

**MINUTES
JOINT
SENATE FINANCE COMMITTEE
HOUSE FINANCE COMMITTEE
February 17, 2005
10:06 a.m.**

CALL TO ORDER

Co-Chair Green convened the meeting at approximately [10:06:27 AM](#).

PRESENT

Senate Finance Members:

Senator Lyda Green, Co-Chair
Senator Gary Wilken, Co-Chair
Senator Con Bunde, Vice Chair
Senator Fred Dyson
Senator Bert Stedman
Senator Lyman Hoffman

House Finance Members:

Representative Kevin Meyers, Co-Chair
Representative Mike Chenault, Co-Chair
Representative Bill Stoltze, Vice-Chair
Representative Mike Hawker
Representative Jim Holm
Representative Eric Croft
Representative Bruce Weyhrauch

Also Attending: SENATOR TOM WAGNOR; REPRESENTATIVE HARRY CRAWFORD; REPRESENTATIVE KURT OLSON; REPRESENTATIVE JAY RAMRAS; MIKE BURNS, Chief Executive Officer, Alaska Permanent Fund Corporation, Department of Revenue; MICHAEL O'LEARY, CFA, Executive Vice President, Callan Associates; DR. JERRY MITCHELL, Member, Permanent Fund's investment advisory council and former, Chief Investment Officer, The Massachusetts Pension Fund;

Attending via Teleconference: There were no teleconference participants.

SUMMARY INFORMATION

Presentation by the Alaska Permanent Fund Board and Advisors

[10:07:55 AM](#)

MIKE BURNS, Chief Executive Officer, Alaska Permanent Fund Corporation, Department of Revenue, introduced the members of the Alaska Permanent Fund Board of Trustees and consultants present at this meeting and gave detailed backgrounds of the consultants' accomplishments.

[10:10:22 AM](#)

MICHAEL O'LEARY, CFA, Executive Vice President, Callan Associates, gave a presentation titled, "Alaska Permanent Fund Corporation, 2005 Capital Market Outlook" [copy on file] and reviewed events in the financial market of the past few years.

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After a Slow Start, Capital Markets Enjoy Second Straight Year in the Black

[Chart showing rates of returns for the years 1999 through 2004 and the five-year average annual rate of return for the years 2000 through 2004 for the following several funds.]

Mr. O'Leary outlined the types of stocks included in the funds.

Mr. O'Leary called attention to the five-year annual rates of return pointing out that this no longer includes the bull market that concluded in 1999. The five-year average includes the bear market years of 2001 and 2002, although fortunately good returns were realized in 2003 and 2004. He stressed the strong performance of bonds and small cap stocks. The inflation rate over this five-year period was approximately 7.7 percent.

[10:13:24 AM](#)

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The Current Economic Environment

Steady Growth But Unsteady Sentiment

- U.S. economy all of a sudden looked hot in 2004, but the expansion has been underway for several years, and growth has actually continued at an orderly, if unspectacular pace.
- Jobs data finally turned around, and unemployment finally fell below 6%.
- Business spending was weak until recently, as many industries are still plagued with overcapacity.
- Inflation remains a low level threat, despite what we read in the headlines. Absent oil price pressures, core rate is around 2%.

- Interest rates are still extraordinarily low:
 - Treasury bonds yields are not that far from their 40-year lows.
 - Fed policy still seems to work, at least on consumers...
- Consumers have been tireless, and the federal government has been spending to boost the economy and for the war in Iraq. However...

Mr. O'Leary stressed that the advisors at Callan and Associates are not economists and this information reflects the organization's perspective of the economy and the future economy. This information is utilized to demonstrate how the organization develops perspectives and determines the range of risks and how those risks change.

Mr. O'Leary relayed that the advisors at Callan and Associates are in consensus that the economy had recovered by 2004, and would have solid growth in 2005. There is no reason this would not continue into 2006.

Mr. O'Leary informed that recovery to date has been led by the consumer and that a large "driver" has been the decline in interest rates, which has supported the housing sector and allowed consumers to refinance and augment income to maintain spending. This has been beneficial in sustaining the economy through the recession and into recovery.

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Leadership Passes from Consumers to Businesses

- With interest rates rising and tax cuts finished, the consumer spending boom is over. Moderate gains in employment and income will drive consumer spending.
- Housing markets have peaked by remain strong.
- Business equipment investment is surging in response to strong profits, growing markets, and technological advances.
- Nonresidential construction is beginning to slow recovery, restrained by excess capacity.
- Budget pressures on state and local government are easing as tax revenues rise, but federal stimulus is ending.
- Exports are rebounding in response to the dollar's depreciation and renewed growth in foreign markets.
- Outlook for 2005 is "good by not great".

Mr. O'Leary commented that the "baton" must now be passed to

business investment to continue to grow the economy.

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The U.S. Expansion is Strengthening

2004 Saw Best Growth Since the Late 1990s

[Bar graph showing Real GDP, annual percent change for the years 1990 through 2004.]

Mr. O'Leary stated that economic expansion was over four percent in "real terms", which "by any standard is a good year". Growth is expected to continue at a slower rate this year, but still above the economy's long-term trend.

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U.S. Economic Growth by Sector

[Spreadsheet listing annual percent changes, and "direction of change" of several sectors for the years 2002, 2003 and 2004.]

Mr. O'Leary detailed that consumption would be moderate, residential investment would remain positive and grow, although the rate of growth would slow. Business fixed investment had "only last year really picked up" and would continue to grow.

Mr. O'Leary continued that the federal government activity would be "less of a stimulative factor" than in the past due to the need for "decremental fiscal stimulus". State and local governments "don't feel flush", however, revenue is "improving" and is expected to continue to improve. Some assistance is expected from an increase in the rate of spending by state and local governments.

Mr. O'Leary next stated that the export sector activities are "attractive" in that the percent increase in exports the previous year was "meaningful". Hopefully, continued export growth would occur, particularly with the dollar "weakness" making the dollar more "competitive." This would assist in diminishing, but not closing, the trade deficit. Simultaneously, import growth is expected to decelerate. Much of the spike in import growth is attributable to higher energy prices.

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Employment Slowly Recovers

December 2004 employment remains 240,000 below its March 2001

peak.

[Bar graph showing annual percent change in payroll employment for the years 1998 through 2004.]

Mr. O'Leary explained this graph supports the projections made on the previous page. Employment growth has been "disappointing coming out of the recession" but has begun to "get on track" in 2004. Expectation is for continued growth.

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Industrial Production is Rebounding
Capital Spending Follows GDP

[Graph showing quarter percent changes of Real GDP, Equipment spending, and High Tech, for the years 1990 through 2004.]

Mr. O'Leary stated this graph demonstrates a sharp decline in spending for high tech and equipment. This was core of the recession. An increase occurred in 2004 for these areas and is expected to continue.

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A Third Good Year for Corporate Profits

[Bar graph showing percent changes for Profits with IVA & CCA for the years 1990 through 2004.]

Mr. O'Leary expressed that profit growth has been "tremendous", and that remarkable changes in the economy are the result of improvement in corporate financial conditions. Corporations have "plenty of cash" or "liquidity" and subsequently have the ability to fund capital expenditures, increase dividends, and buy back stock if advantageous.

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Productivity Growth Has Boosted Corporate Profits, But Not Wages

[Graph showing percent of GDP of Wages and Salaries, and Economic Profits for the years 1999 through 2004.]

Mr. O'Leary noted this graph shows the growing discrepancy between profits and wages and salaries. Wages and salaries "have not participated" in the recovery. As unemployment rates have been reduced and are expected to decline further, wages and salaries

should "begin to pick up". Also, corporate profit margins would continue to improve. This is a normal cyclical pattern.

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The Consumer Is Stretched

- Household net worth has recovered from its 200-02 drop, thanks to rising home prices and the last two years' stock market rally. However, a low saving rate is limiting asset accumulation.
- Federal tax cuts have boosted disposable income growth for three years. Now tax burdens are likely to rise.
- Debt service burdens and the household financial obligations ratio peaked in late 2001. But rising interest rates will forestall further improvement.
- Net result will be a slowdown, but not a retreat.
- Rising employment and income will drive the next phase of the expansion in consumer spending.
- Credit card delinquencies will decrease slightly as the job market improves.

Mr. O'Leary reiterated that it is expected that consumer activities would be less of a factor in "taking the economy forward". This is because the consumer is "pretty leveraged," primarily through home ownership. Given the sharp increases in the price of homes across the country there is concern regarding a "housing bubble."

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Home Prices Have Risen Sharply...Although Low Interest Rates Mean That Homes Are Still "Affordable"

A higher index means homes are more affordable.

[Graph showing the Affordability Index for Existing Single-Family Homes for the years 1972 through 2004.]

Mr. O'Leary noted that although home prices have "absolutely increased at a very significant rate," the impact has been moderated by the decline in interest rates, so that homes are "essentially as affordable today as they were four years ago-five years ago." He acknowledged that individual markets have home values "out of sync" and could experience a decline, but this is not a generalized condition.

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Inflation's (Temporary) Resurgence

- Soaring energy costs, dollar depreciation, a synchronized (if modest) global expansion, and lean inventories have

revived inflation.

- Global commodity prices also reached peaks at times in 2004.
- Consumer prices surged at a 4.1% annual rate in the first seven months of 2004, while core inflation reached 2.4%. For the full year, inflation was closer to 3%.
- Despite the headlines, this recent burst of inflation is temporary.
- Slack labor markets and rising productivity will keep unit labor cost increases in the 2% range.
- Oil prices in the \$40s (or the \$50s) don't mean the same now as in the early 1980s.
- Supply responses will eventually bring down energy prices.
- Bottom line: core inflation will settle in the 2.0-2.5% range after 2004.

Mr. O'Leary stated the inflation outlook is important.

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Inflation Has Ticked Up...

Year-Over-Year Change in Consumer Prices

[Graph showing the percent change of CPI All Urban Cons, and CPI-Core for the years 2001 through 2004.]

Mr. O'Leary informed that inflation accelerated significantly and has increased substantially from the prior year. This is primarily the result of commodity spikes, especially energy. Core inflation increased at a rate of 2.2 percent.

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...But Headline Fears Are Overblown

Year-Over-Year Change in Consumer Prices

[Graph showing aforementioned detail for the years 1980 through 2004.]

Mr. O'Leary demonstrated that in a historic context, inflation is currently at a low level. The expectation for the next five years predicts the CPI would increase at an approximate 2.6 percent rate annually. That is unchanged from the consultant's estimates for the past three to four years.

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The Fed is Moving Toward Neutral
Interest Rate Increases Should Stay Gradual

[Graph showing the percents for Federal Funds Rate and 10-Year Treasury Bond Yield for the years 1994 through 2004.]

Mr. O'Leary stated this graph demonstrates how the federal fund rate has changed. Short term interest rates have been "incredibly low" The "fed and others were very concerned about the possibility of deflation a couple years ago and pumped in massive liquidity and took us to a position where short term interest rates in that one-percent range were actually negative real interest rates." He explained that if it were possible to buy the CPI, money could be borrowed at an interest rate of one-percent and the purchaser would receive a two percent return. He ascertained that the "fed" is "mindful of the long term concern about inflation, but over time short term interest rates have tended to be pretty close to the rate of inflation, maybe plus a little."

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Mr. O'Leary remarked that ten year treasury yields have actually "not moved at all." The expectation is that interest rates would rise as expansion continues, but would not reach the eight to nine percent annual rate of a decade prior.

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2005 Capital Market Preview:

Keeping Those Expectations Low

- The economic recovery will continue, but growth will remain modest. Capital spending will ultimately follow GDP.
- Fed has already shifted to tightening monetary policy.
- The stock market recovery will be slow. Profits cannot outpace GDP, share prices cannot outpace earnings.
- Callan's outlook in a nutshell: expect a low inflation, low interest rate, low return environment.
- Low return expectations mean 8% nominal return assumptions may be difficult to achieve. Callan's 2005 assumptions won't likely generate an expected return for a 60% stock/40% bond allocation greater than 7.4 % over the next five years. To the extent possible, investors may need to shift their focus to real return expectations.

Mr. O'Leary reminded that after the presentation to the Committee the prior year, the Members knew the projections would not change this year. The consultant has not changed projections in any significant for several years. He added that low equity is also expected over the long term.

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Domestic Equity vs. Bond Yields

[Graph showing percentages of S&P 500 Earnings Yield vs. 10-Year Treasury Yield for the years 1981 through 2004 and graph showing Ratio of S&P 500 Earnings Yield and 10-Year Treasury Yield for the same time period.]

Mr. O'Leary referenced the "fed model for valuation". This graph is an attempt to demonstrate the same information. The earnings yield is the "reciprocal of the PE ratio". Since the year 1981, those instances when the earnings yield of the S&P 500 was close to the ten-year treasury suggested that the stocks reasonably valued. In the last five years, the combination of declining stock prices and declining interest rates resulted in the earnings yield above the income yield of the ten-year treasury. He cautioned of the situation of the 1950s in which dividend yield on stocks exceeded the income yield on treasury obligations. The valuation of the stock market despite the two-year recovery, is not excessive provided the anticipated "decent earnings growth going forward."

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Bond Market Faces a Challenging Environment

- With inflation in check, investors poured money into bonds following the bursting of the stock market bubble, driving prices up and yields to 40-year lows.
- Corporate (and particularly high yield) spreads widened through 2002, then staged a remarkable comeback in 2003 and 2004.
- Long-term secular decline in inflation since early 80s fueled bond market returns that may not be seen again for a long time.
- Looking forward, current yields and expectations for inflation and interest rates drive expected future returns. With low current yields and the potential for rising interest rates as the economy expands, prospects for future bond market gains may have faded. The best case for bonds is a faltering economy.

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Domestic Fixed Income

Lehman Aggregate Index - Daily Yield to Worst from 1/1/01 to 12/31/04

[Graph showing Yield to Maturity percentages of every month from January 2001 through December 2004]

Mr. O'Leary outlined highlighted dates of the end of each year on the graph. This demonstrates that the overall rate has not fundamentally changed, despite significant volatility. The current yield on the bond market is a "very good naive" predictor of future returns.

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Representative Croft commented that the graphs indicate an optimistic future and asked if this is because stocks are undervalued.

Mr. O'Leary replied that the relative valuation difference could change by increased interest rates, by increased stock prices with interest rates the same, or earnings collapsing, in which case the earnings yield would decline.

Representative Croft asked if this occurred in the 1960s or 1970s.

Mr. O'Leary replied that the world has changed since the 1950s. During that time the dividend yield on stocks was higher than the income yield on treasuries. Some analysts say the 1980s were an aberration. A relationship has always existed between interest rates and price-to-earnings ratios. If interest rates are high, price earnings ratios would be low.

Representative Croft surmised that the portfolio balance between fixed income and stock should have more investment in stock.

Mr. O'Leary agreed that according to the information presented this would be a reasonable conclusion.

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Senator Bunde noted that a nominal return rate of eight percent has been conventional wisdom. He asked if the information on Page 20 indicates that expectation has changed.

Mr. O'Leary responded that the Permanent Fund expected return the

prior year was 7.6 percent. The eight-percent figure is derived from an assumption of five percent real return and three percent inflation. The real return expectation has not changed, although the inflation rate has changed.

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2005 Capital Market Projections

[Spreadsheet listing Summary of 5-Year Capital Market Projections (2005-2009) by asset class.]

Mr. O'Leary stated this graph indicates the projected annual return for each asset category, and also provides the projection of the previous year. He reminded that the consultant never makes a specific point projection, rather projects a range of returns. He detailed line items on the spreadsheet to demonstrate this. Stocks, over the long term, have tended to return 5.5 to seven percent in real returns. Last year stocks actually returned approximately 11 percent, which reflects the projections. Bonds and real estate have remained relatively unchanged. However, because bond returns are so low, investors are "looking to other things" to attempt to improve their overall fund return without "ratcheting up" the equity exposure further, due to concern about volatility.

Mr. O'Leary informed that equity exposure of 60 plus percent range for major public funds, such as pension funds, is typical. Fixed income exposure is comprised at approximately 25 percent and pension funds are making use of nontraditional investment approaches, including absolute return strategies, farmland, timber, and other resource exposure.

DR. JERRY MITCHELL, Member, Permanent Fund's investment advisory council and former, Chief Investment Officer, The Massachusetts Pension Fund, referenced a handout titled, "Asset allocation of the Massachusetts Pension Reserves Investment Trust Fund" [copy on file.] He compared the Massachusetts Pension Fund to the Alaska Permanent Fund. Both funds have the same challenges to determine what asset classes to make investments to achieve the best possible return at the most acceptable level of risk. The Alaska Permanent Fund has a balance of approximately \$30 billion and the Massachusetts Pension Reserves Investment Trust (PRIT) Fund has a balance of approximately \$36 billion.

Dr. Mitchell joined the PRIT in the year 2001 with the mandate from "a very supportive" board and "active" investment advisory committee was to increase the number of asset classes the fund was invested in. This mandate was given because the board intended to

reduce the volatility of the fund and ensure that those asset classes that could provide a higher return than the ordinary stock market or bond market, had participation. In 1990, the PRIT had five asset classes, which did not change significantly until a sixth asset class was added in the year 2000. At the end of 2004, the PRIT was invested in ten asset classes.

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What has the PRIT Fund done?

1. Increased asset classes from 5 to 10.
2. Increased sub-asset classes to 15.
3. Increased less liquid investments.
4. Increased non-correlation of asset classes.
5. Est. return 8.3 %, est. risk 11.5 %

Dr. Mitchell outlined the first two items on this list. The sub-asset class includes large capitalization equities and small capitalization equities; distressed debt, regular and below investment grade US bonds and emerging country bonds for high yield bonds. The PRIT also emphasized less liquid investments because the theory and practitioners results suggested that willingness to accept a less liquid investment should receive a higher rate of return. An institution or individual who required access to money immediately would not invest in this manner; however, large funds similar to the Alaska Permanent Fund and the Massachusetts pension fund could afford to make these less liquid investments.

Dr. Mitchell stated that when the PRIT increased asset and sub-asset classes, it also increased the non-correlation of asset classes. Different aspects of the economy affected the earnings of different investments. The intention was that as one type of investment was rising, another would rise more slowly and avoid the shocks experienced if all investments were made in US stocks or bonds.

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Dr. Mitchell spoke to the estimated return and estimated risk. That is utilizing estimates similar to those described by Mr. O'Leary. The 8.3 percent return was established due to the actuarial assumption of 8.25 percent.

Dr. Mitchell stated that diversification is beneficial because the asset class that would be the best performer is unknown. Therefore multiple asset classes provide greater protection against volatility.

Dr. Mitchell exemplified less liquid investments as timber, venture capital and leveraged buyout partnerships. Less liquid assets provide a bonus because they could not be sold for a period of time.

Goals

1. Meet 8 1/4 percent actuarial return target.
2. Reduce risk by increasing non-correlation.
3. Continue to diversify.
4. Benefit from less liquid, higher return asset classes.
5. Use indexing in public markets where appropriate.

Dr. Mitchell in certain asset classes, such as large capitalization of US stocks, it is difficult for active managers to "beat the index" It could be done, but those managers are difficult to locate and employ. For these asset classes, the PRIT determined that instead of focusing on securing such a manager, it would index 80 percent of that allocation with two active managers "running 20 percent."

Dr. Mitchell compared this to the finding that with small capitalization and emerging market international stocks, active managers could regularly outperform the index. As a result, the PRIT is 100 percent active in its emerging markets investments and 80 percent active in small capitalization US stocks.

Dr. Mitchell characterized the use of an index to that of a club to provide incentive to managers to work harder. Active managers would be threatened with the possibility that the funds could be removed from their oversight.

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Senator Stedman asked if the Massachusetts pension plan has an "asset liability mismatch".

Dr. Mitchell replied that the Massachusetts plan is a defined benefit plan that is approximately 70 percent funded.

Senator Stedman asked if the plan has a target of 100 percent.

Dr. Mitchell answered it does, although it is uncertain whether it could be achieved.

Senator Stedman asked if efforts are made to protect the PRIT from this mismatch or if a total rate of return is anticipated to solve the total liability issue.

Dr. Mitchell qualified that the Massachusetts fund is unusual in that the management of the asset is overseen by a separate governmental entity that the entity that oversees payout of benefits. He was involved with the entity to manage the funds, with the directive to manage the funds in the best manner possible.

Senator Stedman asked which entity establishes the 8.25 percent target.

Dr. Mitchell responded that the benefit payout agency establishes this with the assistance of an actuarial consultant.

Senator Stedman clarified that the PRIT does not submit its projections to the benefit payout agency for review.

Dr. Mitchell answered, "no", an independent board controls asset allocation. The actuary report is consulted and the funding status of the plan is considered.

Senator Stedman asked if the asset liability mismatch has always existed.

Dr. Mitchell replied it has and informed that when the PRIT was founded, the funding level was approximately 20 percent. The Massachusetts Legislature separated the investment and benefit payout entities to insulate the investment management from the pressures of previous administrations.

Senator Stedman asked if a risk tolerance change, or risk premium adjustment, has occurred since the 1999 market "crash".

Mr. O'Leary replied that investors did not obtain the equity premium anticipated. Callan expectations of premium return for equities have remained at 5.5 to seven percent real return, which has been the long-term record.

Senator Stedman restated his question, asking if in 1999 investors were "more on the top end of the range and today they're more at the low end of the range."

Mr. O'Leary answered, "Undoubtedly yes" because the public expectation of future returns for the equity market was "double digit" of 15 to 17 percent. Four percent inflation added to 6.5 percent real return provides 10.5 percent return. Callan has consistently anticipated the "lower end". At this time last year, "we were a roaring bull compared to what others were saying, when in fact, the assumption was essentially were it had been." The style of Callan forecasts have been to change little from year to

year; others may change their forecasts more, possibly by reviewing a different timeframe.

Mr. O'Leary furthered on the question Senator Stedman posed to Dr. Mitchell regarding public entities. The experience of Callan has been that the discount rate used on the pension "side" in the public sector has been eight percent on average and has not changed significantly. The funded status of public pension funds changed from essentially fully funded status to becoming significantly underfunded for three primary reasons. The first being some combination of benefit enhancements and or contribution reductions because the funds had been well funded. The second reason was the unrealized decline that the expected earnings return for three years during the bear market provided negative returns rather than positive returns of eight or more percent. Over three years, this results in a 24 percent difference in earnings. The third factor is the decline in interest rates. When the value of future benefits is discounted utilizing a lower interest rate, the liabilities are larger. Higher interest rates would improve the funding status. The only method to achieve higher liability matching is high quality fixed investments; however, these provide significantly lower returns and result in higher costs.

Senator Stedman commented that it is difficult therefore to match unfunded liabilities. He surmised the current historic low yields would further hamper this effort. He posed a question of whether the overall policy for risk control should be reviewed periodically.

Mr. O'Leary affirmed the policy should be reviewed. The findings would vary for different systems dependant upon the inflation sensitivity of each system. A system containing health care benefits as a significant portion of liabilities would be more sensitive to inflation.

Senator Stedman then spoke to the present historical years and lower expectations for equities of approximately 7.4 percent over the next five years. He noted that the Permanent Fund has no unfunded liability, but rather a requirement to pay dividends in the event of realized gains.

Mr. O'Leary stated the Permanent Fund has a real return target of five percent. He explained that a actuarial advisement of an eight percent return for a pension fund includes an inflation expectation of 3.5 to four percent over 40 years. Therefore a typical public pension fund has a goal of a greater than 4.5 percent real rate of return. The Permanent Fund consistency of year-to-year return is important given the constitutional provisions stipulating that in

the event of significant volatility, the ability to provide distribution is eliminated.

Senator Stedman asked if the real return expectations have changed significantly since 1999.

Mr. O'Leary answered they have not. He noted that the current policy governing the Permanent Fund target allocation produces an expected real return of five percent. This amount has varied by tenths of percents from one year to another.

Senator Stedman expressed concern with the unfunded pension liability of the Public Employees Retirement System (PERS) and the Teachers Retirement System (TRS) and the target rate of 8.25 percent established in 1998 or 1999. Since that time, changes have occurred in the economy and the market rate. If that rate were reduced the liability would increase. He questioned whether this rate should be reviewed.

Mr. O'Leary remarked that the discount rate would be utilized as a portion of the actuarial set of assumptions through discussions with the actuary and the PERS and TRS boards of directors. He stressed the importance that the set of assumptions be balanced.

Senator Stedman learned from discussions with Mercer Consulting, the actuary for the PERS and TRS plans, that the 8.25 percent rate was not achieved from review of historical market projections, but rather from asset allocation information provided by the Alaska State Pension Investment Board (ASPIB). Mercer Consulting did not independently set the discount rate.

Mr. O'Leary noted that ASPIB determines an expected rate of return target when setting investment policy with a shorter time rise. That shorter time rise target is significantly based on the information provided by Callan and Associates. The ASPIB asset allocation is somewhat more aggressive than that of the Permanent Fund in terms of equity commitment.

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Co-Chair Wilken commented this is the seventh presentation he has attended from Callan and Associates.

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Surplus Reverts to a Massive Federal Budget Deficit

[Bar graph showing Federal and State & Local surplus and deficits for the years 1990 through 2010.]

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The U.S. Current Account Deficit: Over \$600 Billion as Far as the Eye Can See

[Bar graph showing Current Account Deficit and line graph showing Deficit as % of GDP for the years 1980 through 2008.]

Co-Chair Wilken asked about the notations reading "*2005+ forecast - Global Insight" on these graphs, specifically the meaning of global insight.

Mr. O'Leary replied that Global Insight is a business entity that provided the projections used to demonstrate future years on the graphs.

Co-Chair Wilken announced a proposal for a long-term fiscal plan. He asked the Permanent Fund trustees and legislators to review a handout titled, "Senate Bill 88, A Bridge to Development, A Policy on General Fund Revenue Shortfall, February 15, 2005" [copy on file]. He requested critique of this proposal and offered to give a presentation to the trustees. He expressed, "This is the start of a long road" and added, "This group here is the group that would set the course for a long term fiscal plan, whatever that happens to be."

Representative Stoltze appreciated the presentation. He asked the expectation from the trustees of the legislature now that the committees had received this knowledge.

Mr. Burns responded that the Corporation would give a presentation specifically related to the statutory investment list is "doing" either to help or impede the Funds progress in providing the expected returns. The Corporation intended to propose legislation to amend the statutory investment list. The same returns could be achieved at less risk, or higher returns could be realized with the same level of risk if the Corporation were not encumbered by the current statutory investment list.

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Co-Chair Wilken remarked that the Senate Finance Committee has never denied a request of trustees for legislation to amend Fund management procedures. He attributed this to the expertise of the trustees. He asked if removal of allocation restrictions could be implemented over a period of time of possibly five years.

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Representative Hawker clarified that Mr. Burns testified that the

same level of return could be achieved with less risk.

Mr. Burns replied that statistics indicate this is possible.

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Senator Stedman used an assumption that the allocation the defined benefit plan is operating has greater stock exposure and subsequent wider dispersion than the Permanent Fund. However, he held a "lower risk tolerance" for the benefit plan fund than he held for the Permanent Fund. The Permanent Fund would grow in perpetuity and provide dividends in amounts possible, but the pension plan is required to provide payments.

Mr. O'Leary opined that in "a comparative sense" the ASPIB risk tolerance has been more conservative than the typical public pension fund. However, the Permanent Fund has been "much more conservative". He noted that 30 percent of assets of other major endowments of over \$1 billion are allocated to investments the Permanent Fund is prohibited from participating in, with the exception of the basket provision. The Permanent Fund may actually be "sub-optimizing" return that could be produced over the long term. If the current rate of return is desired, the volatility could be reduced if the statutory investment list were changed. Also, it could be determined that the current level of risk were acceptable, the portfolio altered and the Fund could achieve a higher expected rate of return. The ability to maintain a higher return policy in the event of a year or two in which the earnings reserve fund was insufficient to provide any distribution. This nearly occurred a couple years prior.

ADJOURNMENT

Co-Chair Green adjourned the meeting at 11:17 AM