THE STATE
of ALASKA
GOVERNOR BILL WALKER

Department of Revenue

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October 14, 2016

Senator Pete Kelly, Co-Chair, Senate Finance Committee
Senator Anna MacKinnon, Co-Chair, Senate Finance Committee
Representative Mark Neuman, Co-Chair, House Finance Committee
Representative Steve Thompson, Co-Chair, House Finance Committee
Alaska State Capitol
Juneau, AK 99801-1182

Dear Finance Committee Co-Chairs:

This letter is written in response to the intent language of HB 256 which directs the Department of Revenue, in consultation with the Alaska Permanent Fund Corporation (APFC), to evaluate and report to the Finance Committees on the potential consolidation of investment management responsibilities by October 15, 2016. KPMG was retained to assist in the evaluation of the benefits and potential risks of three merger scenarios, including simply transferring the Constitutional Budget Reserve Fund ("CBRF") to APFC and we have attached their findings to this letter.

The KPMG report outlines potential annual savings of up to $13.1 million by consolidating the two organizations under the Treasury Division and up to $9.7 million by consolidating under the APFC. However, after reviewing the findings we are not persuaded that the savings from consolidation are sufficient to outweigh the benefits of maintaining the two organizations based on the following observations:

Potential savings will result in a greater budget request from the general fund
The savings identified would reduce total costs but would have the effect of shifting costs to the funds managed at the Treasury, as the Treasury currently functions at a lower cost base (See Executive findings on page 5). This could in turn lead to greater funding from the general fund of up to $9.6 million.

Potential savings are relatively small in relation to the risk to returns
KPMG has noted in their report that even a modest impact on underlying returns could negate the cost savings of a merger under any scenario. While the cost savings are large in real dollar terms, they are a fraction of the annual returns and losses that the Permanent Fund and the PERS and TRS Trust Funds see each year. For example, the Permanent Fund's 1 percent return for FY16 produced $400 million in net income. The unique approach and specializations

of the two main pensions and the APFC funds have resulted in different annual gross returns, providing diversity of outcomes in the short-term. However, over time, the funds have been able to achieve similar results of between 8.79% and 9.17% over the last 32 years. Consolidation, as assessed in the report, could impact future returns as well as the net of costs performance of the individual funds being managed. Further, it is uncertain where the cost savings and liquidity costs would manifest as a result of the inherent tension between retirement trust fund return requirements and APFC expectations.

The largest target of potential savings is in conflict with the current direction of both organizations

The largest line item of savings, of $4.4-$7.7 million, focuses on reducing staff which conflicts with the Administration's support of both organizations' move to increase the in-house management of investments. In the last couple of years, investment and support staff have been added to the budgets of the Treasury and the APFC in order to capitalize on the experience and talent of staff locally to manage additional assets internally. While total personal services costs have increased, overall costs to the funds have already started to decrease as a result of these efforts. This will not only reduce total costs without cost shifting between funds, but it will also maintain economic value within Alaska as less money is paid to external managers located outside of Alaska.

The APFC was specifically separated from the Department of Revenue to prevent political pressure

When the Legislature created the APFC in 1980, its purpose was, according to the Free Conference Committee report, to move the Fund from the Department of Revenue to a public corporation where it would be protected from political influence. Although the Treasury manages funds, including the retirement trusts and the general fund, it was agreed that "the Permanent Fund, with its fundamentally different goals and large size, should not be in the hands of the same people whose primary duty is managing money for day-to-day use by the state." While the Legislature may wish to reverse its decision, it is important to remember the original intent of separating the two investment agencies.

Merging the APFC and the Treasury could impact the Permanent Fund's standing in the global investment community

The Fund's status as a sovereign wealth fund has allowed the Corporation to access relationships with similar funds around the world, access which is granted in part due to the APFC's perceived status as being separate from the interests of state government and the APFC Board's investment approach, which differs from that of public pension funds and better aligns with other sovereign wealth funds. The loss of these opportunities for knowledge sharing and joint investment that would likely occur if the APFC were no longer seen as separate from the Department of Revenue and could impact future earnings of the Fund.

Consolidation would diminish the diversity gained

When the APFC was separated from the Department of Revenue, the fiduciaries and staff built organizations around the differing directives and objectives of the funds under management. What resulted was unique specializations and the development of efficient, yet different operations for each organization. Efficiencies, such as pooled investment management at the Treasury and specializations, such as the APFC's direct Real estate investments have allowed each organization to achieve different risk/return metrics for the funds managed.

KPMG's assessment identified that the two organizations, although they may look similar at a high level, are indeed diversified against each other. In fact, even the 11 external investment managers the funds have in common have different mandates. Diversity through exposure to different investment experiences, leads to potential opportunities that would otherwise not be available as well as a larger collective knowledge base from which to grow.

Significant governing policies and legal requirements would need to be altered to effect consolidation

Although the assessment assumes that there would be no changes to the structure or function of the oversight boards of the organizations, to the extent that assets are commingled for investment purposes, there will be issues with the coordination of manager selection and asset class definitions among the three fiduciaries. Also not addressed is the legal ability to commingle assets of certain funds with other funds.

Loss of institutional knowledge

KPMG's assessment contemplates the reduction of long-term staff as well as the consolidation to one common custodian. This could lead to the loss of institutional knowledge and availability of historical custodial data, both valuable yet intangible aspects of operations.

The Administration considered the legislative intent as an opportunity in the current fiscal situation to review practices and determine whether potential synergies and savings exist between the Treasury and APFC. KPMG's review and assessment, although identifying cost savings through consolidation, was an analysis as of a single point in time. It did not consider the important issues outlined above or the current transition each organization is undertaking to reduce overall costs and improve net returns through internal investment management.

Having served as past and present fiduciaries of state funds, PERS and TRS Trust Funds and the Permanent Fund, we believe, particularly in this time of fiscal transition where investment income is the major source of State revenue, that the Treasury and APFC should remain as autonomous entities and work with their fiduciaries to determine how best to achieve appropriate overall net returns for the funds managed according to the risk appetite and cash needs of the funds. The other fiduciaries of the funds have already voiced opinions, through resolution or in board records supporting the benefits of remaining independent, along with a move toward internal investment management as a preferred method to reducing overall costs.

Although we do not believe the consolidation of the Treasury and APFC is prudent at this time, we find the work of KPMG to be validating and useful. The analysis identified that both organizations perform in different yet efficient manners, provided insight into the unique processes of each organization that may be able to be leveraged, and highlighted a number of areas that can be explored to achieve further efficiencies. The two agencies have already shared investment support resources and are committed to continuing to find ways share resources where appropriate and identify efficiencies and specializations to improve net returns of the funds under management.

We would be glad to discuss any questions you might have.

Sincerely,

Randall Hoffbeck
Commissioner
Alaska Department of Revenue

Angela M Rodell
CEO
Alaska Permanent Fund Corporation

Cc: The Honorable Bill Walker, Governor

Darwin Peterson, Legislative Director

Members, Alaska Permanent Fund Corporation Board of Trustees

Members, Alaska Retirement Management Board