

**MINUTES**  
**SENATE FINANCE COMMITTEE**  
**HOUSE FINANCE COMMITTEE**  
**March 1, 2007**  
**9:02 a.m.**

**CALL TO ORDER**

Co-Chair Bert Stedman convened the meeting at approximately [9:02:22 AM](#).

**PRESENT**

Senator Lyman Hoffman, Co-Chair, Senate Finance Committee  
Senator Bert Stedman, Co-Chair, Senate Finance Committee  
Senator Charlie Huggins, Vice Chair, Senate Finance Committee  
Senator Kim Elton  
Senator Joe Thomas  
Senator Fred Dyson  
Senator Donny Olson  
Representative Bill Stoltze, Vice Chair, House Finance Committee  
Representative Mike Kelly  
Representative Bill Thomas  
Representative Harry Crawford  
Representative Les Gara

**Also Attending:** CARL BRADY, Chair, Board of Directors, Alaska Permanent Fund Corporation; MIKE BURNS, Executive Director, Alaska Permanent Fund Corporation; MICHAEL O'LEARY CFA, Executive Vice President, Callan Associates, Inc.

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

**SUMMARY INFORMATION**

^Alaska Permanent Fund Corporation Presentation  
APFC Board of Directors

[9:03:40 AM](#)

Co-Chair Stedman introduced and stated the intent of the presentation was to overview the value of the Alaska Permanent Fund, dividend projections and expected rates of returns. The

2007 Permanent Fund dividend payments would likely be approximately \$1,000.

[9:04:33 AM](#)

CARL BRADY, Chair, Board of Directors, Alaska Permanent Fund Corporation (APFC), informed that he was recently re-elected to the position. He introduced other members of the Board, giving background information on their experiences and qualifications.

[9:06:57 AM](#)

Mr. Brady announced that the year 2007 was the 30th anniversary of the formation of the Alaska Permanent Fund.

[9:07:40 AM](#)

Mr. Brady stated that the contribution to the dividend program was unknown at this time. The formula is complicated and could not be predicted. He told of a business owner from Nome making this same request arguing he needed to know the approximate amount area residents would receive to allow him to adequately order merchandise.

[9:10:09 AM](#)

Mr. Brady philosophized that the past is the past and the future was unknown.

[9:10:37 AM](#)

Mr. Brady assured that the Fund investments were diversified and would continue to become more diversified. Performance targets would be met.

[9:11:59 AM](#)

MIKE BURNS, Executive Director, Alaska Permanent Fund Corporation, had planned to report that the balance of the Fund had reached \$38 billion. However, events affecting the Chinese investment market had implications on the worldwide market and subsequently on the Alaska Permanent Fund.

Mr. Burns instead reported that the balance of the fund "closed" at \$37.3 billion on Tuesday. While this is a substantial loss

from "a dollar perspective", it was not the largest loss incurred in a single day and although the events were "dramatic", they were not unexpected. That the events happened as quickly as they did was unexpected.

[9:13:48 AM](#)

Mr. Burns furthered that a "correction" such as occurred earlier in the week was to be expected when investing in public and private markets. The recent events would have no affect on the Board's expectations for the Fund's performance.

[9:14:37 AM](#)

Mr. Burns outlined handout titled, "Alaska Permanent Fund Corporation Fiscal Performance Summary" [copy on file], which reads as follows.

For the fiscal year 2006:

- The Fund returned 11 percent, well ahead of our benchmark of 10.5%
- For the first time the Fund reached \$31, \$32, \$33, \$34 and \$35 billion in value.
- We earned \$3.1 billion on investments, and received an additional \$601 million in mineral revenues.
- And we paid \$689 million in dividends, ending the year with a balance of \$32.9 billion, a gain of almost \$3 billion over FY 05.

For the first six months of fiscal 2007:

- The Fund returned 9.6%, and closed on December 31 with an unaudited value of \$36.4 billion.
- Statutory net income as of December 31 was \$1.9 billion. Statutory net income was only \$257 million for FY 02, the year that falls out of the five-year average, so we expect dividends will be higher this fall.
- Performance since December was trending upward, and the Permanent Fund closed \$40 million short of \$38 billion on Monday.
- Most of this strong performance is the result of gains in both US and non-US stocks, and the markets have held on to some of the gains made since December 31.

[9:16:35 AM](#)

MICHAEL O'LEARY CFA, Executive Vice President, Callan Associates, Inc., gave a presentation titled, "House & Senate Joint Finance Committee Economic & Capital Market Outlook" [copy on file.]

[9:17:12 AM](#)

Mr. O'Leary noted that this presentation reflected five-year capital projections and that "very little had changed" from the prior year.

[9:17:27 AM](#)

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#### Economic Forecast: Contained Enthusiasm

- Growth remained robust in 2006, but economy is slowing toward trend.
- Outlook for 2007 depends heavily on whether housing stabilizes and the effects of the downturn are contained.
- Consumers are spending all of their income, tax cuts are over, and the savings rate is negative. Confidence is high but vulnerable to shocks - housing, war, economy.
- Decent job growth, improving real wages, and lower gasoline prices will help support consumer spending.
- U.S. and China will continue to be the primary engines of growth.
- Oil prices will slide - gradually - but with a new floor of \$50 (\$60? \$70?).
- Inflation will remain a low level threat; oil prices are the wild card, labor costs represent the upside risk.
- The Fed tightened to 5.25 and paused; the rate cuts may still be up to a year away.

Mr. O'Leary reported that 2006 was a "record year" in the Fund's performance. The growth had slowed somewhat to approximately three percent, which was close to expectations.

[9:21:12 AM](#)

Economy is Slowing After Three Strong Years - How Soft a Landing?

[Bar graph showing Real GDP - annual percent change, for the years 1990 through 2007 with a notation that the data for 2007 is an estimate. Global Insight is cited as the source of the information.]

Mr. O'Leary outlined the information, noting that performance had been consistent with expectations.

[9:21:36 AM](#)

U.S. Economic Growth by Sector

[Spreadsheet listing Annual percent change for the following components:

Real GDP

2002	1.6
2003	2.5
2004	3.9
2005	3.2
2006	3.0

Direction of Change: Moderating

Consumption

2002	2.7
2003	2.8
2004	3.9
2005	3.5
2006	3.2

Direction of Change: Moderating

Residential Investment

2002	4.8
2003	8.4
2004	9.9
2005	8.6
2006	-4.2

Direction of Change: Falling Sharply

Bus. Fixed Investment

2002	-9.2
2003	1.0
2004	5.9
2005	6.8

2006	7.5
Direction of Change: Surging	
Federal Government	
2002	7.0
2003	6.8
2004	4.3
2005	1.5
2006	1.9
Direction of Change: Winding Down	
State & Local Govt.	
2002	3.1
2003	0.2
2004	0.5
2005	0.5
2006	2.0
Direction of Change: Budget Pressures Easing	
Exports	
2002	-2.3
2003	1.3
2004	9.2
2005	6.8
2006	8.7
Direction of Change: Surging	
Imports	
2002	3.4
2003	4.1
2004	10.8
2005	6.1
2006	5.9
Direction of Change: Oil Prices]	

Housing downturn reduced GDP growth in 3rd and 4th quarters of 2006 by 1.2% through direct effect on construction alone.

Mr. O'Leary overviewed this data. He pointed out that exports were increasing and that imports were still affected by higher oil prices.

[9:22:21 AM](#)

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Residential Construction Overbuilt

[Line graph demonstrating fluctuations of Residential Fixed Investment - % of GDP for the years 1970 through 2005. Global Insight is cited as the source of the information.]

Mr. O'Leary stated that this chart showed substantial growth in residential investment followed by a significant downturn.

[9:22:35 AM](#)

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Housing Outlook: Hitting Bottom in 2007?

[Line graph demonstrating Millions of Units of Housing Starts overlapped with Year-over-year percent change of Median Existing Single-Family Home Price for the years 2001 through 2006. Global Insight is cited as the source of the information.]

Mr. O'Leary remarked that the types of homes were changing and the median price of homes was declining. Construction of new homes had also declined.

Mr. O'Leary spoke to a recent news release stating that sales of existing homes increased "sharply" in January 2007. This information was learned at the same time information regarding decreased new housing construction was released. Existing home sales are "much more important" to the economy than new housing "starts".

[9:23:50 AM](#)

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Housing Affordability Deteriorated as Interest Rates Rose

A higher index means homes are more affordable

[Line Graph providing detailed status of Affordability Index for Existing Single-Family Homes for the years 1972 through 2005. Global Insight is cited as the source of this data.]

Mr. O'Leary explained that the price of homes is not the only factor in whether homes are affordable. Interest rates are also important.

[9:24:31 AM](#)

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#### Mortgage Equity Withdrawal Fueled Consumer Spending

[Bar graph depicting the Percent of Disposable Income of Net Equity Extraction for the years 1991 through 2005 and the first three quarters of 2006. The source of this data is cited as Federal Reserve - Kennedy/Greenspan data updated as of December 2006.]

Mr. O'Leary reminded that during his presentation given one year prior, he had emphasized the importance to consumer spending of homeowners withdrawing equity in their homes. This was still important but less so than last year. This practice had diminished as housing prices "softened".

[9:25:13 AM](#)

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#### Personal Savings Rate Has Fallen Below Zero

[Line graph demonstrating Personal savings rate, percent of disposable income for the years 1998 through 2006. The following events and corresponding affect are pointed out: 9/11, Post 9/11 auto incentives, Microsoft dividend and Katrina. Global Insight is cited as the source of the data.]

Mr. O'Leary qualified this information excluded home values and certain investments, such as 401k plans. The graph did however, reflect general trends in which rate of savings is low.

[9:25:42 AM](#)

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#### However, Employment is Still Growing

[Bar graph showing Employment - percent change, annual rate, for the years 1999 through 2006. Global Insight is cited as the source of the data.]

Mr. O'Leary characterized this as a positive indication of the economy. Employment was growing "at a pretty hefty rate" and demonstrated "real average hourly earnings growth". The "marked increase" had occurred recently. Previously, a "major source of

concern" was that the country had been "in economic recovery" but wages had not increased.

[9:26:24 AM](#)

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Wage Growth is Finally Beating Inflation

[Line graph showing the Year-over-year percent change of Real Average Hourly Earnings Growth, for the years 2000 through 2006. Global Insight is cited as the source of this information.]

Mr. O'Leary explained that the consumer, "which is over two-thirds of the economy, has propelled growth over recent years." The expectation was that disposable income would grow "a little bit more rapidly than consumption during '27."

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Spending Has Outpaced Income Growth;  
Some Rebuilding of Savings is Likely

[Bar graph showing Percent Growth of Consumption and Disposable Income for the years 2003 through 2006 and estimated figures for 2007. Global Insight is cited as the source of this information.]

Mr. O'Leary explained this graph depicts "the share of national income for employee compensation and economic profits". He furthered, "Profits have done extraordinarily well," which has "not gone unnoticed in Washington" D.C. Policy changes in taxation on profits would not surprise him.

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Productivity Growth Has Boosted Corporate Profits to Record Levels

[Line graph demonstrating Percent of National Income of Employee Compensation and Economic Profits for the years 1999 through 2006. Global Insight is cited as the source of this information.]

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An Incredible Run for Corporate Profits;  
Return to Earth?

[Bar graph showing Percent Change of Profits with IVA & CCA for the years 1990 through 2005 and an estimated amount for 2006. Global Insight is cited as the source of this information.]

Mr. O'Leary reported that corporate profits, with inventory adjustments were almost 20 percent in 2006.

[9:28:13 AM](#)

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Manufacturing Capacity Utilization Reaching the Trigger  
Point for Investment

1960-2002 average = 81.2

[Line graph demonstrating the percentage fluctuations for the years 1970 though 2006. Global Insight is cited as the source of this information.]

Mr. O'Leary shared that economists used to aver that 80 percent capacity utilization required new capacity. This level of capacity had finally been reached, which had helped support an increase in business investment.

[9:28:43 AM](#)

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Capital Spending on Business Equipment is Still Growing

[Line graph showing fluctuations of \$Billions on Unfilled Orders (Nondefense capital goods excluding aircraft) for the years 1998 through 2006. Global Insight is cited as the source of this information.]

Mr. O'Leary pointed out that spending on business equipment had increased substantially.

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Non-Residential Construction is Taking the Lead

[Line graph demonstrating the (4-quarter percent change) fluctuations of Real GDP, Equipment & software, and Buildings for the years 1990 through 2006. Global Insight is cited as the source of this information.]

Mr. O'Leary outlined this data.

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Fed Will Have Room to Cut Interest Rates in 2007

[Line graph showing the percentage fluctuations of Federal Funds and 10-Year Treasury Yield for the years 1999 through 2006. Global Insight is cited as the source of this information.]

Mr. O'Leary commentated, "It's difficult to recall, but it just was a few years ago, federal funds were at the one percent level in '03 and early '04. They're now 5.25." Ten Year Treasury Rates had increased "but no where near as much". Therefore, the current situation was an "inverted yield curve - short rates are higher than longer rates." Arguably, this had discouraged investment and has been a predictor of every recession. However, such inversions has occurred in the past with no recession resulting. The amount of the current inversion was modest, but still should be noted.

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Federal Budget Deficit Has Actually Done Better Than Expected

[Bar graph depicting deficit or surplus in Billions of Dollars, Fiscal Years, for the years 1990 through 2006, and projections for the years 2007 through 2010. Global Insight is cited as the source of this information.]

Mr. O'Leary remarked that the impact of the aging baby boomer population would become prominent. Federal revenue was greater than anticipated and subsequently the budget deficit was less than anticipated.

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The U.S. Current Account Deficit: Peaking at Last?

[Bar graph depicting the Current Account Deficit and Deficit as % of GDP in the Billions of Dollars for the years 1970 through 2006 and projections for the years 2007 through 1020. Global Insight is cited as the source of this information.]

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U.S. Export Growth Catches Up to World Trade Growth - Falling Dollar Helps

[Bar graph showing Percent Change, Real Dollars for U.S. Export Growth and World Import Growth (Excluding U.S.), for the years 1991 through 2006 and a forecast for 2007. Global Insight is cited as the source of this information.]

Mr. O'Leary characterized the Current Account Deficit as "huge" but that it appeared to be "peaking as a percent of GDP "[gross domestic product]. This was largely because export growth had been "strong".

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Inflation Risk Remains Modest

- Despite soaring energy and commodity prices, inflation is contained. Outside energy, core inflation has moved past the Fed's "comfort zone", but shows signs of moderating.
- U.S. is the most susceptible to inflation among industrialized economies - only one with above trend growth.
- Consumer prices surged at times during 2005-06, but came in at 2.5% for the year, down from the 3.4% record in 2005.
- Strong productivity growth and modest wage inflation keep prices in check.

- Oil prices in the \$50-60s don't seem to mean as much to the U.S. economy as once suspected - one of the consequences of a service economy.
- Growth in Europe remains below trend and unemployment rates are high. Japan is still shaking off the effects of a decade of deflation.
- While U.S. capacity is stretched, large amounts of spare capacity exist in other parts of the world. China and other Asian countries continue to export deflation.

Mr. O'Leary outlined this information.

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Inflation Has Ticked Up...

Year-Over-Year Change in Consumer Prices

[Line graph showing the percentage fluctuations of CPI - Core and CPI All Urban Cons, for the years 2001 through 2006. The current CIP - Core is specified as 2.57 percent and the current CPI All Urban Cons is specified as 2.54 percent.]

Mr. O'Leary identified this page as "a comparatively short-term picture of inflation, the rates of change." The tendency was to focus on the core consumer price index (CPI).

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... But Perspective is Necessary

Year-Over-Year Change in Consumer Prices

[Line graph containing the information depicted on the previous page extended to include the years 1980 through 2006.]

Mr. O'Leary noted this page provided a longer term context. He opined, "It's hard to believe that in the late '70s and early '80s we were thinking about inflation rates in excess of 12 percent." The inflation rate had decreased substantially and "while there's been a great deal of volatility, particularly on a month-to-month basis and particularly when you look at the

series that includes energy and food" the rate had "stayed at comparatively low levels.

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The Capital Markets - Context  
Wild Ride for Investors Over the Last Seven Years  
[Spreadsheet containing the following information  
Broad U.S. Stock Market

Russell 3000

2000	-7.46
2001	-11.46
2002	-21.54
2003	31.06
2004	11.95
2005	6.12
2006	15.72

Average Annual Return

Five Years 2002-06	7.17
Ten Years 1997-06	8.64
Fifteen Years 1992-06	10.79

S&P Super Composite 1500

2000	-6.98
2001	-10.64
2002	-21.31
2003	29.59
2004	11.78
2005	5.66
2006	15.34

Average Annual Return

Five Years 2002-06	6.79
Ten Years 1997-06	8.83
Fifteen Years 1992-06	10.89

Large Cap U.S. Stocks

Russell 1000

2000	-7.79
2001	-12.45
2002	-21.65
2003	29.89
2004	11.40
2005	6.27
2006	15.46

Average Annual Return

	Five Years 2002-06	6.82
	Ten Years 1997-06	8.64
	Fifteen Years 1992-06	10.80
S&P 500		
	2000	-9.10
	2001	-11.88
	2002	-22.10
	2003	28.80
	2004	10.88
	2005	4.91
	2006	15.79
	Average Annual Return	
	Five Years 2002-06	6.19
	Ten Years 1997-06	8.42
	Fifteen Years 1992-06	10.64
Small Cap U.S. Stocks		
Russell 2000		
	2000	-3.02
	2001	2.49
	2002	-20.48
	2003	47.25
	2004	18.33
	2005	4.55
	2006	18.37
	Average Annual Return	
	Five Years 2002-06	11.39
	Ten Years 1997-06	9.44
	Fifteen Years 1992-06	11.47
S&P 600 Small Cap		
	2000	11.80
	2001	6.54
	2002	-14.63
	2003	38.79
	2004	22.65
	2005	7.68
	2006	15.11
	Average Annual Return	
	Five Years 2002-06	12.49
	Ten Years 1997-06	11.57
	Fifteen Years 1992-06	13.24
Non-U.S. Stock Markets		
EAFE (\$US)		
	2000	-14.17
	2001	-21.44
	2002	-15.94

2003	38.59	
2004	20.25	
2005	13.54	
2006	26.34	
	Average Annual Return	
	Five Years 2002-06	14.98
	Ten Years 1997-06	7.71
	Fifteen Years 1992-06	7.86
Fixed Income Markets		
LB Aggregate		
2000	11.63	
2001	8.63	
2002	10.26	
2003	4.10	
2004	4.33	
2005	2.43	
2006	4.33	
	Average Annual Return	
	Five Years 2002-06	5.06
	Ten Years 1997-06	6.24
	Fifteen Years 1992-06	6.50
Citi Non-US Bonds		
2000	-2.63	
2001	-3.54	
2002	-21.99	
2003	18.52	
2004	12.14	
2005	-9.21	
2006	6.95	
	Average Annual Return	
	Five Years 2002-06	9.50
	Ten Years 1997-06	4.70
	Fifteen Years 1992-06	6.35
Cash Market		
90-day T-bill		
2000	6.18	
2001	4.42	
2002	1.78	
2003	1.15	
2004	1.33	
2005	3.07	
2006	4.85	
	Average Annual Return	
	Five Years 2002-06	2.43
	Ten Years 1997-06	3.81

	Fifteen Years 1992-06	4.00
Inflation		
CPI-U*		
2000	3.39	
2001	1.55	
2002	2.38	
2003	1.88	
2004	3.26	
2005	3.42	
2006	2.54	
	Average Annual Return	
	Five Years 2002-06	2.69
	Ten Years 1997-06	2.43
	Fifteen Years 1992-06	2.57

\*Annual CPI-U data are measured as year-over-year change.]

Mr. O'Leary pointed out that 2000 through 2002 were the three years of the bear market. He listed the investment categories.

Mr. O'Leary directed attention to the ten year average annual return, which includes the "worst bear market since at least '73-'74, and arguably since the 1930s." It also includes "a very strong recovery subsequent to that bear market." He highlighted some of the asset categories. This information is useful in consideration of capital market projections.

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#### 2007 Capital Market Projections

[Spreadsheet containing the following information.

##### Asset Class: Equities

###### Broad Domestic Equity

Index: Russell 3000

Projected Annual Return-Real: 9.00%

Projected Annual Return-Nominal: 6.25%

Projected Standard Deviation (Risk): 16.90

Projected Yield: 2.10

2006 Projections: 9.00% 16.90

###### Large Cap

Index: S&P 500

Projected Annual Return-Real: 8.85%

Projected Annual Return-Nominal: 6.10%

Projected Standard Deviation (Risk): 16.40

Projected Yield:		2.20
2006 Projections:	8.85%	16.40
Small/Mid Cap		
Index: Russell 2500		
Projected Annual Return-Real:		9.85%
Projected Annual Return-Nominal:		7.10%
Projected Standard Deviation (Risk):		22.70
Projected Yield:		1.20
2006 Projections:	9.85%	22.70
International Equity		
Index: MSCI EAFE		
Projected Annual Return-Real:		9.20%
Projected Annual Return-Nominal:		6.45%
Projected Standard Deviation (Risk):		20.10
Projected Yield:		2.20
2006 Projections:	9.20%	20.10
Emerging Markets Equity		
Index: MSCI EMF		
Projected Annual Return-Real:		9.80%
Projected Annual Return-Nominal:		7.05%
Projected Standard Deviation (Risk):		32.90
Projected Yield:		0.00
2006 Projections:	9.80%	32.90
Asset Class: Fixed Income		
Domestic Fixed		
Index: LB Aggregate		
Projected Annual Return-Real:		5.25%
Projected Annual Return-Nominal:		2.50%
Projected Standard Deviation (Risk):		4.50
Projected Yield:		5.25
2006 Projections:	5.00%	4.50
Defensive		
Index: LB Gov't 1-3 Year		
Projected Annual Return-Real:		4.25%
Projected Annual Return-Nominal:		1.50%
Projected Standard Deviation (Risk):		2.30
Projected Yield:		4.25
2006 Projections:	4.25%	2.30
TIPS		
Index: LB TIPS		
Projected Annual Return-Real:		4.90%
Projected Annual Return-Nominal:		2.15%
Projected Standard Deviation (Risk):		6.00
Projected Yield:		4.90
2006 Projections:	4.65%	6.00

High Yield

Index: SCFB High Yield  
Projected Annual Return-Real: 7.00%  
Projected Annual Return-Nominal: 4.25%  
Projected Standard Deviation (Risk): 11.50  
Projected Yield: 7.00  
2006 Projections: 6.75% 11.40

Non US\$ Fixed

Index: Citi Non-US Gov't  
Projected Annual Return-Real: 5.15%  
Projected Annual Return-Nominal: 2.40%  
Projected Standard Deviation (Risk): 9.60  
Projected Yield: 5.15  
2006 Projections: 4.90% 9.60

Other

Real Estate

Index: Callan Real Estate  
Projected Annual Return-Real: 7.60%  
Projected Annual Return-Nominal: 4.85%  
Projected Standard Deviation (Risk): 16.50  
Projected Yield: 6.00  
2006 Projections: 7.60% 16.50

Private Equity

Index: VE Post Venture Cap  
Projected Annual Return-Real: 12.00%  
Projected Annual Return-Nominal: 9.25%  
Projected Standard Deviation (Risk): 34.00  
Projected Yield: 0.00  
2006 Projections: 12.00% 34.00

Absolute Return

Index: Callan Hedge FoF  
Projected Annual Return-Real: 6.50%  
Projected Annual Return-Nominal: 3.75%  
Projected Standard Deviation (Risk): 9.70  
Projected Yield: 0.00  
2006 Projections: 6.50% 10.20

Cash Equivalents

Index: 90-Day T-Bill  
Projected Annual Return-Real: 4.00%  
Projected Annual Return-Nominal: 1.25%  
Projected Standard Deviation (Risk): 0.80  
Projected Yield: 4.00  
2006 Projections: 4.00% 0.80

Inflation

Index: CPI-U

Projected Annual Return-Real: 2.75%  
Projected Standard Deviation (Risk): 1.40  
2006 Projections: 2.75% 1.40

Mr. O'Leary noted that the five year projections were unchanged from the previous year.

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Domestic Fixed Income

Lehman Aggregate Index - Daily Yield to Worst from 1/1/01 to 12/31/06

[Line graph depicting the Yield to Maturity (%) fluctuations between 3.0% and 6.5% for the odd-numbered months between January 2001 and November 2006. Several specific dates are highlighted.]

Mr. O'Leary deemed the Lehman Aggregate Index "a good measure of the investment grade bond market." The final rate reported for the year 2006, dated November 16, was 5.34 percent. He stated, "As I've told you in the past, this is our basic building block when we start making projections."

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Domestic Fixed Income

Current Yield is a Strong Predictor of Returns

Lehman Aggregate Index 5 Year Returns vs. Lagged Yield to Worst

[Line graph containing Five Year Return (% Annualized) and Yield to Worst (% Lagged) between 2% and 22% of Five Year Annualized Return (t) and Yield to Worst (t-5) for the years 1981 through 2007 and projections of Yield to Worst (t-5) for the years 2007 through 2012.]

Mr. O'Leary cautioned against "naively" assuming that the current bond market yield would remain unchanged for the next five years. This graph demonstrates the actual five-year return for bonds and the Yield to Worst "and just pushes it ahead five years." This methodology is "not perfect but it's a pretty good predictor of bond market returns."

[9:37:08 AM](#)

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Equity Appears to be Reasonably Priced

Trailing P/E Approaching Long-Run Average

[Line graph showing the fluctuations of the Price to Earnings Ratio for S&P 500 (1954-2006) superimposed on the Long-Run Average of approximately 16 percent and a -2 Std. Dev. and a +2 Std. Dev.

A notation reads: Trailing earnings as reported for the fiscal year; includes negative earnings from 1998 onward.]

Mr. O'Leary noted that the five-year projection for nominal stock returns was unchanged in large part because stocks do not appear to be excessively valued. Stock values were "very close" to the long term average. If a significant earning decline were expected, stocks would not be undervalued.

[9:38:00 AM](#)

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Domestic Equity vs. Bond Yields

S&P 500 Earnings Yield vs. 10-Year Treasury Yield

[Line graph showing Yield (%) of S&P 500 Earnings Yield and 10-Year Treasury Yield for the years 1981 through 2006.]

Ratio of S&P 500 Earnings Yield and 10-Year Treasury Yield

[Line graph showing Yield Ratio for the years 1980 through 2006 with specific periods highlighted. Those include Peak of interest rates and inflation in 1982; 1987 Market Crash; Fed tardy in lowering interest rates in 1992 and 1993; Fed raises interest rates to ward off inflation in 1995; Rising rates, falling earnings in 1999 and 2000; and Stocks Undervalued? Return to an old regime? in 2003 through 2006.]

Mr. O'Leary informed of another method to determine stock valuations by comparing stocks to bonds. He told of a model introduced by former Chair of the Federal Reserve Board, Alan Greenspan, which "contrasted the earnings yield on the stock market with the 10-year treasury". The graphs on this page utilized that model.

Mr. O'Leary stated, "The earnings yield is the reciprocal of the price earnings ratio." Therefore the earnings yield would be five if the price earnings ratio was 20. A price earnings ratio of 50 would result in an earnings yield of two. These graphs illustrate that over the last two decades, stocks earnings yield relative to the 10-year treasury "looks pretty attractive today." He cautioned that this "gap could of course be closed" with increasing interest rates or with earnings declining; however, in comparison with high quality bonds, stocks "do not look expensive".

[9:39:35 AM](#)

Page 31

Current Policy with 2007 Projections

Asset Mix Alternatives Optimization Set: 2007

[Spreadsheet containing the following information.

Portfolio Component: Large Cap

Max:	100%
Mix 1:	14%
Mix 2:	19%
Mix 3:	25%
APFC2006:	29%
Mix 4:	32%
Mix 5:	38%

Portfolio Component: Small/Mid Cap

Max:	100%
Mix 1:	4%
Mix 2:	5%
Mix 3:	7%
APFC2006:	5%
Mix 4:	8%
Mix 5:	10%

Portfolio Component: International Equity

Max:	100%
Mix 1:	6%
Mix 2:	9%
Mix 3:	12%
APFC2006:	16%
Mix 4:	15%
Mix 5:	19%

Portfolio Component: Emerging Markets Equity

Max: 100%  
Mix 1: 1%  
Mix 2: 1%  
Mix 3: 2%  
APFC2006: 3%  
Mix 4: 2%  
Mix 5: 3%

Portfolio Component: Domestic Fixed

Max: 100%  
Mix 1: 59%  
Mix 2: 48%  
Mix 3: 36%  
APFC2006: 25%  
Mix 4: 24%  
Mix 5: 12%

Portfolio Component: Non US Fixed

Max: 100%  
Mix 1: 5%  
Mix 2: 4%  
Mix 3: 3%  
APFC2006: 4%  
Mix 4: 2%  
Mix 5: 0%

Portfolio Component: Real Estate

Max: 100%  
Mix 1: 5%  
Mix 2: 6%  
Mix 3: 7%  
APFC2006: 10%  
Mix 4: 9%  
Mix 5: 10%

Portfolio Component: Absolute Return

Max: 4%  
Mix 1: 4%  
Mix 2: 4%  
Mix 3: 4%  
APFC2006: 4%  
Mix 4: 4%  
Mix 5: 4%

Portfolio Component: Private Equity

Max: 4%  
Mix 1: 2%  
Mix 2: 4%  
Mix 3: 4%  
APFC2006: 4%  
Mix 4: 4%  
Mix 5: 4%

Portfolio Component: Cash Equivalents

Max: 100%  
Mix 1: 0%  
Mix 2: 0%  
Mix 3: 0%  
APFC2006: 0%  
Mix 4: 0%  
Mix 5: 0%

Totals for the asset mixes are listed as follows:

Totals  
Mix 1: 100%  
Mix 2: 100%  
Mix 3: 100%  
APFC2006: 100%  
Mix 4: 100%  
Mix 5: 100%

Expected Return  
Mix 1: 6.50%  
Mix 2: 7.00%  
Mix 3: 7.50%  
APFC2006: 7.84%  
Mix 4: 8.00%  
Mix 5: 8.50%

Standard Deviation  
Mix 1: 6.64%  
Mix 2: 8.33%  
Mix 3: 10.16%  
APFC2006: 11.50%  
Mix 4: 12.10%  
Mix 5: 14.09%

Sharpe Ratio  
Mix 1: 0.38%

Mix 2: 0.36%  
Mix 3: 0.34%  
APFC2006: 0.33%  
Mix 4: 0.33%  
Mix 5: 0.32%

A notation reads as follows:

Note that the APFC's implementation of domestic and international equity is accomplished through both global and domestic/international portfolios. The current implementation plan has 14% allocated to global portfolios funded through 7% reductions in both international and domestic large cap.]

Mr. O'Leary posed the question of "what does all this mean." He responded that the assumptions were input to an "optimizer" to develop efficient portfolios. The Permanent Fund existing policy had been included as a point of reference. Utilizing the new capital market assumptions, a return of 7.84 percent was expected. This contrasted with the 7.77 percent return projection developed utilizing the previous year's assumptions.

[9:40:29 AM](#)

Page 32

Efficient Frontier Graph

[Line graph comparing Projected Return to Projected Risk with APFC2006 specified at approximately 7.8 percent. A notation reads as follows.

Current policy is essentially on the efficient frontier. Note that this efficient frontier was developed using constraints in allocation both for private equity & absolute return strategies.]

Mr. O'Leary asserted that the Alaska Permanent Fund policy was "right on the efficient frontier".

[9:41:01 AM](#)

Co-Chair Stedman, referring to the information on Page 31, spoke to the correlation between the Alaska Permanent Fund and the Public Employee Retirement System (PERS) and the Teacher Retirement System (TRS) trust, with regard to the portfolios, long term returns and targets. He requested additional

explanation of the "matrix", specifically to the 2006 target return of 7.84 percent for the Permanent Fund. He also asked how the target could be increased to nine or ten percent and the risk associated with such a change. He suggested this could be considered for the retirement trust.

[9:42:13 AM](#)

Mr. O'Leary gave the following response.

First let me be sure that everybody understands this table and then I'll get to the question.

What we said to the committee, was "We want the lowest risk portfolios between 6.5 percent and 8.5 percent; and we want to look at basically five, so that there are meaningful differences." Then we added in the Permanent Fund.

"Large Cap" refers to large cap US Equities. "Small to Mid Cap" refers to small to mid-cap domestic equities. International Equities; Emerging Markets Equity; Domestic Fixed; Non US Fixed income; Real Estate, Absolute Return; Private Equity, and Cash. Those are the asset categories that were considered.

We constrained Absolute Return to four percent. We said you can't use more than four percent in absolute return. That's hedge funds - [indiscernible] funds and Private Equity. The reason that those were constrained is it's very difficult for a fund of this size to get a lot invested. The Permanent Fund has been moving to get invested in private equity for several years, and has a plan - has made commitments, but the money hasn't actually been drawn down. Those were practical limitations.

[9:44:00 AM](#)

Mr. O'Leary directed attention to Page 30, instructing the Committee to "scan down this list of projected returns", and continued.

You can see that the highest projected return is 12 percent for Private Equity. So theoretically one could have a portfolio of a hundred percent private equity and hope to

earn 12 percent. It would clearly be imprudent, nobody's suggesting that.

Mr. O'Leary returned to Page 31 and pointed out that the Mix 5 scenario would have an expected rate of return of 8.5 percent. The percentages of "Standard Deviation" increased for each asset category listed. The Mix 5 scenario contained only 12 percent of Domestic Fixed and no international fixed income.

Mr. O'Leary continued:

So it's basically 88 percent in equity-linked investments. Real estate equity is equity. Absolute return is hopefully more bond-like in volatility, but is taking aggressive positions. The rest of the portfolio would largely be in publicly traded equity - domestic and international large and small.

Pragmatically, I guess where I'm going Mr. Chairman, is to say, I think you can get up and plan such as the retirement board, have targets near the eight percent level, in today's environment, if you agree that inflation is going to be 2.75 or that order of magnitude.

[9:46:16 AM](#)

Mr. O'Leary cautioned, "It's tough to get much higher than 5.25 percent real return."

[9:46:33 AM](#)

Mr. O'Leary spoke of treasury protected inflation securities (TIPS) as follows.

TIPS today ... has no credit risk -obviously, there's nothing [of] higher quality - treasury obligation. But they have an implicit real return of just a little bit over two percent.

The real return from the highest investment grade bonds is somewhere south of three percent.

Mr. O'Leary concluded:

The more of your portfolio that you have in investment grade bonds the more difficult it is to achieve a real return on the total portfolio in excess of five percent.

[9:47:19 AM](#)

Co-Chair Stedman surmised that increasing the target rate of return from eight percent to ten to twelve percent would substantially increase volatility, which was reflected as a standard deviation.

[9:47:50 AM](#)

Mr. O'Leary affirmed. He explained standard deviation, utilizing Mix 4 as an illustration.

The middle of a distribution of possible outcomes is eight percent with that policy. A standard deviation of 12-1 says that in a year that policy might produce between plus 20.1 percent or a negative return of 4.1 percent. That's one standard deviation. Two standard deviations in a one-year period double that number.

That's the range; huge increase in volatility. I'm going to put it in context. The bear market that we were in was more than a two standard deviation event. So those things do happen. They don't happen, fortunately frequently, but they do happen.

An investor who has a super aggressive strategy, that is almost 100 percent equity, is taking on the volatility. If they can stay the course and don't need the money, they may be much better off in the long run. But they have to live through the shorter run.

[9:49:30 AM](#)

Co-Chair Hoffman attempted to correlate the presentations of Mr. Burns and Mr. O'Leary. Mr. Burn's presentation stated that the Fund returned 11 percent in 2006, which was "well ahead" of the benchmark of 10.5 percent. Co-Chair Hoffman asked if this was the expected return cited in Mr. O'Leary's presentation as well.

[9:49:50 AM](#)

Mr. O'Leary answered it was.

[9:49:54 AM](#)

Co-Chair Hoffman shared that when he first began his service in the Alaska State Legislature, the balance of the Permanent Fund was \$8 billion. The Fund would soon exceed \$40 billion, and at a seven or eight percent rate of return the Fund would exceed \$50 billion shortly. Given the five-fold increase of the Fund from \$8 billion to \$40 billion, he predicted the Fund balance could someday be in excess of \$200 billion.

[9:51:13 AM](#)

Mr. O'Leary characterized this as "the magic of compounding."

[9:51:15 AM](#)

Co-Chair Hoffman asked whether the Fund's Board of Directors had contemplated how large the Fund should grow and the point in which the "philosophy" of inflation proofing should be changed. Inflation proofing would "take larger and larger chunks of the Fund" as the balance of the Fund increases. He asked the point that the Legislature would begin utilizing a portion of the earnings of the Fund for purposes other than inflation proofing the principal of the Fund and payment of dividends.

[9:52:06 AM](#)

Mr. Burns told of a Board of Directors retreat held August 2006 that included staff and Mr. O'Leary. The questions of whether the size of the Fund was reaching an amount in which "we're going to have to think substantially differently about how we do things, why we do things" and whether "size just in and of itself going to change things" were posed. The conclusion was reached that no changes were necessary until the Fund balance was \$60 to \$70 billion.

Mr. Burns admitted, "There's a point out there where you start doing things and you have different constraints." He gave an example as follows.

The huge plans in the country: Cal PERS. In private equity, for them to take a meaningful piece of a private company, gets to be such a large number that they have things that

they have to register with the SEC [federal Securities and Exchange Commission] as an insider and as an investor over a certain threshold.

Mr. Burns assured that the Alaska Permanent Fund was "a long way from those types of constraints." Therefore, the methodology currently employed to manage the Fund would remain the same. A point would be reached "when you're a different type of fund", but that was "a ways away."

9:54:07 AM

Co-Chair Hoffman, noting that the Fund balance increased by \$10 billion in less than 13 months' time, surmised that at a growth rate of 8.5 percent, the Fund would reach \$60 to \$70 billion in a short period.

9:54:31 AM

Mr. O'Leary addressed this as follows.

Number one, I want to underscore, everybody's attitude - we all recognize that this Body [the Legislature] determines what happens with the earnings of the Fund. There's no question with regard to that.

The rates of return enjoyed over the last three years - four years, of market recovery have been well above the long term average.

Mr. O'Leary displayed Page 24 and continued.

I wanted to draw your attention to the 15-year return for bonds - investment grade bonds: 6 1/2 percent per year. That was a significant part of the return enjoyed by the Permanent Fund. Because interest rates are so much lower today, we have great confidence in saying "You're not gonna see 6 1/2 percent from bonds. We think 5.25 is optimistic."

The same can be said for almost every major asset category. You're all aware of how well real estate has done as an asset class. Our expectation for real estate going forward is 7.6 percent. For stocks, it's only nine percent.

So as we look ahead, we are not extrapolating the returns of the last 15 years, nor are we extrapolating the returns of the bounce-back from this horrendous bear market that we saw from 2000 to '02.

[9:56:43 AM](#)

Mr. Burns added for clarification that his earlier testimony stating that the Fund's performance was "ahead of our benchmark" of 10.5 percent, was not speaking to "the 7.8 percent that goes into the asset allocation." He stated that once the 7.8 percent was determined as the "proper asset allocation", "then we go to the benchmarks that are driven" by the information contained on Page 22. He explained the benchmark and its relation to asset allocation as follows.

If we're going to have 12 percent that's going to be tied to the Russell 3000, do we do better than that? That becomes the benchmark. How does that compare with the cumulative benchmarks that are driven by the asset allocation? ... They're different levels.

[9:57:32 AM](#)

Mr. O'Leary further noted, "The 7.84 is using the asset class projections. It is the target index going forward based on these estimates. "

[9:57:41 AM](#)

Mr. Burns concluded his explanation that the benchmark represented "how we performed against the rest of the world this year."

[9:57:49 AM](#)

Co-Chair Stedman, relating to Co-Chair Hoffman's assertion, pointed out that the Fund balance was approximately \$26.5 billion in the year 2000 compared to the present day balance of approximately \$37 billion. Co-Chair Stedman commented as follows.

At some point, there's got to be a policy discussion within the State, as we fuel this economic engine, of how are we going to deal with inflation proofing and how are we going

to deal with any structural changes from a strategy standpoint at this table dealing with our budgets. We're going to be over about a billion dollars in 2015 just inflation proof. So that discussion is I guess is coming attractions. I think that's some of the points that Senator Hoffman was bringing up. This economic engine we have called the Permanent Fund, is most likely the fastest growing economic entity we have in the State. This is a huge driver.

[9:58:59 AM](#)

Mr. Burns advised that the Board of Director's task was to provide the Legislature with as many options as possible with regard to use of the earnings of the Permanent Fund. The intent was for the Fund to be as successful as possible to give the Legislature many choices.

[9:59:14 AM](#)

Senator Thomas asked what factors are utilized as benchmarks.

[9:59:27 AM](#)

Mr. O'Leary listed the S&P 500 and "the Russell family" as benchmarks used for domestic equity; the Lemman Aggregate Bond Index was used for investment grade bonds; the NCREIF Index, which is a measure of institutional grade direct private real estate, was used as a benchmark for real estate; "an appropriate REIT index" was used for "REITs"; Public Equity Markets were used "as a proxy" for private equity; a "specific target rate, [indiscernible] London Interbank Rate plus four percent" was utilized as a benchmark for the absolute return managers; and a high yield bond index was used for high yield.

[10:00:30 AM](#)

Senator Thomas referenced the testimony stating that the Fund performance exceeded its benchmark by one-half of a percent, and asked if the witnesses had a chart to indicate "where that difference came from - how well you were doing in a particular asset class."

[10:00:51 AM](#)

Mr. O'Leary answered that the detail was not included in the presentation; however, the information provided to the Fund managers on a quarterly basis and could be shared with the Committee.

[10:01:04 AM](#)

Co-Chair Stedman requested that the presentation to the Board on the performance "breakdown" of the previous quarter be forwarded to the Committee.

Mr. Burns agreed to provide the information.

[10:01:27 AM](#)

Co-Chair Stedman returned to testimony provided earlier in the presentation regarding difficulty in calculating the dividend amount. He expressed concern that the public could perceive that the dividend calculation was so complex as to only be discernible by the "Wizard of Oz". He requested an explanation of how the dividend was currently calculated, excluding mention of how the Board would like the calculation method to be changed.

[10:01:53 AM](#)

Mr. Burns explained, "The basic number is all driven by realized income."

Co-Chair Stedman interjected to request a definition of realized income.

Mr. Burns assured he would provide such and continued as follows.

When the Fund was first created - and it made a lot of sense at that time because the Fund at creation was only a bond portfolio. You realize income from a bond portfolio for accounting purposes in two ways. You collect your interest or you sell the bond at a profit. Those both are classic accounting realized income.

For a broader portfolio, such as ours, realized income is rents that we receive, it's dividends, it's interest, [and it's] capital gains when we receive them. What it does not

include is unrealized gains. That would be a piece of real estate we buy for \$75 million and it becomes worth [\$]90. There's no realized income in that. We do recognize it for performance but we don't for the dividend formula.

There is a five year trailing average. There's a five year history of realized income. Basically half of that goes into the dividend formula each year. Why that's changing so dramatically right now, as we talked about, the bear markets that were falling off, the number that falls out of the formula, what will become the sixth year, was \$257 million. In the first half of this year our realized income was \$1.9 billion. What that will be the next six months is hard to say but the number will be dramatically different than \$257 million. Next year the number that falls out of the formula is \$355 million. I think without any capital gains being realized, we have probably a 60 - I can't tell you the run rate - but just from dividends, interest and rents, we have a run rate substantially higher than that.

Every time you make a change in the portfolio you're selling something to put something in another place and what you sell realizes income. Actually just paying the dividend itself - and we have to come up with \$700-800 million to pay the dividend - we're selling things that hopefully creates profit. The realized income is generated in that way.

I would add that we do not manage the Fund with an eye towards realized income. We track it, we keep track of it, but we don't make investment decisions based on realizing income. We make investment decisions based on what is best for the Fund's total return.

[10:05:00 AM](#)

Co-Chair Stedman clarified that unless the financial markets "turn really really sour" substantial increases in dividend amounts would occur for the next "couple years".

Mr. Burns affirmed.

[10:05:22 AM](#)

Co-Chair Stedman inquired about the 50 cent impact on the dividend amounts as a result of data that was lost and subsequently had to be reentered into the computer system.

[10:05:42 AM](#)

Mr. Burns deferred to the Department of Revenue, as the Permanent Fund Corporation has no involvement in the administration of dividend payments.

[10:06:25 AM](#)

Co-Chair Stedman commented that the issue was not significant, but should be publicized.

[10:06:33 AM](#)

Senator Huggins directed attention to the Inflation figures contained on Page 24. He asked the impact of deflation, specifically as a result of the events of the past week, and generally to the risk factor. He theorized that inflation could be managed by that deflation "could be our greatest nightmare."

[10:07:23 AM](#)

Mr. O'Leary defined deflation as destruction of wealth, which is "exceedingly bad for financial markets." He continued as follows.

I generalize by saying there are only two types of investments. You can lend somebody money or you can be an owner. Being an owner in a deflationary environment tends to be bad. Being a lender, if the lender doesn't go bankrupt, is good.

If you really felt that deflation were a significant risk, the best investment strategy would be to own long term government bonds. That's part of a diversification strategy. That's one of the roles that bonds fulfill in a diversified portfolio. If you saw signs of that coming, you might accept a lower real return to try to protect your store of value.

[10:08:40 AM](#)

Co-Chair Hoffman expressed appreciation to the Board of Directors on behalf of all Alaskans for its hard work and dedication.

[10:09:17 AM](#)

Senator Thomas asked if the Asset Mix Alternatives Optimization Set, as shown for the year 2007 on Page 31, was undertaken every year or whether the portfolio components of the Fund were generally the same as shown for APFC2006.

[10:09:46 AM](#)

Mr. O'Leary replied that Callan Associates reviews the asset allocation each year and would update the Board with the latest information later in the day. Each year, the Board adopts an asset allocation policy. The Board is mindful of the changes in relative value between stocks and bonds and other asset categories, and "are constantly considering ways to try to improve the return and risk characteristics of the policy."

Mr. O'Leary reminded that the Legislature recently provided "enhanced flexibility" to the Permanent Fund, which resulted in the addition of asset categories, such as absolute return and private equity. He commented, "Those, in my view are still in the ramp-up stage and five or ten years from now, I'd fully expect them to take a larger role in the portfolio." The total equity position has increased over the last ten years "by quite a bit."

[10:11:12 AM](#)

Mr. Burns told of a change to the manner in which domestic allocation and international allocation to equities are reflected. These no longer included global managers, which has been made a specific allocation. This change did not effect operations.

[10:12:29 AM](#)

Senator Elton, noting that the rate of return has been "far outpacing" the rate of inflation, surmised that the balance of the Fund would reach \$60 to \$70 billion. He specifically wanted to know of the planning currently underway to implement the

management changes that would be required of the larger Fund balance.

[10:13:24 AM](#)

Mr. Burns responded that the current status of the Fund "is the size to be able to access the very best talent in the world." He furthered, "That's our challenge to make sure we're getting the best talent. So we are in that upper tier already and we will continue to be in that upper tier." He acknowledged that challenges could arise as the size of the Fund increases, but that "a change in thought" would be more appropriate than a change in management.

[10:14:15 AM](#)

Mr. O'Leary agreed with Mr. Burns. Mr. O'Leary informed that the State of Washington held over \$58 billion in investments for its retirement system. For 20 years that state "makes extensive use of what others perceive to be liquid markets and real estate operating companies and private equity." However, time is required to build infrastructure to support that type of investment program. He shared, "That's the type of change that I would envision" for the future of the Alaska Permanent Fund.

[10:14:57 AM](#)

Representative Mike Kelly referenced earlier testimony that unrealized gains were not reflected in the calculation of the dividends. He asked if "any sideboards" on unrealized losses were considered with the transition of Fund investments into riskier ventures.

[10:15:23 AM](#)

Mr. Burns answered that unrealized losses were considered part of the principal of the Fund under the ruling of an attorney general opinion.

#

**ADJOURNMENT**

Co-Chair Bert Stedman adjourned the meeting at [10:15:35 AM](#)