

SENATE FINANCE COMMITTEE  
February 21, 2012  
9:06 a.m.

[9:06:47 AM](#)

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 Dennis Egan  
Senator Donny Olson  
Senator Joe Thomas

MEMBERS ABSENT

Senator Lesil McGuire, Vice-Chair  
Senator Johnny Ellis

ALSO PRESENT

Michael Burns, Executive Director, Alaska Permanent Fund;  
Michael O'Leary, Executive Vice President, Callan Associates

SUMMARY

^Capital Markets Outlook and Permanent Fund Performance Review

[9:07:17 AM](#)

MICHAEL BURNS, EXECUTIVE DIRECTOR, ALASKA PERMANENT FUND, presented a PowerPoint presentation, "Alaska Permanent Fund, Designed for Sustainability." He looked at slide 2, "FY 2011 Performance", and noted that the total return was 20.6 percent, the benchmark return was 21.5 percent, the ending balance was \$40.1 billion, the change from FY 11 was \$6.9 billion, and the dividend was \$801 million.

Mr. Burns discussed slide 3, "FY 2012 to-date", and explained that the total return was -4.5 percent, the

benchmark return was -4.6 percent, the ending balance was \$39 billion, and the change from FY 11 was -\$1.1 billion.

Mr. Burns highlighted slide 4, "Renewable Resource", and stated that \$15.6 billion had been deposited into the Fund to date; \$19.2 billion had been paid in dividends to date; and the current value of the fund was \$40.7 billion.

Co-Chair Hoffman wondered how much the legislature had deposited since the Permanent Fund's inception. Mr. Burns replied that the number was included in the \$15.6 billion, and estimated that it was approximately \$15.5 billion. He stressed that the Fund mostly consisted of oil royalties.

Mr. Burns discussed slide 5, "Tysons Corner Center." He explained that Tysons Corner Center in Washington, DC had 2 million square feet developed, and 1.4 million square feet were entitled. The building held apartments, office space, and a hotel; and train access was in under development from DC to Dulles.

Co-Chair Stedman requested an analysis of the three, five, and ten-year compounded returns. Mr. Burns stated that the compounded returns would be presented later in the meeting.

[9:13:17 AM](#)

Mr. Burns looked at slide 6, "299 Park Avenue." He stated that 299 Park Avenue was a recent acquisition. The partners were the Fisher Brothers, and it was 1.1 million square feet of office space. The total property value was \$1.2 billion. He stressed that it was a major investment, and the Permanent Fund Corporation was a 50 percent partner with the Fisher Brothers. He noted that the Fisher Foundation, which was founded by the Fisher Brothers, opened a Fisher House at the Elmendorf Hospital. He stated that there were 56 Fisher Houses at military and veterans hospitals. He felt that the Fisher House was beneficial to families of wounded soldiers.

Co-Chair Stedman surmised that 299 Park Avenue was worth approximately \$1 billion. Mr. Burns expounded that it was worth \$1.2 billion. Co-Chair Stedman surmised that the State had a 50 percent share. Mr. Burns agreed. He furthered that the State contributed \$400 million, and there was some debt on the State's share.

Co-Chair Stedman wondered if the State's leverage equaled that of the Fisher Brothers. Mr. Burns responded that the debt was already on the property, because the State bought out another partner.

Co-Chair Stedman wondered if the \$400 million was for the entire property or strictly on the State-owned portion. Mr. Burns replied that the \$400 million was on the entire property.

Co-Chair Stedman requested further information regarding how the real estate was managed. He believed that the real estate owned by the Permanent Fund Corporation was mostly equity. Mr. Burns replied that the preferred method was to own the properties outright, although, if there was some existing debt it would be managed appropriately. He explained that there was some debt at the Tyson Center, and the real estate investment trust that handles the retail end calls for use of modest leverage.

Mr. Burns discussed slide 7, "City Centre II & III." He stated that City Centre was located in Houston, Texas. It was 150,000 square feet of retail and office space, and would be 270,000 after construction. The City Centre II and III had a \$50 million property value. He added that there was going to be a City Centre IV. He explained that City Centre III would be the campus for the Texas A & M Business School. He stressed that it was currently an active year for real estate.

[9:18:08 AM](#)

Mr. Burns introduced Mr. O'Leary. He explained that Callan Associates had been the Permanent Fund Corporation's investment consultant since 1990.

MICHAEL O'LEARY, EXECUTIVE VICE PRESIDENT, CALLAN ASSOCIATES, stated that he was going to present the final performance numbers and the benchmark number for the first six months. He remarked that the performance was slightly better than previously reflected, because the benchmark index reflecting all categories was slightly worse than what Mr. Burns had indicated. He stated that the half-year saw a negative return of \$466 million, versus a benchmark return of -\$526 million (six months, ended December 2011).

Co-Chair Stedman requested a table format of the various nominal and real returns. Mr. O'Leary agreed to provide that information.

Mr. O'Leary discussed the PowerPoint presentation "2012 Economic Environment and Capital Markets Review Senate Finance Committee" (copy on file). He stated that the intention of his presentation was as follows:

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.

[9:23:01 AM](#)

Co-Chair Stedman requested a definition of "strategic" within the industry. Mr. O'Leary replied that the word, strategic, referred to the general level of long-term risk and return that a particular fund or advisor was pursuing. He explained that an equity mutual fund had a strategic allocation, and a balance fund typically had a strategic target of 60 to 65 percent in equities and the remainder in bonds. Short-term actual asset allocation may vary from the strategic allocation target, but not typically by very much. He noted that major funds like the Permanent or State pension systems tending towards strategic targets, and recognized that many investments were not liquid.

Mr. O'Leary stressed that he and his associates were not considered economists. He furthered that their expectations were incorporated with the economic setting and important secular relationships with respect to long-run growth, estimates, and inflation.

Mr. O'Leary highlighted slide 2, "Themes Explored in Setting the 2012 Expectations." He stressed that the projections were made for every major asset category. He

explained that the focus was on a range of expected returns. The middle of the range was projected, followed by the extremities of the range. He stated that the range would be broader, if the time-horizon was shortened. He stated that the projection process began in late 2011, and reminded the committee that the first quarter in 2011 was pretty good, the second quarter was "not terrible", and the third calendar quarter was "a disaster." The third quarter was bad, because the equity markets plummeted; the interest rates spread widened markedly between credit instruments and government instruments; and the dollar strengthened markedly as the worldwide investors were very concerned with developments in Europe. He noted that the fourth quarter saw a significant recovery in the equity market, and a slight narrowing credit spreads. He stated that there was an expectation of greater growth than what was ultimately realized, due to the effects of the earthquake in Japan. He noted that the pace of the recovery was slower than other economic recoveries. He explained that during the formulation of expectations, a broad range of outcomes was considered.

[9:28:56 AM](#)

Mr. O'Leary briefly discussed slide 3, "The Capital Markets in 2011." He noted the extremely low level of cash returns in 2011, and the consumer price index (CPI) had increased by almost 3 percent. He remarked that the Barclays Capital (BC) aggregate had increased by almost 3 percent. He furthered that the international stocks were significantly lower than expected.

Mr. O'Leary displayed slide 4, "Stock Market Returns by Calendar Year." He stated that the histogram displayed the returns for the prior four calendar years. He announced that the current day's market had reached a point that had not been achieved since May 2008, which was before the onset of the financial meltdown.

Mr. O'Leary discussed slide 5, "Below-Par Recovery for the U.S. Economy." He stated that the graph displayed the annualized rate of real Gross Domestic Product (GDP) growth, with the gold bars representing projections.

Mr. O'Leary highlighted slide 6, "Deeper Recession, Slower Recovery." He explained that the graph displayed the comparison between the current economic recovery and the

average post-1950 economic recovery. He stated that the graph highlighted the GDP growth from the low-point, and stressed that the current recovery was a "muted" recovery compared to the 1950s, 1960s, 1970s, 1980s, or 1990s.

Mr. O'Leary discussed slide 7, "Will We Fall Back Into Recession?" He highlighted the reasons why there could be another recession: an economy near stall speed is vulnerable to shocks; the Fed cannot help much; there were risks of policy mistakes like premature fiscal tightening and policy paralysis; the Eurozone is the immediate risk; and oil shocks are a perennial threat. He also highlighted the reasons why there would not be another recession: U.S. banks were in better shape than 2008; nonfinancial corporation's balance sheets were strong; exposures to Eurozone sovereign debt were better understood than were the exposures to sub-prime debt; and Europe was unlikely to allow a major institution to collapse similar to Lehman.

[9:33:46 AM](#)

Mr. O'Leary displayed slide 8, "Modest Employment Growth and High Unemployment Sapped Confidence." He explained that the red line represented the unemployment rate. He felt that the unemployment rate was not as good as the statistics portrayed, and did not see anything devious. He stressed that there was employment growth, but there was a significant contraction in the labor force participation rate. He noted the unemployment indicator known as "USCIS" pointed out that the broader number of part-time, discouraged workers and those receiving unemployment benefits was near 15 percent.

Mr. O'Leary discussed slide 9, "Good News: Initial Unemployment Insurance Claims Are Edging Down." He stated that the slide showed some improvement in unemployment insurance claims.

Mr. O'Leary highlighted slide 10, "A Rebound in Household Formation Required for Recovery in Housing Starts." He noted that the household formation had risen, so there was a new focus on house demand.

Co-Chair Stedman queried the definition of "household formation." Mr. O'Leary replied that he understood "household formation" to mean two or more people living together.

Mr. O'Leary discussed slide 11, "Consumers Spending Has Not Been a Strong Driver of Recovery." He explained that consumer spending had been a source of some growth, but was not robust.

Mr. O'Leary displayed slide 12, "Pent-up Demand for Durable Goods Drives Growth in Consumer Spending." He noted the sharp turn-around in durable goods, specifically related to auto sales.

Mr. O'Leary highlighted slide 13, "So is Rising Inflation an Emerging Threat?"

Economic theory says inflation HAS to take off:

- Unprecedented, synchronized global monetary stimulus.
    - Interest rates at historic lows.
  - Unprecedented fiscal stimulus.
    - Corresponding unprecedented federal budget deficit.
    - Inflation beneficial to debtors—moral hazard?
  - Commodity prices itching to rise at the first sign of growth.
  - Dollar must weaken, furthering pressure on inflation.
- Practical reality:
- The U.S. and the rest of the world face very slow recoveries:
    - Fiscal and monetary stimulus kept us out of a longer, deeper recession, but
    - Aggregate demand is weak, no post-recession surge as fiscal stimulus fades.
    - Capacity utilization has plummeted in the U.S.; we are awash in new capacity overseas, and still importing deflationary pressure.
    - Weak job market, no wage pressures.
  - Interest rates may rise sharply without a surge in inflation.
  - Inflation a very real threat, but it may be up to five years off.
  - Commodity prices represent a wildcard threat in the shorter term, particularly a supply-side disruption.
    - Commodity spike more likely to trigger another slowdown than a general price spiral.

Mr. O'Leary discussed slide 14, "Consumer Price Inflation Expected to Ease in 2012." He pointed out that inflation should relax in 2012.

9:38:40 AM

Mr. O'Leary displayed slide 15, "Corporate Liquidity and Growth." He stated that the graphs were sourced from a J.P. Morgan publication, and illustrated that the aggregate corporate balance sheet was doing well. He explained that the cash graph was represented as the percentage of total current assets. He remarked that dividends had increased, but not as rapidly as the cash increase. He remarked that the tax uncertainty had an impact on individual's dividend pay-out decisions that some share-holders may regret. He furthered that share-holders could retain assets through stock buy-backs; cash for capital expenditures; and mergers and acquisitions. He stressed that asset-retention did not have meaning related to mergers and acquisitions, but the capital expenditures were a driving force in the economy.

Co-Chair Stedman wondered how the current economy would compare to the economy at the end of World War II. Mr. O'Leary did not know, but agreed to provide that information.

Mr. O'Leary highlighted slide 16, "Business Equipment Demand is Strengthening." He remarked that business equipment demand was currently strengthening.

Mr. O'Leary discussed slide 17, "U.S. Economic Growth by Sector." He explained that the spreadsheet displayed the year to year percentage change for the major sectors of the economy. He pointed out that in 2011, real GDP growth was only 1.8 percent.

-GDP hit bottom in Q2 2009. After inventory and stimulus boost, economy was fully expected to slow in second half of 2010 and through 2011, but the bottom seemed to fall out of economic growth, particularly during the first half of 2011.

-As confidence deteriorated with the European debt crisis and the US budget impasse over the summer, concerns rose for a return to recession,

-However, data on the U.S. economy began to surprise, notching solid growth in the 3rd and 4th quarters. Indicators ranging from orders to jobs to consumer spending all strengthened in direct contrast to depressed reports on consumer and business confidence.

-Note: Imports are a negative number in the calculation of GDP.

Mr. O'Leary displayed slide 18, "What Will the Fed Do?"

-The Fed is worried; it had expected 2.7-2.9 percent growth for 2011, 3.3-3.7 percent for 2012.

-2011 came in at 1.8 percent.

-Global Insight (and consensus) forecast now: 2.0 percent (2012), 2.4 percent (2013).

-Fed has used its prime ammunition already.

-No rate hike till mid-2013 "promised."

-Market assumes no hike before 2014.

-Hurdle for QE III is high - but we may clear it.

[9:43:40 AM](#)

Senator Thomas wondered if there was more science regarding what was currently occurring, or if the focus was mainly historical. Mr. O'Leary replied that the focus was historical. He stressed the significance of emerging economies, those economies were much more stable than many developed nations. The emerging economies had lower debt burdens.

Mr. O'Leary highlighted slide 19, "Federal Funds Rate Near Zero Until 2015." He explained that the federal funds rate was near zero, and long rates would also stay low, with a steep yield curve. He explained that the red line represented federal funds, the yellow line was the 10-year treasury, and the blue line was the 30-year mortgage rate.

Mr. O'Leary discussed slide 20, "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 events and emotions combined to spur investors into a series of risk on/risk off trades that drove market volatility.

-Economic data suggest the economy continues to grow, but such growth will remain modest.

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

Callan's outlook:

-Inflation will likely drift higher, but not immediately. Painfully low interest rates will persist, now that the Fed has "guaranteed" low rates through 2013. We expect interest rates to rise gradually after 2013.

-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 2011, saving the results for the 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 still hangs 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.

[9:48:33 AM](#)

Mr. O'Leary highlighted slide 21, "Equity is more Reasonably Priced." He explained that the price-to-earnings ratio for the Standard and Poors 500 (SP 500) was trailing below its long-run (1954-2011) average. He stated that if interest rates rise 1 percent from their end-of-year level, a 30-year treasury would decline in value by nearly 20 percent. There is no yield cushion to protect bond investors.

Mr. O'Leary displayed slide 22, "Building U.S. Equity Expectations."

Dividend Yields Likely to Stay Near Current Levels.

-Financing uncertainty continues so cash unlikely to be returned to investors.

-Fixed income yields expected to remain low.

Equity Valuations Currently Moderate to Attractive After Market Angst During 2010 and 2011.

Corporate Profits Near Long-Term Growth Rate.

-Companies may be able to sustain trend or above trend profit growth even in a weak recovery.

Company Balance Sheets Are Strong, But No One is Eager to Spend. Large Cash Holdings a Drag on ROE.

Consumption Still Dominates Economic Growth.

-Unemployment high but finally declining,

-Wealth depleted,

-Deleveraging continues,

-Savings replenished.

Exports Remain Strong, in Spite of Strengthening Dollar but Impact Muted by Size of Economy.

Mr. O'Leary discussed slide 23, "Current Yield is Exceptionally Low." He stated that the BC aggregate bond index daily yield was the worst from January 2, 2001 to December 30, 2011. He stated that the index that was displayed in 2011 had a duration of almost five years. He stressed that the yield-to-worse for the investment grade bond market represented in the chart was a "naïve" predictor of the next five-year return for bonds, or 2.25 percent.

Co-Chair Stedman requested a definition of duration. Mr. O'Leary replied that duration was a measure of interest-rate sensitivity and cash-flow. He explained that a duration of five, would suggest that if there was a 1 percent change across the entire yield curve, there would be a 5 percent change in the price of the bond.

[9:52:37 AM](#)

Mr. O'Leary highlighted slide 24, "Treasury Rates Fell with Fears of a Faltering Recovery." He communicated that the graph showed the U.S. Treasury yield curve at the end of the six years, prior. He noted that the change from 2010 to 2011 was represented by the gold arrow. He urged the committee to study the chart, because it demonstrated the magnitude of the change primarily at the "front-end" of the yield curve. He noted that the change was due to decreasing demand, but also due to monetary policy actions. He explained that the 2.75 percent short-term interest rate projection over ten years was due to the unremarkable history.

Co-Chair Stedman inferred that there would be substantial "bleeding" within the bond market. Mr. O'Leary affirmed, and added that the long-term rates had fallen, so when the short-term rates rise, customers would demand a premium to incur the risk of longer term rates rising.

Co-Chair Stedman requested a bond portfolio projection recommendation to the Permanent Fund Corporation. Mr. O'Leary suggested that the Permanent Fund Corporation be flexible in their intentions. He felt that the Permanent Fund Corporation should not "lock up" the 3 percent, 30-year treasury bonds. He noted that the bond market reflected a widening in spreads between non-government issuers and the reserve currencies.

Co-Chair Stedman queried the treasury inflation-protected securities (TIPS). Mr. O'Leary replied that TIPS had been the highest performer in his personal retirement savings. He felt that the real yields on TIPS were currently very small, but provided good long-term inflation protection.

Mr. O'Leary highlighted slide 27, "Capital Market Expectations, Return and Risk." He stated that a geometric return was a compound annual return, and an arithmetic return referred to a return for a single year. He explained that the more volatile an asset category, the greater the difference between the expected arithmetic and geometric returns. He noted that the focus should be on the risk of the geometric mean return related to the expected standard deviation.

[10:01:16 AM](#)

Mr. O'Leary looked at slide 28, "2012 Capital Market Expectations Largely Unconstrained, Asset Mix Return and Risk Absolute Return Capped at 5 percent."

Co-Chair Stedman queried the 2011 tenure geometric return versus the projected 10-year geometric return reflected in the fourth column. Mr. O'Leary responded that the far right column reflected the 2011 expectations. He noted that interest rates had changed, so the starting-point for bonds was even lower than what was expected. He stressed that there was a different 10-year period than the 10-year period that was expected the year prior.

Co-Chair Stedman observed that the projected 10-year geometric return only showed two years with higher than 8 percent emerging markets, equity and private equity. He wondered how the goal would be achieved with an 8 percent benchmark. Mr. O'Leary responded that 8 percent would be a very aggressive benchmark. He noted that the benchmarks could be considered an estimate of long-term returns, but the orientation would be mostly equity based. Co-Chair Stedman asked if 60 percent was put in the SP 500, and 40 percent in TIPS, a balance portfolio would reflect a 4.68 percent return. He wondered if that was a proper interpretation. Mr. O'Leary responded with page 28, "Fallout of 2012 Capital Market Expectations."

What happened in 2011? The economic recovery appeared to lose steam, investors lost faith, the equity market took beating through Q3, and interest rates fell sharply, from already-low levels. Strong fourth quarter pushed U.S. equities back up, but only enough to end the year flat sharply; non-U.S. markets were not so fortunate. Bonds recorded yet another (unexpected) stellar year as interest rates dropped in the flight from risk.

Bond returns going forward- not a lot of room for optimism. Interest rates have nowhere to go but up, right?

Cash cannot sustain a negative real yield over the longer term. Or can it? We project an upward sloping yield curve, with very a slim risk premium for bonds over cash.

Building equity returns from long-term fundamentals:

- Earnings growth - outlook now in jeopardy.
- Real GDP - how slow can we go?
- Dividends & other returns on free cash flow - can dividends surpass Treasury yields? For how long?
- Valuation - cheaper, but cheap enough?

Co-Chair Stedman expressed concern regarding the substantial deviation from the expectations and forecasts. Mr. O'Leary agreed to be available for further meetings.

[10:12:50 AM](#)

Mr. O'Leary continued to discuss slide 29:

- How to make investors very unhappy in 3 easy numbers:
- Bonds = 3 percent, or less

- Stocks = 8 percent, or less
- 60/40 = 7 percent, or less...
- Our 2012 numbers reflect our optimism for the economy, for inflation, and for the capital markets.
- The challenge: to refrain from translating these expectations into a need to take on more risk in pursuit of return.
- How does one keep invested in fixed income - a prudent investor's anchor to windward -when we all KNOW it's going to lose money while interest rates rise?

Co-Chair Stedman expressed concern regarding the ten-year geometric expected return. Mr. O'Leary responded that if there was a significant portion of the portfolio earning 3 percent, there would not be an expectation beyond 7 percent.

Mr. O'Leary discussed slide 31, "10-Year vs. 30-Year Capital Market Expectations."

Over a 30-year time horizon, our capital market expectations would reference long-term historical mean results, with an overlay of informed judgment. Key elements to consider:

- Nominal returns
  - Inflation
  - Real returns
  - Risk premia - bonds over cash, stocks over bonds, long duration over short
  - Long term underlying economic growth (real GDP).
- Current expectations:
- Stocks: 7.75 percent nominal, 5.25 percent real, 4.50 percent premium over bonds
  - Bonds: 3.25 percent nominal, 0.75 percent real, 0.50 percent premium over cash
  - Cash: 2.75 percent nominal, 0.25 percent real
  - Inflation: 2.5 percent
  - Underlying economic growth (real GDP) - 2 to 3 percent per year.
- Long-term (30-year) expectations:
- Stocks: 9.5 percent nominal, 6.5 percent real, 4.5 percent premium over bonds
  - Bonds: 5 percent nominal, 2 percent real, 1 percent premium over cash
  - Cash: 4 percent nominal, 1 percent real
  - Inflation: 3.0 percent

-Underlying economic growth (real GDP) - 3 to 3.5 percent per year.

Mr. O'Leary concluded his presentation. He stressed that his company routinely compares its approaches to others.

[10:17:49 AM](#)

Co-Chair Stedman requested an additional presentation regarding the Permanent Fund Corporation's conclusions. Mr. Burns replied that the ultimate asset allocation would not be determined until the following May, and then there would be a few months until it was ultimately finalized.

Senator Olson looked at slide 7, and wondered if there was any anticipation of a financial buffer to steer the presidential election on a particular direction. Mr. O'Leary replied that it was unlikely, unless there was a traumatic event.

Senator Olson pointed out that there were issues in Greece regarding the euro-zone, and wondered how that affected the strength of the dollar. Mr. O'Leary replied that the expectation was that government bond rates and the current economic climate was difficult to envision, because the bond rates were very high.

Senator Olson stressed that he would like to know what would happen to the strength of the dollar, as a result of the financial status in Europe. Mr. O'Leary stated the dollar is strengthened and the interest rates decline.

Co-Chair Stedman discussed the following day's agenda.

#

ADJOURNMENT

[10:23:12 AM](#)

The meeting was adjourned at 10:23 AM.