HOUSE FINANCE COMMITTEE
February 12, 2002
1:41 PM

TAPE HFC 02 - 23, Side A
TAPE HFC 02 - 23, Side B
TAPE HFC 02 - 24, Side A

CALL TO ORDER

Co-Chair Mulder called the House Finance Committee meeting to order at 1:41 PM.

MEMBERS PRESENT

Representative Eldon Mulder, Co-Chair
Representative Bill Williams, Co-Chair
Representative Con Bunde, Vice-Chair
Representative Eric Croft
Representative Richard Foster
Representative John Harris
Representative Bill Hudson
Representative Ken Lancaster
Representative Carl Moses
Representative Jim Whitaker

MEMBERS ABSENT

Representative John Davies

ALSO PRESENT

Jim Sampson, Chair, Board of Trustees, Alaska Permanent Fund Corporation; Robert D. Storer, Executive Director, Alaska Permanent Fund Corporation; Allan Moore, Chief Investment Officer, Alaska Permanent Fund Corporation; Chris Phillips, Director of Finance, Alaska Permanent Fund Corporation; Michael O'Leary, Executive Vice-President, Callan Associates; Robert Maynard, Chief Investment Officer, State of Idaho Retirement System.

PRESENT VIA TELECONFERENCE

There were no teleconference participants.

GENERAL SUBJECT(S):

Alaska Permanent Fund Corporation
Capital Markets Outlook 2002

The following overview was taken in log note format. Tapes and handouts will be on file with the House Finance Committee through the 22nd Legislative Session, contact 465-

2156. After the 22nd Legislative Session they will be available through the Legislative Library at 465-3808.

| LOG | SPEAKER | DISCUSSION |
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| | **TAPE HFC 02 - 23 SIDE A** | **ALASKA PERMANENT FUND CORPORATION CAPITAL MARKETS OUTLOOK 2002** |
| 039 | JIM SAMPSON, CHAIR, BOARD OF TRUSTEES, ALASKA PERMANENT FUND CORPORATION | Introduced board members and others. |
| 301 | ROBERT D. STORER, EXECUTIVE DIRECTOR, ALASKA PERMANENT FUND CORPORATION | Introduced staff. |
| 339 | ALLAN MOORE, DIRECTOR OF FINANCE, ALASKA PERMANENT FUND CORPORATION | Discussed the capital market outlook. He noted that the Board annually sets an asset allocation policy. The Corporation's job is to monitor investments in respect to the policy. If the markets move beyond the ranges around their targets they will recommend to the Board that the portfolio be rebalanced. |
| 519 | Mr. Moore | Noted that their investments are on target. As of the end of January 2002, 34.4 percent of the Fund was in domestic fix income (target 35%) and non-US fixed income was at 2.5 percent or $600 million (the target is 2%). He noted that at the end of January 2002 there was $9.2 billion dollars in domestic stocks or 36.6 percent (target 37 percent). |
| 601 | Mr. Moore | Explained that corporate bonds are domestic fix income. |
| 615 | Mr. Storer | Explained that the portfolio is only in investment grade bonds. They do not hold high yield or junk bonds. |
| 628 | Mr. Moore | Observed that domestic stock is handled internally. Equity managers are external professionals that are hired under contract. |
| 645 | Mr. Moore | Observed that at the end of January there was just under $4 billion dollars in non-US equities or 15.8 percent (the target is 16 percent). There is a 10 percent real estate allocation. The actual market value at the end of January was 10.8 percent or $2.7 billion dollars. |
| 718 | Mr. Moore | Noted that the markets have been violently fluctuating. He pointed out that the numbers are close to their targets even after the turmoil. They had |

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| | | an opportunity, as reported in the quarterly report, to rebalance the Fund. Stocks had fallen far enough and bonds had performed well enough that they were further away from the target than is prudent. Under less turbulent times the dividend payout in the fall is so large that they use that occasion to rebalance. Selling assets that are not performing well pays dividends. The gyrations of the market were such that it needed an additional rebalancing. The markets have since behaved close to the targets. |
| 909 | Co-Chair Mulder | Ask if the goal percentage changed from the prior year? |
| 920 | Mr. Moore | Responded that they did not change from the previous year. Projects generally change slowly in order to not be influenced by what is happening in the short term. |
| 1009 | Representative Croft | Observed that real estate investments performed higher than the target. |
| 1112 | Mr. Moore | Acknowledged that real estate remained relatively stable and explained that their real estate allocation includes a sub allocation to the state investment trust securities, which performed well in comparison to other stocks. |
| 1139 | Chris Phillips, Director of Finance, Alaska Permanent Fund Corporation | Provided members with a handout: Financial Outlook for the Fund Growth and Income (copy on file). She explained that the statistics in the handout were based on December 31, 2001 numbers. |
| 1224 | Ms. Phillips | Observed that the total Fund is $24.8 billion dollars: containing principal and earnings reserve income. They are invested as one asset pool. |
| 1239 | Ms. Phillips | Observed that, at the end of December, there was $21.2 billion dollars in principal. In December 31, 2000, there was $20.2 billion dollars in principal. There has been an increase in principal of $1 billion dollars. She explained that $700 million dollars of this was the result of legislative inflation proofing. This amount was transferred from the Earnings Reserve Account to the principal. The rest of the increase came from additional mineral revenue. |
| 1299 | Ms. Phillips | Noted that the Earning Reserve Account moved from $6 billion dollars [FY00] to $3.6 billion dollars [FY01]. She explained that the loss was the result of |

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| | | inflation proofing, dividends and a $600 million dollar loss in the market. |
| 1402 | Vice-Chair Bunde | Observed that there was a $3 billion dollars loss over the past year. The largest general fund appropriation made by the state is for the permanent fund dividend. |
| 1500 | Ms. Phillips | Clarified that the permanent fund dividend payout was 1.1 billion dollars. |
| 1509 | Ms. Phillips | Discussed page 3 of the handout. She observed that $7.2 billion dollars of the principal has come from dedicated oil revenues, $6.9 has come through legislative inflation proofing and $7.1 from special appropriations by the legislature. She concluded that 66 percent of the Fund has come from legislative appropriations. |
| 1604 | Ms. Phillips | Explained that the Earnings Reserve Account is divided between realized and unrealized income. This represents undistributed accumulated income. She discussed unrealized income. When an asset is sold a realized gain or loss is recorded on the sale. All income ends up in the Earnings Reserve Account. |
| 1653 | Co-Chair Mulder | Pointed out that on July 1, 2001 there was $1.9 billion in realized income and $200 thousand dollars in unrealized gains. There has been a gain in the 6-month time frame. |
| 1830 | Co-Chair Mulder | Observed that there will be another $700 million dollar transfer for inflation proofing and close to an $1 billion dollar payout for dividends. He noted that funds from the Earnings Reserve Account pays inflation proofing and dividends. |
| 1904 | Representative Whitaker | Observed that the Earnings Reserve Account is the shock absorber for the entire fund. |
| 1926 | Co-Chair Williams | Noted that the legislature has taken this funding and placed it into the corpus of the fund. The legislature has added $6.9 for inflation proofing and $7.1 from special appropriations. |
| 1951 | Ms. Phillips | Reviewed projects for the next 5 fiscal years. She observed that if the Fund continues in its current form that there is a 50 percent probability that the it would be $27.7 - $36.6 billion dollars [after five years]. The median is $31.9 billion dollars for the entire fund in |

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| | | FY07. |
| 2206 | Co-Chair Mulder | Observed that the December 2001 OMB budget forecast was derived from the median case. |
| 2226 | Ms. Phillips | Clarified that actual December 31, 2001 values were used in their handout. |
| 2240 | Mr. Storer | Explained that the numbers were the median of July 30, 2001. Figures have been revised down. |
| 2303 | Ms. Phillips | Pointed out that the principal component variation is slight. Values are narrow and predictable. The inflation rate tends to move in small increments from year to year. The probable variation for FY02 is only $1.5 billion dollars. |
| 2424 | Co-Chair Mulder | Observed that the predicted increase to the principal is the same amount as the inflation proofing. |
| 2437 | Ms. Phillips | Explained that the inflation rate has come down to 2.83 percent ($600 million dollars). Mineral revenues are $200 million dollars. The total is $800 thousand dollars. |
| 2447 | Co-Chair Mulder | Noted that they do not expect future large gains in the Permanent Fund. |
| 2504 | Ms. Phillips | Observed that the Earnings Reserve Fund represents accumulated undistributed earnings: realized and unrealized earnings. It will absorb the market volatility for both the earnings reserve and principal. As income is collected it is reinvested. Any volatility is reflected. |
| 2556 | Representative Croft | Clarified that figures on pages 6 and 7 assume the statutory amount. |
| 2624 | Ms. Phillips | Pointed out that the Corporation tried to communicate that the bull market was unsustainable. The affect of the bear market is being demonstrated. |
| 2653 | Co-Chair Mulder | Questioned when did they see the bear market and how long is it expected to last. |
| 2712 | Mr. Storer | Noted that the bear market started about 2 years ago. |
| 2730 | Co-Chair Mulder | Constitutionally required deposits from oil revenues should be approximately $200 million dollars. |
| 2749 | Ms. Phillips | Noted that $100 million dollars of this amount had been realized. |
| 2821 | Ms. Phillips | Explained that there is some volatility projected in the inflation-proofing rate of the principal. |

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| 2828 | Mr. Storer | Interjected that there are times when there would be insufficient income to met needs for payout and inflation proofing. Income accrued from prior years may be used. |
| 2912 | Vice-Chair Bunde | Observed that inflation proofing can be looked at from two points of views: (1) inflation proof for our grandchildren or (2) not be the miser that dies with all the money in the bank. He questioned how they would respond to each point of view. |
| 3016 | Mr. Storer | Observed that the maximum payout that can be paid and sustained to meet the entire obligation for the future generations is 5 percent. A higher percentage would recognize the current need, but not the future. If the payout were 3 – 3.5 percent the current generation would receive less and the future more. It is a policy decision. |
| 3125 | Vice-Chair Bunde | Pointed out that it is a dialog that must be engaged in with the public. |
| 3138 | Ms. Phillips | Reviewed page 8 of the handout: range of annual statutory net income. Statutory net income is the cash received from dividends, bonds, interest, real estate and gains or losses on the sale of an asset. The appreciated asset is not changed until actually sold. They expected $1 billion dollars in net income for this year. Now it looks like $800 million dollars. If they do not receive $800 million dollars they would have to dip into the earnings reserve. |
| 3321 | Representative Hudson | Noted that the reserve would have to be dipped into, which is currently $3.6 billion dollars. If the payout is greater than the income the difference will come from the Reserve Account. He pointed out that the account was over $6 billion dollars in FY01. |
| 3421 | Ms. Phillips | Observed that between FY92 - FY00 statutory net income was $2 - $2.5 a year. Now it is $1 billion - $800 million dollars. |
| 3438 | Ms. Phillips | Reviewed the range of distributed income. The dividend is calculated at the Division. The transfer is calculated at the Corporation and is based on 10.5 percent on the last 5 year's statutory net income. |
| 3518 | Representative Croft | Clarified that the distributed income is the amount that is transferred to be |

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| | | distributed. It comes before inflation proofing. The transfer occurs on paper. It stays invested. |
| 3625 | Ms. Phillips | Discussed projections of the lump sum distribution amount, which is lower for the next few years. It is expected to come down to between $850 and $1,550 by FY05. |
| 3809 | Representative Lancaster | Asked the percentage of growth. |
| 3816 | Ms. Phillips | Noted that the current return is expected at 4 percent. The capital markets in the future would result in a total return of 7.95 percent and a realized return of 6.60 percent. The population growth used in the model is 1.5 percent. |
| 3829 | Ms. Phillips | Observed that their financial statements are reported on their website along with other information. |
| 3911 | Vice-Chair Bunde | Noted that there has been editorials suggesting that the dividend should be taxed at 20 percent. He expressed concern regarding the view of the IRS. |
| 4001 | Mr. Storer | Observed that the Permanent Fund is not deemed as taxable since it could be used for a governmental purpose. If it were used for another purpose the tax status could be at risk. He stated that he could not comment on the tax implications. |
| 4136 | Co-Chair Mulder | Observed that there has been a protracted bear market he questioned how long it has to go before the "other half of the dividend equation kicks in". |
| 4206 | Mr. Storer | Observed models for the next 2 years did not show the Earnings Reserve Fund kicking in. |
| 4249 | Co-Chair Mulder | Observed that a graph was developed in 1999 showing the "do nothing" course on the dividend. He recalled that the dividend would drop to about $400 dollars. He asked if the drop would occur sooner since no action had been taken. |
| 4357 | Mr. Storer | Agreed and explained that the time frame would be shortened since the bear market has lessened the fund. As assets are liquidated to met funding needs the impact is for dramatically lower dividends in the out years. |
| 4507 | Co-Chair Mulder | Noted that to drive the payouts some of the assets are liquidated. The net assets continue to dwindle. He asked for a model with standard assumptions. |

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| | **TAPE HFC 02 - 23, Side B** | |
| 4618 | Representative Hudson | Observed that there is nowhere to go except into the Earnings Reserve Fund unless a 15 – 20 percent income tax was enacted. He noted that the median range on page 9 that would go into the dividends. He observed that legislation, which split the income to pay 50 percent to the state government, would reduce the dividend amount by half. |
| 4236 | Ms. Phillips | Observed that the range of distributed income is calculated before inflation proofing. If the amount is not sufficient to cover inflation proofing and dividends they would use the Earnings Reserve, which they anticipate doing in the current year. |
| 4202 | Representative Hudson | Stressed that with a billion dollar shortage the state will have to choose between funding education, roads or dividends. |
| 4054 | Co-Chair Mulder | Noted that the governor's income tax would be 20 percent. |
| 4034 | Representative Hudson | Clarified that the Governor's proposal is 20 percent of the federal tax paid, not the adjusted gross income. He pointed out that it would be half the level of taxes previously collected by the state. |
| 4011 | MICHAEL O'LEARY, EXECUTIVE VICE-PRESIDENT, CALLAN ASSOCIATES | Discussed the 2002 Capital Market Outlook. Observed that 2000-2001 have been a remarkable (and painful) run for the U.S. Technology and dot-com bubble burst. The NASDAQ decline has been one of the worst on record. The Fed has been accommodating especially after the terrorist attacks, ensuing war, and broken confidence. The NASDAQ is off 57.2%. The Fed cut interest rates 11 times (4.75%), the steepest cut in history. Interest rates are near a 40-year low. Much-touted federal surplus sighted in fiscal 2000, only to disappear again in the current fiscal year. |
| 3629 | Mr. O'Leary | Explained that the U.S. economy officially peaked in March 2001, thus entering recession in the second quarter of the year. Observed that Christmas may have been merrier than expected, and data suggest a fourth quarter growth rate near zero. The recession may already be technically over. The consumer has spent a lot of money during the recession. |

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| 3532 | Mr. O'Leary | Observed that the slow down has occurred around the world and that the world is looking to the U.S. to lead them out. |
| 3455 | Mr. O'Leary | Reviewed Page 7 of his handout: 2002 Capital Market Outlook (copy on file.) In the real economy the recession has not appeared particularly severe. Unemployment rates have not been out of line with the past but are expected to rise. |
| 3352 | Representative Lancaster | Asked if the unemployment rate reflects adequately the results of layoffs from 9/11/01. |
| 3327 | Mr. O'Leary | Felt that the rate could be off due to a lack of filling by discouraged people. |
| 3259 | Mr. O'Leary | Observed that there has been a stronger banking system and a more balanced real estate markets. There were also a stronger fiscal and monetary policy response. |
| 3134 | Co-Chair Mulder | Noted that confidence has returned. |
| 3055 | Mr. O'Leary | Agreed that confidence is returning but pointed out that the downturn was strong. He thought that the uncertainty from ENRON has affected investor confidence. |
| 2952 | Vice-Chair Bunde | Asked why there was an inverse relationship between savings and wealth or income. |
| 2919 | Mr. O'Leary | Explained problems, which occur in measuring savings. Homes and retirement assets can continue to grow through appreciation. |
| 2848 | Mr. O'Leary | Pointed out that consumer debt is high. Consumers have taken advantage of refinancing and low interest rates. |
| 2808 | Co-Chair Mulder | Noted that those that have stretched their resources in order to continue their standard of living will have slowed recovery because their options would be more limited. He concluded that the ability for an accelerated recovery is reduced. |
| 2756 | Mr. O'Leary | If consumers had entrenched and increased savings, then when the economy improved they would have the power to accelerate recovery. The recovery will turn on consumer income growing and the confidence to spend. |
| 2635 | Mr. O'Leary | Reviewed page 14: Inflation Will Decelerate as the Economy Softens. He observed that from FY00 to FY01, core inflation, which does not contain the |

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| | | volatile items, rose. Energy costs are contained in the CPI, but not in the core. |
| 2511 | Mr. O'Leary | He explained that a long-range estimate for inflation is developed when the capital market forecast is developed. Last year they estimated 3.25 percent. This year the estimate has been reduced to 2.9 percent, because they did not expect the terrorist attack and a greater weakness in the economy. |
| 2411 | Mr. O'Leary | Clarified that the CPI is a federal government statistic that encompasses the entire U.S. He observed that 1999 was the last full year of the bull market. He reviewed the fall of stock prices since 1999. Smaller companies did better than large companies. He concluded that there was an overvaluation in the mega companies, especially in high growth areas. The NASDAQ had more extreme motion up and down. |
| 2223 | Co-Chair Mulder | Questioned the break point for small cap companies. |
| 2211 | Mr. O'Leary | Explained that the size of the market value of the company is used for determining the category. |
| 2120 | Mr. O'Leary | Pointed out that much of the bull market trend made it into the big companies. He stressed the importance of being well diversified. |
| 1950 | Co-Chair Mulder | Questioned if most of Alaska's public trade companies are small cap. |
| 1934 | Mr. Storer | Noted that there are several large companies in the state of Alaska. |
| 1854 | Mr. O'Leary | Reviewed page 24. He noted that it shows the yield to maturity for a bond index. The index is a good indication of the yield. He explained that the assumption is that bonds will be held to maturity and that the income would be reinvested at the same rate. The yield at the beginning of 2001 was 6.25 percent; at 9/11/01 they were at 5.60; and after 9/11/01 they plummeted to 4.75 [11/7/01]. Interest rates for a bond portfolio were below 5 percent. They have returned to the 9/10/01 level. |
| 1550 | Mr. O'Leary | Reviewed page 25. He noted that the 5-year return rate was 20 percent between 1981 and 1986. Through the 90's bonds returned less than 10 percent per year and more recently less than 8 percent. |

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| | | The expected bond return for the next five years is 5.575 percent, which is less than it has earned over the previous five years. This is a third of the portfolio. |
| 1306 | Mr. O’Leary | Noted that the SP 500 is projected at a 9 percent return. Last year it was 8.9 percent. The inflation number was reduced. The bond return expectation has been reduced. We are closer to recovery. The market has substantially declined. |
| 1134 | Mr. O’Leary | He noted that they developed three sets of estimates based on asset classes (contained on page 29). |
| 945 | Mr. O’Leary | Reviewed page 30. He noted that the return versus risk ratio has increased. |
| 801 | Mr. O’Leary | Discussed page 31. He noted that nothing is targeted for short-term investments. The rate of return is 7.95 percent, which is lower than what was expected last year because of the low bond rate of return. |
| 621 | Mr. O’Leary | Reviewed mixes of investment options on page 32. He concluded that there is no reason for a substantial change in policy. |
| 505 | Mr. Storer | Observed that inflation is also lower. The real rate of return is the same as in prior years [5 percent]. |
| 433 | Mr. O’Leary | If more than 5 percent of the value of the portfolio is spent it is difficult to maintain the purchase power of the corpus. |
| 408 | Co-Chair Mulder | Summarized that the computer model does not do a good job with the subjective factors. |
| 338 | Mr. O’Leary | Pointed out that the results have always been within the range. He stressed that there is an equal possibility that anything in the range could happen. Overtime the range narrows because the probability of having subsequent bad years over many years is reduced. He stressed that the bear market was within the range of possibilities. |
| 154 | Co-Chair Mulder | Acknowledged that the money that was lost in real value translated to the risk factor. He stressed that there is a subjective art to forecasts other than computer analysis. |
| 105 | Mr. O’Leary | Agreed that computer models suggest a level of precision that does not exist. |
| | **TAPE HFC 02 - 24,** | |

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| 005 | Representative Whitaker | Noted that bonds and real estate are providing a lower rate of return. He asked why real estate was affected. |
| 011 | Mr. O'Leary | Explained that real estate values reflect low bond expectations. People price to earn a premium in relation to bonds. It is a tougher environment. |
| 424 | ROBERT MAYNARD, CHIEF INVESTMENT OFFICER, STATE OF IDAHO RETIREMENT SYSTEM | Stated that projections are accurate over a 5-year period. Accuracy increases with longer time periods. |
| 809 | JERROLD MITCHELL, CHIEF INVESTMENT OFFICER, STATE OF MASSACHUSETTS | Referred to Page 32. He observed that number 4 is the same asset allocation used by the state of Massachusetts. |
| 822 | ALLAN BUFFERD, TREASURE, MASSACHUSETTS INSTITUTE OF TECHONOLOGY | Spoke to the question of inflation proofing a $25 billion dollar fund. He observed that with a 3 percent inflation rate, in 24 years you would need $50 billion dollars to have the same purchasing power. If inflation protection is not provided the purchasing power would be cut in half in a relatively short time. He explained that volatility is 11 percent. The range of return could be –3 to +20 and would be observed 65 percent of the time. |
| 1110 | Co-Chair Mulder | Explained that the Fund would only be $14 billion dollars if there had not been legislative appropriations. |
| 1210 | Mr. Bufferd | Stressed that the question is political in regards to the people's expectations. |
| 1245 | Vice-Chair Bunde | Asked if the parents should sacrifice so that the children don't have to work. |
| 1339 | Representative Hudson | Questioned the advantage of using percent of market value. |
| 1412 | Mr. O'Leary | Explained that a reasonable level of maximum expenditures and consistency of distributions, and discipline in the process would be the benefit of a percent of distribution policy. |
| 1517 | Representative Hudson | Questioned the opportunity to invest for higher return. |
| 1543 | Mr. Mitchell | Noted that the percent of market value does not prevent taking a three year average to smooth the amount. He stressed that the major advantage is greater transparency to what the fund is doing and why. It is easier to relate investment policy to spending priorities |

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| | | of the legislature and for the legislature to track what is going on and have better projections. |
| 1728 | Mr. Bufferd | Explained that the current structure, which is based on the concept of trust law for the definition of income, drives a behavior pattern in terms of generating income for the payout requirement. There is a tendency to invest where there are dividend and interest payments and to take realized gains. The total return approach does not care about the character of appreciation in the fund. The measure is in terms of the totality of the fund. |
| 1837 | Co-Chair Mulder | Asked what happens to the future of the dividend if we do nothing. He questioned if no action toward increasing revenues and closing the fiscal gap would result in a dramatic affect to permanent fund dividends within 3 – 4 years. |
| 1918 | Mr. Storer | Responded that it would draw down on the fund to the point where there would be no dividend. The Fund would be drawn down to the principal within 4 – 8 years. |
| 2025 | Representative Croft | Noted that there is a tendency to use the capital market forecast as a function of price earnings as opposed to the underlying value or what the economy is doing. He questioned if it is a function of the 401K markets. |
| 2057 | Mr. O’Leary | Explained that supply is a function of demand. The level of household investment in the stock market increased dramatically in the 90’s. The height of equity investment in retirement contribution plan was reached simultaneously with the market peak. Many people did not derive the benefit of the strong market but invested at the top. |
| 2223 | Mr. Bufferd | Noted that prices move only when there is another buyer. The market fell and institutionalized investors returned. |
| 2322 | Co-Chair Williams | Noted that the legislature has been working on a fiscal plan since 1998. He observed that there are those that do not think there is a problem. |
| 2553 | Mr. Bufferd | Stressed that the use of the earnings of the Permanent Fund after inflation proofing is clearly a decision of the state of Alaska. |
| 2689 | Mr. Maynard | Noted that the state of Alaska was been in similar position in 1985. He stressed |

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| | | that given the asset allocation of the Fund; there cannot be an expectation to make more than 5 percent above inflation over a 5 - 10 period. Decisions that would use above 5% should be considered as dipping into the purchasing power of the Fund for future generations. |
| | ADJOURNMENT | The meeting was adjourned at 3:45 PM |