. jurisdictions.

UPMIFA continues these fundamental principles as a needed upgrade of UMIFA. Both investment in assets and expenditure for charitable purposes have grown exponentially in the 35 years since UMIFA was drafted; asset management theory and practice have also advanced. UPMIFA, as an up-date and successor to UMIFA, establishes an even sounder and more unified basis for charitable fund management than UMIFA has done.

INVESTMENT

In 1972, UMIFA represented a revolutionary advance over prevailing practices which imposed upon endowments the limited investment opportunities available for managing trust assets – even endowments not organized as trusts. By stating the first prudent investor rule in statutory law, UMIFA allowed endowments to invest in any kind of assets, to pool endowment funds for investment purposes, and to delegate investment management to other persons (*e.g.*, professional investment advisors), as long as the governing board of the charitable institution exercised ordinary business care and prudence in making these decisions. A range of factors guided the exercise of prudence.

UPMIFA incorporates the experience gained in the last 35 years under UMIFA by providing even stronger guidance for investment management and enumerating a more exact set of rules for investing in a prudent manner. It requires investment "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." It requires prudence in incurring investment costs, authorizing "only costs that are appropriate and reasonable." Factors to be considered in investing are expanded to include, for example, the effects of inflation. UPMIFA emphasizes that investment decisions must be made in relation to the overall resources of the institution and its charitable purposes. No investment decision may be made in isolation, but must be made in light of the fund's entire portfolio, and as a part of an investment strategy "having risk and return objectives reasonably suited to the fund and to the institution." A charitable institution must diversify assets as an affirmative obligation unless "special circumstances" dictate otherwise. Assets must be reviewed within a reasonable time after they come into the possession of the institution in order to conform them to the investment strategy and objectives of the fund. Investment experts, whether in-house or hired for the purpose, are held to a standard of care consistent with that expertise.

UMIFA initiated the era of modern portfolio management for charitable institutions. UPMIFA provides the standards and guidelines that subsequent experience tells us are the most appropriate for the purpose. Charitable institutions will have more precise standards to guide them. Courts will have more precise standards with which to measure prudence in the event of a challenge. The result should be more money for programs supported by charitable funds, including endowments.

EXPENDITURE

UMIFA initiated the concept of total return expenditure of endowment assets for charitable program purposes, expressly permitting prudent expenditure of both appreciation and income and replacing the old trust law concept that only income (*e.g.*, interest and dividends) could be spent. Thus, asset growth and income could be appropriated for program purposes, subject to the rule that a fund could not be spent below "historic dollar value."

UPMIFA builds upon UMIFA's rule on appreciation, but it eliminates the concept of "historic dollar value." UPMIFA, instead, provides better guidance on prudence and makes the need for a floor on spending unnecessary. UPMIFA states that the institution "may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines to be prudent for the uses, benefits, purposes and duration for which the endowment fund is established." Seven criteria guide the institution in its yearly expenditure decisions: "1) duration and preservation of the endowment fund; 2) the purposes of the institution and the endowment fund; 3) general economic conditions; 4) effect of inflation or deflation; 5) the expected total return from income and the appreciation of investments; 6) other resources of the institution; and, 7) the investment policy of the institution." These standards mirror the standards that apply to investment decision-making, thus unifying both investment and expenditure decisions more concretely.

UPMIFA includes an optional provision that allows states to enact another kind of safeguard against excessive expenditure. If a state does not want to rely solely upon the rule of prudence provided in UPMIFA, the state may adopt a provision that creates a rebuttable presumption of imprudence if an institution expends an amount greater than seven percent of fair market value of a fund, calculated in an averaging formula over three years. While the seven percent rule is likely not to be necessary, it is available for those states that may be uncomfortable with the general standards.

RELEASE OR MODIFICATION OF RESTRICTIONS

UPMIFA recognizes and protects donor intent more broadly than UMIFA did, in part by providing a more comprehensive treatment of the modification of restrictions on charitable funds. Sometimes a restriction imposed by a donor becomes impracticable or wasteful or may impair the management of a fund. The donor may consent to release the restriction, if the donor is still alive and able to do so, but if the donor is not available the charity can ask for court approval of a modification of the restriction. The trust law doctrines of cy pres (modifying a purpose restriction) and deviation (modifying a management restriction) probably already apply to charitable funds held by nonprofit corporations. UPMIFA makes this clear. Under UMIFA, the only option with respect to a restriction was release of the restriction. UPMIFA instead authorizes a modification that a court determines to be in accordance with the donor's probable intention. If the charity asks for court approval of a modification, the charity must notify the state's chief charitable regulator and the regulator may participate in the proceeding.

UPMIFA adds a new provision that allows a charity to modify a restriction on a small (less than $25,000) and old (over 20 years old) fund without going to court. If a restriction has become impracticable or wasteful, the charity may notify the state charitable regulator, wait 60 days, and then, unless the regulator objects, modify the restriction in a manner consistent with the charitable purposes expressed in any documents that were part of the original gift.

CONCLUSION

UPMIFA reflects and incorporates the 35 years of experience that has accumulated under the original UMIFA. Rather than changing institutional investment or expenditure practices, it brings them up to date and unifies them across a broad range of charitable funds. The better charitable institutions manage investments and prudently control expenditures, the more money they should have for program purposes.

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