

**MINUTES**  
**SENATE FINANCE COMMITTEE**  
**February 12, 2003**  
**9:06 AM**

**TAPES**

SFC-03 # 3, Side A  
SFC 03 # 3, Side B

**CALL TO ORDER**

Co-Chair Gary Wilken convened the meeting at approximately 9:06 AM.

**PRESENT**

Senator Lyda Green, Co-Chair  
Senator Gary Wilken, Co-Chair  
Senator Con Bunde  
Senator Ben Stevens  
Senator Lyman Hoffman  
Senator Donny Olson

**Also Attending:** SENATOR JOHN COWDERY; SENATOR FRED DYSON; SENATOR HOLLIS FRENCH; SENATOR ROBIN TAYLOR; SENATOR THOMAS WAGONER; ROBERT D. STORER, Executive Director, Alaska Permanent Fund Corporation, Department of Revenue; ERIC E. WOHLFORTH, Chair, Alaska Permanent Fund Board of Trustees; CLARK GRUENING, Vice Chair, Alaska Permanent Fund Board of Trustees; CARL BRADY, Member, Alaska Permanent Fund Board of Trustees; WILLIAM A. CORBUS, Commissioner Elect, Department of Revenue and Member, Alaska Permanent Fund Board of Trustees; MICHAEL J. O'LEARY CFA, Executive Vice President, Callan Associates Inc.; CHRIS PHILLIPS, Director of Finance, Alaska Permanent Fund Corporation, Department of Revenue

**Attending via Teleconference:** There were no teleconference participants.

**SUMMARY INFORMATION**

The Committee heard an overview from the Permanent Fund Corporation regarding the Fund's current and projected financial status.

Presentation by the Permanent Fund Corporation Board of Trustees

Co-Chair Wilken informed the Committee that the Alaska Permanent Fund Corporation's presentation would include an introduction of its Board of Trustees, a general update on issues being addressed by the Corporation, a capital market outlook, and a financial forecast for fund growth and income.

ROBERT D. STORER, Executive Director, Alaska Permanent Fund Corporation introduced Eric Wolfforth who is serving a second term as Chair of the Alaska Permanent Fund Corporation Board of Trustees.

ERIC WOHLFORTH, Chair, Alaska Permanent Fund Corporation Board of Trustees, acknowledged Clark Gruening, Carl Brady, and William Corbus as members of the Permanent Fund Corporation Board of Trustees who were in attendance. He mentioned that other attendees include Bob Maynard and Allen Bufford, who, as members of the Fund's Council of Advisors, provide a professional "outside look and a critical look" as to how the Fund is performing. He noted that today's presentation would be conducted by Michael O'Leary, senior officer of Callan Associates, a consulting firm that reviews and advises on the activities of the Fund's managers and the Fund's internal investment strategies.

Mr. Storer informed the Committee that, in addition to generating a five-year financial forecast based on market conditions, Callan Associates performs an annual review of the Fund's capital markets and asset allocations. He noted that the review, which includes the earnings return expectations for each asset category such as real estate, stocks, and bonds, is presented to the Corporation each February in the form of an educational meeting. He remarked that the Corporation would address the review's findings during an upcoming March meeting.

MICHAEL J. O'LEARY CFA, Executive Vice President, Callan Associates Inc. referred the Committee to the Callan Associates Inc. "2003 Capital Market Outlook Legislative Work Session" handout [copy on file], dated February 2003. He stated that the information on page two of the handout reflects that the years 2000, 2001, and 2002 were the first years since the 1930's that the Stock Market "has been down" three consecutive calendar years. He stressed that these three years fared worse than the market decline of the 1973-4 bear market and were similar to "the market descent" of the 1930's. However, he voiced optimism that these years were "the bottom of a retractive bear market" that has been "very deep in terms of percentage loss."

Mr. O'Leary stated that the Lemman Brothers (LB) Aggregate Bond Index numbers on the page reflect the "magnitude of the bond market returns" over the same three-year period. He ventured that "the relative performance difference between stocks and bonds...has never been greater," and he identified declining interest rates as a contributing factor to the "extraordinary" bond performance. He stressed that the implications of this bond market trend would be significant as the market moves forward.

Mr. O'Leary continued that, additionally, the Standard and Poor (S&P) Stock Index "rolling 20 quarter returns" graph titled "Rolling 5 Year Returns for Stocks" depicts that, in 2002, stocks had their first negative return since 1973-4. He noted that, if the returns for 1998 and 1999 were removed from the chart, "the cumulative returns would be horrendous because those two years were so strong."

Mr. O'Leary stated that page four reflects cumulative return and growth comparison tables for stocks, bonds and cash for the previous forty years, in five-year increments. He expressed the importance of noting that overall stock returns have been "comfortably above the return" generated by bonds. He pointed out that this is denoted by the 10.49 percent cumulative 40-year stock return achieved in spite of the recent bear market. He compared the relative value of a dollar to stocks and bonds returns as depicted in the table at the bottom of page four.

Co-chair Wilken asked how a stock is defined in this review.

Mr. O'Leary replied that the stocks referred to in this research are defined as the Standard and Poor (S&P) 500.

Mr. O'Leary continued that while evidence such as a growing economy indicates that the recession is coming to an end, the information on page five addresses the current economic environment which includes: a weak business investment trend; the lowest treasury bond yield in forty years; a narrowed spread between corporate and treasury bond yields; and the fact that the equity risk "premium is unusually wide." He stated "that people are very risk adverse, currently," which, he stressed, is supported by the public's immediate and negative response to daily news reports regarding terrorism and the result that this response has on the investment market.

Mr. O'Leary voiced that numerous state and local governments are in "difficult financial circumstances" as a result of declining tax revenues, continuing growth and expenditures, and "very unfortunately, a real increase in pension funding requirements" on

the national level which is affecting both public and corporate pension funds.

Mr. O'Leary stated that the graph on page six "depicts the yield to maturity for the bond market as measured by the Lehman Aggregate Index." He identified the first of the seven daily yield points highlighted on the graph as being September 10, 2001, the day before the terrorist attacks on New York City and the Pentagon. He stated that this point signifies the beginning of a "dramatic" daily yields "fall." He stated that, "people running to quality, drove the interest rates down" as a result of the federal government "opening the faucet to provide sufficient liquidity in the system." He continued that on December 31, 2001 the interest rates rose to approximately the same level as before the September 11<sup>th</sup> terrorist attacks. He continued that during the first quarter of 2002, interest rates increased, and an economic recovery appeared to be occurring; however, he shared, economic factors began to decline and the "whole investment grade bond market from Triple A to B double A" continued in a downward trend to "a very low level" in September 2002. He stated that the bond market recovered at the beginning of the fourth quarter of 2002 "with interest rates spiking back up" then declining again at the end of 2002 to an interest rate of approximately four percent. However, he expressed, during the first two days of 2003 "the yield to maturity of the bond market increased approximately 25 basis points."

Mr. O'Leary stressed that the "yield to maturity on the bond market is a good naïve indicator of the rate of return" expected for investment grade bond earnings over the next five years; however, he shared, "there have been some structural changes in the bond market in the composition of this index so that as we look ahead, this indicator would not be quite as reliable as it has been in the past." Nonetheless, he continued it does provide "a starting point" for what could be expected of a bond investment.

Mr. O'Leary explained that the graph on page seven compares the S&P 500 earnings yield over a twenty year period to the corresponding ten-year treasury bond yields. He pointed out that in 1981-2, the treasury bond yield, which is currently four percent, was 14 percent. He furthered that the stock market yield exceeded ten percent in 1981-2; however, he qualified, its yield is also currently four percent. He expressed that over time, "there is a linkage between the price investors are willing to pay for future earnings and the general level of interest rates as measured by a riskless investment" in a ten-year treasury bond.

Mr. O'Leary noted that the linkage between the S&P Earning Yield and the Ten-Year Treasury Yield is reflected in the ratio

comparison chart at the bottom of page seven. He noted that in 1987, the graphing line dipped "very low" which indicates that consumers viewed stocks "as very expensive relative to interest rates" at that time. He continued that this relationship was "corrected" in the fourth quarter of 1987 when the stock market "tanked" and stock values declined more than twenty percent. He noted that interest rates also declined at this time. He characterized the years 1999 and 2000 as "bubble-mania," when the market was "absurdly" valued and "interest rates were comparatively low." He stated that the correction to this situation has been the recent three-year "painful bear market." He summarized that currently, "stocks appear to be attractively priced relative to treasuries."

Mr. O'Leary stated that page eight reflects a valuation measurement comparing the United States stock market to other national markets. He noted that, "all markets appear to be below their long run averages."

Mr. O'Leary informed the Committee that page nine identifies features imbedded within the financial analysis including: continuing economic recovery; continuing low inflation rates; "comparatively little risk" of deflation; a slowing of consumer spending to align with disposable income levels because "everyone who could refinance has already done so;" a slow stock market recovery; and a tapering off in the housing market as interest rates begin to rise. He noted that it should be considered a "blessing" that the housing market has remained as strong as it has.

Co-Chair Wilken asked the problems created by deflation.

Mr. O'Leary voiced that "moderate inflation of three percent or less" is healthy for the economy, as it makes for "easy adjustments in relative prices." In response to Co-chair Wilken's question, he characterized an employee review as being similar to the "scary scenario" of an "deflationary environment;" wherein, the employee is told that as a reward for doing a great job, his or her salary would be decreased only one percent rather than the four percent designated in the budget. He commented that in a deflationary environment, it is hard "to pay off your debt." He continued that the value of a person's home "has been a great source of the growth of equity;" however, he stressed, "in a protracted period, the price" of a house would decline rather than being stable or increasing. He declared that this would adversely affect an individual's sense of well-being and the economy as a whole.

Co-Chair Wilken asked when the United States experienced its most

recent deflationary period.

Mr. O'Leary responded that the most recent deflationary period occurred in the 1930's. He continued that, within the last six months, national economists announced that people "were really worried about" the risk of deflation occurring; however, "that risk seems to have diminished."

Senator Bunde commented that Alaska experienced a downturn in the value of homes during 1985-6, which, he reminded the Committee, corresponded with, among other factors, a decrease in State spending.

Mr. O'Leary stated that the information on page ten provides details from the five-year capital market projection that Callan Associates, Inc. generates each year.

Mr. O'Leary explained that the chart on page eleven identifies "the middle point of a range" of projected market possibilities, and that the range is referred to as the Standard Deviation or risk factor. He stated that Standard Deviation is further explained on page twelve.

Mr. O'Leary noted that page 13 depicts the 2003 Capital Market Projections. He pointed out that the 2002 inflation number projection has been reduced from 2.9 percent to 2.6 percent in 2003, which, in effect, causes a 0.3 percent reduction "in the expected return of every asset category."

Mr. O'Leary continued that the biggest change in this year's annual report when compared to previous reports is "the change in the expectation of bond return" as the result of the "substantial" decline in interest rates. He stated that the 2002 bond return projection was 5.75 percent; however, he noted, the actual return for 2002 was ten percent, with four years remaining on that five-year forecast. He stated that some analysts consider Callan Associates' 2003 bond return projection of 4.75 percent optimistic; while others consider the projection to be low, in light of the 2002 ten percent return. He noted the approximate 4.75 percent 2003 bond return would lower the overall return level during the five-year projection period.

Mr. O'Leary continued that an internal debate occurred within Callan Associates "about the likelihood of an equity return." He commented that, "over a protracted period of time, the real return to common stock investors" has averaged six percent, "even incorporating" the recent sharp decline in the stock market. He voiced that "we are closer to the end of a bear market than the

beginning of a bear market," and he commented that it could be argued that the expectation is "for an above average real return" for the next five years. He stated that the 2003 forecast identifies a 6.1 percent real return on the S&P 500 and that, including inflation the nominal rate of return is projected to be 8.7 percent.

Mr. O'Leary continued that the chart on page 13 compares the 2002 projections to the 2003 capital market projections for equities, fixed income assets, inflation, and other investments such as real estate, and their corresponding projected annual returns and standard deviations. He commented that the Alaska Permanent Fund has benefited from its "substantial allocation" of real estate since real estate has fared well during the recent market downturn; however, he noted, the real estate market, and in particular the competitive leasing market situation, on the national level has weakened.

Mr. O'Leary indicated the graph on page 14 reflects the range of return and standard deviation mixes using "the most conservative to very aggressive" 2002 equity numbers and also reflects the range using the 2003 projections. He explained that, in 2003, a conservative and "low volatility" equity allocation percentage of twenty percent would generate approximately a six percent return.

Mr. O'Leary, referring to market risks such as terrorist attacks, inflation, and a stagnating economy, stated that the five-year market projection detailed on page 15 takes into consideration the current political conflict in the Middle East with "the key assumption" that were military action to occur, it would be contained to that area and would be short in duration. He stated that this projection must be revisited, were the conflict scenario to differ from this assumption.

Mr. O'Leary continued that the chart on page 16 applies the 2003 financial projections to the Alaska Permanent Fund Corporation (APFC) portfolio components. He compared the current portfolio component allocation percentages as established "by the policy of the Fund" to various asset allocations referred to as "mixes." He declared that the target allocations are projected to result in a 2003 expected rate of return of approximately 7.38 percent with a standard deviation of 10.84 percent. He explained that the 10.84 percent standard deviation number indicates that the range of the return could be between negative 3.56 percent and positive 18.22 percent.

Mr. O'Leary stated that, "the Permanent Fund's current policy is essentially at the statutory limit for equity exposure, exclusive

of the basket clause." He explained that, "the basket clause provides added flexibility" and in the case of a strong stock market rally, would "allow for the percent allocated to equities to be increased." He continued that the basket clause also allows the Corporation "to invest in areas that otherwise are not explicitly approved by statute."

Mr. O'Leary utilized the term "efficient frontier" to refer to the market position in which the asset allocations produce the projected rate of real return. He mentioned that the chart on page 17 depicts the "efficient frontier" and the current "target mix" of investments.

Mr. O'Leary continued that the bar graph on page 18 illustrates the target rate of return and the various rates of returns generated by differing asset allocation mixes for a one-year period. He stated that the targeted asset allocation mix's medium range of return is projected to be 7.38 percent; the 5<sup>th</sup> percentile projection is 26.62 percent; and that the 95<sup>th</sup> percentile projection, "which is two standard deviations," is a negative 8.93 percent.

Mr. O'Leary noted that page 19 and page 20 portray the rate of return over a three-year and five-year period, respectfully. He noted that the contrasting "worst and best case scenarios are both less extreme" than those experienced in a one-year period, and, he continued, the five-year period range of returns has the lowest extremes. He reiterated that, "most of the benefit derived from diversification really occurs within a five-year period."

Mr. O'Leary characterized the information on page 21 as a "forewarning" of the impact of the statutory limitation of 55 percent asset allocation in equities. He explained that as the allocation "moves toward higher volatility, higher risk, and higher return alternatives, that's when the statutory constraint begins to have an effect."

Mr. O'Leary, referring to the review's conclusion on page 22, stated that an important question is whether the fund's policy is on the efficient frontier, and he concluded, "the answer is yes." He continued that the policy is "prudent and produces the highest expected return for the level of risk that is undertaken." However, he expressed, in the auspice of today's five-year projection, "the policy mix is inconsistent with the obtainment of a five percent real return target."

Mr. O'Leary declared that this is the first time the Permanent Fund's rate of return on its investments has faced this situation, and the reason, he clarified, is because bonds are a "very

substantial part of the Permanent Fund portfolio" and "the expected real return on bonds is so low." He stressed that after factoring in inflation, the projected real return on bonds would be 2.1 percent, which is below the projected five-year return of five percent. He stated that the Permanent Fund Board of Trustees would be addressing this issue. He noted "that there have been other periods in history when the financial markets haven't produced the types of targeted real returns that people were striving for, and that can change, but right now...it is unreasonable to expect a five percent real return over the next five years."

Co-Chair Wilken asked for further information regarding the various market mix allocations depicted on page 20, particularly information about Mix 3 in which all of the projected returns are positive.

Mr. O'Leary responded that Mix 3 reflects a 95 percent probability of a 0.09 percent return with a median return of 7.12 percent. He commented that Mixes 4 through 8 reflect larger medians than the Target allocation median of 7.38 percent; however, he noted "there is also an increased chance of some negative returns over that five-year period."

Co-chair Wilken understood, therefore, that the efficient frontier would be between Mix Three and Four.

Mr. O'Leary referred the Committee to the asset allocation mixtures detailed on page 16. He explained that Mix 3, with a domestic or non-dollar bond component of 43 percent, reflects "a heavier bond component" than Mixes 4 through 8; however, he clarified, these various "mixes are all efficient in that they produce the highest return possible for that level of risk." He qualified that these mixes "are riskier, that is there is more volatility, but that doesn't make them any less appropriate."

Senator Bunde noted that in previous presentations, Mr. O'Leary projected a targeted goal of an eight percent return with an actual realized gain of five percent. However, now, he noted, the targeted goal reflects a lower return. He asked whether this is the result of the lower inflation factor.

Mr. O'Leary replied yes, "a lower total return is in part a function of a reduction in the inflation number." He noted that at the time of the eight percent return projections the inflation factor was approximately three percent. He continued that this would result in a five percent rate of real return were this the only factor. However, he continued, another factor in the reduction of returns is the "significant change in the level of interest

rates."

Senator Bunde commented that Permanent Fund Dividends have been calculated based on a five percent rate of return.

Mr. Storer concurred that the dividend projections were factored at a five percent rate of real return. He noted that upcoming Permanent Fund Division testimony would address this matter.

Senator Bunde asked whether the price of oil is a factor in the projections.

Mr. O'Leary assured the Committee that the issue of fluctuating oil prices is addressed in the report.

Senator Bunde asked whether this fluctuation affected the accuracy of the 2002 projections.

Mr. Storer noted that the analysis is conducted on a five-year basis rather than on an annual basis.

Mr. O'Leary furthered that Callan Associates routinely conducts an annual review of previous five-year projections to ascertain "how accurate they were." He stressed that the objective is for the projections to be within the forecast range, both within each asset allocation and as a total portfolio. He announced that this objective has been achieved with one exception in which the equity return was higher than projected; however, he clarified, the total portfolio projections were within the projected range.

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Co-chair Wilken asked the effect of the growth of global industry on the American economy, as, he noted, American jobs have been lost and capital investments into the U. S. economy have been reduced.

Mr. O'Leary responded that the globalization concern has prompted responses "from free marketers arguing that globalization benefits all by helping accelerate growth and efficiency." He stated that "fortunately" the United States' economy is flexible and better able to cope with this issue than other nations. He continued that "composition of the United States economy" is transitioning toward becoming more service and high technology oriented, and that "the traditional manufacturing base" is now being serviced from abroad. However, he noted, foreign economies are impacting American manufacturing and high end, traditional blue-collar jobs, and he stressed that people would require retraining "in the service equivalent of those jobs." He mentioned that an increase in foreign

industry sales also could affect inflation. He explained that the United States' dollar value is weakened as the cost of importing goods increases. He stated that this issue has resulted in a variety of inflation range projections within the financial industry.

Senator Wilken asked whether globalization has been a significant factor in the recent recession in America.

Mr. O'Leary voiced that he could not adequately respond to that question.

Co-chair Wilken thanked Mr. O'Leary for the presentation.

Mr. Storer informed the Committee that Chris Phillips would present the current Permanent Fund balance, models, and projections. He stated that he would then comment about the Fund's performance and asset allocations.

CHRIS PHILLIPS, Director of Finance, Alaska Permanent Fund Corporation, Department of Revenue, spoke regarding the "Alaska Permanent Fund Brief history and financial outlook for Fund growth and income" booklet [copy on file], dated February 2003. She noted that the history of the Permanent Fund total value, which is comprised of the Fund principal and the earnings reserve account, is portrayed on the first page of the booklet. She noted that the Fund's balance, as of 12/31/02, was \$22.9 billion and is comprised of the following: \$7.5 billion of dedicated oil revenues; \$7.5 billion from inflation proofing; and \$7 billion from special appropriations. She noted that the special appropriations component is comprised of "special appropriations from the general fund in the early years and recently from the earnings reserve account into principal."

Senator Bunde asked which of these three units the Corporation recognizes as the corpus of the Fund.

Ms. Phillips responded that the Corporation recognizes the corpus to be the entire principal balance of \$22 billion.

Ms. Phillips noted that the graph on page 2 identifies the earnings reverse account balance. She explained that the \$3.5 billion earnings reserve account balance on June 30, 2000 is the value after the State accounted for the June 2000 dividend and inflation proofing appropriations. She noted that the earnings reserve account is "split between the realized earnings reserve and the unrealized earnings reserve." She explained that the realized earnings reserve is defined as the "cash flow from interest from bonds, dividends from stocks, and cash flow" from Corporation real estate holdings, as well "as the realized gain or loss on manager

sale of assets."

Ms. Phillips continued that the unrealized earnings reserve income is the accumulated appreciation of the assets that remain in the Corporation. She noted that the Fund market value as of 12/31/02 was approximately \$900 million, comprised of \$1.2 billion in realized earnings reserve and a loss of \$300 million in the unrealized earnings reserve. She explained that the earnings reserve account absorbs the market volatility for the entire Fund.

Ms. Phillips stated that the chart on page 3 explains how the earnings reserve account balance has been reduced from a \$6.5 billion balance on June 30, 2000, to the \$900 million balance on December 31, 2002.

Senator B. Stevens asked for confirmation that "the Earnings Reserve absorbs the entire volatility of all the principal."

Ms. Phillips responded that is correct.

Senator B Stevens surmised that, "the principal is the dedicated revenue in nominal dollars, not in dollars that have any increased gain."

Ms. Phillips responded, "yes, it is a nominal notational number, and the entire market volatility is recorded in the earnings reserve."

Senator B. Stevens concluded, therefore, that \$22 billion is the value of the dollars deposited into the fund.

Ms. Phillips concurred. She reiterated that the Earnings Reserve account balance of \$6.5 billion at the beginning of June 2000, as depicted in the chart on page three, "already" factors in the removal of the June 2000 dividend and inflation proofing dollars. She explained that the chart additionally reflects all activity since that date, including: a gain of \$2.4 billion for two years of interest, dividends and real estate; a negative \$0.8 billion in realized losses; a negative \$1.3 billion total for the years 2001 and 2002 inflation-proofing transfers to the principal; a negative \$2.0 billion payout for two years of distributions for Permanent Fund Dividends; and a negative \$3.9 billion loss reflecting two years of changes in unrealized holdings that the State owns. She concluded that the total Earnings Reserve Balance as of December 31, 2002 is \$0.9 billion.

Senator Bunde opined that the fund could be recognized as being "double inflation proofed." He exemplified normal inflation proofing as the fund earning eight percent, including a three percent inflation-proofing factor; thereby resulting in a real gain of five percent. He continued that the "current practice is to take money

out of the earnings reserve and, once more, inflation-proof" the fund. He asked whether "it is fair to describe this practice as double inflation proofing."

Ms. Phillips responded that the State makes the decision on the amount to be granted to inflation proof the fund each year and "actually physically moves it from the earnings reserve to principal."

Mr. Storer pointed out "if the five percent limit" were included in the State's constitution the second action of moving money from the Earnings Reserve Account to the principal would not be required. He continued that were statute changed, "the money would reside there but would not be formally moved to the principal, therefore, it would not be considered as inflation proofing."

Senator Bunde concluded that an actual transfer of money from the earnings reserve would be considered inflation proofing; however, he continued, if the inflation proofing calculations were made but not transferred, it would not be considered as such.

Mr. Storer noted that a State statute specifically mandates a reduction be reflected in the earnings reserve account with a corresponding increase reflected in the principal account. He continued that "absent the constitutional amendment memorializing the limitation, if that stayed, then you would not in fact be inflation proofing then you would really be increasing the size of the earnings reserve which could be appropriated at a future date."

Mr. Storer explained the bar chart on page three, titled "Fund's total return." He stated that the total Fund "annualized return" over the last 18.75 years is 9.6 percent, and that the five-year return of eight percent was projected prior to the February 2003 report from Callan Associates. He noted the projected rate would be adjusted to reflect the report. He explained that the chart also indicates the negative total returns of the Fund in the fiscal years 2001, 2002, and 2003. He remarked that the negative returns could not be ignored. He continued that, "it is clear that during this bear market the Fund has suffered along with everyone else." He described a Division evaluation that judges the performance of the Alaska Permanent Fund against other public fund peer groups, "predominately retirement funds", which found that the Fund is faring approximately two percent better than other funds.

SENATOR JOHN COWDERY asked the loss the Fund has experienced, "in hard dollars", during the last three years.

Mr. Storer referred the Committee to the earnings reserve reconciliation chart on page three that specifies \$800 million in realized losses and negative \$3.9 billion in depreciation.

Senator Cowdery declared that this would affect "the dividend payout by approximately a billion dollars a year."

Ms. Phillips clarified that the dividend formula utilizes a five-year average, and that the previous two fiscal year appropriations were approximately one billion dollars. She continued that the average appropriation is expected to be reduced as the older, higher earning years are removed from the five-year calculation.

Senator Bunde, referencing testimony that the Fund's earnings are "on target," asked whether earnings in the worst-case scenario of the 95<sup>th</sup> percentile, which is within the targeted range, are possible.

Mr. Storer informed the Committee that the Fund "is experiencing lower case probability in virtually every instance from market value, from returns, from the dividend payout, etc." He stated that "it was studied, it was understood when we adopted the asset allocation that this was a probability, albeit an extreme probability." He reiterated that, "this is one of the worst bear markets since the '30s."

Mr. Storer stated that page four denotes the Fund's current asset allocation as being: 37 percent invested in the domestic stock market; 16 percent invested in international equity market; 35 percent invested in United States investment grade bonds rather than high yield bonds; two percent invested in non-dollar bonds comprised of sovereigns of high quality countries such as England, France and Germany; and ten percent in real estate.

Mr. Storer noted that the chart on page four supports Mr. O'Leary's testimony regarding the probability of achieving a goal over a five-year period. Mr. Storer referenced the chart information that states, "there is a 1 in 4 (25%) chance that the Fund will earn a negative return in any single year, there is only a 1 in 20 (5%) chance over a 5-year period and a 1 in 100 (1%) chance over a 10-year period of a negative return" if current asset allocations were maintained. He emphasized the importance of adopting "the appropriate asset allocation" that combines near and long term objectives, and in holding that course. He explained, "Funds that shift and react to near-term news are the ones that are the unsuccessful funds ultimately because they are always responding to yesterday's headlines."

Senator Bunde understood Mr. O'Leary to say that the Fund would not earn five percent under the asset allocation restrictions that have been placed on the Corporation. Therefore, he asked whether the Corporation would be requesting changes to be made involving the current asset allocation restrictions.

Mr. Storer responded that the Corporation recently "reconstituted" its Board of Trustees and "reformed" its Legislative Committee. He continued that the Board would be familiarizing itself with numerous issues, including the five percent clause and evaluating whether the basket clause should be expanded.

Ms. Phillips stated that the chart on page five portrays the results of statistical models that evaluate and project future earning returns. She explained that these "returns are just not a firm number, but a range around an expected value." She voiced that the range model developed by Callan Associates is applied two times a year and "incorporates market volatility into the projected outcomes" of its "300 scenarios of capital market returns." She stated that the charts depict "an array of outcomes with their associated probabilities." She stated that all models contain assumptions, such as: the fall revenue forecast; the dividend formula as defined in statute; as well as the most recent financial data. She explained various components of the graph, and she stressed that, "the range of market value does already assume that the dividend has been deducted from this market value."

Ms. Phillips stated that the chart at the bottom of page five, depicts the range of the realized earnings reserve projected for FY 03 through FY 08. She reminded the Committee that the earnings reserve, combined with the principal, comprise the total Fund value.

Ms. Phillips continued that the chart at the top of page six reflects the range of the total earnings reserve. She specified that the realized earnings reserve is the cash flow. Furthermore, she asserted, it is the portion of the Fund on which the permanent fund dividend allocation is calculated. She noted, "the total earnings reserve includes the realized earnings and the accumulated market appreciation or depreciation on the assets."

Ms. Phillips communicated that the chart at the bottom of page six projects the range of per capita dividends for the current fiscal year and the subsequent five years.

Co-chair Wilken asked for further information regarding the "Range of total earnings reserve" chart on page six, specifically the information pertaining to FY 08. He voiced the understanding that, in FY 08, there is a 90 percent chance that the earnings reserve would reflect a negative amount.

Ms. Philips replied that these numbers project a ten percent probability that the fund would reflect a negative \$1.4 billion or less or a 90 percent chance that it would be negative \$1.4 billion or greater.

Co-Chair Wilken asked for further explanation about the FY 08

earnings in the Range of total earnings reserve chart on page six.

Ms. Phillips provided further interpretation regarding the projected totals for FY 08. She reminded the Committee that the total amount reflected in this chart does not contain the money dedicated for the permanent fund dividends and for the inflation proofing transfer as they are already subtracted from the total.

Senator Bunde asked for clarification that the \$400 permanent fund dividend levels projected in FY 05 and FY 06 are based on a five-year average that includes years in which the fund's earnings were in a negative range.

Ms. Phillips concurred, and noted that the average is lowering as the higher earning years are removed from the five-year calculation formula. She stated that the monthly-realized earnings of approximately \$70 million is a known factor; however, she explained, the managers' buy and sell activity and market appreciation or depreciation are unknowns.

Ms. Phillips remarked that the chart on page seven "reflects the comparison of the historical and projected realized income of the Fund." She stated that this information is overlaid with actual and projected State oil revenue. She stated that this information anticipates the realized income from the Permanent Fund to increase, while revenues from oil decrease.

Co-chair Wilken ascertained from the chart that by FY 2018, oil revenue deposited into the general fund is projected to be \$500 million and Permanent Fund revenue is projected to be \$3.2 billion.

Ms. Phillips concurred; however, she reminded the Committee that these numbers do not account for market volatility.

Senator Bunde asked when further direction from the Board might be anticipated.

Mr. Storer informed the Committee that the newly reconstituted Alaska Permanent Fund Board of Trustees recently met for the first time. He shared that committees were formed, some committee meetings were scheduled, and that the next scheduled Board meeting is March 25 and 26, 2003. He voiced that the Legislative Committee would probably meet prior to the next Board meeting.

Co-chair Wilken congratulated the new appointees to the Alaska Permanent Fund Board of Trustees.

#### **ADJOURNMENT**

Co-Chair Gary Wilken adjourned the meeting at 10:20 AM