

SENATE FINANCE COMMITTEE
FOURTH SPECIAL SESSION
November 1, 2017
1:35 p.m.

[Note: The meeting was held in Anchorage, Alaska at the Anchorage Legislative Information Office.]

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CALL TO ORDER

Co-Chair MacKinnon called the Senate Finance Committee meeting to order at 1:35 p.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Anna MacKinnon, Co-Chair
Senator Click Bishop, Vice-Chair
Senator Gary Stevens
Senator Peter Micciche (via teleconference)
Senator Donny Olson
Senator Natasha von Imhof

MEMBERS ABSENT

None

ALSO PRESENT

Angela Rodell, Executive Director, Alaska Permanent Fund Corporation; Senator Cathy Giessel; Representative Chris Birch; Representative Matt Claman; Senator Mike Dunleavy.

SUMMARY

^PRESENTATION: CEO ANGELA RODELL, ALASKA PERMANENT FUND CORPORATION

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ANGELA RODELL, EXECUTIVE DIRECTOR, ALASKA PERMANENT FUND CORPORATION, presented the PowerPoint, "Alaska Permanent Fund" (copy on file).

Ms. Rodell looked at slide 2, "The Alaska Constitution":

Over four decades ago, in 1976, Alaskans in an historic vote amended the Constitution of the State of Alaska by a margin of 75,588 to 38,518 and created the Alaska Permanent Fund.

Alaska Constitution Article IX, Section 15

Section 15. Alaska Permanent Fund

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.

Ms. Rodell looked at slide 4, "The Fund - Two Accounts":

Principal

Established

Alaska Constitution -Article IX, Section 15
Permanent -Not Available for Appropriations

Contributions

Mineral Royalties -constitutionally mandated
Inflation Proofing -subject to appropriation
Special Appropriations

Earnings Reserve Account (ERA)

Established

Alaska Statutes 37.13.145 (a)
Available for Appropriation

Contributions

Net Investment Earnings -AS 37.13.140
Includes: lease payments, stock dividends,
bond interest, private dividends, and net
realized gains.

Co-Chair MacKinnon wondered whether the asset allocations were invested in the same manner in the ERA as they were in the corpus. Ms. Rodell replied that the funds were managed as if it were one fund, so there was the same exact asset allocation.

Ms. Rodell looked at slide 5, "Invested as One Fund":

Alaska Permanent Fund Corporation
Investment and Management of the Fund

One Target Asset Allocation
Stocks, Bonds, Real Estate, Alternatives

Pro Rata Shares of Each Investment
Principal
ERA

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Vice-Chair Bishop queried the methodology for the split percentage. Ms. Rodell replied that it was based on how much was currently in the principal, versus how much was in the ERA. She explained that the ownership of investment would be owned solely by the principal if the ERA was reduced to zero

Senator von Imhof queried the reason for the separation of the funds. Ms. Rodell replied that spending of the principal was not allowed. She furthered that all money in the principal must be held in perpetuity. She stressed that combining them would be difficult to ascertain that which belonged to the principal and what was available for spending.

Ms. Rodell displayed slide 6, "Principal and ERA":

Asset

Principal: Cost Basis, Unrealized Gains
ERA: Cost Basis, Unrealized Gains

Sale

Cost Basis Returned: Principal and ERA
Net Realized Gains: ERA

Principal

Reinvestment

ERA

Reinvestment

Available for Appropriation

Senator von Imhof felt that there should be a conversation about the recommendation from 10 years prior to combine the accounts, and how that might affect the tracking of the principal and the mechanism required to change the constitution. She also wondered how the POMV would affect that possible change.

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Senator Stevens noted that Article 15 said that the income from the permanent fund should be deposited in the general fund, and he wondered how it dealt with the ERA. Ms. Rodell replied with slide 2. She deferred to the Department of Law to explain a court ruling rationale. She stated that the ruling gave permission to the legislature to create the ERA as a receptacle, rather than directing all the income into the general fund.

Ms. Rodell continued to discuss slide 6. She remarked that the principal had its cost basis for investment and the ERA had its cost basis.

Co-Chair McKinnon felt that it may be difficult to keep track of all the dollars. She wondered whether there was a previous bill or proposal to change the accounting of the principal and the ERA. Ms. Rodell replied that there were various versions of the percentage of market value (POMV) bills, there was the idea of statutory net income calculation to determine what should be included in the calculation. She stressed that it was not a generally acceptable accounting practice, rather it was a statutory principal to comply with the constitutional language. She moved to slide 7, which showed that the statutory net income was defined in AS 37.13.140.

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Senator Micciche noted that the net realized gains would move into the ERA, and the cost basis would return to the principal. He wondered how losses were handled in the fund, and whether it would be considered a loss in perpetuity. Ms. Rodell replied that, in the past, the cost basis was returned to the principal. She furthered that net losses and net gains were combined, but an overall loss was deducted from the ERA. She remarked that the one year that had a net loss in the ERA was after the crisis in 2007 and 2008. She explained that, historically, the fund had been fortunate in that the net gains had mostly offset the net losses occurring in the same year.

Co-Chair MacKinnon shared that she was on the House Finance Committee in 2007 and 2008, and there was some consternation that the state was almost unable to pay the dividend based on the interpretation of the loss.

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Ms. Rodell addressed slide 7, "Statutory Net Income AS 37.13.140":

- Pursuant to state law (AS 37.13.140), at the end of each fiscal year APFC calculates and reports on the net realized gains accounted for during the fiscal year.
- These net realized gains and investment income are the funds in the ERA that are subject to appropriation by a simple majority of the Alaska Legislature. • Net realized gains = realized gains accumulated during the fiscal year (-) minus realized losses accounted for during the year.
- Unrealized gains earned by Principal are part of Principal, only until realized at which time they are transferred to the ERA.

Ms. Rodell highlighted slide 8, "Assets Under Management." The slide outlined the 78 percent and 22 percent break between the principal and the ERA. She noted that the first quarter of FY 18, the assets under management had continued to grow in the ERA. She noted that the principal was not growing as fast as the ERA.

Co-Chair MacKinnon wondered whether there was a percentage of cash that was held in the asset allocation. Ms. Rodell replied in the affirmative. She explained that the target asset allocation included a 2 percent for cash. She stated that the corporation held roughly \$1 billion in cash every day for its investment activity, capital calls, settlements, and operations.

Co-Chair MacKinnon asked whether the 2 percent was added to the \$1 billion. Ms. Rodell responded that the target was 2 percent. The \$1 billion was within the 2 percent. She stated that 2 percent of \$62 billion was roughly \$1.2 billion. The goal was to not fall below \$1 billion. She furthered that there was also flexibility for management, to not be forced to sell assets.

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Co-Chair MacKinnon recalled that there was a reduction to the permanent fund dividend (PFD) two years prior. The legislature had brought forward a reduction of a dividend. She remarked that the permanent fund board was statutorily required pay two dividends at the full level. She wondered whether the cash was invested or held as liquid assets in cash. Ms. Rodell replied that, in 2016, the corporation was building up the nearly \$1.5 billion cash transfer over the roughly \$1 billion in cash holding. She stated that reducing the dividend forced the corporation to take the difference and deployed it back into the asset classes cash. The money stayed invested in the permanent fund.

Co-Chair MacKinnon remarked that there was a recent article in the Juneau Empire that asserted that the legislature's lack of rules for the permanent fund had cost Alaskans money. Ms. Rodell understood the concern. She stated that there was a plan for a cash draw that was based in statute. She remarked that there were conversations in the board about liquidity, and directions to staff to work on a program to manage liquidity to a more effective return.

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Co-Chair MacKinnon stressed that the point of the meeting was to understand the issues about the various aspects of the permanent fund.

Senator von Imhof wondered how the permanent fund would change to prepare for the \$2.5 billion draw, should there be passage of SB 26. Ms. Rodell replied that there would be discussions with Department of Revenue (DOR) Treasury Division cash management about what was needed for the transfers. She stated that the cash management program understood the resources for managing cash. She furthered that the permanent fund would then point their liquidity to those agreed upon dates.

Senator von Imhof assumed that it would be easier for the permanent fund to manage their assets with a stable mechanism, such as a POMV, to look back at the market value for five years to predict the management of cash. Ms. Rodell responded that treasuries also cannot make a solid plan, because they manage cash based on the expectation of the other entitled revenues.

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Vice-Chair Bishop felt that the sooner the knowledge was known, the sooner one could maximize the opportunity costs. Ms. Rodell replied that it would minimize opportunity costs and maximize profit.

Co-Chair MacKinnon recalled that there was a conversation the prior day about DOR using \$2 billion in the constitutional budget reserve (CBR) as a bridge for the payments coming in over time that were due to the state that may not arrive at the start of each fiscal year. She remarked that there may be lower returns, because it was desired that the money in the CBR be in liquid form. She remarked that there was a hope of continuity that there would be at least \$2 billion as "bridge money." She felt that the permanent fund should have ample opportunity to respond to any legislative policy. She wondered whether that there was communication for cash management, because the issue was "very contentious." Ms. Rodell agreed. She stated that the conversations were ongoing. She remarked that, because the ERA was not used for anything other than dividends, it maintained the same asset allocation as the fund.

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Co-Chair MacKinnon remarked that she had conversations about "lost opportunity for the state." She expressed

frustration about losing three years of opportunity. She remarked that the Senate passed a bill, which would have created a framework. She stressed that there was not agreement about the framework, so the state was losing opportunities. She stressed that there needed to be an examination of using the ERA. She remarked that it was not easy to simply cut \$2 billion from the budget. She stressed that most of the budget items had statutory substance that required payments. Ms. Rodell replied that the board wanted to have a structured plan.

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Ms. Rodell looked at slide 9, "Unrealized Gains in billions." She stated that there was \$39.9 billion in the principal in perpetuity, which was the nominal dollar amount of the royalty revenue that the fund was entitled to under the constitution; and inflation proofing and other deposits. She stated that the amount only changed with additional deposits into the principal of the fund. She stressed that there was no inflation adjustment to the number.

Ms. Rodell highlighted slide 10, "Fund Balance FY 18 Q1 and FYE 17." She stated that she included the financial statements, because there was good information in financial statements. She announced that APFC posted its financial statements monthly. She stated that there was a tremendous amount of transparency into the activity of the fund. She stated that the slide showed the financial statements of the first quarter of FY 18 as compared to FY 17. She noted that assets continued to grow from total assets of \$60.5 billion to over \$62.3 billion in just three months. She noted that the assets were in cash and other types in investments.

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Senator Micciche noted that the realized earnings and the unrealized appreciation on invested assets reflected the ERA balance. Ms. Rodell agreed.

Senator Micciche stressed that the committee would never "endanger" the principal. He surmised that, by law, whatever structure that was adopted could not interfere with the balance of the principal. Ms. Rodell replied that

there was no way to interfere with the corpus of the fund, because it was constitutionally protected.

Senator Micciche wondered what would occur, should there be a consolidation on a loss in the corpus with an appropriation from the ERA. He felt that was the only way to potentially impact the value of the corpus. Ms. Rodell replied in the affirmative.

Ms. Rodell highlighted slide 11, "Changes to Fund Balance." She stated that the slide was the statement of revenues, expenditures, and changes. The page showed the activity that led to the increase in the ERA the unrealized gain in principal. She noted the PFD transferred out \$716.3 million. The PFD was funded in two payments in August and September.

Vice-Chair Bishop wondered whether the two PFD payment method would be a "true up" on the last payment to "catch" some sudden eligible people. Ms. Rodell stated that the first payment was to help pay for the operations budget.

Co-Chair Hoffman asked whether the state paid any amount to defend the lawsuit. Ms. Rodell assumed that Co-Chair Hoffman was referring to the lawsuit in the Supreme Court regarding the appropriation. She agreed to provide further information.

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Ms. Rodell addressed slide 13, "Board of Trustees":

As the fiduciaries, the Trustees have a duty to Alaskans in assuring that the Fund is managed and invested in a manner consistent with legislative findings: AS 37.13.020

- The Permanent Fund should provide a means of conserving revenue from mineral resources to benefit all generations of Alaskans.

- The Permanent Fund's goal should be to maintain safety of principal while maximizing total return.

- The Fund should be used as a savings device managed to allow the maximum use of disposable income from the Fund for the purposes designated by law.

Ms. Rodell addressed slide 14, "Investment Oversight":

Board of Trustees

As Fiduciaries of the Fund, Full Authority to Make Investment Decisions.

- Provide Authority to Invest Within Set Bands
- Approve Target Asset Allocation
- Adopt Investment Policy

Chief Executive Officer

Assures Strategies Adopted by the Board are Successfully Implemented

Chief Investment Officer

Makes Strategic and Tactical Allocations to Allow the Fund to Grow in Value

Portfolio Managers

Responsible for the Investment and Performance of Each Asset Class

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Co-Chair Hoffman queried a list of the board members, their terms, and how often they met. Ms. Rodell agreed to follow up in writing. She stated that the board was comprised of six trustees: four were members of the public, who must have experience in business or finance; and two were members of the governor's cabinet, with one as the commissioner of DOR and one of the governor's choosing. The four public member terms were four-year terms that expired annually.

Ms. Rodell looked at slide 15, "The Portfolio." She noted that it was a diversified allocation, which was designed to have a mix of risk and reward. The portfolio was designed for a longer-term investment horizon of ten years plus, and balanced the potential need for liquidity with nonliquidity.

Co-Chair Hoffman queried a breakdown of what was invested internationally. Ms. Rodell agreed to provide that information.

Co-Chair MacKinnon wondered how the fund was invested "across the globe." Ms. Rodell stated that she had some of that information, but not in detail. She recalled that the \$26 billion public equities were in global and international equities.

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Co-Chair MacKinnon addressed slide 17, "Fixed Income Plus \$11.7 B":

Director of Fixed Income Plus

Oversees Internal Team (4)

Leads the daily trading activity and determines allocation between various fixed income products.

Looks at how much to hold in corporate bonds vs treasuries or listed infrastructure.

Management

Internally Managed -\$7.7 B

Externally Managed -\$4.0 B

Bonds, REITs, Listed Infrastructure

Liquid -Income

Investment Grade Bonds

High Yield Bonds

Emerging Market Debt

Real Estate Investment Trusts (REITs)

Listed Infrastructure

Co-Chair MacKinnon highlighted slide 18, " Private Equity and Special Growth \$7.0 B":

Director of Private Equity

Oversees Internal Team (2) and Portfolio Investments

Evaluates investment opportunities

Concentrates on exceptional themes and talented Managers

Management

Fund Managers -External
Co-Investments -Internal
Direct Investments -Internal
Board approved Direct and Co-Investing in 2013

Private Holdings

Illiquid -Growth
Venture Capital
Buyouts

Ms. Rodell looked at slide 19, "Infrastructure, Private Credit and Income Opportunities \$3.2 B":

Director of Private Income

Oversees Internal Team (1) and Portfolio Investments

Aims to provide a high level of income and limited volatility

Manages a broad range of assets providing current income

Management

Fund Managers -External
Co-Investments -Internal
Direct Investments -Internal
Board approved Direct and Co-Investing in 2013

Public and Private Holdings

Illiquid -Income
Infrastructure: Energy, Transportation, Water,
Timber
Private Credit: Mezzanine Lending, Distressed
Credit
Income Opportunities: High End Rentals

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Ms. Ryder highlighted slide 20, "Absolute Return \$2.2 B":

Director of Private Income

Oversees Internal Team (1) and Hedge Fund
Managers
Selectively chooses funds
Ensures diversification based on geographies,
securities, and strategies

Management

Fund of Funds -External
Co-Investments -Internal
Direct Investments -Internal
Moving towards fully direct approach -based on
the Board's approval of Staff's recommendation in
May 2016

Hedge Fund Portfolios

Illiquid -Growth
Strategies: Global, Macro, Commodities, Event
Driven

Senator Stevens queried the definition of "Mezzanine Lending." Ms. Rodell replied that most people were familiar with "senior lending." She used an example of a mortgage. She stated that mezzanine lending occurred with a series of revenues.

Senator von Imhof remarked that the mezzanine debt was sometimes the second person paid, but there was more money upon payment.

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Ms. Rodell addressed slide 21, "Real Estate \$5.6 B":

Director of Real Estate

Oversees Internal Team (3) and External Advisors

Targets a mix of investment styles, ownership structures, property life cycles and property types.

Focus on steady cash flow and preservation of capital

Management

Portfolio is managed by APFC's Team and 5 External Advisors.

Advisors provide property management services

Real Estate Holdings

Illiquid -Income

56 properties -US and Europe

Residential, Retail, Industrial, Office Buildings

Build to Core

Ms. Rodell highlighted slide 22, "Asset Allocation and Risk \$4.5 B":

Director of Risk and Asset Allocation

Oversees Internal Team (1) and External Managers

Manages Cash and Over Arching Mandate

Monitors Risk Factors: Markets, Liquidity, Concentration, Inflation

Management

External CIO Program

Currency Overlay Liquidity Management

Strategies

Partnering with Best In Class Firms

Amount of cash held is determined by investment goal, time horizon and risk tolerance

Vice-Chair Bishop wondered whether the corporation was buying and selling dollars. Ms. Rodell replied in the negative. She explained there was a currency manager in London, who looked at the portfolio and APFC's exposure to the Euro. That manager was running dollar currency futures for the APFC.

Co-Chair MacKinnon wondered whether APFC was purchasing gold, silver, or other minerals. Ms. Rodell replied in the negative. She stated that APFC did not tend to buy direct commodities.

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Ms. Rodell addressed slide 24, "Fiscal Year 2017 Performance." She stated that FY 17 was a good year for the fund. She remarked that it was most important to focus on the longer-term performance, and whether the strategies could "bear fruit."

Vice-Chair Bishop felt that the slide reflected what was averaging for inflation. Ms. Rodell replied that the three-year calculation for inflation was 0.92 percent. She stated that, since inception, the inflation was around 2.5 percent.

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Ms. Rodell looked at slide 25, "Asset Class Performance." She noted the "drivers" of generating the \$7 billion in additional new value over FY 17. She noted that normally international, global, and domestic were "up" over the same period.

Vice-Chair Bishop asked for more information about the types of infrastructure. Ms. Rodell replied that infrastructure was contracted income. She stated that it was a long-term contract with defined income. The infrastructure was large structural assets. She stated that most of the opportunities were over weighted in

infrastructure. She stated that the United States offered fewer opportunities for infrastructure, because of the regulatory environment.

Senator von Imhof wondered whether there was a consideration to invest in a toll road in Alaska. Ms. Rodell replied that the Alaska statutes were very clear that the Permanent Fund should and can invest in Alaska when that investment returns were at least better than what was received outside of Alaska.

Ms. Rodell continued to address slide 25. She remarked that the private credit line item was reflected, and the reason that APFC was in the asset class.

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Ms. Rodell addressed slide 26, "Callan's Capital Markets Forecast." She stressed that past performance was not an indication of future performance. She remarked that, each year, Callan prepared a capital markets forecast for all its clients.

Ms. Rodell looked at slide 28, "APFC Quarterly Investment Management Fees." She stated that APFC was continually trying to improve its level of transparency.

Senator von Imhof wondered how APFC could invest in the state, and how to make the state more attractive for infrastructure investment.

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Senator Stevens wondered whether Callan was hired for general reasons or specifically for Alaska. Ms. Rodell replied that APFC had used Callan for more than 25 years, and focused on many different organizations.

Co-Chair MacKinnon stressed that the legislature would be conservative in its approach to the permanent fund and its expectations.

Co-Chair MacKinnon discussed the week's schedule.

#

ADJOURNMENT

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The meeting was adjourned at 3:18 p.m.