

SENATE FINANCE COMMITTEE  
February 25, 2011  
8:07 a.m.

[8:07:08 AM](#)

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 8:07 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair  
Senator Bert Stedman, Co-Chair  
Senator Lesil McGuire, Vice-Chair  
Senator Dennis Egan  
Senator Donny Olson  
Senator Joe Thomas

MEMBERS ABSENT

Senator Johnny Ellis

ALSO PRESENT

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

SUMMARY

^Overview: Capital Markets and Permanent Fund Performance Review.

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Co-Chair Stedman introduced the chair of the Alaska Permanent Corporation Board.

BILL MORAN, CHAIR, ALASKA PERMANENT FUND CORPORATION BOARD introduced his cohorts. He discussed the agenda for the day.

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MIKE BURNS, EXECUTIVE DIRECTOR, ALASKA PERMANENT FUND CORPORATION, DEPARTMENT OF REVENUE provided a presentation titled: "Alaska Permanent Fund Designed for Sustainability (copy on file)."

Mr. Burns began with Slide 2: "FY2010 performance." He explained the various markets.

Total return	11.7%
Benchmark return	10.2%
Ending balance	\$33.3 billion
Change from FY10	\$ 3.4 billion
Dividend	\$858 million

Mr. Burns discussed Slide 3: "FY 11 performance as of December 31."

Total return	14.5%
Benchmark return	16.6%
Ending value	\$38.4 billion
Change from FY10	\$ 5.1 billion

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Mr. Burns discussed the sources of the fund as listed on Slide 4: "Renewable Resources." He explained that Alaskans have deposited \$14.7 billion into the fund to date. He added that \$18.4 billion have been paid out in dividends. The current value of the fund is \$39 billion as of 2/24/11. He concluded that the fund has provided a successful socioeconomic experiment.

Slide 5: "Fund Deposits." He noted that the constitutional royalty deposits equal \$11.8 billion. Legislative transfers from the general fund (FY81 through FY 85) totaled \$2.7 billion. Another \$2 million were classified as settlement deposits.

He explained the difference between the investment income and outflow on Slide 6: "Inflow and outflow." He informed that 1983 was the first year of operation for the fund. The royalty deposit in 1983 was \$421 million, the accounting net income was \$471 million and the dividend was

approximately \$64 million. He explained that in 1991 dramatic changes occurred. The pipeline saw 665 million barrels of oil in 1991 and the price was \$25 per barrel with a royalty deposit of \$435 million. He mentioned that the accounting net income was \$1 billion and the dividend was \$490 million. He continued with the year 2000 when the royalty deposit was \$311 million, the accounting net income was \$2 billion and the dividend was \$1 billion. In 2008, the permanent fund received the greatest royalty deposit to date and coincidentally paid the highest dividend. The Trans-Alaska pipeline saw 258 million barrels of oil; however, prices peaked at \$133 per barrel. The royalty deposit in 2008 was \$844 million and the accounting net income was at a \$1.4 billion loss. The dividend was the largest ever at \$1.3 billion. He concluded that in 2010 the royalty deposit was \$680 million, the accounting net income was \$3.5 billion and the dividend was \$858 million. The source of the committee questions included the relative inflow. He informed that investment income drove the fund.

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Mr. Burns discussed Slide 7: "Risk Based Asset Allocation." He explained that interest rates comprised 6 percent and existed for times of crisis, deflation, and disinflation. The interest rates provided a safe haven asset from United States (US) treasury bonds and non-US sovereign debt. Company exposure was shown as the largest slice in the pie chart at 53 percent. Investing in public and private companies provided the state the opportunity to benefit from growth and prosperity. The company exposure group included all public and private equities, corporate investment grade and high yield bonds. Real assets comprised another piece of the pie at 18 percent. The asset group was viewed as protection from inflation risk. The group included real estate tips which were treasury inflation protected securities and infrastructure. He added another category termed "special opportunities" at 21 percent. The purpose of the allocation was to allow the permanent fund to invest in special opportunities and take advantage of dislocations in the market. The special opportunities category was viewed as a limiter. The final category was cash at 2 percent. The cash allocation was designed to allow the fund to build up reserves over the course of the year to meet the expected liabilities.

Mr. Burns discussed Slide 8: "Dollar Allocation Limits by Risk Class (1/31/2011)." The slide provided a visual image of the fund's performance. The slide illustrated the actual dollar allocation to the risk grouping. With the exception of real assets, all were in the green zone. Values were required to be in the green zone. When a measure moved into a yellow zone, the Chief Investment Officer and Mr. Burns reviewed the situation to take action within 90 days. If a value fell into the red zone, the board must be notified immediately to rectify the situation within 30 days unless the board grants an exemption. The bands were designed specifically to encourage communication. When bands move out of the green zone, the goal was to return to green as quickly as is prudent.

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Mr. Burns discussed Slide 9: "Tail Risk: Scenarios (1/32/2011)." The graph illustrated the performance of the portfolio under specific conditions, including the 2007 through 2009 subprime mortgage meltdown. He mentioned the various scenarios presented.

Mr. Burns continued with Slide 10: "Tail Risk: Stress Tests (1/31/2011)." The test included dividing the portfolio and devising various tests. One example was a test of the fund's performance if the US dollar dropped 20 percent overnight. He mentioned the various situations presented in the test. The test allowed the corporation to gauge certain risks.

Co-Chair Stedman asked about the stress test. He wondered if the various proposed risks were individually triggered, particularly the component of global equities. Mr. Burns replied that the test illustrated the measure of risk shown in the equity portfolio. He stressed that one of the proposed events would not occur singularly in reality.

Co-Chair Stedman asked if the global equity exposure was tested regardless of the other holdings. Mr. Burns stated that everything would remain the same. He added that the reaction to other asset classes in this type of simulation was complicated.

Co-Chair Stedman asked about the individual components of risk as shown in the graph. Mr. Burns explained that the benchmark portfolio provided a comparison.

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Mr. Burns discussed Slide 11: "Peer Recognition."

- aiCIO Industry Innovation Award
- Public and private fund managers
  - Singapore Government Investment Corp
  - Norway Government Pension Fund
  - Mitsubishi UFJ Trust & Banking
  - Massachusetts PRIM
  - California STRS
  - University of California

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Co-Chair Hoffman wondered about the board's opinion regarding oversight in the legislative review. Mr. Burns responded that the legislative or administrative oversight was vital to the continued confidence of the citizens of Alaska. He expressed the challenge of the state's resources and the wisdom of the decisions regarding the spending of state money. He stressed that the permanent fund was a profit center for the state. He commented that general fund money was not used. The oversight of the legislature was critical, although separation from the general fund money among the opinion of the public was also essential.

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Senator Thomas asked about Slide 5 and the realization that the settlement deposits were so small. He understood that the receipts are based on royalty deposits. He was informed that where lawsuits were concerned, for every dollar spent, 10 were collected. He assumed the information was based on production tax, but expected a similar discrepancy on the royalties. Mr. Burns responded that the fund does not benefit from a tax settlement. An increase in taxes lowers the royalty value.

Senator Thomas asked about the timeframe for interest rates depicted on Slide 8. Mr. Burns responded that the duration of the portfolio was approximately five years.

Co-Chair Stedman asked for a definition of duration. Mr. Burns responded that duration was the amount that the

portfolio changes with a one percent difference in interest rates.

Co-Chair Stedman asked about the adjustment of the benchmark for the asset allocation. Mr. Burns responded that the corporation measures itself against its peer group. The mandates for benchmarks had changed.

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MICHAEL O'LEARY, EXECUTIVE VICE PRESIDENT, CALLAN ASSOCIATES, presented "2011 Economic Environment and Capital Markets Review (copy on file)." He explained Callan Associates involvement in the permanent fund since 1989.

Mr. O'Leary provided a brief review of the capital market outlook. He provided a description of Slide 1: "Callan's Capital Market Projection Process."

- Evaluate the current environment and economic outlook for the U.S. and other major industrial countries:
  - Business cycles, relative growth, inflation.
- Examine the relationships between the economy and asset class performance patterns.
- Examine recent and long-run trends in asset class performance.
- Apply market insight:
  - Consultant experience-Plan Sponsor, Manager Search, Specialty
  - Industry consensus
  - Client Policy Review Committee
- Test the projections for reasonable results.

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Mr. O'Leary described Slide 2: "Stock Market Returns by Calendar Year." The histogram illustrated the calendar year performance for the U.S. stock market over 200 years. He used the histogram to demonstrate the extreme 2008 market as well as the recovery in 2009 and 2010.

Mr. O'Leary detailed Slide 3: "The Current Economic Environment."

- Growth returned in the second half of 2009, but job market struggles to revive well into 2011.

- o Unemployment remains above 9%.
  - o Wealth has been hit, consumers de-levering, savings are rebuilding.
  - o QE II the "last" round of monetary stimulus.
  - o Tax compromise provides new fiscal stimulus in 2011-12.
- Steep recoveries usually follow steep recessions.
- However, recoveries after financial crises are slow.
  - o Financial stress has been greatly reduced..
  - o ...but private credit is still contracting-banks reluctant to lend, households and businesses reluctant to borrow.
- Everyone expected growth to subside in 2010...
  - o Stimulus fades and the inventory cycle is complete.
  - o Europe struggles with slow growth and sovereign debt crisis.
  - o Emerging markets wait on our recovery.
- But the capital markets freaked out as projections come true.
  - o Equity hammered through Q3 2010, retail investors fled risk, and bond inflows remained substantial.
  - o Interest rates headed even lower.
- Q4 saw signs of economic stability, return of investor confidence.
- Tax compromises will likely push 2011 GDP growth to 3 percent, a year ahead of expectations.
- Federal government faces harsh budget realities. Defense, social security, Medicare/Medicaid and Interest dominate spending.

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Mr. O'Leary described Slide 4: "Is Rising Inflation an Emerging Threat?" He spoke about governments across the country coping with budgetary lows. The economy began recovering in 2009 and continued through 2010, but the job market remained sluggish. He mentioned unprecedented steps taken to alter the direction of the economy in terms of monetary and fiscal policy. The tax compromise reached in the fourth quarter was another indication of the perceived need for continued support of the economy.

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Mr. O'Leary addressed Slide 5: "The Economy and the Capital Markets."

The economy was fully expected to meander through a weak recovery, as the combination of recession, financial crisis and deleveraging required time to work through the system. GDP growth was expected to slacken in 2011, but tax compromise may boost growth to the long-term trend (3%).

Inflation is in the headlines, but deflation remains the real concern to the Fed. Inflationary pressures stemming from Fed and Treasury actions are less of a concern in the short to medium term.

Double-dip is possible, but not the expected outcome.

Callan's outlook: Inflation will likely drift higher, but not immediately. Painfully low interest rates may persist through 2011, but are expected to rise after that, as the Fed eventually removes accommodation.

Historic nominal return averages will be hard to achieve over the short, medium and even the longer run.

Stocks rallied in the fourth quarter of 2010 and turned in a good year. However, prospects for above-trend growth are weak; companies are strong enough to attain trend profit growth, but not a lot more.

The housing market has yet to truly hit bottom, despite mortgage rates at an all-time low. The "shadow inventory" of homes yet to foreclose hangs heavy over the market.

The chance that we could see another leg down on housing is the greatest risk to the economy, and to a deflationary spiral.

The dollar should face substantial downward pressure as a result of U.S. policy. The problem, of course, is what other currency can take the dollar's place?

The path to a rational set of long-term capital market outcomes is likely through an ugly shorter term period of rising interest rates, capital losses in fixed income, and volatile equity markets.

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Co-Chair Stedman asked about Slide 5 and the statement that historic nominal return averages would be difficult to achieve over the short, medium and even the longer run. Mr. O'Leary responded that he wanted to communicate that the

legislature must be conservative with expectations. He added that the issue was driven by the outlook for interest rates.

Mr. O'Leary detailed Slide 6: "Starting asset valuations dominant return expectations."

Equity valuations, both domestic & international, appear reasonable (not cheap but not expensive)  
Analyst expectations already envision decent 2011 eps growth  
Corporate balance sheets provide good flexibility  
Developing countries are expected to enjoy strong absolute growth which should offset soft demand in much of the developed world

Interest rates are a different story.  
Even with low inflation real short-term interest rates remain negative  
Inflationary pressures could build (e.g. commodity inflation, excess demand in emerging world)  
Rates are so low across the curve that the "income cushion" to rising rates is minimal (see Q4 2010 bond returns for perspective)  
Equity earnings yield versus Treasury or Corporate bond yields look attractive but spread could be narrowed quickly with a rise in rates.  
Our conclusion is that rates will rise and limit P/E expansion opportunities

Major theme is nominal returns for both stocks and bonds will be positive but limited for the short-intermediate term.

Mr. O'Leary described the graph on Slide 7: "Equity Is More Reasonably Priced." He explained that the red line represented the long-run average. The blue line suggested that the price earnings ratio was at an average.

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Mr. O'Leary described the statistics on Slide 8: "Absolute valuation measures indicated that stocks were "reasonably" valued." He noted that the price earnings ratio based on the most recent fiscal year earnings illustrated mid teen levels, which historically were not considered excessive.

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Mr. O'Leary discussed Slide 9: "Dividend yields are in line with recent experience by not high." He explained that the blue lines represented the S&P 500 earnings yield which was the reciprocal of price earnings ratio. With a price earnings ratio of 20, a dividend yield of 5 was seen. He added that the red line represented the 10 year treasury yield which is compared to the blue line. The graph showed that stocks were attractively priced when compared to ten year treasuries. He stated that the difference was narrowed in various ways.

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Mr. O'Leary jumped to Slide 12: "Despite Q4 Increase Current Yield is Exceptionally Low." The investment for the bond market allows for a current yield on the investment grade bond market or the Barclays aggregate. At the end of 2010, the "yield to worst" on that index was less than 3 percent.

Mr. O'Leary skipped to Slide 16: "Decomposition of Aggregate Bond Returns Note Shrinking Income Component." He called attention to the low income component. He pointed out that the panel in the upper right illustrated the interest component, while the panel in the lower left detailed the price change component. Prices of bonds increased when interest rates decreased and prices of bonds decreased when interest rates increased. He pointed out the low income component in the upper right panel, which was relative to recent history. He opined that low interest rates present the source of greatest concern with regard to the outlook.

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Mr. O'Leary detailed Slide 13: "History of Recent Interest Rate Hikes 1982-2010." He pointed out that the blue line represented the federal funds rate. The shaded areas on the page captured periods where the fed funds rate increased. He mentioned six periods of federal tightening over the past 28 years; each was unique and bond returns were positive in many ways.

Co-Chair Stedman supposed that the graph depicted substantial interest rate decreases that might slaughter

the bond market. Mr. O'Leary countered that the positive returns were seen in the bond market, but for less than the interest earned. The challenge was the lack of cushion against a rate hike. He did not anticipate a "slaughter."

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Mr. O'Leary described Slide 14: "Rate Hike Summary." He explained that the graph endeavored to illustrate through symbols the shape of the yield curve. The yield curve was positively sloped and short term interest rates were much lower than long term interest rates. In other environments, the yield curve was flat.

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Mr. O'Leary continued with Slide 17: "2011 Capital Market Expectations-Traditional Asset Categories." He explained that the table represented different return numbers including the projected arithmetic return and the five and ten year geometric mean returns. The standard deviation was a measure of volatility of return. The greater the standard deviation, the greater the difference between the average return and the compound return. He quoted the adage that "if you go down 50 percent you must come back 100 percent to be even."

Co-Chair Stedman asked if the return expectations were similar to those seen by the Alaska Retirement Management Board (ARMB). Mr. O'Leary answered yes. He stated that the return expectations were updated annually and the ARMB had seen the expectations and would evaluate their asset allocation considering various combinations of asset classes. The same projections were used for the permanent fund. The building blocks were identical.

Mr. O'Leary described Slide 18: "2011 Capital Market Expectations-Traditional Asset Categories." The slide provided an illustration of a segment of the efficient frontier including six different mixes. He called attention to the projected arithmetic return line showing limited bond exposure.

Mr. O'Leary continued with Slide 19: "APFC Policy Index Projections."

Mr. O'Leary backed up to Slide 18: "Illustrative Efficient Mixes- Traditional Characterization." He noted that the volatility of the mix was high. A mix was not suggested to most institutional investors.

Mr. O'Leary returned to Slide 19 and explained the focus on global corporate securities and domestic equity. The permanent fund grouped international and domestic equities into global equities. The global government bonds were hedged to measure the interest rate sensitivity.

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Co-Chair Stedman asked about the ARMB and permanent fund comparisons as seen on Slide 20: "Current Policy versus Efficient Frontier." He struggled with the targeted return of 8.25 percent, which he deemed too high. He recalled that the ARMB planned to lower the target to 8 percent. He also struggled with the perceived risk exposure. He wondered about the appearance of a more risky and aggressive portfolio in the retirement system. He believed that the permanent fund should be able to take more risk than the retirement funds. He added that the permanent fund was not required to meet the liability obligation that the retirement fund must. Mr. O'Leary responded that many complex elements were involved. The 8.25 percent was an actuarial earnings assumption. The actuary developed consistent sets of expectations. A key driver of the liability was an expectation about future inflation, which was the actuarial expectation with respect to salary growth.

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Mr. O'Leary stated that a pension system was investing for forty plus years and the contributions affected by the actuary's expectation of future salary increases were 20-40 years.

Co-Chair Stedman commented that the committee had a low comfort level with the targets of 8.25 percent in the retirement system. Mr. O'Leary added that both the permanent dividend fund and the retirement funds both pursued a 5 percent long term real return target. He noted that the target might be achievable in the future.

Co-Chair Stedman agreed, but added that the short term might bankrupt the state. Mr. O'Leary concurred.

Mr. O'Leary pointed out that the ARMB projected standard deviation was higher than the permanent fund in the 13 percent range. He noted that ARMB had a greater commitment to private markets.

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Mr. O'Leary explained that projections must be developed for private equity and direct real estate. He noted that Callan Associates always used high risk levels for both categories because they were equity investments.

Co-Chair Stedman asked about a chart with asset allocations for ARMB and the permanent fund to allow for comparison. He wondered how similar the standard deviation might be.

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Mr. O'Leary suggested viewing Mix 4 and Mix 5 on Slide 18. He stated that ARMB would exist between the two.

Co-Chair Stedman proposed discussion about the targeted return of the allocation.

Mr. O'Leary responded that the discount rates used in the public pension arena have declined and existed at 7.75 percent and 8 percent.

[9:16:24 AM](#)

Co-Chair Hoffman asked about the actual rate of return over the last ten years.

Mr. O'Leary replied that the cumulative return for the permanent fund over ten years was 526 and the benchmark was 519. The ten year period included the dot com meltdown and the more recent recession. The ten year return for the pension systems using preliminary real estate numbers for calendar year 2010, were 445.

Co-Chair Hoffman asked the monetary values of the differing numbers.

Mr. O'Leary did not know. He offered to calculate the numbers later for the committee. He stated that the Public Employees Retirement System (PERS) had a return of 12.44 percent and Teachers' Retirement System (TRS) a return of 12.54 percent. The two year annualized returns were 12.87 and 12.97 percent respectively.

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Co-Chair Stedman commented the permanent fund would have a higher risk exposure and higher rate of return than the retirement portfolio with its liability stream and finite life.

Mr. O'Leary responded with Slide 22: "Expected Range of Returns 1, 5, and 10 years." He pointed out the challenge for the board and the state, given the nature of the closed pension system. The policy would change toward one of more conservative investment. The change might occur at a higher level of interest rates.

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Co-Chair Stedman commented that upcoming liability stream payments would be \$3 billion per year. He noted that the legislature struggled to devise a plan to meet the payments. The issue required resolution, since the liability was spreading.

Mr. O'Leary agreed. He stated that the "dirty little secret" about private pension funds was that an investment in government bonds would yield an investment earning rate of less than 5 percent.

Co-Chair Stedman stressed the importance of balanced investment.

[9:25:02 AM](#)

Senator Egan requested definitions for the terms real and long term rates of return.

Mr. O'Leary responded that real rate of return was communicated in constant dollars without inflation. The presumption was that a real rate of return was earned while maintaining the value in nominal terms. He noted that publicly traded equities ranged between 5.5 and 8 percent.

[9:26:48 AM](#)

Co-Chair Hoffman asked about the the real rate of return for the permanent fund's portfolio for the last ten years.

Mr. O'Leary responded that the Consumer Price Index (CPI) plus five, over ten years was 735. He pointed out that 735 was the rate of return required to achieve a 5 percent real rate of return. The actual nominal return was 526.

Co-Chair Stedman asked for the real rate of return and nominal rate of return.

Mr. O'Leary responded that the nominal return was 526 for ten years.

Co-Chair Hoffman added that the real rate of return was a little over two percent.

Co-Chair Stedman invited Mr. O'Leary to testify for future ARMB and PFD presentations.

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Co-Chair Hoffman asked about the 18 months ending April 2009 when the fund lost in excess of \$13 billion. He wondered about actions taken by the board to address the loss.

Mr. Burns responded that the board rebalanced into the weak equity market. He added the adoption of a robust focus on risk management and assessment. He focused on the risk management and learned many lessons.

Mr. O'Leary informed the committee about changes in the industry to build investment programs with ample liquidity. He agreed that an explicit liquidity plan was necessary to meet the annual dividend. He noted that the interest rate was restricted to highly liquid government obligations that were not subject to the types of spread-widening seen in the broader investment grade bond market. He advocated for greater attention to potential liquidity needs. He pointed out that all funds considered altering their strategies in pursuit of less volatility within the equity component of their programs.

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Co-Chair Stedman mentioned the Constitutional Budget Reserve (CBR) and Statutory Budget Reserve (SBR). He noted the substantial savings in the accounts and the discussions regarding the management of the assets. He advocated for building a separate savings portfolio to protect the permanent fund. He mentioned concerns regarding the management style of the Department of Revenue (DOR).

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Co-Chair Stedman asked about the relationship with Callan Associates Inc. and the DOR regarding the CBR and SBR.

Mr. O'Leary responded that he had no relationship pertaining to the CBR or the SBR. He understood that staff could utilize the Callan Associates' capital market projections. Callan Associates had no participation in discussions regarding the investment policy for the CBR or SBR.

Co-Chair Stedman added that the questions asked of Mr. O'Leary were no surprise. He requested a letter clarifying the relationship between Callan Associates and DOR. He mentioned discussions between the finance co-chairs and the governor's office regarding the management of the funds. He hoped for a concise plan. He stressed Alaska's strong fiscal position during rough times in other parts of the country.

[9:41:25 AM](#)

Senator McGuire asked about funds within funds managed for other jurisdictions or companies regarding energy.

Mr. O'Leary recalled deliberation about energy issues in the legislature. He stated that many major funds had an explicit allocation to energy related strategy as part of their investment program.

Co-Chair Stedman clarified the question. He asked about a spin-off of revenue or a percent of market value.

Mr. Burns replied that he managed the mental health trust fund money within the permanent fund. He added that the

sub-fund concept was utilized. The asset allocation and investment goals remained similar.

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Co-Chair Stedman commented that the issue required resolution by April 2012.

9:44:30 AM

#  
ADJOURNMENT

The meeting was adjourned at 9:44 AM.