SENATE FINANCE COMMITTEE
February 10, 2009
9:01 a.m.

9:01:39 AM

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:01 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Charlie Huggins, Vice-Chair
Senator Johnny Ellis
Senator Kim Elton
Senator Donny Olson
Senator Joe Thomas

MEMBERS ABSENT

None

ALSO PRESENT

Mike Burns, Executive Director, Alaska Permanent Fund Corporation, Department of Revenue; Michael O'Leary, Executive Vice President, Callan Associates, Inc.

SUMMARY

^Overview: Economic and Capital Market Outlook & Permanent Fund Performance Review

OVERVIEW: ECONOMIC AND CAPITAL MARKET OUTLOOK & PERMANENT FUND PERFORMANCE REVIEW

9:05:00 AM

Co-Chair Stedman introduced Callan Associates as the state's principal investment advisor for the permanent fund, the Alaska retirement funds, and the Treasury Division. The firm had been invited to help the committee understand the interrelationship of the state's major savings accounts and to offer advice.

9:06:21 AM

MIKE BURNS, EXECUTIVE DIRECTOR, ALASKA PERMANENT FUND CORPORATION (APFC), DEPARTMENT OF REVENUE, gave a brief history of the permanent fund. The state has deposited about

$13.4 billion into the fund from mineral royalties, from general fund appropriations, and from legal settlements. Over the life of the fund, the corporation has paid out $16.7 billion in dividends. Today the fund has between $28 billion and $29 billion. He suggested holding the perspective of the success of the fund. Callan Associates has provided the board with asset allocation advice, performance measurements, manager searches, and other duties since 1990.

MICHAEL O'LEARY, EXECUTIVE VICE PRESIDENT, CALLAN ASSOCIATES, INC., presented a PowerPoint "Alaska Senate Finance Committee Market & Economic Review, 2009 Capital Market Projections and APFC Performance, February 2009" (Copy on File).

Mr. O'Leary provided a fourth quarter overview (Slide 1):

- Terrible market environment for all major asset classes.
- Credit markets froze around the world.
- Extraordinary governmental policy actions initiated quickly but not as rapidly as many had hoped.
- Flight to quality resulted in sharp declines in short-term government rates and increases in "risk" premiums.
- Commodity fell sharply as expectations regarding the length and depth of economic slowdown mounted.
- U.S. dollar strengthened significantly hurting profits for multinationals, unhedged international investors and returns on international investments for U.S. based investors.

Mr. O'Leary described Slide 2, "Second Half of 2008: Startling," as a list of the major financial news items that impacted the market, including:

- Fannie Mae and Freddie Mac placed into conservatorship.
- Lehman Brothers declared bankruptcy.
- AIG rescued by government.
- Merrill Lynch sold to Bank of America.
- Morgan Stanley and Goldman Sachs convert to bank holding companies.
- Washington Mutual seized by regulators and assets sold to JP Morgan.

Mr. O'Leary highlighted December 16, 2008 on the timeline, the date the Federal Reserve System (The Fed) target interest rate was reduced to between zero and 0.25 percent.

9:12:31 AM

Mr. O'Leary turned to Slide 3, "U.S. Fixed Income," with a graph depicting the U.S. Treasury yield curves. He explained that the blue line represents the Treasury yield as of the end of calendar year 2008, the green line represents the September 20, 2008 yield, and the yellow line represents the year end 2007 yield. The graph illustrates the remarkable change in Treasury rates during the year. By the end of the year, the 30-year bond was yielding less than 3 percent. The graph on the right depicts the yield deferential for various sectors of the bond market over Treasurys. Bar graphs at the bottom of the page show the absolute returns for various sections of the bond market relative to Treasurys. For example, corporate high yield investments in the quarter were down 17.9 percent in absolute return, down 24.9 percent relative to like-duration Treasurys.

Mr. O'Leary described Slide 4, "The Capital Markets: What a Difference One Year Can make," as illustrating the calendar year performance over the last several years for the U.S. stock market and various other components. He highlighted the 2008 inflation number of 0.09. During the year on a year-over-year basis, it seemed as though inflation would be up around 5 percent; this means all the decline in the consumer price index (CPI) occurred in the later half of the year. In the shaded years, the five-year compounded returns for each of the market indexes are listed, the five years ending at the end of 2007 and the five years ending at the end of 2008. The same is repeated for the ten-year and fifteen-year intervals. He emphasized that the numbers show the notable change in the long-term return for various asset categories because of one year. He cited the example of the Russell 3000 Index, a broad measure of the stock market, illustrating how one significant year can have a huge impact on longer-term results.

9:16:32 AM

Mr. O'Leary explained that Slide 5 shows real estate returns, including the National Council of Real Estate Investment Fiduciaries (NCREIF) returns.

Co-Chair Stedman returned to Slide 4 and asked for more information on fixed income and cash markets.

Mr. O'Leary explained that the Lehman [Brothers] Aggregate Bond Index (LB Aggregate), now called the Barkley's Capital Bond Aggregate, is a measure of investment-grade bonds. Over the fifteen year period including 2008, the LB Aggregate return is nearly as great as the return for the Russell 3000. Over shorter periods the return is far superior, and driven by long-term Treasury returns. The index below the LB Aggregate is the Citigroup Non-U.S. [Dollar World Government] Bonds Index, a government index issued in foreign currency terms. The return reflects both the return in local currency and changes in the value of the dollar. Cash Market is the 90-day Treasury (T-Bill).

9:18:14 AM

Mr. O'Leary continued with Slide 5. Many institutional funds invest in direct real estate. The graph at the bottom of the slide provides a sense of real estate returns. The blue line represents the total return of the index and the red line reflects the income component of the index. The graph shows a sharp decline in the fourth quarter of 2008 for the values assigned to direct real estate investments.

Co-Chair Stedman asked how real estate is priced in the model. Mr. O'Leary answered that the index is based on appraisals of unlevered real estate and comprised of hundreds of properties held by institutional investors throughout the country. There is detailed information available on the income generated and other factors. The properties in the index are appraised at least annually, but if there is a transaction, the actual value of the transaction is captured. During the periods when the asset is not appraised, the appraisal methodology is applied to the financials for the property. Recently, there was some increase in vacancies; the required yield increased more because risk interest rates are higher and the spread difference is wider.

9:21:10 AM

Mr. O'Leary explained that Slide 8 shows a calendar year performance for the Callan Public Fund [Sponsor] Database; the red dot reflects the preliminary return numbers for the Alaska permanent fund, negative 25.7 percent during 2008; this is essentially at median. He pointed out that the importance of the real estate chart is to demonstrate how comparisons can be muddied; many public funds report their real estate returns with a quarter lag. The end of December report shows in effect the twelve months ending in September. The permanent fund values its real estate on a current quarter basis, with one investment as an exception. Therefore, it has already incorporated the significant decline in the valuation of real estate. Others in the distribution may or may not have; Callan's sense is that lagging is common. The graph shows:

- The permanent fund did better than the median public fund in 2001 and 2002, both declining market environments;
- The fund lagged in 2003;
- The fund was very competitive in 2004 and 2005;
- In 2006, the return was attractive, but essentially median;

* In 2007, the return was attractive;
* In 2008 return was at median.

9:23:22 AM

Mr. O'Leary directed the committee to Slide 9, "Stock Market Returns by Calendar Year," with a histogram graph putting 2008 performance in perspective within of the history of the U.S. stock market. The 2008 return is highlighted; stocks were down 37 percent. Most of the time, the stock market has produced a positive return. The only years with returns as bad as 2008 were in the 1930s.

Mr. O'Leary pointed out that whenever anyone talks about stock market returns, they will point out things like the market is down one in four years or more. People will talk about the typical decline. The 2008 decline, while atypical, is consistent with other bear markets; what is unusual is that it was concentrated in so short a period.

Co-Chair Stedman asked if the bear market was over. Mr. O'Leary replied that he did not make that statement. Co-Chair Stedman asked if the measurement were then complete. Mr. O'Leary responded that it was not complete through January of 2009, which was also a negative month.

9:26:21 AM

Mr. O'Leary reported that Slide 10, "Rolling 5-Year Geometric Returns" illustrates another way of viewing the situation. A blue line on a graph depicts the actual five-year return for periods ending December 1930 through December 2008; for the most recent five years, the S & P [Standard & Poor's] 500 had an annualized return over five years of negative 2.91 percent. The average of all the averages was 10.35 percent. The left side of the graph shows how bad the five-year returns were during the 1930s; the declines were between negative 10 and negative 16 or 17.

Mr. O'Leary turned to Slide 11, "Credit Spreads Exceed Historic Highs," showing investment grade credit spreads from 1979 through 2008. He explained that credit spreads were the difference in returns and yields between debt instruments that are highly rated over comparable maturity treasury securities. By the end of 2000, there were unprecedented levels for the 1979 through 2008 period. Subsequent to year end, credit spreads have narrowed.

9:28:30 AM

Mr. O'Leary listed the potential implications of the financial crisis (Slide 12):

- Structure of the U.S. financial system is changed permanently.
  - End of traditional investment banks.
  - Consolidation of financial institutions into large, highly regulated commercial banks.
  - More government oversight and regulation.
  - Lower leverage and ultimately lower risk in financial system.
  - Tighter credit conditions for foreseeable future.
- U.S. deficit and overall federal debt will expand dramatically.
  - Trillion dollar plus deficits likely in near term.
  - Risk of devaluation of U.S. dollar elevated.
  - Long-term risk of higher real interest rates and crowding out of private borrowing.
- U.S. consumer is being forced to delever.
  - Loss of wealth in housing and equities will change behavior.
  - Less spending and consumption.
  - Postponed retirements, second jobs, will expand labor force.
- Financial markets become smaller and less efficient.

9:30:42 AM

Mr. O'Leary directed attention to Slide 13, "U.S. Economic Growth by Sector." A graph illustrates the importance of the consumer to economic growth, especially the composition of real gross domestic product (GDP) and how much growth is the result of consumption, residential investment, and so on.

Mr. O'Leary pointed to a graph on Slide 14, "Hard Landing for the U.S. Economy," showing real GDP. There have been modifications of the reported numbers for 2008; the decline in the second half of the year is shown, plus the projection for negative growth in 2009.

Mr. O'Leary highlighted a few points on Slide 16, "The Current Economic Environment: Slow going until 2010":

- Optimistic outlook: government intervention stabilizes credit markets, fiscal stimulus kick-starts rapid upswing. Beware of inflation lurking in the wings.
- Pessimistic scenario: vicious downward spiral between the economy and credit markets worsens. Specter of deflation looms.
- Most likely scenario: severest declines in GDP will be recorded in fourth quarter of 2008 and first quarter of 2009. GDP resumes modest growth in the second half of 2009, as credit markets slowly unthaw and confidence returns.

Mr. O'Leary reported that there will be a lag before the impact of government intervention arrives. The situation deteriorated during the fourth quarter; however, by the end of December there were signs of stabilization. There have been signs of improvement in financial conditions, primarily credit risk spreads. New bonds have been issued over the last several weeks by investment grade issuers and were received well by the market, which did not happen in the fourth quarter. There is no question that the economy is continuing to decline, although there are indications in some areas of emerging stability. The bulls would say that the market begins to recover before the economy. The average recession has been ten months in duration. The current recession began in the middle of 2008. Major economists say there will not be improvements until July or the first quarter of 2010.

9:34:43 AM

Mr. O'Leary said the pessimist's view is that the damage to the financial system is extreme enough to create concern about deflation.

Mr. O'Leary turned to Slide 17, "The Current Economic Environment: Slow going until 2010." He explained that every year Callan Associates goes through a long-term planning exercise for expected returns. Callan is always going to project the central estimate of stock returns to be above bond returns and bond returns to be above cash, and tries to capture variability by the range of expected returns as measured statistically. Callan thinks inflation will be a non-issue in 2009, and not a significant issue in 2010, but that during the forecast period, inflation will become more of an issue. Callan thinks that stocks will anticipate and lead the recovery, not cause it. The firm has studied every stock market recovery subsequent to a major bear market; early on, the returns are attractive. The key issue is figuring out when is too early.

9:36:54 AM

Co-Chair Hoffman asked what the federal stimulus package would do. Mr. O'Leary responded that they did not know yet, since the package is not detailed. The composition of the final package will most importantly affect confidence. He understood the bill that is likely to be enacted is primarily spending as opposed to tax cuts and that the composition of the spending is less stimulative than the critics wanted. Part of the assessment reflects Callan's view toward longer-term inflation. He opined that the package would help the economy shorter term, but there were still questions.

9:39:18 AM

Mr. O'Leary stated that the expectation is that there will be meaningful stimulus, but stressed that affecting consumer attitude is critically important.

Senator Elton asked how the stimulus package would affect consumer attitude. Mr. O'Leary replied that the housing market is particularly important for many people. If the package holds promise of stabilizing housing or reducing the risk of foreclosure, it could have a very positive affect on attitude. An immediate increase in income through payroll tax reductions would also help.

Senator Elton asked if consumer attitudes would be affected through the Trouble Assets Relief Program (TARP) funds. Mr. O'Leary responded that he was speaking of the stimulus package in Congress.

9:42:04 AM

Mr. O'Leary continued with Slide 18, "Equity Is More Reasonably Priced: Trailing P/E [Price to Earnings Ratio] Dips Below Its Long Run Average". He maintained that financial assets look very attractively valued if the stance is taken that in the next two years there will be the beginning of a financial recovery. The case is easier to make for investment-grade bonds then for equities, although the case is just as strong. This is because earnings will be dismal in the short term. The leveraged operating flexibility of major corporations is tremendous. Valuation levels for equities are often seen as normal earnings power and not 2009 expected earnings, which means asking where corporate earnings will be five years from now. Taking a look at the equity markets in light of the 37 percent decline in the past year, stocks appear very attractively valued. There is risk; broad diversification is essential.

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Mr. O'Leary explained that the data on Slide 19, "Past Recessions and Subsequent Market Performance," is taken from the JP Morgan Guide to the Markets, December 31, 2008. The average economic expansion since 1900 has lasted 45 months and the average recession has lasted 14 months. The table shows the post World War II recessions at an average of ten months. During the recession in the post World War II era, stocks went up 1.4 percent on average, indicating that recovery began before the recession ended. This was not true in the 1970s and in 2001.

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Mr. O'Leary pointed to graphs on Slide 20 depicting the yield to worst on the Lehman Aggregate Bond Index from

January 1, 2001 to January 16, 2009. Yield to worst presumes that a bond gets called if it is advantageous for the issuer of the bond to call it. At the end of 2008, the yield to worst on the Lehman Aggregate was just under 4 percent; subsequently, yields declined even further. The index can be used for future five-year bond returns. Over the next five years, bonds could be expected to return to near 4 percent.

Co-Chair Stedman referenced the 5.7 percent yield on 10/31/08. He asked for clarification about the inverse relationship with value. Mr. O'Leary gave the example of a concept called durations. If interest rates go up, the value of existing bonds declines, because the rational investor will not buy at 4 percent when a new bond will come out with a 5 percent yield.

9:48:48 AM

Co-Chair Stedman added that when yields go up to 5.5 percent from 3.75 percent, the value of the bonds will decline because of downward pressure. Mr. O'Leary pointed out that Treasurys were great last year but have been terrible in 2009 because long-term Treasurys have gone up as panic in the markets lessened.

Mr. O'Leary told the committee that the graphs on Slide 21 give some sense of the composition of bond market total return. The upper left graph shows the total return, the sum of the market value change plus income. The upper right graph shows the income return. The lower left graph shows the price change. The income return component tends to be fairly stable, but the price change tends to be volatile, reflecting the changes in the general level of interest rates.

9:50:17 AM

Mr. O'Leary turned to Slide 23, "Bond Market Opportunities":

- We don't know when markets will react positively to the extraordinary governmental policy actions taken to restore liquidity to credit markets, but we are confident that they will.
- We believe that risk spreads (both credit and equity) have reached very attractive levels and patient investors will be handsomely rewarded from recent price levels.
- We do not expect credit spreads to return to the slim premiums of 2004 to early 2007.
- The extraordinarily low yield and duration on the Aggregate mask the extreme divergence between the component sectors of the index, and therefore the potential opportunities.

- Very large increase in specialized “distress” oriented fixed investing.

Mr. O’Leary explained that one of the reasons for the downturn was too much liquidity. Investors did not require enough of a premium for the risk they were taking. One manifestation of that was the sub-prime confusion; people were given loans, and the risk was not reflected in the price they were paying for the loans. The confusion was not limited to sub-prime; it occurred across the financial spectrum.

9:51:14 AM

Mr. O’Leary directed attention to Slide 25, “2009 Capital Market Expectations,” a narrative explaining expectations for the major asset categories.

- Bond returns held at 5.25%. Current measures of the broad market are very unusual. We expect Treasury rates to rise, but spreads will narrow and opportunities abound in the non-Treasury portion of the market.
- Project an upward sloping yield curve, with a risk premium for bonds over cash (2.25%).
- Building equity returns from long-term fundamentals gets us to about 9%: 3-4% real GDP growth, which means 5.75%-6.75% nominal earnings growth, 2% dividend yield, 0.5%-1% “buyback yield.” Shorter term, these fundamentals may look weak, but equity looks cheap relative to longer-term valuations. Equity markets tend to perform well after substantial declines, and typically lead the economy out of recession. Broad U.S. equity expectations are increased 50 bps [basis points], from 9.0% to 9.5%. Non-U.S. equity returns are increased by a similar amount.
- Real estate return held at 7.6%; returns may not recover as quickly as liquid equity markets.
- Private equity return held at 12%, narrowing its premium over public equity markets.

Co-Chair Stedman asked for a breakdown relative to time. Mr. O’Leary responded that in the shorter term, over the next year or two, Treasurys are not likely to produce a very attractive return, because the starting interest rate levels are so low, and the issuance needs for the Treasury are so great. He stated that a high-quality credit bond would return more than Treasurys.

Mr. O’Leary speculated that a five- or six-year return for highly-rated investment credit bonds could easily be in the over 6 percent range and near 3 percent for Treasurys. Callan’s longer-term expectation for total returns from

Treasury Inflation-Protected Securities (TIPS) is around 4.9 percent. This is much higher than for Treasurys because the market is not pricing in future inflation.

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Mr. O'Leary turned to the subject of the permanent fund. He directed the committee to Slide 26, which addresses findings of the National Association of College and University Business Officers (NACUBO), a group with a mission similar to that of the permanent fund.

Mr. O'Leary explained that the permanent fund is permanent and so has an advantage very few other pools of capital have. The fund has a long-term investment horizon; its objectives are to preserve the purchasing power of the fund over the long term and to make distributions that are consistent with that. The legislature has historically determined the pace of distributions.

Mr. O'Leary compared the permanent fund with major university endowments. Distribution policies may be expressed differently but the objective of both is to preserve the purchasing power of the principal and to make distributions that support the objectives of the institution or fund.

Mr. O'Leary observed that NACUBO commissions a comprehensive survey of college and university endowments. Slide 26 contains the most recent data taken from a survey of 774 institutions. The table shows how the institutions have invested their money. He encouraged focus on endowments greater than $1 billion, calling them a "peer group" for the permanent fund. He listed the various asset investment categories of the major endowments:

- 40 percent invested in equities of all kinds;
- Only 11 percent invested in fixed income
- 6 percent invested in real estate;
- More than 22 percent invested in hedge funds;
- 10 percent invested in private equity;
- 3.6 percent invested in venture capital; and
- 5.3 percent invested in natural resources.

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Co-Chair Hoffman noted the large spread between investment pools of $25 million and $1 billion. Alaska's fund is substantially higher than that. He asked how many institutions had pools above $1 billion. Mr. O'Leary guessed there were around 20. Co-Chair Hoffman asked if the larger endowments had a large spread in the allocation of their investments.

Mr. O'Leary pointed out the difference between the dollar-weighted average and equal-weighted average. The dollar-weighted average is dominated by the 20 large institutions. Within those, there is a wide spread, but not as wide as the spread in the $500 million to $1 billion group. He offered to get more detailed information.

Co-Chair Stedman solicited an explanation on hedge funds, private equity, venture capital, and natural resources. He wondered if the categories were all forms of equity ownership versus debt ownership. Mr. O'Leary responded that the private equity and venture capital were predominantly illiquid equity investment. Both the permanent fund and the state pension pools invest in private equity; there is not a distinction between private equity and venture capital. The targets are about 7 percent for both entities.

10:00:33 AM

Co-Chair Stedman asked for a brief overview of hedge funds. Mr. O'Leary explained that hedge funds are not an asset class but an amalgamation of investment strategies and characteristics, private partnerships that typically invest predominantly in public securities using a variety of strategies. He emphasized that there are over 8,000 hedge funds, which makes them difficult to generalize. They often have niches by types and try to achieve a return that is like a publicly traded equity return without the volatility. On average hedge funds are looking to achieve a return greater than that available from a bond market. Others try to have less short-term volatility than traditional equity-only portfolios. Hedge funds are very expensive; the general partner in the limited partnership is paid a fee and a percent of profits. Hedge funds can sometimes pursue very aggressive investment strategies which can cause other investors to cash out.

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Senator Elton asked how the 2008 numbers compared to the 2007 numbers for the larger funds. He specifically wondered if they started moving towards hedge funds and private equity. Mr. O'Leary answered that five or more years ago the equity allocation was higher, the hedge fund and private equity allocations lower, and the bond allocations higher. Reduction in the bond allocation has been the primary source of funding. In some cases, they've also reduced equity to get a different form of equity management from a segment of the hedge fund world.

Senator Thomas asked which university endowments were largest. Mr. Burns thought that Harvard's endowment was about the size of the permanent fund. Mr. O'Leary answered that Harvard, Yale, and Stanford were the three largest.

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Mr. O'Leary pointed out that private foundations have investment policies similar to the permanent fund. He stated that half of the assets of a major private foundation he works with are illiquid, invested in real estate, absolute return, hedge funds, and private equity.

Senator Elton asked if managers' options for the permanent fund were negatively restrained because of the prescribed asset allocation. He wondered if the state had the flexibility of other large funds.

Mr. Burns replied that the law was changed three years prior to allow the corporation to invest as a prudent investor. He added that the state does not have the risk tolerance of the private endowments like Harvard or Yale. The corporation is not constrained. One of the differences is that a university foundation graduates a new group of donors each year, while oil is a finite resource.

Mr. O'Leary referred to the time of the statutory list when the permanent fund was at a disadvantage. The legislature has been responsive to requests for liberalization, including giving the permanent fund board the authority to modify things. The pension system has had greater flexibility. For example, the army has more money invested in private equity than the permanent fund, because the army was able to start earlier.

10:08:28 AM

Mr. O'Leary presented Slide 27, "2009 Capital Market Expectations, Return and Risk." Callan has always focused on five-year return estimates, but financial markets are very volatile. If one invested dollar loses 50 percent, it has to gain 100 percent in order to break even. The table considers an arithmetic mean return, or the average expectations in a single year, and then geometric mean returns for five and ten years. The five-year number is lower than the arithmetic mean number, but the arithmetic mean is used to calculate the five-year number, which reflects the effect of volatility. The further the time horizon is extended, the less meaningful the volatility is. The numbers, with the notable exception of fixed income, reflect an increase in five-year return from previous numbers. The reason is the significant decline that has occurred. None of the numbers get that back in the short run. If there was a 9 percent broad domestic equity return number last year as a five-year projection, that same number would now be 9.63.

Co-Chair Stedman asked if the state would be unable to get back to expectations of a year ago at the end of the five- or six-year cycle.

10:11:18 AM

Mr. O'Leary returned to Slide 10 and explained that projections now are consistent just as they were a year ago with the type of volatility and range of five-year returns depicted on the graph. Over the last five years, the return was negative 2.19 percent. There could be a five year period with a return of over 20 percent, and that would be consistent with the projects being built in to the modeling. The five-year number is the average of thousands of simulations of returns calculated using the arithmetic mean return assumption and the annual standard deviation looking at the history. Two standard deviations capture 95 percent of the range of expectation. There could be a wide range of returns.

Mr. O'Leary reported that Callan thinks that given the magnitude of the decline and the presumption that the economy will eventually recover there will be a period of above-average returns over the next five years.

Co-Chair Stedman asked when the change in assumptions occurred.

10:14:22 AM

Mr. O'Leary responded that there was no expectation of a recession one year ago and the downturn in July affected thinking about reasonable rates of return.

Co-Chair Stedman asked when Callan became concerned about a recession. Mr. O'Leary replied in 2007.

Co-Chair Hoffman asked what projections were in September of 2008. Mr. O'Leary replied that Callan had not modified their projects from the year previous; they had extensive conversations with concerned clients. Lehman Brothers had gone bankrupt September 15 and the markets were not functioning. He described normal transactions that could not be completed.

Co-Chair Hoffman asked if a hypothetical $1 billion should have been invested high-risk or low-risk in September of 2008. Co-Chair Stedman restated the question with various timelines.

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Mr. O'Leary responded that if the timeline were one year, the investment should be in something safe such as a bond portfolio. For a twenty year timeline, assuming minimal possibility of significant cash outflow, the answer would be that that is a very long investment horizon and there would be a heavy equity commitment. The shorter the time, the lower the equity commitment, with a norm being a balanced portfolio in the 60 or 70 percent range. The key variability is the probability of the money disappearing. The more certainty, the easier it is to be aggressive. If a person will retire in five years, the advice would be in the direction of meaningful equity participation. If the subject is a child's college savings fund, a portion of which will be needed in five years to pay tuition, then the investment should be balanced but more conservative.

10:20:05 AM

Co-Chair Hoffman described aggressive and non-aggressive investments related to the permanent fund and asked whether Mr. O'Leary would have recommended in September 2008 that the investment be in more aggressive funds, given what is now known about the market. Mr. O'Leary stated that he would not have invested if he had known the market would decline 20 percent. He would have been willing to invest any reserves in more aggressive investments as that market environment was unfolding. Callan does not attempt to time markets, but advises clients to have a long-range policy and to try and maintain it through good and bad times. For example, almost every institutional fund in the country had less equity than their target equity by the end of calendar year 2008 because equities went down more than bonds went down. Every investor had to make decisions about whether to change the target to being more conservative or moving allocations to get back on target.

Co-Chair Hoffman asked what the recommendation would have been in September 2008. Mr. O'Leary responded that [equities and bonds] were not out of balance in September; the recommendation would have been to maintain the long-run policy. In December the recommendation would have been to begin rebalancing the portfolio.

10:23:06 AM

Senator Elton asked if Callan would shift back towards equities if given $1 billion to invest now. Mr. O'Leary answered that if he would if he were under his long-term target in light of the new projections. He would invest in other risk assets besides equities, such as high-yield bonds or real estate. He cited an example related to another major corporation for whom he is doing an asset allocation and liability analysis. The corporation has never owned direct real estate, but is seriously considering establishing it as a category for investment in their pension plan.

Mr. O'Leary turned to Slide 29, "Illustrative Efficient Mixes Using 2009 Projections." He said the table takes the permanent fund's existing allocation asset policy and uses Callan's long-term capital market projections and the five-year simulated return given the new inputs as 9 percent, compared with the previous year's 8 percent. The table looks forward.

Co-Chair Stedman asked if last year's market point could be projected forward with the previous year's 8 percent and other considerations. Mr. O'Leary said he could provide the information.

10:26:20 AM

Mr. O'Leary returned to the table on Slide 30 and said his consulting advice was not to pick a particular point on the efficient frontier but to pick an area that is consistent with risk and return expectations. The 9 percent line provides positive real return above inflation. Volatility for the total portfolio is estimated at 12.82 percent.

Mr. O'Leary directed attention to Slide 42, "Tax Exempt Yields vs. Treasury." The graph depicts a yield spread with a ratio of municipal bond index yield to the ten year Treasury. The graph helps demonstrate how significant the disruptions in the credit markets have been.

Mr. O'Leary turned to Slide 44. Grantham, Mayo, Van Otterloo & Company (GMO) is a major investment management firm that does monthly seven-year projected real returns. The company has a history of being very conservative. He said that J.P. Morgan has a similar projection process; their most recent projections as of the end of November show a longer term compound number. He assured the committee that the numbers used by Callan are consistent with the numbers used by many in the financial industry as long-term projections.

10:30:27 AM

Mr. O'Leary described "Year-end Strategists Projections" on Slide 46. At the end of the calendar year a service asks noted authorities in the financial industry to make their single price target projection for the equity market. He noted that some of the projections are from the year end and helps illustrate that market timing has not been mastered.

Co-Chair Stedman asked for tables depicting December 31, 2007 and December 31, 2008 allocations for the permanent fund, retirement funds, and the constitutional budget reserve.

Senator Olson queried Callan's recommendations regarding inflation in the permanent fund.

10:33:50 AM

Mr. O'Leary recommended using real assets such as real estate, infrastructure investment, timber, TIPS, and so on as a defense against inflation. The defense can take many different forms, such as. Equities do a better job of preserving purchasing power than fixed assets over the long run. The more one is concerned with future inflation, the greater the emphasis should be on those types of asset categories. He thought this was particularly true of the permanent fund. The permanent fund has greater flexibility because of limited liquidity needs. Ideally there should be nothing left in the retirement fund when the last beneficiary dies. The system is designed to meet the requirements of the participants.

Mr. Burns added that regarding inflation, the corporation has tried to come up with the present value of future cash flows from oil revenues.

10:36:26 AM

Co-Chair Stedman asked how the corporation deals with less liquid investments if forced to re-balance. Mr. Burns replied that the target for domestic fixed income is 19 percent plus or minus 6 percent, or 25 percent; the fund is at 26.67 percent, or slightly high in domestic fixed income. Some of that is a holding place for some underfunded asset classes. The target for domestic equities is 26 percent plus or minus 5 percent; the fund is at 23.11 percent. The target for international equity is 13 percent plus or minus 3; the fund is at 10.53 percent. The target for global equities is 14 plus or minus 4 percent; the fund is at 11.57 percent. The target for international fixed income is 3 percent plus or minus 3 percent; the fund is at 3.99 percent.

Mr. Burns reported that for illiquid assets, the target for real estate is 10 percent plus or minus 3 percent; the fund is at 13.09 percent. He thought there were valuations that would bring the percentage down. The permanent fund is approximately a quarter ahead of most funds, but there are still changes in values that will adjust that. The target for private equity is 6 percent plus or minus 5; the fund is only at 2.13 percent. The corporation does not control the outflow; funds have been committed funds to partnerships, but the issue is how fast the corporation can find targets to invest in. The corporation does not like to accelerate the investment process. The target for absolute return is 6 percent plus or minus 3 percent; the fund is at 7.58 percent. The target for infrastructure, the newest asset class, is 3 percent plus or minus 3 percent; the fund is at 1.3 percent.

Mr. Burns summarized that overall the corporation is still heavy in fixed income and light in equities, but are within margin.

10:39:53 AM

Co-Chair Stedman asked for the information in a data page. He did not want the fund to be forced to rebalance by selling premium real estate. Mr. Burns replied that there was no pressure to sell privately owned real estate, although the public real estate trust has been sold down. The market is slow.

Senator Huggins asked about deflation. Mr. O'Leary responded that the deflation cycle was a consequence of the credit markets locking up; it would have occurred in the second half of 2008. Before that time, inflation was the larger concern. The price of oil reflects that. He did not think the economy was currently in a deflationary period, although he acknowledged that there was a risk.

10:42:40 AM

Senator Huggins pointed to Slide 17, which states that deflation is a problem. He referred to another bullet point on Slide 17 stating that inflation would be contained and low interest rates persist.

Mr. O'Leary placed the statement about deflation in context. The Federal Reserve System (the Fed) is focused on stabilizing the financial system and kick-starting the economy. He agreed with the Fed that deflation will be a problem if they don't get credit moving. Callan's expectation is that the Fed will get credit moving. There is enough slack in the economy that demand-pull inflation could be an issue in 2009 and most of 2010.

Senator Huggins asked if inflation could be a problem. Mr. O'Leary answered in the affirmative.

Co-Chair Stedman asked for a summary of realized and unrealized losses in the permanent fund and the fund's ability to pay a dividend.

10:45:11 AM

Mr. Burns responded that the fund had been in a similar situation in 2002, and the markets righted. The board asked the attorney general and the Department of Law to come up with an opinion regarding correct accounting if the notional value of the principal was less than the market value of the fund. The 2003 opinion was that unrealized gains and losses should be allocated to principal and the earnings reserve stood by itself. This is still the operative opinion. Multiple audits done by Klynveld Peat Marwick Goerdeler (KPMG) agree. The board asked for the current administration to give an opinion, which has not yet been issued. Testimony has been that the opinion agrees with previous opinion, but it has not been published.

Mr. Burns added that as of the end of the year (12/31/08), there is approximately $3.9 billion in the earnings reserve. The dividend is difficult to estimate; the rough estimate is around $1 billion, exclusive of the energy rebate. There is currently enough money to pay a dividend.

Co-Chair Stedman noted the question was of concern to many citizens.

Senator Olson asked if he could assure constituents that they would receive a dividend.

Mr. Burns did not know if there was assurance in today's market. He stated that the opinion of the Department of Law [that unrealized gains and losses should be allocated to principal and the earnings reserve stood by itself] was the operative opinion but could be challenged.

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ADJOURNMENT

The meeting was adjourned at 10:48 AM.