



THE STATE  
of **ALASKA**

GOVERNOR BILL WALKER

**Department of Revenue**

COMMISSIONER'S OFFICE

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February 14, 2018

The Honorable Les Gara  
Alaska State Representative  
State Capitol Room 515  
Juneau, AK 99801

Re: House Finance Amendments to HB 213

Dear Representative Gara:

You have asked for a brief memo explaining the amendments that the House Finance Committee made to HB 213, relating to the public school trust fund.

By way of brief background, the public school trust was established by the legislature in 1978. See AS 37.14.110-.170. The public school trust was a replacement for a territorial era public school land grant trust called the public school permanent fund. The intention of the legislature was to transfer the balance of the public school permanent fund on 6/30/1978 (approximately \$8.5 million) to the new public school trust, and replace the land grant as a source of income with a one-half percent dedication of revenue from state lands, including royalty interests. AS 37.14.150. The impact of this change was to substantially increase the revenues deposited into the trust.

When the public school trust was established in 1978, the legislature used a trust accounting structure that was common at the time: a principal and income trust. Deposits were treated as "principal," and investments of principal resulted in "income" in the form of cash interest and dividends. The principal was to be retained in perpetuity, and the cash receipts could be spent for public school purposes. See former AS 37.14.110 and .140. In 1988, the legislature amended the trust statute to clarify that capital gains and losses are to be retained in principal and not spent. AS 37.14.110 and .140.

Over the last half of the 20<sup>th</sup> century, experts in investment portfolio management and trust administration have considered some of the challenges experienced by principal and income trusts structured around the notion of "retain the principal, spend the cash." The primary challenge is that the investments of such a trust tend to be weighted to assets that generate cash receipts: dividend paying stocks and interest yielding bonds. But portfolios comprised of just these securities may suffer in two respects: they may be insufficiently diversified and they may not be sufficiently exposed to higher return asset classes such as growth equities. In other words, portfolios that focus primarily on cash generation may be inefficient--they potentially have higher risk and lower return. To respond to this challenge, experts in portfolio management began to promote the idea of a fully diversified "efficient" investment portfolio that seeks to

achieve a maximized level of return for a given level of acceptable risk. This is often referred to as “modern portfolio theory.”

In connection with the development of modern portfolio theory, trust administrators began to promote a new concept of trust expenditure. In lieu of spending only the cash generated by the trust, experts began to recommend spending some specified and sustainable percentage of the market value of the trust. This approach is sometimes referred to as the “percent of market value” (POMV) approach. The goal of the POMV distribution percentage is to preserve the inflation adjusted value of deposits to the trust, while maximizing the income paid out to beneficiaries. Administering a POMV trust is a continual balancing act between meeting the needs of today’s beneficiaries while preserving the inflation adjusted value of the trust so that the needs of future beneficiaries can also be met for an indefinite period of time.

Taken together, modern portfolio theory and the POMV approach form the foundation of modern trust administration practices.

To provide guidance in determining how much to spend, trust law experts developed the “prudent expenditure rule” which prescribes factors to evaluate to achieve the permanent duration of a trust while meeting the current and future needs of trust beneficiaries. See Uniform Law Commission, Uniform Prudent Management of Institutional Funds Act (codified at AS 13.65). Factors include consideration of macro-economic conditions, the purpose and duration of the fund, and expected returns. See, e.g., AS 13.65.020(a).

The House Finance amendments to HB 213 are intended to convert the public school trust from a principal and income trust to a modern POMV trust. The amendment does this by eliminating the statutory requirements to separately account for and maintain the distinction between principal and income. As follows:

- Adds AS 37.14.110(c) to the repealer clause, section 5. AS 37.14.110(c) is the statutory directive to account for the public school trust “in a manner that preserves the distinction between principal and income.” This change repeals AS 37.14.110(c).
- Deletes “in separate principal and income accounts for” from AS 37.14.160(2). Again, this eliminates the requirement to separately account for principal and income.
- Deletes “that distinguish between the principal and income of the fund” from AS 37.14.160(3). This too eliminates the requirement to separately account for principal and income.

Additionally, the amendment modifies the 4.75% POMV distribution language in the bill:

- Inserts “not more than” before the 4.75% POMV distribution language in section 3 of the bill. This means that the Department of Revenue can recommend expenditure of less than 4.75% of the average market value if circumstances suggest that a smaller distribution is prudent. In this regard, the Department of Revenue would implement the prudent expenditure rule discussed above.

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These changes, in conjunction with sections 2 and 3 of the bill (which establish the 4.75% POMV distribution percentage and 5 year average market value methodology), complete the conversion of the public school trust to a modern POMV trust fund.

The Department of Revenue would welcome the enactment of this legislation. Conversion to a modern POMV trust would enable the Treasury Division, which administers the investments of the public school trust, to adopt a new asset allocation more heavily weighted to equities. Over periods of time this should generate additional growth in the value of the trust fund, as well as additional income for the beneficiaries of the trust. If enacted in its current form, the Department of Revenue would additionally welcome the opportunity to implement the prudent expenditure rule in recommending to the Legislature what distribution percentage to apply under the "not more than 4.75%" clause in section 3 of the bill.

Sincerely,



Michael A. Barnhill

Deputy Commissioner

c: Sheldon Fisher, Commissioner

Genevieve Wojtusik

Rep. Justin Parish