

HOUSE FINANCE COMMITTEE
February 24, 2016
2:04 p.m.

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CALL TO ORDER

Co-Chair Neuman called the House Finance Committee meeting to order at 2:04 p.m.

MEMBERS PRESENT

Representative Mark Neuman, Co-Chair
Representative Steve Thompson, Co-Chair
Representative Dan Saddler, Vice-Chair
Representative Bryce Edgmon
Representative Les Gara
Representative Lynn Gattis
Representative David Guttenberg
Representative Scott Kawasaki
Representative Cathy Munoz
Representative Lance Pruitt
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Pete Ecklund, Staff, Representative Mark Neuman; Joan Brown, Staff, Representative Mark Neuman; Angela Rodell, Executive Director, Alaska Permanent Fund Corporation.

SUMMARY

HB 256 APPROP: OPERATING BUDGET/LOANS/FUNDS

HB 256 was HEARD and HELD in committee for further consideration.

PRESENTATION: INVESTMENTS & STRUCTURE OF THE PERMANENT FUND

#hb256

HOUSE BILL NO. 256

"An Act making appropriations for the operating and loan program expenses of state government and for certain programs, capitalizing funds, making reappropriations, making supplemental appropriations, and making appropriations under art. IX, sec. 17(c), Constitution of the State of Alaska, from the constitutional budget reserve fund; and providing for an effective date."

Co-Chair Neuman reviewed the agenda for the day. He explained that the new Committee Substitute (CS) for the operating budget was stripped of the governor's items that included his proposed revenue measures.

Co-Chair Thompson MOVED to ADOPT the proposed committee substitute for HB 256, Work Draft 29-GH2740\S (2/23/16, Wallace). There being NO OBJECTION, it was so ordered.

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PETE ECKLUND, STAFF, REPRESENTATIVE MARK NEUMAN, discussed the general changes in the committee substitute. He remarked that the language section of the governor's version included changes to the Permanent Fund (PF) predicated on passage of his proposals. The legislation that proposed the changes were still in committee. He voiced that the operating budget could not be passed containing language that presumed passage of the PF legislation. The CS removed all of the PF related transactions the governor had included and was replaced with the basic statutory dividend calculation and inflation proofing. In addition, the money necessary to issue Pension Obligation Bonds was not included in the CS as well as "a couple" technical changes. He characterized the language section in the CS as "status quo." He revealed that the CS was introduced so the subcommittee recommendations and other language section changes would be incorporated into the CS version.

JOAN BROWN, STAFF, REPRESENTATIVE MARK NEUMAN, described the changes to the language section in the CS. She read from a prepared statement as follows:

Committee Substitute for HB 256 (Finance), the FY17 operating budget bill, version 29-GH2740\S, Wallace, 2/23/1016

Mr. Co-Chair, this version of HB 256 includes the Governor's December 15 numbers section as section 1.

As Pete, Mr. Ecklund mentioned, we included two key changes that affect several language sections and made some minor technical changes. The Language sections begin on page 53.

Mr. Co-Chair, all references to the Governor's Alaska Permanent Fund Protection Act (HB 245) have been removed from the bill. Section 8 re the Alaska Permanent Fund on page 53 now contains the standard appropriations for dividends and inflation proofing.

Mr. Co-Chair, we changed section 27(b) Constitutional Budget Reserve on pages 72 and 73 so that it is the standard language to balance revenue and general fund appropriations - the language to cover the deficit. The Governor's original subsection (b) appropriated the balance of the Constitutional Budget Reserve Fund to the Statutory Budget Reserve Fund.

Mr. Co-Chair, we deleted section 28, Statutory Budget Reserve Fund on page 73 as this section was part of the Governor's fiscal plan. (Subsection (a) appropriated \$3 billion to the earnings reserve fund and subsection (b) had the Statutory Budget Reserve Fund cover the budget deficit.)

Mr. Co-Chair, we deleted section 31, Contingent Effect, as it related to both the original Constitutional Budget Reserve language and the Statutory Budget Reserve section.

Mr. Co-Chair, this version of HB 256 also accepted the Governor's amendment that deletes all reference to Pension Obligation Bonds. This affected the Debt and Other Obligations section 19 (had been subsection (m) on page 59 of the Governor's original bill (page 64 of this version) for the estimated \$12,725,000 million for bond issuance costs) and the Retirement System Funding section 23 on pages 65-67 in the original bill (now this section is on page 70).

Mr. Co-Chair, a technical change in this version also removes reference to the Alaska Aerospace Corporation from section 20 Federal and Other Program Receipts on page 64 as it was redundant since section 6 on page 52

already appropriates any additional receipts to the corporation.

Mr. Co-Chair, another technical change we made was to add a new Section 28 on page 73. This is for the repeal submitted by the Governor of section 11(a), ch. 25, SLA 2015, as we corrected the transfer for the FY17 permanent fund dividend payment in our revised section 8(b). The repealed language was in HB 72 last year and it had an incorrect date.

The replacement language in the Permanent Fund section 8(b) makes it clear that earnings through June 30, 2016 are to be used to pay the FY17 dividends in October 2016, exactly as we have always done.

Dividend payments have always followed the statutory framework, but a date in the appropriation language was incorrect.

New Section 31 has an April 17, 2016 effective date for the repeal of the permanent fund dividend transfer in our new section 28.

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Representative Gara asked what the amount was for payment of pension debt included in the current budget. Ms. Brown responded that the payment was \$116.7 million for the Public Employees' Retirement System (PERS) and \$99 million for the Teachers Retirement System (TRS).

Co-Chair Neuman interjected that if the one-time \$3 billion payment from the Constitutional Budget Reserve (CBR) to the retirement systems had not been made several years ago the current payment would be roughly over \$1 billion.

^PRESENTATION: INVESTMENTS & STRUCTURE OF THE PERMANENT FUND

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Reconvened

ANGELA RODELL, EXECUTIVE DIRECTOR, ALASKA PERMANENT FUND CORPORATION, introduced the Power Point Presentation: "Alaska Permanent Fund" dated February 24, 2016 (copy on file).

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Ms. Rodell began with slide 2:

1969: The debate begins.

Alaska receives \$900 million in Prudhoe lease sale bonuses

Prior year state budget: \$112 million

Ms. Rodell turned to slide 3:

1976 Voters Guide

"Alaska's state government [should] set aside a rainy day fund to benefit this and future generations of Alaskans."

Alaska State Chamber of Commerce

Alaska Voters Agreed:

By a margin of 75,588 to 38,518, voters decided to create the permanent fund

Ms. Rodell moved to slide 4: "The Alaska Constitution":

At least twenty-five percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law [Effective February 21, 1977].

Ms. Rodell discussed slide 5:

From 1976 to 1980, Alaskans debated the Fund's purpose:

Development Bank or Investment Fund

Ms. Rodell relayed that ultimately it was decided to create and investment fund "and preserve the financial resource for future generations."

Ms. Rodell continued to slide 6:

1980: Investment Fund Concept adopted, and with it:

Senate Bill 161

Created the Alaska Permanent Fund Corporation to manage the investments of the Fund, separate from the state's other investments managed by the Department of Revenue. This bill also created a Board of Trustees to oversee the Fund and started the legal list of allowed investments.

Senate Bill 122

Created the Permanent Fund Dividend program.

Ms. Rodell reported that the corporation resided within the Department of Revenue (DOR).

Ms. Rodell advanced to slide 7:

APFC Board of Trustees.

- Six board members
- Two state members
- Four public members
- Appointed by Governor
- Experience in finance, investments, or business management
- May only be removed "for cause"

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Ms. Rodell scrolled to slide 8:

Statutory investment rules evolve

- Evolution from legal list to prudent-investor
- Starting in 2005: "Prudent-investor rule" guides investment of Fund assets

- -Duty of care
- -Duty of loyalty
- The Board will maintain a reasonable diversification of assets

Ms. Rodell continued to slide 9:

Fund Advantages:

Size

- Access to investments
- Ability to negotiate fee savings

Time Horizon

- No set liability

Ms. Rodell discussed slide 10: "Fund Challenges":

Location

- Business travel to financial centers
- Recruitment from financial centers

Flexibility

- New resources often arrive long after they are needed due to lengthy budget process

Staff size

- Small staff limits bench strength, creates gaps during travel and vacancies

Representative Guttenberg indicated that "a great deal of investing" was accomplished with "outside consultants and fund managers." He wondered whether the fund had grown large enough and matured to a point where all of the investing could be done "in-house." Ms. Rodell stated that the fund was at that point. She reported that two previous chief investment officers had won national awards for institutional investment. The officers were able to recruit capable staff and attributed their legacy to the growth and success of the fund within the last 10 years and subsequent to the prudent-investor rule. She shared that the corporation wanted to selectively hire certain types of financial managers "strategically" in-house. She believed that paying investment fees was prudent if the returns from the investment justified the fees.

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Vice-Chair Saddler asked whether the prudent-investor rule "imply any specific kinds of management, policies, or techniques. Ms. Rodell responded that the rule did not speak to any particular policy or management style. The rule guided investing towards the duty of care and duty of loyalty.

Representative Kawasaki asked why the state did not outsource the entire investing function since the purpose of the fund was to "make money." Ms. Rodell suggested that outsourcing was a policy call for the legislature to make. She indicated that outside management was expensive. Internal management enabled more "nimble and strategic" investing and the investment decisions were made exclusively for the benefit of the fund and Alaska. When management was given to an outside entity, the decisions made benefitted the entity's business model and not necessarily the fund and "may not be the best course of action." Representative Kawasaki questioned why outside investor management was not a good choice for the fund. He asked that "if it was just money and the sole purpose was to make more money under the prudent-investor rule why were Alaskans involved in the {investing} decision." Ms. Rodell responded that the policy call was made to have the state manage the fund.

Co-Chair Thompson interjected that he saw figures related to in-house investment of the fund that saved the state money. Ms. Rodell responded that the corporation calculated that \$28 million in fees was saved annually by in-house investing.

Representative Pruitt opined that the state should move more management of the fund in-house. He felt that outside management's goal was commission and in-house investor's goal was the fund. He thought that in-house management increased the amount of money that stayed in the fund.

Co-Chair Thompson thought there were three additional investment positions included in the current budget. Ms. Rodell answered that 6 positions were requested and 5 were investment professionals.

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Representative Kawasaki maintained that his questions were related to the investment challenges noted on the slide regarding being located far from financial centers, flexibility, and limited staff. He wondered whether the state could make more money with outside financial managers. Ms. Rodell responded in the negative. She referred to national studies concerning in-house versus outside management and reported that typically the difference amounted to "5 basis points of improved performance as a result of in-house management." She disagreed that exclusive outside management would improve performance of the fund.

Representative Edgmon wanted the record to reflect the service of Mike Burns [former Director, APFC]. He added that the creation of the Permanent Fund Dividend was not universally embraced. The Hammond administration embarked on an arduous year-long effort to advance the fund. He shared that historically many citizens wanted "the money spent on public services because the state was so poor."

Ms. Rodell moved to slide 11:

Target Asset Allocation:

Bonds 20%
Stocks 36%
Real Estate 12%
Special Opportunity 4%
Private equity 6%
Infrastructure 4%
TIPS 2%
Cash 2%
Absolute Return 11%

Ms. Rodell explained slide 12 titled "Risk vs. Return." She discussed that diversification of the fund was attempting to balance the effort of "risk versus reward." The chart demonstrated that state would have a risk volatility that was too high if the amount of return chosen was too high in the area of 7 percent to 9 percent.

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Ms. Rodell pointed to the yellow line on the chart on slide 13 titled "The effect of diversification." She commented that the corporation was trying to "create an all-weather

portfolio" that contained an "upside strategy" regardless of what was happening in the market and limiting the downside potential losses. She advanced to slide 14: "Stock Portfolio." She pointed out that as of June 30, 2015 the fund contained \$20.9 billion in stocks. The graphic depicted the breakdown of the stock investments. The heaviest concentration of stocks was in the United States (US) economy. Approximately one third of the stocks were invested in the US market and the remainder was invested globally. The funds were also invested by management strategy; active, passive, and quasi-passive.

Ms. Rodell reviewed slide 15:

Bond Portfolio Composition

\$11.1 billion as of 06/30/2015

Non-U.S. Government 11%

Mortgage-backed 7%

CMBS 4%

Non-U.S. Corporate 10%

Ms. Rodell reported that the bond portfolio was in existence since the inception of the fund and was managed exclusively in-house. The bond fund contained some limited global exposure.

Ms. Rodell turned to the pie chart on slide 16:

Real Estate

\$6.5 billion as of 06/30/2015

58 directly held properties

Exposure to Europe growing

Office 27%

Industrial 4%

REITs 20%

Multifamily 24%

Retail 25%

[REIT - real estate investment trust]

Ms. Rodell remarked that the corporation's real estate investments were fairly balanced. She indicated that the corporation recently began investing in industrial property as well as in Europe. Three properties were purchased in

the prior two years located in Portugal, Spain, and England, United Kingdom.

Vice-Chair Saddler asked how much revenue the fund generated from Alaska based investments. Ms. Rodell reported that currently the only real estate asset in the portfolio was the Goldbelt Building in Juneau, Alaska.

Ms. Rodell transitioned to slide 17: "APFC Real Estate." The map graphic of the US depicted the location of the fund's real estate investments. She offered that the color of the circles signified the type of real estate. She discussed the corporation's "crown jewel" of real estate that was highlighted on slide 18: "Tysons Corner Center." She communicated that the center was located in Tysons, Virginia and was purchased in 1985 along with the partner, Macerich. The mall contained over 300 stores and received 22 million visitors each year. Virginia extended its public transit system and included a stop at Tysons Corner. Subsequently, the corporation engaged in its first construction project and added a luxury apartment building, a 22 story office building with two anchor tenants; Deloit and Telestat. She added that a Hyatt Regency Hotel was also constructed on the sight. She declared that the investment was tremendously successful.

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Representative Wilson thought it was a missed opportunity not to invest in the State of Alaska. She wondered whether a statute change was necessary to direct investment in the state or if there were not any worthy investments in the state. Ms. Rodell thought that it was a challenging question to answer. She explained that the statute authorized Alaskan investment but part of the problem was finding quality investment opportunities. She added that the corporation was periodically approached with offers to invest in the state and was evaluated and seriously considered but ultimately the goal of the fund was to maximize income to the fund. She wondered what the issues were that prevented strong investment opportunities in Alaska.

Ms. Rodell moved to slide 19:

Absolute Return

\$5.3 billion as of 06/30/2015

Externally Managed-\$2.5 billion

Internally Managed-\$2.8 billion

Ms. Rodell advanced to slide 20:

Private Equity

\$3.2 billion as of 06/30/2015

2,800 underlying companies

Co-investment program implemented in FY2014

Ms. Rodell shared that the co-investment program consisted of co-investing with another fund or investor in private equity.

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Ms. Rodell continued to slide 21:

Infrastructure Holdings

\$1.5 billion as of 06/30/2015

Transportation 38%

Energy 50%

Water & Waste Management 11%

Co-investment program implemented in FY14, currently at \$35 million

Properties in the U.S., U.K., India, Argentina and Canada

Ms. Rodell detailed that co-investing allowed the corporation to save on management fees.

Representative Kawasaki referenced the PFC's investment in a LNG export facility and wondered why the state was investing in its "competitors." He asked her to discuss the investment. Ms. Rodell responded that she was not aware the energy sector investment.

Co-Chair Thompson referred to slide 20 and asked about the bullet point that noted "2,800 underlying companies." He asked for clarification. Ms. Rodell answered that the

companies were privately held companies seeking to raise capital and avoid the publically traded markets. The corporation invested in funds that capitalized the companies. The companies were chosen based on specific strategies. Co-Chair Thompson asked whether any Alaska companies were involved. Ms. Rodell answered that a timing issue caused a missed opportunity to indirectly invest in a fund that contained a significant Alaska-based company. The corporation invested in Apollo that offered a fund that contained Callis but was not able to include the specific fund in the portfolio at the time it was offered. She identified the situation as one way to invest in Alaska companies. Co-Chair Thompson recapped that there were indirect opportunities like the Apollo fund that took its investment money and invested in the Callis oil company in Alaska. Ms. Rodell answered in the affirmative.

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Representative Pruitt thought that if the state's policy shifted to turn the fund into a development bank then a lot of the funds investing would "flow into Alaska." He ascertained that the decision to make the fund an investment structure meant that the fund was seeking the greatest return on investment. He opined that "he had no problem taking money from Virginia and spending it in Alaska." He felt that the current conversation was the "crux" of the initial decision on how to invest the permanent fund.

Vice-Chair Saddler noted that the state had the Alaska Industrial Development and Export Authority (AIDEA), Alaska Energy Authority (AEA), Alaska Housing Finance Corporation (AHFC), and other agencies that provided money to help develop the state's economy. He asked for the definition of co-investment (slide 20). Ms. Rodell replied that APFC made an investment into a company alongside another investment fund investing in the company and used the same terms as the co-investor's fund. She noted that the practice was not a direct investment in a company. Vice-Chair Saddler stated that the corporation "invested in the fund and then made a side bet on the same terms..." He asked whether the amount was the same as the investment in the fund. Ms. Rodell responded in the affirmative and related that the corporation called the co-investment "sidecars." She answered that the investment amounts could differ from the co-investor's amount.

Representative Wilson voiced that due to low population Alaskan investments could not compare to investments in other states. She wondered whether a portfolio of Alaskan investments could exist in the PF to help "boost" the Alaskan economy when the fund grew large enough. She realized the issue was a policy call. Ms. Rodell replied that the possibility existed but current statute was clear and a new policy directive would be in order. She felt that the purpose of the fund needed to be revisited to ensure that the state was not harming itself with its PF investments and that "sometimes it was not just about the money."

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Ms. Rodell moved to slide 22:

Special Opportunities:

- Direct investments in private companies-examples: Juno Therapeutics and Denali Therapeutics.
- Direct investments in specialized funds - examples: Dyal and Blackstone funds.
- 1.9 billion as of 06/30/2015

Ms. Rodell discussed what happened to the income and earnings after the investments were made and continued to slide 23:

Statutory Net Income

Principal (income-producing investments)

Net Income gets deposited into the ERA {Earnings Reserve Account}

Income in ERA available for Appropriation

Ms. Rodell defined that Statutory Net Income (created in statute) accounted for the realized earning and losses which was different from the generally accepted definition that defined income to include unrealized earnings.

Representative Edgmon cited the governor's proposed Permanent Fund Protection Act. He wondered whether the same flow of earnings would still be applicable. Ms. Rodell

responded in the affirmative. Representative Edgmon remembered a provision that required four times the amount of the annual fixed draw to be in the Earnings Reserve Account (ERA). He asked whether the bill would change the investment strategy if adopted. Ms. Rodell answered that currently she did not believe so. She was unclear whether the bill would change the ERAs asset allocation and how the fund was invested due to demand on the fund. He wondered whether the permanent fund board fully studied the act. Ms. Rodell reported that the board recently had a meeting regarding all of the PFD legislation and the potential ramifications. Through modeling the board determined that none of the proposals would change the core mission to manage the principal and move earning into the ERA. The board would adjust as necessary management of the ERA. She voiced that "it was too premature for the board to make any adjustments or take any action." She noted that the ERA was managed under the legislature's request.

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Representative Munoz referenced the various rates of return from 4.5 percent to 6.5 percent from the three plans being proposed. She asked whether Ms. Rodell was comfortable with the "conservative rate of return" and its impact. Ms. Rodell responded in the negative. She added that all of the plans were fairly close in terms of results and it was left to policy decisions on the specific withdraws and deposits into the account. On balance, all three plans were much more similar than different.

Representative Kawasaki asked whether the board had a recommendation regarding the PFD proposals. He also asked whether discussions ensued regarding the size of deposit into the fund or inflation proofing. Ms. Rodell replied in the negative for all parts of the questions.

Vice-Chair Saddler asked for clarification about the definition of Statutory Net Income. Ms. Rodell answered that the state's Statutory Net Income definition remained in statute to exclusively include realized earnings. She reiterated that the recent GAAP (generally accepted accounting principles) definition of income changed to include unrealized earnings. He asked whether there was a specific schedule when accounting for realized earnings. Ms. Rodell responded in the negative and elaborated that realized earnings were accounted for when earned. At the

end of the fiscal year the corporation calculated the Statutory Net Income for the year according to a specific distribution formula within statute. Subsequently, the corporation prepared financial statements in accordance with GAAP. She noted that the GAAP income reported was very different than the Statutory Net Income figures.

Ms. Rodell advanced to slide 24: "Fund breakdown." She pointed to the chart that reported the following:

ERA \$7.2 (\$6.6 deposits, \$1.1 unrealized gains)

Principal \$45.6

- \$39.2 in deposits
- \$6.4 unrealized gains

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Ms. Rodell explained that when the gains were realized they moved into the ERA and the unrealized gains in the account were due to ERA investments. She highlighted slide 25: "Pro rata share of main fund assets, not cash, are transferred to ERA." She delineated that the pie charts depicted the distribution of the pro rata shares. She turned to slide 26: "Statutory Net Income" and indicated that the chart portrayed the realized net income and realized return (listed as a percentage over the last ten years. She pointed to the losses in 2009.

Ms. Rodell reviewed slide 27: "Use of Realized Net Income." She highlighted that the pie chart illustrated the distribution of realized income as follows:

General fund \$536.3 million
Dividend appropriations \$23,002.7 billion
Inflation proofing transfer to principal \$16,236.4 billion
Special appropriations to principal \$4,340.3 billion
Undistributed realized income balance \$6,146.5 billion

Ms. Rodell remarked that the undistributed realized income was deposited into the ERA.

Vice-Chair Saddler announced that the legislature had appropriated approximately \$16 billion in inflation proofing and \$4 billion in special appropriations totaling \$20 billion back into the corpus that the legislature could

have spent but did not. He asked whether his statement was correct. Ms. Rodell stated that he was correct.

Ms. Rodell discussed inflation proofing on slide 28:

Inflation proofing

- Provides a deposit back to corpus
- Maintains purchasing power of corpus
- Added \$16.2 billion to corpus
- Based on value of corpus on June 30 and inflation rate for prior two calendar years

Fiscal Year	Transfer
2005	\$641
2006	\$856
2007	\$860
2008	\$808
2009	\$1,144
2010	\$0
2011	\$533
2012	\$1,073
2013	\$743
2014	\$546
2015	\$624

Ms. Rodell elucidated that the only way the corpus of the fund grew was through the "mineral royalty deposits" and any other appropriation deposited directly into the principle. The buildup of wealth from the fund was credited to the ERA. She recommended that the legislature consider "if and how" the deposits should continue into the corpus.

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Ms. Rodell scrolled to slide 29:

Money in and out, and current value

\$39.2 billion Deposited into Principal
\$45.6 billion Market Value of Principal
\$52.8 billion Total Fund Value 6/30/15

Ms. Rodell reported a small loss since the beginning of 2016 and noted the current value of the fund was over \$50.2 billion.

Ms. Rodell turned to slide 30:

Principal vs. Earnings Reserve

- The Fund buys an investment for \$20
- Earnings reserve reflects 25% of total fund
- \$20 investment was funded with
 - \$15 of principal
 - \$5 of earnings

Ms. Rodell advanced to slide 31:

Capital Appreciation

- The value of the investment appreciates from \$20 to \$40
 - \$20 in unrealized gains are distributed proportionally
 - Principal's share now worth \$30
 - Earnings reserve's share now worth \$10
- Unless APFC sells (realizes) a portion of the investment,
- The increased value reflects unrealized gain, not statutory net income
 - No income is transferred from principal to earnings

Co-Chair Thompson asked whether the recent losses were considered unrealized losses. Ms. Rodell responded in the negative. Co-Chair Thompson surmised that an investment was still part of the fund until it was sold. Ms. Rodell affirmed his statement and added that the value depended on a moment in time. She provided an example to illustrate that realized gains or losses changed with the market conditions at the time.

Representative Munoz asked Ms. Rodell to talk about Juno Therapeutics. Ms. Rodell explained that Juno Therapeutics was a venture capital investment. The venture was a strategy to fight blood born cancers through cell manipulation. The research was conducted under a joint venture between Memorial Sloan Kettering Cancer Center and Fred Hutchinson Cancer Research Center in Seattle. The PFDC invested \$129 million in the venture. The biotech venture

offered an initial public offering (IPO) in December, 2014, and the corporation used stock performance to measure returns on the investment.

Ms. Rodell turned to slide 32:

Harvesting Gains

- APFC sells the investment for \$40, and the \$20 unrealized gain is realized

- \$15 remains in principal to cover its cost

- \$15 realized gain is transferred to earnings reserve

- Earnings reserve now has \$25

- \$5 original cost

- \$5 of its realized gain

- \$15 of realized gain from principal

Ms. Rodell noted that the slide illustrated her point that the inflation proofing deposits were the only way the principle grew.

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Representative Kawasaki referred the Callan report [Callan Associates Inc.] that spoke to the PFD proposals that eliminated inflation proofing and cited one proposal that deposited 25 percent instead of 30 percent into the corpus. He related that the 10 year total projection with status quo inflation proofing totaled \$12.5 billion added to the principle and only \$3 billion with each of the three proposals without inflation proofing. He asked why the board had not discussed the issue. Ms. Rodell stated that the Callan reported assumed a 2.25 percent inflation rate and wanted to inform the committee that Callan used an assumption to quantify the \$12.5 billion anticipated inflation proofing over the next ten years. She stressed that the board's position was that its role was to manage the principle corpus of the fund but not the ERA.

Ms. Rodell moved to slide 33:

Capital Depreciation

- The value drops from \$20 to \$12

- principal investment is valued at \$9, reflecting unrealized loss of \$6
- Earnings investment is valued at \$3, reflecting unrealized loss of \$2
- Should APFC sell or hold?

Ms. Rodell turned to slide 34:

Realizing Losses

• Assume we conclude it is prudent to sell the investment for \$12

- \$12 is returned to principal from sale proceeds
- \$3 is moved to principal from earnings reserve
- Leaving earnings reserve with a loss of \$8

• Note: with a long-term time investment horizon, this activity is rare (example-2009).

Ms. Rodell discussed slide 35:

ERA Going Forward

Liquidity Consideration

- Some APFC asset classes, like private equity, are illiquid, making a portion of the ERA liquid
- Yet all of the ERA is "available for appropriation"

Volatility Consideration

- Permanent Fund and ERA are subject to ups and downs experienced by capital markets
- Going forward, is a long-term time horizon for ERA workable?

Ms. Rodell scrolled to slide 36:

ERA Going Forward

Counterweight

- Net Income in ERA is immediately invested alongside main fund
- Allowing the nominal value of this income to remain deployed and continue earning income until it is appropriated

- Over the last ten years, the Fund's annualized return was 6.4%

Co-Chair Thompson pointed out that the unrealized losses did not mean that the fund lost cash and stated that losses did not occur until the asset was sold. He judged that the ten years average of 6.4 percent which included 2009 was "pretty good." He voiced that over the long-term the fund made up its losses and wondered whether the statement was correct. Ms. Rodell responded in the affirmative.

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Vice-Chair Saddler returned to slide 32. He inquired whether the corpus itself was inflation proofed since every realized gain was shifted into the ERA. Ms. Rodell felt that his statement was accurate. She added that under the status quo a natural inflation proofing existed. The challenge and policy call going forward was consideration of how much and how fast the ERA would be drawn on if restructured. She revealed that the ERA acted as a "counterweight" to the activity in the corpus and drawing down the ERA would strip the fund into one principle fund.

Vice-Chair Saddler asked whether she had concerns with the ERA restructuring proposals. Ms. Rodell did not have any concerns with the plans. She added that the PFC was performing its statutory requirement dealing with the corpus. She remarked that the ERA was always presented as a reserve fund. She did not hold any legal concerns. He asked whether she knew of any independent authority or legal opinion on the matter. Ms. Rodell believed that PFC had all of the necessary legal authority that was needed to invest. She revealed that when the Constitutional Budget Reserve (CBR) was established, statutes granting the corporation authority (passed through the Commissioner of the Department of Revenue) to manage the CBR. She added that the authority was never utilized since its inception in 1991. She regarded the debate over appropriation of the various funds out of the board's prevue.

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Vice-Chair Saddler asked whether she had any independent authority or was relying on the Attorneys General's (AG) opinion to maintain the position she stated in her previous answer. Ms. Rodell asserted that she was relying on the

accumulation of all of the former AG's over the past 30 years.

Representative Gara wondered how the 6.4 percent return over the last decade compared to the S&P (Standard and Poor's) index. Ms. Rodell was uncertain and stated the corporation did not use it as a benchmark. He deduced that the corpus of the fund was "somewhat" inflation proofed by the royalties deposit each year. Ms. Rodell was unsure but there was a general sense that minerals royalties provided some amount of natural inflation proofing. Representative Gara noted that last year the inflation proofing amount was \$624 million and was projected at roughly \$800 million in the current year. Ms. Rodell reported that the inflation proofing calculation for 2016 was \$27 million.

Co-Chair Thompson mentioned a presentation that showed that \$800 million in royalties were deposited into the fund last year.

Representative Gara suggested that the ultimate question was whether she had an opinion if "just inflation proofing the fund was enough with royalties and additional money to meet the rate of inflation for the prior two years was reasonable" until the state had sufficient revenue again. Ms. Rodell thought it was a reasonable approach to take under the circumstances and reminded him that the legislature had the "power of the purse."

Co-Chair Thompson thanked Ms. Rodell for her presentation. He reviewed the agenda for the following day.

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ADJOURNMENT

3:30:06 PM

The meeting was adjourned at 3:30 p.m.