

SENATE FINANCE COMMITTEE
LOG NOTES
01/12/01

GENERAL SUBJECT(S): Alaska Permanent Fund Corporation

The following overview was taken in log note format. Tapes and handouts will be on file with the Senate Finance Committee through the 22nd Legislative Session, contact 465-4935. After the 22nd Legislative session they will be available through the Legislative Library at 465-3808.

Time Meeting Convened: 9:04 a.m.

Tape(s): SFC-01 # 2, SIDE A & B

	PRESENT:
X	Senator Donley
X	Senator Kelly
	Senator Austerman
X	Senator Green
X	Senator Hoffman
X	Senator Leman
X	Senator Olsen
X	Senator Ward
X	Senator Wilken

ALSO PRESENT:
CLARK GRUENING, CHAIR, BOARD OF TRUSTEES, ALASKA PERMANENT FUND CORPORATION
ROBERT D. STORER, EXECUTIVE DIRECTOR, ALASKA PERMANENT FUND CORPORATION
JIM KELLY, DIRECTOR OF COMMUNICATION, ALASKA PERMANENT FUND CORPORATION

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LOG	SPEAKER	DISCUSSION
001	Co-Chair Donley	<p>Introductions</p> <p>Purpose: Overview from Alaska Permanent Fund</p> <p>Schedule for the House Finance Committee</p> <p>Suggested that those seeking to Chair subcommittees should attend House meetings.</p>
034	Clark Gruening, Chair, Board of Trustees, Alaska Permanent Fund Corporation	<p>Introduced Robert Storer, Executive Director and Jim Kelly, Director of Communication.</p> <p>What we are going to do today is follow through on the handouts. Jim Kelly is going to talk about the mechanics and Robert Storer is going to touch on investment principles and performance.</p>
067	Jim Kelly, Director of Communication, Alaska Permanent Fund Corporation	<p>Good idea to revisit the fundamentals. Hit the fundamentals of how the fund works.</p> <p>Page 2: Permanent Fund Market Value</p> <p>Two parts to the permanent fund: the principle and the income.</p> <p>Total fund: \$26.7 billion</p> <p>Principle has three parts. The principle is a number that represents the appropriations and deposits into that account. Dedicated oil revenues, inflation proofing and the special deposits. The principle cannot be spent.</p> <p>Page 3: Permanent Fund Income. There are two parts: realized and unrealized. As provided by law all the income from the permanent fund investments is deposited into the earnings reserve account. The interests that are earned on the bonds, the dividends that Alaskans reserve from the stock investments, cash flow that permanent fund generates and the appreciation or depreciation in the value of all those assets. There has been \$23.5 billion generated since the inception of the fund. In simple terms the fund is here for current and future generations. The legislature put in two provisions for dividends and inflation proofing: one to pay dividends and second the amount to offset the effect of inflation, which is to be transferred.</p> <p>The dividend calculation. Formula set in</p>

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		<p>law by the legislature. The formula says that we are to figure out what is one-half of 21 percent of the net income of the fund over the last five years. If that number is larger than what is in the earnings reserve account the formula says that we will pay out half of what is in the earnings reserve account.</p> <p>Page 5: Income paid out for dividends. Interesting, the dramatic increase in the amount of money that has been transferred, because of the booming stock markets. Eight or nine years before, 4 to 6 million dollars were paid out for almost a decade. We are a little bit above the trend line. Inflation proofing the board has cared about for a long time. There is a formula. It is set up by statute. Only applies to the principle. What we are saying is that the fund lost \$675 million in value in the last year to rising prices. To combat that the legislature has transferred that money from the earnings reserve account to the principle.</p> <p>Page 6: Chart shows statutory income vs. state oil reserve. History: oil has a lot of volatility although the direction is plain and some volatility, but less in the fund income. Looking forward: the gold bars represent 63 billion dollars of income that the permanent fund will produce over the next 20 years. Permanent Fund Projections Chart pointed out the current year, FY 2001, and the total fund balance. We are actually going to have to draw down money from the earnings reserve account to meet the two statutory requirements this year.</p>
255		<p>Page 7: One caveat about the future. \$63 billion of income that you can expect the fund to earn over the next 20 years may be more and may be less.</p>
261	<p>Robert Storer, Executive Director, Alaska Permanent Fund Corporation</p>	<p>Principle #1: Diversification When we create a portfolio it is well diversified. We want to meet a goal of investing for the long-term while maximizing that return within the levels of risk tolerance. To do that we spend a lot</p>

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		<p>of time on due diligence. Spend a lot of time evaluating the market. We are now a mature fund. We invest for the long-term and it is important to be patient. We are experiencing short-term volatility. We must balance the income between current and future generations. We do have a significant payout to current generations. Page 8: Time series; Holding Period vs. Average Annual Return. Know short-term volatility is a part of the process. He referenced to different financial analysts publications with regards to short-term and long-term risk. We recognize that there is interim volatility, but construct a portfolio with long-term. Risk tolerance chart comparing different portfolios: bold, somewhat bold, somewhat timid and timid. The permanent fund portfolio is in the middle ground with 53 percent in equities, 38 percent bonds and the rest in real estate. Important point is staying power. Short-term is going to have volatility. Have to have a well thought out portfolio construction and recognize that you will be challenged, but you must stay the course.</p>
367	Mr. Gruening	<p>We recently discussed the idea of value and growth. Stocks are booming want to chase that return. We have taken good advice on keeping a balance.</p>
371	Mr. Storer	<p>We not only diversify among asset classes, but among styles. In equity there are two; one is growth and the other is value. Growth manager will have a more aggressive portfolio. Value manager will have lower volatility, older companies that are slightly out of favor. Growth out performed value by 20 percent. Tendency is to gravitate to the current higher earnings. Trying to diversify styles, because sometimes growth does better and sometimes value does better. In the calendar 2000 we are finding that value is doing significantly better than growth in the .com stocks. Discipline within the asset class has assisted the permanent fund</p>

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		through this period of increased volatility.
395	Senator Hoffman	In the stocks do you differentiate between the .com stocks and the NASDAQ stocks.
398	Mr. Storer	<p>We do evaluate the more aggressive stocks. Part of the balance in constructing the permanent fund portfolio is the recognition that we want more protection on the down side. Reducing volatility as much as possible. Will not find permanent fund investing in .com stocks. Managers are instructed to invest with quality companies with proven earnings. While our returns have not been great we also have not suffered, because we have not chased those speculative stocks.</p> <p>Page 9: Year 2000 capital market assumptions. We look at the respective asset classes that were invested in and the expected return over a five-year time horizon. We know there is volatility, so what you see here is a median expected return of each asset class. Smaller companies are a bit more volatile. We define risk as volatility. It is well diversified. The chances of losing money in a specific company are really non-existent. We measure volatility by standard deviation. One other piece; how do they correlate. How do they interact in the different financial markets. Then we start a portfolio. We have about a 25 percent chance of a negative return in a single year, but over longer term, if we are disciplined, we will make higher return. Don't want to abandon that discipline.</p>
455	Co-chair Kelly	What would a more aggressive portfolio anticipate for their overall return.
459	Mr. Storer	On average most of the funds our size probably have an asset allocation of 60 to 70 percent in the equity market, so they are accepting far more interim volatility. Most of our piers are retirement plans with a funding ratio that they be under funded,

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		<p>imbedded in that is probably an expected return are 8 or 9 percent. There chances of a negative return in a single year probably, conceptual number, 30 to 35 percent.</p> <p>Page 10: Target Asset Allocation Domestic Equities and International Equities. We want to have a discipline that tells us when to rebalance in some systematic way. We don't want high turnover. Domestic equities and international equities make up the total equities, domestic bonds and non-dollar bonds make up the total bonds and then there is total real estate. We don't invest in "junk bonds". 38 percent of the portfolio is in fixed income, non-U.S. fixed income is 2 percent, U.S. equities is 33 percent, non-U.S. equities is 16 percent, real estate is 10 percent, Alaska CDs 1 percent.</p>
503	Senator Hoffman	The legislature gave the fund the authority to invest in international equities. How has that been according to what you have projected the earnings to be.
506	Mr. Storer	<p>It has gone very well. Over that time period 11.5 percent has been earned on international equities. It has paled in comparison to the U.S. equity market, although we have earned well above what expected. Very diversified.</p> <p>Page 11: Fund's long-term average annual total returns; chart comparison. Changes in the Fund's annual market value.</p> <p>Page 12: Volatility. Drop in October is due to dividend payout. The second chart is on permanent fund's total return (actual and projected).</p>
549	Senator Wilken	Talk about how you have used the basket provision.
	Co-Chair Kelly	Re-explain basket provision
553	Mr. Storer	We have a statutory list of what we may invest in. The legislature approved HB 156, Basket clause, which allowed the fund to use 5 percent of the portfolio following the prudent investor rule to invest in asset classes that do not fall within the statutory list. Noted early that we are a

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		very mature fund and due diligence is a very important part of what we do. The board did a very thorough study investigating private equity. It is really a clause to help us look at sophisticated investment vehicles and those take time.
572	Co-Chair Donley	Overview of why you are introducing that legislation.
576	Mr. Gruening	Page 13: Three objectives. See that the fund's purchasing power is preserved. If you are going to maximize distributions over the long-term you have to have inflation proofing. Minimizing fluctuations in annual payouts.
589	SIDE B	
589	Mr. Gruening	<p>QUOTE "Inflation is like a thief in the night. It steals from you silently and nobody knows what's being done." Inflation proofing came about. Looking at the long-term we've been blessed by healthy markets and high oil revenues, but looking down the road the best approach was a limit based on long-term research of a payout of market value. Our proposal is to limit a five percent of a five-year average of the market value of the fund. It does not require any changes in the statutes and it would not affect the payout of the dividend, but it establishes a limit on the payouts, which gives strength to the term "permanent".</p> <p>Page 14: Allowing the trustees to be removed only for cause. It is a provision that exists in the statutes that relate to the pension fund. It gives the kind of continuity that is necessary for preserving the course in investments and allowing the board to function well.</p>
564	Mr. Storer	Something I've observed and an important issue. This is a very mature and sophisticated fund and takes a while to educate you on those responsibilities. A very important issue is ensuring the continuity in how decisions are being made. Long-term investment issue. Very important that something is in place that ensures the continuity of the education and institutional memory of the decisions that

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		have been made.
552	Co-Chair Donley	Current cycle of turnover? There are staggered terms?
548	Mr. Gruening	It is one every year. The board consists of six members. Two are commissioners and the other four are public and they serve a staggered term. Essentially any Governor has the opportunity to replace half the board within the first year. Our desire is to put ourselves on par with pension funds. You still have rollover, but it was not until recently that we have such large rollovers. Something we think the legislature should look at.
539	Co-Chair Donley	This year ballot measure 3: New Governor would have to have a reason to replace someone on the board.
535	Senator Wilken	Comment: Sometimes there are folks that want to make you feel guilty that you have \$\$\$ in the bank. Only state in the nation that have this discussion. Others would long to be seated at this table. Humble by the responsibility. Proud of this report.
525	Senator Hoffman	Back to Page 6. In the past the most important figure to the public was the amount of the dividend. Why is that figure not put under the projections today?
517	Mr. Gruening	One comment. Different division deal with the dividend. Revenue calculated based on population.
512	Mr. Kelly	We have provided that number, but as a general rule we don't. The millions of dollars that are transferred that we know about. We assume a number.
508	Senator Hoffman	But to the average Alaskan that is the most important figure of all.
	Mr. Gruening	Get asked about it a lot.
505	Co-Chair Donley	Follow up on Senator Wilken's remark. Page 2 of the handout. It is quite phenomenal that 66 percent of the current principle of the dividend has been by special appropriation action of the legislature.
497	Mr. Kelly	We ought to invite the politicians from Washington up here, because it is not necessary to spend every dime that is on the table and here in Alaska we have done a good job of not doing that.
491	Co-Chair Donley	Thank you for joining us today. Adjourned

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		at 10:00 a.m.
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