

SENATE FINANCE COMMITTEE  
February 1, 2010  
9:06 a.m.

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CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:06 a.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

Senator Charlie Huggins, Vice-Chair

ALSO PRESENT

Senator Joe Paskvan; Pat Galvin, Commissioner, Department of Revenue; Jerry Burnett, Deputy Commissioner, Division of Treasury, Department of Revenue; Gary Bader, Chief Investment Officer, Treasury Division, Department of Revenue.

SUMMARY

^Overview by Department of Revenue of state savings accounts and budget reserves.

9:10:02 AM

PAT GALVIN, COMMISSIONER, DEPARTMENT OF REVENUE, introduced his colleagues. He explained that Mr. Burnett would provide the committee with an overview of the department's various savings accounts, with himself and Mr. Bader available to answer questions.

JERRY BURNETT, DEPUTY COMMISSIONER, DIVISION OF TREASURY, DEPARTMENT OF REVENUE provided a PowerPoint presentation:

"An Update on the State's Savings Accounts" and discussed Slide 3: "General fund and other non-segregated funds." He stated that as of December 31, 2010, the account was worth \$6 billion. He explained that the general fund was where tax money is held until it is used to make payments. He pointed out that approximately \$1 billion was in a type one Memorandum of Understanding (MOU) account. The type one account includes various funds. Some are available to spend and others are not. The funds retain their earnings at the end of the year. Another \$2 billion of the \$6 billion was in a type two MOU account, which includes various accounts where the earnings remain in the general fund. The unrestricted general fund begins each year at zero, so the balance of \$3 billion was from the current year; the money was appropriated in previous years but had yet to be spent.

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Co-Chair Stedman asked for explanation of the reverse sweep. Mr. Burnett replied that since 1993, there have been borrowings from the Constitutional Budget Reserve (CBR) to balance the budget. Over time, approximately \$5 billion was borrowed. At the end of each fiscal year, all unused money that is not appropriated from the general fund is moved into the CBR by operation of the constitution. Each year in either the operating or capital budget, there is a provision that appropriates the money that was automatically paid from the general fund into the CBR back into subfunds of the general fund. Following a legislative appropriation to repay working capital funds the previous year, the unrestricted general fund would have a zero balance, but the fund's balance was restored with a debt to the CBR of about \$401 million.

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Co-Chair Stedman agreed there must be a sweep to zero and then a reversal of the sweep to meet the technical requirements to operate the state; the structures will change with the eventual payoff of the CBR. He requested definitions of the terms illustrated in the pie chart on Slide 3.

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GARY BADER, CHIEF INVESTMENT OFFICER, TREASURY DIVISION, DEPARTMENT OF REVENUE, explained that the depicted short-

term fixed income is depicted cash of thirteen months or less, and the intermediate term is depicted as one to three years.

Co-Chair Stedman clarified that the term "money market account" would be a better way to describe the accounts for the public.

Mr. Burnett noted the market value over the past three years, specifically remarking on the good tax collection in 2008. The year-to-date (YTD) earnings in the "Returns" section refers to the calendar year of 2009, and the fiscal year-to-date (FYTD) earnings are from July 1 to December 31 of 2009. He thought the funds had done well relative to bench marks and expectations.

Co-Chair Stedman noticed the substantial spread between the benchmarks of the general fund, and requested the numbers be explored further.

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Co-Chair Hoffman wondered how the forecast of 3.6 percent was determined, because the FYTD was only 1.6 percent. Mr. Burnett responded that the FYTD was only six months, but when doubled it was 3.2 percent, a little below the forecast of 3.6 percent.

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Co-Chair Stedman noted that Alaska was reclassifying \$700 million in other state funds to general funds, and queried the impact on managing the investment. Mr. Burnett stated that Alaska will continue to invest funds in the same manner.

Mr. Burnett continued with Slide 4: "Constitutional Budget Reserve Fund." He mentioned that the subaccount is actually larger than the main account. He explained that the main account refers to available money invested in intermediate term, short term, and broad market securities with moderate risk. Most of the growth from 2007 to 2009 occurred because of appropriations and settlements in the range of \$5.6 million and some from the sweep of the last fiscal year.

Co-Chair Stedman requested definitions of each of the division's titles in the pie chart, specifically "Broad

Market." Mr. Bader explained that the broad market refers to what was previously known as the Lehman Aggregate fixed income benchmark, and is now known as the Barclays Aggregate. The composition of the aggregate is generally mortgages, treasury bills, corporate bonds, and other asset-backed securities. The corporate bond's composition changes as the market changes, but the aggregate is the benchmark. The intermediate term refers to a Merrill Lynch 1-3 Government Index and the short-term fixed income refers to money market or cash.

Co-Chair Stedman asked whether the broad market was actively managed or indexed. Mr. Bader responded that it was actively managed.

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Mr. Burnett furthered that about \$16 billion of fixed income is actively managed by the Treasury Division.

Co-Chair Stedman asked what was specifically actively managed and indexed. He realized the presentation was generic and would include more detail later, but remarked that the worst market in years was not reflected in the presentation.

Senator Thomas wondered whether the yield was only interest. Mr. Bader explained that the returns represented interest earnings plus losses or gains from market movement.

Senator Thomas queried the benchmarks. Mr. Bader answered that the benchmarks for the broad market were the Barclays Aggregate, the intermediate term was the Merrill Lynch 1-3 Government Index, and the cash was the 90-day Treasury Bill.

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Mr. Burnett pointed out that the [2009] YTD actual was 4.23 percent, the FYTD actual was 2.46 percent, the three-year actual was 5.56 percent, and the five-year actual was 4.81 percent. An exception was for the three-year actual, which did not outperform the benchmarks. Based on capital assumptions and benchmarks, the forecast of 4.18 percent was higher than the FYTD of 2.46 percent.

Co-Chair Stedman asked whether Mr. Burnett had the one year actual with him. Mr. Burnett offered to get the information.

Mr. Burnett continued that the other part of the CBR was treated as an investment fund, and was created by the legislature in 1998. At that time, the legislature was considering borrowing money, and wanted to be sure the investments were earning a higher rate than what was being borrowed. The decision came out of the Senate Finance Committee. The subaccount lost 25 percent in the first year and had \$400 million, but it did rebound a bit. The fixed income was the same as the broad market in the main account. It has international equities, which is a Europe, Far East, and Asia (EFA) index fund.

Mr. Bader continued that the international equities are EFA index, but are also 80 percent active. The EFA is considered both indexed and actively managed.

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Co-Chair Stedman observed that the EFA was basically a 80/20 split. Mr. Bader agreed.

Mr. Bader pointed out that the Domestic Equity is based on the Russell 3000 Index. The Russell 3000 Index is an index of approximately 3000 domestic companies with the highest market value. Russell looks at the companies and creates an index based on them.

Mr. Burnett continued that the Russell 3000 Index is a much broader index than the Dow Jones Industrial Average (DJI) or Standard & Poor's 500 (SP 500). He remarked that the Russell 3000 index mirrors the domestic economy more closely than the DJI or SP 500.

Co-Chair Stedman pointed out that the DJI represents industrial stocks and the SP 500 represents the 500 largest stocks, so the Russell 3000 Index is merely broadening out to the 3000 largest stocks.

Co-Chair Hoffman asked whether the forecast included the fiscal year. Mr. Burnett replied that it was the forecast for the asset allocation, and is based annually on the capital market.

Co-Chair Hoffman wondered whether the general fund forecast was for the fiscal year or the calendar year. Mr. Burnett specified that it was for the fiscal year.

Co-Chair Hoffman revisited the general fund (Slide 3) and pointed out that the FYTD was 1.6 percent, but the forecast was 3.6 percent. The forecast results from doubling the FYTD and factoring in a 0.4 percent growth. He then queried a discrepancy in the CBR subfund returns, specifically the FYTD of 16.61 percent with a forecast of only 7.87 percent.

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Mr. Bader explained that the high-risk funds were predominantly stocks, which have far greater returns, but also suffer from greater volatility.

Co-Chair Hoffman wondered whether the stock markets would lose funds, because the forecast was so much lower than that FYTD. Mr. Burnett explained that the forecast was as expected at the beginning of the fiscal year, so the FYTD has done better than what was forecast.

Co-Chair Stedman added that the broad market had a substantial rebound above what was expected.

Co-Chair Hoffman assumed that the forecast was for the next six months, and noted that the forecast should have been updated. Mr. Burnett explained that his presentation would later highlight forecast incomes for the Revenue Sources Book, which would update the actuals using the 7.87 percent earnings rate as the forecast.

Co-Chair Hoffman clarified that the forecast was obsolete. Mr. Burnett conceded.

Co-Chair Stedman explained that historical data and assumptions are used when projecting a return in a volatile equity market. There is variance with the forecast, so it is difficult to forecast the equity market in advance. He suggested exploring how benchmarks are created.

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Mr. Bader stated that projected earnings assumptions for each of the asset classes were presented to the Treasury Division and the Alaska Retirement Management Board (ARMD).

Results were put into an optimizer that looked at combinations of risk and return, which could be used as a central tendency forecast.

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Co-Chair Stedman requested a ten-year return actual, because the last ten years were historically low for rolling ten-year averages. He suggested a focus on range of outputs and dollars based on allocations, rather than the broad distribution of the 7.87 percent forecast of the high-risk investments. He anticipated a presentation of all the major accounts at once, including the \$35 billion permanent fund, the \$15 billion retirement accounts, and the savings accounts. He clarified that he is not interested in going into the retirement accounts, but he stressed the importance of understanding how all of the accounts in the state are managed. He projected that the permanent fund will need some serious attention after a few decades, because the oil and gas basins will mature and dry out.

Co-Chair Stedman queried the definition of "moderately long investment horizon." The year before, the account had been referred to as "moderately long savings account." Mr. Burnett reported that both referred to the same thing

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Co-Chair Stedman thought an evolution may occur, because there had been some internal discussion among committee members as to whether the state should hedge with oil prices. There had also been discussion that the large cash reserves were the hedging mechanism. He suggested that the taxes are structured to capture spikes, so the revenue was held to protect against implosions in price. He pointed out that there were peripheral influences, and the finance committee needed to reassure the administration of the committee's direction.

Senator Olson addressed the subfund of the CBR and requested explanation of the difference between the market values from 2007 and 2008, because it jumped over 650 percent in just one year. Mr. Burnett explained that the appropriation of \$2.3 billion for the CBR was put into the subfund and transferred to the main account. In FY 08 and FY 09, the legislature appropriated approximately \$5

billion to the CBR. The difference was an addition of \$4.1 million and investment losses.

Co-Chair Stedman recommended the committee have a policy discussion regarding how the money should be spent. He stated that the committee may want to restructure the allocation.

Senator Olson wondered whether Co-Chair Stedman wanted a more conservative approach.

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Co-Chair Stedman explained that he would like a discussion among committee members, but he anticipated that the group would decide on a more conservative structure for the savings account.

Mr. Burnett continued with Slide 5: "Power Cost Equalization Fund." The Power Cost Equalization Fund (PCE) is an endowment fund for paying power cost equalization. The fund has a 7 percent annual payout, 20 percent international equity, 37 percent fixed income, and 43 percent domestic equity. The fixed income refers to the broad market and the domestic equity refers to the Russell 3000 Index.

Co-Chair Stedman surmised that the allocation was 63 percent equity and 37 percent income and was similar to the subaccount of the CBR. Mr. Burnett agreed.

Co-Chair Stedman asked how far behind the CBR was from the initial investment. Mr. Burnett reported that it was currently behind by about \$300 million.

Co-Chair Stedman queried the numbers at the beginning of January, in order to have numbers align. Mr. Burnett explained that the CBR was about \$200 million behind, stating that it was approximately the same as June 2008.

Co-Chair Stedman asked whether the allocation was intentional. Mr. Burnett explained that the allocation was set to achieve the return necessary to pay out 7 percent per year. On an efficient frontier with specific assets, there will be similar asset allocations.

Co-Chair Stedman queried the time horizon of the PCE. Mr. Burnett stated that the horizon was long term with no end to the PCE endowment fund, likening it to the permanent fund.

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Co-Chair Hoffman pointed out that the CBR has two classes: moderate and high risk. He wondered where the direction came to invest all the PCE on high risk. Mr. Burnett noted the statute that sets up the endowment fund requires a 7 percent annual payout, so it is invested assuming a 7 percent return.

Co-Chair Hoffman requested they focus on a more moderate investment scheme. Mr. Burnett noted that 37 percent of the PCE is invested in fixed-income securities and broad index.

Co-Chair Hoffman surmised that a high-risk investment will only bring in 7 percent. Mr. Burnett explained that based on the asset mix and the capital assumptions, the central tendency over time would be to achieve the forecast earnings of about 7 percent. Furthermore, the higher the rate of return that one tries to achieve, the higher probability of a loss in any given period.

Co-Chair Hoffman requested the ten-year actual.

Co-Chair Stedman considered the 7 percent return unsustainable, because common payouts are closer to 4 percent. He worried that the ten-year actual would be less than 7 percent, because the five-year actual was only 3.55 percent. He reiterated the importance of a policy discussion about the potential erosion of the PCE purchasing power and actual value.

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Co-Chair Stedman discussed the portfolio as a long-term time horizon in perpetuity, which is different from the five-year time horizon of the CBR. He suggested the committee look at the difference later.

Mr. Burnett pointed out that the YTD return was 21.64 percent, the FYTD return was 15.77 percent, the five-year actual was 3.71 percent, and the three-year actual was

zero. Most of the money went into the account about three years prior.

Co-Chair Stedman reiterated that there was an equity infusion, and suggested it be measured by weighing the cash flow based on time. Mr. Burnett indicated that the timing was not the best.

Co-Chair Stedman mentioned the equity infusion to the courts accounts. He understood good and bad timing.

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Mr. Burnett addressed Slide 6: "Public School Trust Fund." The income account is 100 percent fixed income, because that was where the money was spent from on an annual basis. The principle account is moderate risk, with 43 percent domestic equity, and 57 percent fixed income. He explained that the fund lost money, but has regained it. The YTD returns were 17.64 percent, the FYTD were 12.28 percent, the three-year actuals were 1.38 percent, and the five-year actuals were 3.59 percent, with a forecast of 6.95 percent.

Co-Chair Stedman requested an inflation column be included in a revised chart. He stressed the importance of observing the benchmarks, purchasing power, and performance. Mr. Burnett agreed and explained that the income fund is a cash-only account.

Co-Chair Stedman inquired about the pay out for the income account. Mr. Bader responded that the interest earnings and dividend earnings go into the income account, which is available for appropriation by the legislature.

Co-Chair Stedman asked how the losses are allocated. Mr. Bader replied that the capital gains and losses are retained in the principle fund.

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Mr. Burnett discussed Slide 7: "PERS & TRS [Public Employees' Retirement System and Teachers Retirement System]."

Mr. Bader explained that the "Fixed Income" is primarily broad income market debt. "Domestic Equity" includes active and passive managers, which includes large capital and

small capital. The "International/Global Equity" has two components: one is a merging market, which includes countries that are beginning to merge into the global economy, including China; and the others are developed international markets with large capital. The missing component in the international/global equity is an international market with small capital. "Real Assets" refers to money that is intended to act as a hedge against inflation. These include energy, real estate, timber, farmland, and treasury inflation protected securities. "Alternatives/Infrastructure" refers to hedge funds and private-equity investments in startup companies.

Mr. Burnett addressed market values, and noted that both funds are complex from a cash-flow basis. There is money that comes in on a monthly basis from employers, there is money that goes out monthly to retirees, and there are special appropriations by the legislature into the funds. He emphasized the constant cash flow in the accounts, and also losses and gains in investments. The FYTD was 12.3 percent, the three-year actual was negative 1.87 percent, and the five-year actual was 3.35 percent. The forecast of 8.25 was an assumed rate, because the investments are structured to meet the rate. The Teacher Retirement System is almost the same investment rate as PERS, but there is a slight variance in returns because of cash-flow differences.

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Co-Chair Stedman recalled the 8.25 return that was forecast in the previous year. Based on the last three years, he felt that a forecast of 8.25 percent was too high. He asked for advice on how to obtain 8.25 percent, since it had not been achieved in the past three years.

Mr. Burnett stated that the same question was asked in the last two meetings of the ARMD. There was an asset-liability study done and a presentation by the actuary of the state. The presentation showed an expected return base of around 8.4 percent. He conceded that the 8.25 percent was inconclusive, but the board was focused on determining the correct assumptions.

Co-Chair Stedman remarked that lowering the forecast of 8.25 percent would have repercussions on the targets. He

would be willing to have a discussion if the division wanted to raise the forecast to 8.4 percent.

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Mr. Burnett clarified that the 8.4 percent was not a recommendation. The board felt that a forecast of closer to 8 percent was more reasonable. He specified that he did not believe that the presented forecast of 8.25 was too low.

Co-Chair Hoffman questioned why a forecast under moderate risk was higher than a forecast under high risk. Mr. Burnett could not conclude definitively the reason for the difference, but remarked that the assets in the PERS and TRS were not liquid as the PCE.

Co-Chair Hoffman suggested the PCE be invested in a similar fashion as PERS and TRS.

Co-Chair Stedman furthered that the definitions should remain consistent. He thought that the investments outside of stocks and bonds could expect to have an impact on the evaluation. He suggested an examination of the liquid assets be conducted, in order to determine their value.

Mr. Burnett agreed to provide an explanation about the PERS and TRS funds, and noted that the funds had moved away from leveraged investments and real estate over the last year.

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Mr. Bader explained that 80 percent of the real-estate investments were known as core real-estate, meaning they are institutional-grade properties with no leverage. Sections of 20 percent of the investment portfolio for PERS and TRS were collective funds and had significant leverage.

Co-Chair Stedman wanted to have an informal discussion about the permanent fund. One concern was whether to refinance, because the lenders might be unable to refinance. He stressed the importance of evaluating the accuracy of the estimates on the market value, because of the possibility of liquidation. He noted there was less risk paying cash than leveraging. Mr. Bader agreed that was true in the collective funds, but remarked that the assets were held in a separate account and were close to market value.

Co-Chair Stedman noted that the committee would explore the subject further during the permanent fund presentation.

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Mr. Burnett discussed Slide 8: "Alaska Permanent Fund Corporation Board" (APFC). He remarked that most of the descriptions fall under a risk-based analysis, so he would not address the definitions. He pointed to the value in 2007 of \$38 billion, noting a drop in 2008 of \$28 billion, and then back up to \$34 billion in 2009. The FYTD was 14.3 percent, the three-year actual was negative 1.25 percent, and the five-year actual was 3.48 percent. The forecast return was 8.28 percent, which was just slightly better than the PERS and TRS forecast. He restated that the APFC would be giving a presentation to the committee, so he deemed it unnecessary to explore the fund.

Co-Chair Stedman commented that the APFC was invested differently from the retirement accounts. PERS and TRS have a shorter time horizon than the APFC, and have a payout that must be met for retirees. He noted that the APFC did not have a requirement, and was based more on market flow. He stressed the importance of profiling the risk exposure for both accounts.

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Mr. Burnett discussed Slide 10: "FY 2010 Investment Revenue Forecast." He mentioned that the forecast in the Revenue Sources Book was based on a combination of actuals and forecasts. He noted the actual unrestricted earnings in FY 09 were \$82.8 million, with a forecast through FY 10 of \$101.3 million, totaling \$184.1 million for the revenue source.

Co-Chair Stedman asked whether \$182.7 million was the gain for the year. Mr. Burnett clarified that the \$184.1 million was the estimated unrestricted investment earnings for FY 10, in primarily general funds. Of that \$184.1 million forecast \$82.8 million been earned so far.

Mr. Burnett continued with restricted investments, money that stays in the CBR, subfunds of the general fund, endowments and trusts, and the permanent fund. The forecast for FY 10 was \$1.7 billion, but it already earned \$5

billion in FY 09. He noted that the restricted earnings had done well, but the unrestricted earnings were slightly below target.

Co-Chair Stedman remarked on the exceptional rebound since April 2009. Mr. Burnett agreed, but stressed the volatility in the market from day to day.

10:24:45 AM

Co-Chair Stedman requested that staff review the presentation and some of the mentioned issues.

Commissioner Galvin offered to answer questions from the committee.

Co-Chair Stedman discussed a future presentation by the Department of Transportation and Public Facilities (DOT/PF) and the possibility of additional stimulus monies.

Senator Ellis expressed frustrations about DOT/PF, and its backlog of projects. He hoped to address the issues during the DOT/PF presentation.

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ADJOURNMENT

The meeting was adjourned at 10:30 AM.