

MINUTES
SENATE FINANCE COMMITTEE
HOUSE FINANCE COMMITTEE
February 23, 2006
9:14 a.m.

CALL TO ORDER

Co-Chair Gary Wilken convened the meeting at approximately [9:14:14 AM](#).

PRESENT

Senator Gary Wilken, Co-Chair
Senator Con Bunde, Vice Chair
Senator Bert Stedman
Senator Lyman Hoffman
Senator Donny Olson

Representative Kevin Meyer, Co-Chair
Representative Mike Chenault, Co-Chair
Representative Bill Stoltz, Vice-Chair
Representative Mike Kelly
Representative Jim Holm

Also Attending: CARL BRADY, Chair, Alaska Permanent Fund Corporation, Board of Trustees; MIKE BURNES, Chief Executive Officer, Alaska Permanent Fund Corporation, Department of Revenue; MICHAEL O'LEARY, CFA, Executive Vice President, Callan Associates, Inc.; BOB BARTHOLOMEW, Chief Operating Officer, Alaska Permanent Fund Corporation, Department of Revenue

Attending via Teleconference: There were no teleconference participants.

SUMMARY INFORMATION

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Presentation:
Alaska Permanent Fund Fiscal 2005 Summary
By
Alaska Permanent Fund Corporation
Callan Associates, Inc.

[9:15:59 AM](#)

CARL BRADY, Chair, Alaska Permanent Fund Corporation, Board of

Trustees, introduced the members of the Board. Mr. Brady referred to the 2005 passage of HB 215.

[9:18:16 AM](#)

MIKE BURNES, Chief Executive Officer, Alaska Permanent Fund Corporation, Department of Revenue, presented members and the public with a handout titled: "Alaska Permanent Fund Fiscal 2005 Summary" [copy on file].

[9:18:47 AM](#)

Mr. Burns noted that, in FY 05, the total [Permanent] Fund return was 10.4 percent; the real rate of return after inflation was 7.7 percent; and the balance in the Fund, as of June 30, 2005, was \$29.96 billion, which is an increase over FY 04 of almost \$2.6 billion.

[9:19:06 AM](#)

Mr. Burns observed that the total return for the first six months of FY 06 was 6.7 percent, which equates to 13.4 percent on an annualized basis. The value of the Fund on December 31, 2006, was \$32.2 billion, which is a gain of \$2.3 billion. The Fund increased an additional \$1.3 billion between December 31, 2006 and February 23, 2006. The realized income, which is used for dividend calculations, for the first six months was \$1.3 billion; the total realized income for FY 05 was \$1.75 billion.

[9:21:05 AM](#)

Mr. Burns referred to the new authority [given to the Alaska Permanent Fund Corporation (Corporation)] under HB 215. The Corporation has adopted new regulations for investments with consultation of out-side managers (Callan Associates) and legal counsel. The "prudent investor" rule was defined and an attempt was made to cover all possible investment opportunities. The investment regulations are detailed and complex, and were driven by the new combinations of asset classes.

[9:22:31 AM](#)

Mr. Burns explained that a new confidentiality regulation was adopted and assured members that nothing in the new regulations "changes anything". Statutes have been in place since the inception of the Corporation in 1980, which requires confidentiality. Regulation only enforces the policy. There are three asset classes; real estate is the first asset class. The Corporation can

not negotiate and compete with others to buy real estate if their numbers are known to their competitors. Once a purchase occurs, all pertinent information is listed on their website and made available to the public.

There are two areas which are difficult for the Corporation: private equity and absolute return, which deals with the intellectual property of the investment managers. Mr. Burns observed that 75 - 80 percent of the success in these asset classes is in the top tier. Top tier assets have the most intellectual property to protect. Statutes require them to honor that confidentiality. He reiterated that there is nothing confidential today that was not confidential 25 years ago.

[9:25:23 AM](#)

Co-Chair Wilken asked for a definition on "absolute return". Mr. Burns explained that "absolute return" refers to hedge fund strategies [managers seek positive returns in both up and down markets]. The Corporation takes part in 14 strategies. Most are non-directional strategies. Equity markets are relative to their peers and bench marks. A manager is hired to get a set return on so many basis points over the London Interbank Offered Rate (Libor). Absolute return is more attractive than fixed income and is less volatile. There is one manager or "gate keeper" that puts the Corporation into partnerships and moves money depending on what is most attractive.

[9:26:38 AM](#)

Mr. Brady described hedge funds as a long-short, market neutral transaction. He gave the example of buying General Motors long and the Ford Company short. The concept is a bond rate of return plus 2 - 3 hundred basis points. The risk is relatively low; the upside is not that great, but it is a vehicle that many institutions use. He observed that 40 - 50 percent of university investments are in this class.

[9:27:35 AM](#)

Senator Stedman asked for further explanation of the London Interbank Offered Rate and long and short investment strategies.

[9:28:37 AM](#)

MICHAEL O'LEARY, CFA, Executive Vice President, Callan Associates, Inc., provided information regarding the London Interbank Offered Rate. He explained that Libor is a short term, floating interest

rate, a day-to-day interest rate, and is the standard for borrowing and lending money on a short-term basis. He compared it to an overnight borrowing rate in the United States. Libor is evaluated in dollars and provides a high quality, risk-less investment. A lot of floating rates are tied to the Libor.

Mr. O'Leary clarified that the use of "long" in context of investment means the security is owned. "Short" refers to the sale of a security that is not owned and is obligated to deliver to the purchaser as facilitated through security lending. A broker is used to sell the security short. The broker borrows the security and delivers it, so that whoever bought the security is the owner. The short seller, or their agent, receives the proceeds and is responsible for closing out the position by buying out the security. A security is "short" when the manager thinks it will decline in value. Money is made if the value declines when the position is closed out by buying it at a lower price. He gave further examples and summarized that relative prices are the source of the return. He pointed out that an attractive return could be achieved regardless of market performance if the long and short are judged correctly. Rising market exposure can be negated by being equally long and short.

[9:33:05 AM](#)

Senator Stedman noted that they would make money if the stock goes up when they are long; and they would make money if the stock goes down and they are short.

[9:33:14 AM](#)

Mr. O'Leary added that the general volatility would be removed if there is equal weighting in both positions. A matched trade would result in 4 or 5 percent over a risk-less short investment.

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In response to a question by Co-Chair Wilken, Mr. Burns affirmed that Libor could be compared to the federal fund rate.

[9:34:00 AM](#)

Mr. O'Leary gave a presentation: "Economic & Capital Market Update" [copy on file]. Each year Callan does 5 year projections, which are changed "at the pace of a glacier." The focus is on making long-term forecasts; they are not focused on what markets would do this year. Stocks are expected to return more than bonds and bonds more than cash, but they recognize that at times bonds are better than

stocks. A range of returns are forecast around the central midpoint return. Ownership equity is much wider than high quality bond investments.

[9:36:41 AM](#)

Mr. O'Leary observed that projections on inflation influence judgments regarding the level of short-term, cash returns that can be expected. Over the long-term, cash returns have seldom been significantly in excess of inflation; when short-term, cash returns have been over inflation it has been due to an overestimation of inflation.

Mr. O'Leary noted that the same approach is taken in regards to fixed investments; they focus on the relationship and expected return between stocks and bonds; they also consider large cap versus small cap stocks, and domestic versus international stocks.

[9:38:29 AM](#)

Mr. O'Leary reviewed the calendar period of return for major asset classes over the last six years (page 4). The six year period begins with the start of the Bear market. The first 3 years achieved poor returns; the last 3 years have been a recovery period. He directed member's attention to LB Aggregate at a return of 5.87 percent; stocks only returned 1.58 percent using the Russell 3000 as a measure of the broad U.S. stock market. He observed that the ten year return is a reflection of the long-term relationship between stocks and bonds.

[9:40:32 AM](#)

Mr. O'Leary noted that consumer spending is the biggest component of the economy. Consumer spending has carried the economy, but has probably done better than there is a right to expect. The rate of increase in consumer spending has to decline according to most economists. Savings are low or negative. The beneficial affect of tax cuts in regards to dispensable earning are largely past. Interest rates are up, which is significant in terms of the impact on housing and the ability to extract equity from housing. Energy costs are up. He pointed out that a mild winter in much of the country was helpful.

[9:42:17 AM](#)

Mr. O'Leary observed that the ability of the consumer to spend is a function of income, which is a function of jobs. Employment growth has been strong. During the recovery period, employment was

initially slow, but has picked up and the number of jobs created has been high. Employment growth must continue to support consumer spending growth.

[9:42:48 AM](#)

Mr. O'Leary noted that consumption has grown more rapidly than income. Global Insight projections show the reverse. He concluded that the pace of growth in spending must diminish.

[9:44:03 AM](#)

In response to a question by Representative Kelly, Mr. O'Leary clarified that Global Insight projected that the country would flip from consuming more than income grew to the reverse.

[9:44:56 AM](#)

Mr. O'Leary referred to research by Alliance Bernstein, contained on page 9 of the handout. The numbers depict the growth of mortgages in excess of new housing investments. The values of mortgages for each calendar year were reviewed for the value of the mortgages relative to the value of new real estate investment. He summarized that, in FY 05, \$350 billion in mortgages were issued in excess of the value of housing investments; this refers to the amount of money that came out of housing into consumers' pockets for other uses and accounts for a large amount of the personal consumption expenditures. Consumers would not be able to sustain that level of spending if their ability to take money out their houses went away.

[9:47:06 AM](#)

Co-Chair Wilken summarized that the total for those that used their equity mortgages to finance other spending was \$350 billion. Mr. O'Leary observed that there has been a lot of appreciation on housing, but that consumers may feel as if they still have the same level of equity.

[9:48:13 AM](#)

Co-Chair Chenault asked for information on interest only loans and how they apply. Mr. O'Leary explained that if a new homeowner purchased a home through a interest only loan, they would have net new investment in the amount of the home and it would not show up in the above calculations.

[9:48:54 AM](#)

Co-Chair Chenault pointed out that consumption money would be available, at some point in time, with interest only loans. Mr. O'Leary agreed and added that a traditional mortgage would allow less spending on other items.

[9:49:31 AM](#)

Mr. O'Leary continued to evaluate research by Alliance Bernstein on new housing investment, which increased by \$650 billion in a 9 month period during 2005. Net increase in mortgage debt was \$1 trillion in the same period, with \$350 billion in equity extracted. He pointed out that this important source of growth in the economy is not forecasted to go away, but would be less powerful and less beneficial in the future, resulting in a reduction of consumer spending.

[9:50:43 AM](#)

Mr. O'Leary noted that the real price of oil has increased tremendously but is below where it was in the 1970's. From a consumer's perspective, the increase becomes a real reduction in the consumer's ability to spend.

[9:51:33 AM](#)

Mr. O'Leary reviewed the CPI of all urban consumers, which was 3.4 percent and noted that core inflation has been at 2.2 percent. Most economists and many in finance focus on core inflation because it has less volatility and noise than the broader rate, but noted that permanent changes in food and energy prices work their way through to the core rate.

[9:52:38 AM](#)

Co-Chair Wilken clarified that the core rate is minus energy and fuel. Mr. O'Leary affirmed

Mr. O'Leary observed that the inflation picture constitutes a change; inflation has decreased over the last 20 years. He believes that inflation has been in a "sideways" period. He acknowledged that there might be a bias toward be slightly higher [inflation]. The current U.S. account deficit is projected at \$900 billion, which is a substantial portion of the GDP (gross domestic product).

[9:53:55 AM](#)

Co-Chair Wilken questioned what has driven this trend. Mr. O'Leary

explained that the U.S. economy has been stronger than most in the world, with a lot of outsourcing, which results in a poor balance of trade. Trade and the money flow are reflected. There have been high deficits that must be financed. Foreign investors have been willing to finance U.S. obligations, partially because of high U.S. interest rates, which are better than other countries. He thought that foreign investment in our treasury debt has exceeded the issuance in the past two years.

[9:55:18 AM](#)

Representative Stoltz asked the affect on housing extraction if interest rates increase. Mr. O'Leary explained that further increases in interest rates would tend to have a negative affect on new housing activity and it would be more difficulty for existing homeowners to refinance, which would slow down related industries. He summarized that it would be a negative for economic activity. He felt that interest rates were reaching a plateau.

[9:56:51 AM](#)

Senator Bunde observed that the state of Alaska is planning to embark on the largest construction project that the world has ever seen in terms of cost. He acknowledged that interest rates may be flattening, but asked for further speculation on financial conditions in relation to the \$20 billion gas line project.

[9:57:46 AM](#)

Mr. O'Leary noted that the economy is "collectively happy to see it" as a reliable source of energy supply. Business fixed investment is an important source of economic growth. He could not speak to the details. He was optimistic that inflation would remain reasonably stable. A recession is not forecast for the next 2 - 5 years. He felt that the economic environment was reasonable.

[9:59:32 AM](#)

Mr. O'Leary looked at inflation during the 60's and 70's and the subsequent deceleration of inflation during the 80's and 90's. He pointed out that since 2000, inflation has been reasonably stable. The five year inflation forecast is at 2.75.

[10:00:24 AM](#)

Mr. O'Leary explained that the total return, on a calendar year basis, for the Lehman bond index is comprised of earned income, and market price changes during the year. He noted that the income

component diminished, as the general level of interest rates declined. Price volatility has also declined.

[10:01:16 AM](#)

Mr. O'Leary addressed the Lehman aggregate bond index from, January 2001 through the end of 2005, which ended at 5.08 percent. Forecasts are based on what investors collectively think. The current yield on the bond market is a good forecaster of the next 5 year total return. He expected that investment grade bonds would return approximately 5 percent over the next five years.

[10:02:19 AM](#)

Mr. O'Leary referred to the calendar returns for the S&P 500. Stocks have returned, in nominal terms, 10 - 11 percent over the long-term, but there has been a great deal of volatility. He stressed how volatile the return can be on a year-to-year basis, but added that there are more positives than negatives.

[10:03:51 AM](#)

Mr. O'Leary spoke to the long-run, average price earnings ratios for the stock market, which is based on reported earnings, not projected earnings. By the end of FY 05, they were near the average, way below where they were before the "bubble burst". He pointed out that, while the stock market has gone up; profits have grown at a faster rate.

[10:05:00 AM](#)

Mr. O'Leary compared the valuation of equities in relationship to the yield on 10 year treasury bonds. This was a useful tool, through most of the 80's and 90's, in determining relative value of stocks to bonds. Using this as one measure, stocks look relatively attractive versus bonds.

[10:05:59 AM](#)

Mr. O'Leary summarized that their five year capital market projections are basically unchanged from those made a year ago. Estimated inflation has increased to 2.75 (a 15 point basis point increase from last year). Short term cash returns were also increased due to rising interest rates. Bond rates were set at 5 percent. Domestic equity returns in aggregate (Russell 3000) were left unchanged at 9 percent. Real estate was held at 7.6 percent. Private equity was held at 12 percent. International stocks did better than domestic stocks in the previous year, so they slightly

narrowed the expected return for international stocks relative to U.S. stocks from 9.25 to 9.20.

[10:07:40 AM](#)

Mr. O'Leary referred to the projected standard deviation column on page 22 of the handout, which is a measure of risk and volatility of returns. Emerging markets are very volatile; the projection is almost 33 percent volatility, which is almost twice the rate of U.S. stocks.

[10:08:40 AM](#)

Mr. O'Leary concluded that an efficient frontier was developed and compared using the projections of: expected return, risk, and a correlation of the two. There are a number of mixed scenarios. He observed that a 6.5 percent return might be expected on a low risk strategy. On the other end of the spectrum, 14.27 percent would be consistent with a high risk return.

The Permanent Fund policy, which was adopted in November 2005, has an expected return of 7.77. This is consistent with a targeted real return of approximately 5 percent, given their assumptions.

[10:09:51 AM](#)

Senator Hoffman observed that were corrections to the markets in the early 1990s. He questioned if there is a housing bubble in the U.S., and whether it would be corrected.

[10:10:21 AM](#)

Mr. O'Leary responded that there are clear areas where there has been too much building in response to extraordinary increase in the price [of housing]. He concluded that in these areas, "it could be painful for the people that were doing the building". He did not see a national bubble that needed to be burst. He anticipated that the rate of increased prices would diminish, and added that they have already diminished, resulting in a slow down of sales. He concluded that housing is still comparatively affordable because interest rates have remained level. Those dependent on adjustable rate mortgages are being "squeezed out of that market".

[10:11:51 AM](#)

Senator Stedman noted that a Board policy change resulted in a redirection of assets and changed the way dividends are calculated. Realized returns are needed to increase the dividend due to the

change. He questioned if management style has changed to a percent of market value approach, as opposed to one that would realize greater income toward dividends.

[10:13:15 AM](#)

Mr. O'Leary maintained that the focus has been on the total return over the fifteen years he has worked with the Fund. Statutory limitations have restricted the number of options or approaches that could be used. He didn't think there has been a significant change on the likely affect on realized income due to the shifts. He explained that, in absolute return, the turnover rates associated with the strategies tend to be high, which results in quicker realization of gains over losses. The Board has incorporated high yield fixed investments as part of an expanded opportunity set for the bond area that is also a high income generator. Real estate is the major liquid asset category, which has been a fixture of the Fund for some time. The primary driver has been income return for direct investments, but there is a meaningful portion of the real estate allocation that is invested in REIT's (real estate investment trusts), which are actively managed, so there is both income and realized gains or losses affecting realized income. Private equity is the one place that would not be invested in if there were an income orientation, since it is an inherently long term and capital gains investment strategy. A typical private equity fund has a six to eight year holding period before the gains are distributed. The actual amount invested is significantly less than that targeted at a 4% allocation. The Board has not suggested increasing the overall equity allocation, which would have a greater impact.

[10:16:47 AM](#)

Mr. Burns added that the statutes do not direct the Board toward investing with an eye on realized income. Statutes address the "maximum prudent return". The maximum return must be considered even if unrealized income provides the best maximum return. Managers are not responsible for the distribution formula.

[10:17:47 AM](#)

Senator Stedman referred to page 23 of the handout. He observed that for mix 5, a targeted rate of return of 8.5 percent, if private equity, emerging market equity, international equity, small/mid cap, and large cap equities are included there is a 74 percent allocation to equities. The Permanent Fund's target is 7.77 percent return at 57 percent equity exposure. He questioned how the asset mix plays into the projections published on their

website.

[10:19:37 AM](#)

BOB BARTHOLOMEW, Chief Operating Officer, Alaska Permanent Fund Corporation, Department of Revenue, explained that the five year range was used for the whole fifteen year projection. The projections are not changed after five years.

[10:20:02 AM](#)

In response to comments by Senator Stedman, Mr. O'Leary explained that the expected growth in liabilities for pension programs are affected by projected inflation. Actuaries typically use estimates of inflation that are reasonable for a "very" long-term perspective (3.5 - 3.75 percent). Financial markets deal with current inflation; inflation today is lower, which is reflected in cash markets and fixed income investments. The projections used an inflation rate of 2.75 percent. A 40 year forecast would use a higher inflation number, which would result in a higher expected return for stocks and bonds. The actuarial rate is 8.25 percent. The expected return from their existing portfolio using the same assumptions in their policy mix is just under 7.9 percent. The difference is due to a heavier commitment to private equity more in the absolute return area than the Permanent Fund had been able to do.

[10:22:48 AM](#)

Senator Stedman referred to actively traded stocks, where the rate of return is public and known. He observed that the rates of return for private equity assets are based on estimates. He asked if the variability of potential outcome would be spread.

[10:23:40 AM](#)

Mr. O'Leary noted that a high risk number is used for investments where volatility is not observed. He used real estate as an example and explained that the standard deviation for volatility is 16.5 percent, but when real estate volatility is observed it looks like it is less than that for bonds because of the appraisal process. In the private equity arena, the industry convention is to carry investments on a cost basis until there is a financing event that would provide a basis for increasing the value. This creates a J curve, where because fees are paid, the returns are negative, but to the extent the investments are productive the return is achieved with liquidation. Just as with real estate, gains are not realized until the property is disposed or refinanced. He concluded that

private equity is inherently risky but it also has attractive return opportunities. A comparatively small portfolio in the Permanent Fund of 4 percent is the target and is appropriate. As other endowments and foundations are observed, it is not uncommon to see upwards of 50 percent of the investment pool invested in a combination of private equity (up to 15%) and alternative strategies, including hedge funds, of another 30 or more percent.

[10:26:11 AM](#)

Senator Stedman stressed that there are a lot of interrelationships between the pension portfolio's management and the Permanent Fund and both are critical to the citizens of the state. He concluded that the more volatility in the estimate of the portfolio, the harder it is to understand the potential exposure in the retirement system and observed that the liability side is hard enough.

[10:27:11 AM](#)

Senator Hoffman noted constituent questions after the Governor's announcement of a potential 20 percent state investment in the natural gas pipeline (\$20 - \$25 billion). The Governor's budget includes a down payment of \$400 million. He recalled discussions of a possible investment by the Permanent Fund and questioned the likelihood of such an investment.

[10:28:20 AM](#)

Mr. Burns clarified that they have not been presented with a specific proposal. The Board has been advised that various scenarios are being discussed. The Board plans to discuss the RFP that would allow them to hire a financial adviser to look into three broad areas: Board education regarding capital infrastructure products, how they are being utilized and how they might fit into the Permanent Fund's portfolio; a determination of the potential investment merits; and if it is a good investment, how does it fit into and complement the portfolio. The process of hiring an independent expert is occurring.

[10:29:49 AM](#)

Senator Hoffman questioned if the Board believes it has the authority to make an [investment] decision, or would it require legislative approval.

[10:30:14 AM](#)

Mr. Burns thought that initial review would address the question:

"Is this prudent?" The Board would not go forward if it is not prudent. They must consider: "Is it a good investment and is it a good investment for this portfolio."

[10:31:05 AM](#)

Mr. Burns emphasized that there would be significant input by the legislature and noted that the legislature controls their budget.

[10:31:31 AM](#)

Senator Olson asked if there is a misconception that high oil prices result in larger dividend payments, and noted that high-energy costs affect the market. He asked which has the greatest impact: high oil prices or low energy costs.

[10:32:25 AM](#)

Mr. O'Leary responded that the health of financial markets has the greatest affect, which he clarified to mean: not disruptive energy prices.

[10:32:54 AM](#)

Mr. Burns spoke to inflation, estimates and potential damage of different levels of inflation. He pointed out that the Fund is protected against all but a "really extraordinary jump in inflation." He acknowledged that current yield could be sacrificed for the future protection from inflation, but concluded that the trade offs were not compelling.

[10:34:33 AM](#)

Senator Stedman asked about expectation of state dividend in the near future.

[10:35:05 AM](#)

Mr. Burns explained that the realized income for the first 6 months [FY 06] of \$1.3 billion was more than the number that falls out of the formula. The Fund receives, at a minimum, \$60 - \$70 million a month in interest and dividend income. The number going into the formula should be significantly higher. He pointed out that the formula contains low numbers (\$280 - \$300 million) over the next two years. He concluded that the dividend would go up in 2006 and be even higher in the next two years, if the markets hold. There are extraordinarily low numbers for 2007 and 2008.

[10:36:19 AM](#)

Mr. O'Leary emphasized that a percent of market approach toward distributions results in greater consistency and predictability.

[10:37:03 AM](#)

Co-Chair Wilken thanked the trustees for their leadership and service.

#

ADJOURNMENT

Co-Chair Gary Wilken adjourned the meeting at [10:37:59 AM](#).