

SENATE FINANCE COMMITTEE
March 12, 2009
9:07 a.m.

9:07:31 AM

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:07 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Johnny Ellis
Senator Donny Olson
Senator Joe Thomas

MEMBERS ABSENT

Senator Charlie Huggins, Vice-Chair

ALSO PRESENT

Darwin Peterson, Staff, Co-Chair Bert Stedman; Mike Burns, Executive Director, Alaska Permanent Fund Corporation, Department of Revenue.

PRESENT VIA TELECONFERENCE

Jason Brune, Executive Director, Alaska Resource Development Council.

SUMMARY

SJR 9 Proposing amendments to the Constitution of the State of Alaska relating to and limiting appropriations from the Alaska permanent fund based on an averaged percent of the fund market value to protect the fund from inflation and assure that the real value of the fund will be preserved over the long term.

SJR 9 was HEARD and HELD in Committee for further consideration.

#sjr9

SENATE JOINT RESOLUTION NO. 9

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DARWIN PETERSON, STAFF, CO-CHAIR BERT STEDMAN, SPONSOR, introduced a PowerPoint presentation, "Dividend Stabilization Plan" (Copy on File). He read from AS 37.13.020(1), defining the permanent fund as providing "a means of conserving a portion of the state's revenue from mineral resources to benefit all generations of Alaskans." He pointed out that SJR 9 intends to resurrect the idea that the fund should benefit all generations.

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Mr. Peterson turned to Slide 3, "Is the Fund broken?"

- Only part of the Fund is protected from inflation.
- The Fund's long-term investment strategy conflicts with its realized earnings-based payout policy.
- The Fund can't assure payouts in bad years.
- The Fund can be overspent in good years.
- The size of payouts is unpredictable and unstable from year to year.

Mr. Peterson explained that earnings are not inflation-proofed. Only the principle of the fund is protected from inflation by a statutory annual appropriation. Overspending is allowed in good years; in some years up to 20 percent of the fund has been available for appropriation. However, in bad years there is the possibility of reduced or zero payouts for other purposes. Payouts are based on realized income and are incompatible with the fund's current investments.

Mr. Peterson detailed a graph on Slide 4, "Asset allocation over time." When the fund was created, it was invested entirely in bonds. A payout method based on realized income made sense at that time. Now the payout method is outdated, because the fund is invested in stocks, real estate, and other asset classes, in addition to bonds. The assets increase in value as well as provide cash income. The fund's current portfolio would be more compatible with a payout based on the fund's market value.

Mr. Peterson emphasized the dangers of overspending (Slide 5):

- Overspending in good years means there will be no cushion for down years.

- Overspending can decrease a fund's benefit to future generations.

Mr. Peterson added that an annual spending limit of no more than 5 percent of the total value of the fund would protect the entire fund from overspending.

Mr. Peterson explained that the graph in Slide 6, "FY 2008 comparison," shows actual numbers for FY08 and compares a 5 percent spending limit with the current method of allocating the earnings. Under the current method, 81 percent of the fund is constitutionally protected; \$7.1 billion or 19 percent in the earnings account can be appropriated by the legislature. Under the 5 percent spending limit, 95 percent of the fund would be constitutionally protected. The graph illustrates the danger of being able to overspend.

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Mr. Peterson turned to Slide 7, "Payout source volatility," with a graph delineating the percent of change from year to year, comparing market value with realized income. The orange line, which is fairly static, represents the annual market value of the whole fund. The green line is much more erratic and represents the realized income, which is what the fund uses to determine the dividend distribution amounts. Under a percent of market value (POMV) dividend stabilization plan, the line would be more static.

Mr. Peterson Slide 8, "What is the answer?"

- Changing the spending limit for the Permanent Fund to an endowment-like payout method based on market value.
- Under the dividend stabilization plan, no more than five percent of the Fund's market value may be withdrawn each year.
- Under the current system, all realized earnings are available for spending from the Fund.

Mr. Peterson added that inflation-proofing is inherent and no longer requires an appropriation by the legislature.

Mr. Peterson explained how the dividend stabilization plan would work (Slide 9):

- 8% is the projected average annual return on investments.
- 3% would be retained in the fund for inflation-proofing.
- 5% can be used by the legislature as the maximum annual payout.

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Mr. Peterson described Slide 10, "Is it really 5%?" as showing how the amount would be calculated under the dividend stabilization plan. Currently, an average is taken of the last five fiscal years. Under the stabilization plan, the first five of the preceding six fiscal years would be considered, allowing a one-year buffer when calculating the average. He used hypothetical numbers as an example:

- Year 1: \$30 billion value
- Year 2: \$31 billion
- Year 3: \$32 billion
- Year 4: \$33 billion
- Year 5: \$36 billion

Mr. Peterson explained that the average amount of the five hypothetical years is \$32 billion. Five percent of that average is \$1.6 billion. If the current year value of the fund in the example is \$36 billion, 5 percent is more than \$1.6 billion.

Mr. Peterson turned to Slide 11, "Who uses the payout method?" He reported that most fund trustees and managers around the country use a similar payout method.

- Anchorage, Fairbanks, North Slope Borough and Sitka residents voted to limit spending based on a percent of the market value of municipal trust accounts.
- Private foundations are required by the IRS to pay out at least 5% of their market value.
- 83% of college and university endowments use a payout method based on a percent of their market value.

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MIKE BURNS, EXECUTIVE DIRECTOR, ALASKA PERMANENT FUND CORPORATION, DEPARTMENT OF REVENUE, directed attention to a handout from the Alaska Permanent Fund Corporation (APFC), "Financial projections FY 2009 - FY 2018" (Copy on File). He emphasized that the projections are fluid.

Mr. Burns reported that the corporation was expecting an approximately \$967 million dividend, or about \$1,512 per person. The number is subject to change as the portfolio is adjusted. There has also been a change in management. He explained that when the fund is down, there are unrealized losses; any activity realizes losses.

Mr. Burns estimated that by the fall of 2010, the dividend number may be \$561 million. He did not think the change in subsequent years would be for the better.

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Co-Chair Stedman asked for an explanation of how built up unrealized losses are dealt with over time. Mr. Burns estimated that a good number is about 30 percent, realizing around one-third of unrealized losses on an on-going basis. However, the value of the fund changes with rebalancing and external turnover; other flaws, such as bad managers, are revealed when the market is down. He pointed out that actively managed assets are being moved to passive accounts.

Mr. Burns referred to the 2/10/09 presentation by Callan Associates. Mr. O'Leary had presented a histogram showing that 2008 was one of the five worst years in over 200 years of U.S. stock market performance.

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Co-Chair Stedman asked for projections for upcoming years.

Mr. Burns explained that the projections assume an 8 percent growth rate of the fund and 20 percent asset turnover, which could be light.

- FY2009: \$967 million dividend
- FY2010: \$561 million dividend
- FY2011: \$188 million dividend
- FY2012: \$254 million dividend
- FY2013: \$79 million dividend

Mr. Burns emphasized that the projections are speculative because of the volatility of the market. The market has only recently begun to turn back up. The projections illustrate the long-range effect of unrealized earnings.

Co-Chair Hoffman found the swing in dividends under the current program staggering. In fiscal year 2013, the dividend could be as low as \$68; in 2018 it could be as high as \$1,771. Under the dividend stabilization plan the numbers fluctuate from \$779 in 2014 to \$1,512 this year, or a swing of only \$373, illustrating that stabilizing the dividends could create more consistency. He compared totals over a longer period: in ten years under the current plan, individuals would receive a total of a little over \$9,000, while under the stabilization plan, individuals would receive close to \$12,900. He thought if the state adopted the dividend stabilization plan, the dividends would be stabilized and individuals would get larger checks.

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Mr. Burns added that extreme volatility contributed to large differences in performance. Once the negative years drop out, even a modest up year will change the formula dramatically.

Mr. Burns reported that the position of the permanent fund board has been dormant. Only two members of the current board have ever voted on the issue.

Co-Chair Stedman requested that the board study the issue over the coming period of time and make suggestions regarding stabilizing the fund.

Mr. Burns stated that SJR 9 would help the board become actively involved.

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Co-Chair Stedman wanted an opinion regarding the earnings reserve account. Since the state has the ability to appropriate from the account, the permanent fund has been seen in the past as a last resort for emergency appropriations. He queried the status of the permanent fund in the current budgetary cycle and in the near future as a fallback fund. Mr. Burns replied that between the anticipated 2010 dividend and the inflation-proofing appropriation, as well as estimated adjustments to the portfolio for the balance of the year, there would not be much available in the fund. He thought the projected 2010 dividend was optimistic. The reserve is being used rapidly. He could not say exactly how rapidly. The Department of Law has interpreted the availability of the earnings reserve for appropriation. He opined that the bulk of the reserve would be used up.

Co-Chair Stedman asked whether there would be funds available if there were economic challenges in two years. Mr. Burns answered that the markets would have to dramatically turn for the fund to grow to that extent in the near term. He stated that the reserve would be a limited resource in the next two years.

Co-Chair Stedman agreed that it might be optimistic to view the permanent fund as a fallback fund in the next two years. Mr. Burns answered that making projections requires making assumptions. Other scenarios could be drawn. The one given is a middle case. The board has spoken of the 5 percent number in previous discussions of a distribution method. He suggested the board might ask if 5 percent is a reasonable number in light of changing capital markets.

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Co-Chair Stedman pointed out that there was more than one issue under discussion. One issue is capping the maximum payout; the initial draft puts the maximum at 5 percent. Another issue is the fiscal stability of the state. At some point there needs to be protection of the fund as a fallback fund for the state. Mr. Burns recalled when the pension obligation bonds were first being discussed. The issue was extensively discussed by the rating agencies.

Co-Chair Stedman asked for the per-person dividend under the stabilization plan. Mr. Burns replied that the number was one-half of 5 percent distribution.

Co-Chair Stedman stated that over the period of nine years, the total payout would be \$12,009 if paying out the entire 5 percent. Mr. Burns thought the number that would be left in an earnings reserve account was \$8.721 billion.

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Co-Chair Stedman recalled discussions about the earnings reserve as a savings account and a cushion for the state.

Co-Chair Hoffman asked if there had been discussion regarding the permanent fund investing in energy projects such as the bullet line. Mr. Burns responded that a bill introduced in the House authorizes the fund to invest up to \$1 billion in in-state energy projects. The corporation has the statutory authority to invest in in-state projects if the projects meet the same risk reward thresholds as other projects. He noted the legislation was not requested by the APFC.

Co-Chair Stedman opened public testimony.

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JASON BRUNE, EXECUTIVE DIRECTOR, ALASKA RESOURCE DEVELOPMENT COUNCIL (RDC) (testified via teleconference), spoke in support of the legislation. He explained that RDC is a state-wide, non-profit, membership-funded organization founded in 1975. The membership is comprised of individuals and companies from Alaska's oil and gas, mining, timber, tourism, and fisheries industries, as well as Alaska Native corporations, local communities, organized labor, and industry support firms. The organization's purpose is to link diverse interests together to encourage a strong, diversified, private sector in Alaska and expand the state's economic base through the responsible development of natural resources. The RDC board of directors has supported the POMV approach for some time; the board of the permanent fund has also endorsed the concept since 2000. He

listed three resolutions to that effect by chairs in 2000, 2003, and 2004.

Mr. Brune pointed out that the POMV approach is currently used by many large endowments and public trusts. If enacted for the permanent fund, the approach would balance the goal of maximizing the availability of income from the fund with the long-term goal of protecting its value through inflation-proofing. Ultimately, the POMV approach will simplify how the fund is distributed, making it a lot more understandable to Alaskans. The approach will eliminate the confusing distinction between principal and earnings and provide for the option of an annual distribution through dividends, while providing a means for conserving a portion of the state's revenues for mineral resources in order to benefit future generations of Alaskans.

Mr. Brune explained that although RDC has historically supported using some of the distribution of the permanent fund to help fund state government, they support the current approach of not tying the constitutional amendment and the POMV concept to how the money is used, whether for dividends, funding public services, or otherwise. He encouraged the committee to vote for the amendment to protect future generations.

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Co-Chair Stedman reminded listeners that the committee is not acting on the measure but addressing potentially low future dividends.

Senator Ellis queried the wisdom of both the permanent fund board and the state retirement board employing the same financial advisor, Callan Associates. He wondered if more diversity in financial advice would be prudent.

Mr. Burns reminded the committee that Callan Associates is also the principal investment consultant for the University of Alaska Foundation, for the Anchorage municipality as well as fire and police departments, and possibly for other organizations in the state. He stated that the permanent fund corporation has been pleased with Callan's services of over 20 years. He agreed that the corporation could benefit somewhat from other points of view, but he pointed out that the business of asset allocation is very slow moving. He thought the difference between a firm like Callan Associates and another firm would be minimal, and that the experience the firm had with the state was valuable.

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Senator Ellis stated that from the legislative perspective, he did not think it wise to have only one source of financial advice for so many funds. He did not have confidence in the situation. He referred to the recent merger of Callan Associates with Mercer Investment Consulting and stressed that the state had had a bad experience with Mercer and had sued the firm because of bad judgment. He questioned how the merger could be good for Alaska. Mr. Burns replied that the corporation was comfortable with the situation. He stated that the Mercer controversy was related to actuarial activities, which the state does not deal with. The corporation's primary concern is whether Callan Associates will be affected; the current assessment is that Callan's service will not change. The corporation will watch carefully to determine if business methods change.

Senator Ellis asked if the corporation would put the question of remaining with Callan before the permanent fund board. Mr. Burns answered that the Callan contract was up for renewal at the end of June 2009. The renewal would be for one year. He thought the one-year renewal was the last one. Generally the contract is brought before the board's February meeting. The announcement about The Mercer merger came up a few days before last month's meeting. The current feeling among board members was to move ahead with the renewal and see how the new relationship with Mercer develops. He reminded the committee that all contracts can be cancelled at will at any time.

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Senator Ellis thought the ability to cancel a contract was to the state's advantage. He asked if anyone on the board was alarmed by the announcement that Callan was merging with a firm that the state had had such terrible experience with. He recalled mistakes and bad advice from Mercer regarding the retirement funds and the unfunded liability. Mr. Burns answered that the issue had been discussed; the corporation and the board are aware and would remain the vigilant. He emphasized that Callan does not have international consulting experience, while Mercer does. The merger will result in the largest financial consulting firm in the country, which could be good or bad for the state.

Co-Chair Stedman echoed concerns that the state had one advisor for both the retirement funds and permanent fund.

Senator Olson asked if the permanent fund board or corporation had ever cancelled a contract because of poor performance. Mr. Burns answered contracts with investment managers had been cancelled. He stated that underperformance

is not usually the issue. He described a "lift-out" situation, where a firm will lose an entire team of people, which affects established relationships.

Senator Olson voiced grave concerns regarding the merger of Callan and Mercer.

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Senator Thomas echoed the concerns of other committee members. He understood remaining with a company because of on-going relationships. Mr. Burns assured the committee that the situation would be carefully monitored.

SJR 9 was HEARD and HELD in Committee for further consideration.

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ADJOURNMENT

The meeting was adjourned at 9:55 AM.