

SENATE FINANCE COMMITTEE
February 16, 2023
9:02 a.m.

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CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:02 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Donny Olson, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Click Bishop
Senator Jesse Kiehl
Senator Kelly Merrick
Senator David Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Gregory Allen, Chief Executive Officer, Chief Research Officer, Callan; Steven Center, Senior Vice President, Callan.

SUMMARY

PRESENTATION: CALLAN - CAPITAL MARKETS and PERMANENT FUND SUSTAINABILITY

Co-Chair Stedman discussed the agenda. He highlighted that Callan was a consulting firm that would advise on the Permanent Fund. Additionally, Callan advised on pensions. He noted that the committee members had reviewed the Power Cost Equalization (PCE) Endowment, aspects of which could be discussed. He thought the main focus of the meeting's discussion would be the Permanent Fund. He mentioned that there had been committee discussion pertaining to the prudent investor rule and the prudent man rule, which could generate questions for the presenters.

^PRESENTATION: CALLAN - CAPITAL MARKETS and PERMANENT FUND SUSTAINABILITY

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GREGORY ALLEN, CHIEF EXECUTIVE OFFICER, CHIEF RESEARCH OFFICER, CALLAN, introduced himself and discussed his background. He had been at the firm for almost 30 years, and the firm was celebrating its 50th anniversary in 2023. He had first worked with the Permanent Fund on a project basis in 1989, and had been the general consultant for the Permanent Fund for the previous decade. For the previous twenty-plus years he had maintained a model of the fund that helped in understanding the impact of asset allocation on all of the fund's financials. He considered that he had a good mechanical understanding of the Permanent Fund, which he thought could be useful to the committee during the meeting.

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STEVEN CENTER, SENIOR VICE PRESIDENT, CALLAN, introduced himself and discussed his background. He had been with Callan for almost 13 years. He had worked in institutional consulting for over 20 years. He had worked directly with Mr. Allen on the Permanent Fund relationship for approximately 8 years. He was also the co-consultant for the Alaska Retirement Management (ARM) Board. He qualified that while there was no ARM Board information included in the presentation, he would be able to answer questions on the topic.

Co-Chair Stedman thought there could be questions regarding the stability of the Earnings Reserve Account (ERA) of the Permanent Fund, as there was concern about the account's stability amongst the members. He mentioned roughly 90 percent of the fund being in illiquid securities.

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Mr. Allen showed a PowerPoint presentation entitled "Senate and House Finance Committees - Alaska State Legislature - Capital Market Outlook and Alaska Permanent Fund Performance Update," (copy on file). He looked at slide 2, "Outline":

- Callan's capital market projection process
- Current economic and capital market environment
- Summary of Callan's 2021 capital market projections
- Projected return and risk for APFC policy portfolio
- Alaska Permanent Fund
 - Recent Performance Review
- Concluding observations

Mr. Allen mentioned the use of capital market projections in making decisions about the Permanent Fund.

Mr. Allen spoke to slide 3, "Callan Capital Market Projection Process":

- Callan updates long term capital market projections each year in January and uses them for the full year with all clients for strategic planning purposes.
- Projections take into account long term relationships balanced with current market conditions.
- Consensus expectations (central banks, economists, asset managers, consultants, etc.) are carefully considered as an integral part of the process.
- Each number - return, risk, correlation - for every asset class must be individually defensible, and the numbers collectively need to work together as a set to generate reasonable portfolios during strategic planning exercises.
- Projections change slowly over time and are not designed to provide tactical insights.
- Process is executed by Callan's capital markets research group and projections are peer reviewed by Client Policy Review Committee as well as the hundreds of the clients that use them every year.
- Process is battle proven it has evolved and improved, but hasn't fundamentally changed over the last four decades.

Mr. Allen highlighted that Callan had about 400 clients that used the capital market projections, mostly large institutional investors with over \$1 billion in assets. He noted that the projects were used for long-term planning. Most of Callan's clients did a ten-year projection every year and considered asset allocations every five years. He discussed the work on developing projections and noted that he oversaw the work of the committee of individuals that made the final decisions on the numbers.

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Mr. Allen referenced slide 4, "Callan Capital Market Projection Process":

Historical Rolling 10-year Return - US Large Cap Equity

- Historical 10-year return for US large cap has averaged 10.5%.
- 2023 mid-point of projected range is 7.2%.
- Very few periods historically of negative 10-year return for US equities.
- Current outlook is in lower third of historical distribution, driven by relatively high valuations and secular decline in equity risk premium.

Mr. Allen looked at the graph on the slide and noted that the blue line was indicative of the return on the Standard and Poor (S and P) 500, which was an equity index, for the previous ten years. He noted that over ten-year periods, returns were much smoother. He noted that there were a couple of times shown on the graph where the ten-year annualized returns were below zero, one in 1938 and one at the end of 2008. He pointed out other ten-year periods with annualized returns as high as 20 percent. He used the example of the period ending 2021, in which the annualized return on the S and P 500 over the previous ten years was almost 17 percent.

Mr. Allen pointed out that Callan's projection for the S and P 500 was the green line and was 7.2 percent for the next ten years, which was a mid-point within a range considering a standard deviation. He noted that the average over the previous 100 years was 10.5 percent. Callan's projection going forward was less than the average over the previous 100 years.

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Mr. Allen turned to slide 5, "Callan Capital Market Projection Process":

Historical Rolling 20-year Return - US Large Cap Equity

- Historical 20-year return for US large cap has averaged 10.8%.

- 2023 mid-point of projection range is 7.2%.
- Very few periods historically where the 20- year return was below 7.20% projection
- Longer time horizons reward equity risk takers with more consistent positive returns.
- Worst 20-year period for S&P 500 since 1926 was period ended 12/31/1950 (great depression, WW II).
Annualized Return 3.1%
(almost entirely dividends)

Mr. Allen noted that the chart on slide 5 was the same but reflected rolling 20-year returns. He noted that there had never been a 20-year period where there was zero return on the S and P 500. He commented on the difficulty of predicting short period stock performance.

Mr. Allen considered slide 6, which showed a graphical representation of annual stock market returns by calendar year, which offered another perspective on the market. The tallest columns represented years where the return was between zero and 10 percent. The column to the right was the years between 10 and 20 percent. He pointed out that in 2008 and 2002, there was a -37 percent and -22 percent in a ten-year period, which is why there was a below-zero ten-year return. He pointed out highlighted columns that reflected recent positive returns.

Mr. Allen displayed slide 7, which showed two linear graphs addressing post-pandemic market performance. He noted that there was a bad year in 2022, in which the markets lost money and the Permanent Fund was reduced in size. The chart showed performance since the beginning of the pandemic, and the orange line showed the peak of return of the market before the pandemic. He noted that even with the losses from 2022, the markets were still well above pre-pandemic levels. He cited that in 2022 the bond market also had its worst year by more than three times the previously observed worst year in the bond market. He summarized that markets were above where they were before the pandemic.

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Mr. Allen highlighted slide 8, which addressed an equity drawdown. He commented that the markets had declined but were coming back in the first part of the current year. The charts were to illustrate how long the market declines

typically lasted. He mentioned the "dot-com bubble" which was shown in blue and was a long-lasting market decline that persisted for 521 trading days. The teal line represented the global financial crisis, which had persisted for almost a year. He commented that the pandemic downturn was the shortest bear market in history and snapped back within 30 trading days. The green line showing 2022 was less like the pandemic and more like down markets in the past. He noted that the data for the graph only went through the end of December, after which time there had been a rally in the equity markets.

Mr. Allen looked at slide 9, titled "U.S. Equity Market: Key Metrics." He relayed that when doing projections, one of the things Callan considered was whether the market was fairly valued. The chart on the slide looked at forward price to earnings (P/E) ratios for the S&P 500. He explained that if the blue line was in the center of the dotted lines, it signified that the market was about the same as average over time. He shared the perspective that going into 2022, the market was not over or undervalued and one could expect relatively decent returns out of the equity market for the following ten years.

Mr. Allen addressed slide 10, "Range of Protected Equity Returns," which showed a bar graph. He highlighted that when Callan was projecting returns, it projected a range. The slide included Callan's projected returns for public and private equity for the Permanent Fund. He pointed to a chart on the slide and highlighted the bar to the left that reflected the Permanent Fund's public equity portfolio, with a range between the tenth percentile and the ninetieth percentile. He highlighted the range reflecting a 10 percent chance the Permanent Fund's public equity portfolio would perform positive 15.8 percent and a 10 percent chance it would return -0.16 percent over the next 10 years. He noted the midpoint of the range.

Mr. Allen addressed the fund's private equity portfolio and noted that the Permanent Fund had close to a 20 percent allocation to private equity, which was illiquid and had been growing. The fund had added to the portfolio since it had a higher than expected return but faced more risk on the upside and downside than the public equity portfolio. The graph illustrated the impact of risk and return, with a higher midpoint but further spread outcomes.

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Senator Kiehl looked at the last bullet on slide 10, which indicated that losses in public equities had largely not been realized in private equity portfolios. He asked Mr. Allen to elaborate on why he used the term "realized."

Co-Chair Stedman asked Mr. Allen to define private equities and how the value was calculated.

Mr. Allen explained that in public equity markets, the price of companies changed micro-second by micro-second, and it was possible to sell stock and get money out within a three-day settlement. He continued that public markets picked up on the smallest sensitivities and translated the information to prices immediately. Private equities were funds that invested in privately owned companies, in many cases the fund would own an entire company or do a start-up. The privately held companies could not be traded minute by minute nor sold minute by minute. As a practical matter, there was a lot of time spent on valuing private companies when offering out more shares. On a daily basis, there was not a need to value the company since it was not traded. The net result was that private equity did not have the same volatility as public equity markets.

Mr. Allen continued that when the prospects for an individual company began to grow worse, it took some time for the information to affect the price. He noted that valuation was done not in individual transactions but rather than guessing and only knowing the worth once an asset was sold. In practice private equity markets did not go down as much as public equities. He summarized that public equity losses had all been realized, while private equity impacts filtered slowly into valuations slowly as transactions happened. He qualified that if all the private equity in the Permanent Fund were to be sold tomorrow, it would most likely be worth less than what was on the books.

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Co-Chair Stedman asked how the value of public equities was assessed, and how often the value was restated for purposes of the Permanent Fund's financial statements.

Mr. Allen replied that typically the Permanent Fund received updates on the value of the funds on a quarterly

basis. Typically, the information arrived one quarter after the quarter that the update included. He qualified that there were typically long lags of time between the end of the year and when it was known how much the private holdings were worth. Additionally, if there were not transactions, the values did not necessarily reflect a potential loss if the asset was sold.

Mr. Center wanted to note that the use of the word "realized" did not reflect a financial realized loss. He pondered that "recognized" would be a better word to use in the case of Senator Kiehl's question. He that realized gains and losses trickled into the ERA, and he did not want the term to be misinterpreted.

Co-Chair Stedman relayed that it was helpful during presentations to see bugle charts on returns listed in dollars. He thought once the percentages were shown in real dollars, it was easier for the average person to understand the magnitude of risk exposure. He thought most people in the building had no clue of how much risk exposure was present when viewing percentages.

Mr. Allen avowed to consider Co-Chair Stedman's comments for his presentation the following year and noted that his model for the Permanent Fund translated returns into dollars.

Mr. Allen advanced to slide 11, "Callan Capital Market Projection Process," and relayed that he wanted to discuss fixed income. He cited a projection of 4.25 percent and noted that the average return over the previous 100 years was about 5.4 percent. He directed attention to the last data point on the graph, which represented the end of 2022 and showed a return of 1.3 percent annualized for ten years. He commented that it was the worst ten-year period for bonds, and commented that it had been an "epic" ten-year event in the bond market.

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Mr. Allen looked at slide 12, "Yield Curve Rose and Inverted in Second Half of 2022," which he described as a complex slide for anyone that was not in his business. He looked at the line graph and addressed the blue line, which was the yield curve at the end of 2021, and measured the yield on bonds at different maturities. He discussed bond

returns over time and discussed the lack of yield. He commented that when bond yields go up, bond prices go down; and when bond yields went down, bond prices go up. The orange line showed the end of 2022, when T-bills went from earning zero to earning over 4 percent, while the 30-year bond went from earning 2 to 4 percent. The immediate impact was that the bond market lost about 12 percent.

Mr. Center continued to address slide 12. He commented that the good news was that starting the new year showed over 4 percent yield for bonds, which made for a better future outlook. There had not been good yield on bond portfolios in about a decade, and there were opportunities for investors to potentially take on a little less risk for a greater return.

Co-Chair Stedman asked about the inverted yield curve for December 31, 2022; and whether it should be paid attention to.

Mr. Allen cited that Mr. Center had made the point the previous day that all the recessions observed over the previous 20 years had come on the heels of an inverted yield curve. He noted that it was not clear that there was a causal relationship, but suggested that an inverted yield curve could be indicative of a slowing down in Gross Domestic Product (GDP). He considered other factors of the economy, such as the low unemployment rate. He opined that the reason the curve was as inverted as was shown was an artifact of how quickly the fed raised the short rates. He thought there was an expectation that the fed would back off and it would flatten out the curve. He did not think Callan had the position that there would be a recession because of the yield curve, but he thought it was important to know that every recession observed for the previous 20 years was preceded by an inverted yield curve.

Co-Chair Stedman asked how many inverted yield curves had occurred without a subsequent recession.

Mr. Center agreed to get back to the committee with the information.

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Mr. Allen showed slide 13, "Credit Spreads Widened to Long Term Average Levels," and discussed the importance of

credit spreads, which was the difference between the yield on a corporate bond versus a treasury bond. He noted that credit spreads had widened in 2022, and that usually when the equity markets went down there was more yield spread for buying a corporate bond. He felt spread was positive for the future. He reiterated that it had been a terrible year for bonds, but that there was an outlook for better bond returns in the future.

Mr. Allen referenced slide 14, "Starting Yield Strongly Predicts Forward Returns," and thought the chart showed that if the yields were known at the beginning of the ten-year period, there was a good idea of what the return would be at the end of the ten years. The orange line depicted the return at the end of the ten years, and the blue line was the yield at the beginning of the ten years. He commented that predicting bond returns was easier than for stock returns.

Mr. Allen turned to slide 15, which showed a table of fixed income forecasts. He had circled the aggregate index of 4.2, which represented the bond market in the United States (U.S.) He noted that the Permanent Fund had more things in its bond index (such as high yield, emerging market debt, non-U.S. bonds) and had a slightly higher return expectation. He cited a 2.5 percent increase in expected return for bonds, which was a larger change than he had previously seen. He emphasized that there had been important repercussions.

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Mr. Allen displayed slide 17, "Highlights of 2023 Capital Market Projections," and pointed out that there was a slight rise in inflation expectations, as well as a rise in public equity and bond expectations. He continued that Callan projected a premium of expected returns in private markets over public, with an expectations of private equity at 8.5 percent, and public equity at 7.6. He noted that the expected premium had come down, of the private markets over public. He theorized that the change was partly because the private markets had not fully absorbed the losses that the public markets had, which would result in a lower spread over the next ten years.

Mr. Allen highlighted slide 18, which showed a table of return expectation that each of the asset classes employed

by the Permanent Fund. He highlighted that the circle at the bottom signified Callan's return expectation for the total fund. The range of returns had a mid=point of 7.25 percent for the next 10 years. The expectation was up by close to one percent from the previous year. The outlook for the fixed income portfolio was 4.35 percent and the outlook for equities was 7.6 percent, both of which were better than the previous year. He considered that the state was in many ways in a better position in the beginning of 2022 than in the beginning of 2021, if one did not consider the amount of money the Permanent Fund lost over the course of the year.

Co-Chair Stedman asked how the 5 percent yearly draw affected the Permanent Fund portfolio.

Mr. Allen estimated that there was about a 4.75 percent real rate of return. He commented that the fund was in a better position than at the same time the previous year in terms of the projection for making the draw. He mentioned that a five percent draw was actually 5 percent of the first five of the previous six years. As market values generally trended upward, it signified that the effective draw on current market value was less than five percent. He reiterated that his estimate was that on average, the model should result in a 4.7 percent draw of the current market value. He relayed that Callan's view was that there was about a 50 percent chance of making enough return to make the draw, whereas last year there had been a less than 50 percent chance.

Co-Chair Stedman commented that there were not good odds.

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Senator Bishop thought the answer informed the committee that it needed to keep more reserves in the Constitutional Budget Reserve Fund (CBR).

Co-Chair Hoffman suggested that it was also possible to lower the 5 percent draw. He recalled that Mr. Allen mentioned advising other funds that were close to \$1 billion. He asked why the state could not use similar allocations for the Power Cost Equalization (PCE) Fund as it did for the Permanent Fund to reduce costs and level out the returns. He cited a \$200 million loss in the PCE Fund the previous year. He asked why education funds and other

long-horizon funds were not invested similarly or the same as the Permanent Fund.

Mr. Allen relayed that the Permanent Fund with its \$80 billion balance had a lot of resources at its disposal to be able to invest in complex asset classes such as private equity, private fixed income, and real estate. He continued that the typical \$1 million fund was managed by one or two people and could not do the same things at the same scale that the Permanent Fund could. He pondered if the Permanent Fund could manage some of the other funds in the state to take advantage of the scale of the fund and the expertise. He commented that doing so in a separate \$1 billion fund was almost impossible.

Co-Chair Hoffman asked why the state was not utilizing the Permanent Fund management for the other funds, and pointed out that the practice was already done with the Alaska Mental Health Trust Fund. He stated that Mr. Allen's point was well taken and thought the state should capitalize on the expertise of the Permanent Fund and possibly participate in it to potentially lower risk. He emphasized that the PCE Fund was very important to rural Alaska and expressed concern about the \$200 million downturn on the \$1 billion investment. He mentioned that Co-Chair Olson, Senator Bishop, and himself represented communities that benefitted from the PCE Fund because of high electrical costs. He thought the committee should ponder Mr. Allen's point of trying to capitalize on the expertise that managed the \$80 billion fund.

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Co-Chair Stedman added that there was a portion of the Permanent Fund that was comprised of Amerada Hess settlement funds, which were co-mingled with the other assets. He pondered a policy change that would allow for the comingling of some of the other funds as mentioned by Co-Chair Hoffman. He discussed having the other funds managed by the Permanent Fund with the same allocation. He thought the topic was something for the members to consider.

Co-Chair Olson asked about the potential downsides of Co-Chair Hoffman's concept of comingling the PCE Fund with the Permanent Fund for investment purposes.

Mr. Allen qualified that he could not speak for the Alaska Permanent Fund Corporation (APFC) and its willingness to comingle and administer other funds. He cited that there would be some administrative and accounting overhead to account for separate funds and potential draws. He mentioned that the Permanent Fund was not immune to losses and had lost money in some years. He noted that part of the portfolio involved private markets and therefore smoothed the drawdowns. He reiterated that the Permanent Fund could take illiquidity risk, which had the dual benefit of a higher return and a smoother ride. He guessed that the PCE Fund was mostly likely invested mostly in public markets, and had gone down more than the Permanent Fund did in 2022. In the long run he thought the Permanent Fund would generate a higher return because of its ability to invest in all the different asset classes in a very professional way.

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Mr. Allen looked at slide 19, "The Return of Yield," which showed a table that reinforced the point that there was currently a bunch of yield that was not previously seen. He noted that the orange bars showed the change in yield for all the different alternatives.

Mr. Allen addressed slide 20, "Relationship Between Expected Return and Volatility," which showed a chart that he called a 'risk-return chart.' He noted that moving to the right indicated more risk and moving upward on the chart indicated more return. He explained that it was not possible to get more return without taking more risk in the capital markets. He pointed out that private equity was the riskiest, with the greatest chance of the largest losses; and cash was the safest. He emphasized the importance of assuming risk in an efficient way, with as much return possible per unit of risk. He referenced the benefit of the size of the Permanent Fund as an asset structure and cited that the fund outperformed in private and public equity as well as in fixed income due to its skillful and efficient handling of risk.

Co-Chair Olson referenced Mr. Allen's comment about cash being more stable. He referenced the high rate of inflation.

Mr. Allen relayed that with cash one rarely lost money, but there was a risk of losing purchasing power if inflation was high and the cash stayed at the same level. He conveyed that cash did not earn enough to keep up with inflation. He cited that the fund had to earn 7.25 percent in order to cover the yearly draw and account for inflation, which necessitated owning private equity and other risky items.

Co-Chair Olson considered cash versus precious metals. He realized that the market was up and down but thought metals might be more stable than cash.

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Mr. Allen relayed that the price of a precious metals portfolio was pretty volatile and could go down as much as 15 percent to 20 percent in a year. He cited that there were funds that did own commodities (like precious metals), but usually used as an inflation hedge or diversifier, but had to be held in combination with other asset classes due to the volatility.

Mr. Allen advanced to slide 21, "Mixes Yielding 7% Expected Returns Over Past 30+ Years," which showed four pie charts. The charts showed what a portfolio would need to look like to earn 7 percent using Callan's capital market projections at different times. He observed that in 1993, bond returns were relatively high, and it would have been possible to have a portfolio that was 97 percent bonds and 3 percent equity, and there would have been a good chance of earning 7 percent over the following ten years. He discussed 2008, when bond yields were lower, and it was necessary to add international equities to earn the same 7 percent return. He cited that at the beginning of 2022, one could only afford to have 4 percent in bonds and still earn the 7 percent return. Because the yields had gone up so much in one year, it was possible to have a 30-year portfolio in bonds and earn the 7 percent.

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Senator Bishop asked if interest rates drove the bond market up or down.

Mr. Allen answered affirmatively.

Mr. Allen spoke to slide 25, "APFC FY 2023 Total Fund Policy Target," which showed a pie chart and the Permanent Fund's investment policy. The fund had 36 percent in public equities, 20 percent was in public fixed income, and the other 44 percent was in private markets. He described that the Permanent Fund had been on a careful, well-executed path from what was almost entirely public market securities to now a 56-45 public private mix. He noted that private equities was a complex asset class that generated a higher return than public markets. Real estate and private credit were other complex asset classes. The fund had gone down the path as most of Callan's other large clients in taking on more illiquidity in private markets and taking on more complexity as a way to earn what was necessary for the 5 percent draw.

Mr. Allen thought it was an important point that Callan still considered the Permanent Fund to have a balanced portfolio. He mentioned that relative to other endowments (with less in fixed income) it was a conservative portfolio, although relative to public funds, the Permanent Fund's portfolio was riskier than average. He noted that there were some forthcoming performance charts that would bear out the assertion.

Mr. Allen appealed to the committee to consider any way to not increase the annual draw from the ERA. He explained that the bigger the draw, the more pressure on the investment team to stretch the rate of return. He did not think there was an asset allocation possible that could cover a ten percent draw. He commented that even with the current sophisticated asset allocation, there was still a 50 percent chance that the fund would not achieve the desired rate of return. He emphasized that the more draw that was required, the more pressure was put on the investment team, the more risk, and the greater losses in down markets.

Co-Chair Stedman thought Mr. Allen was indicating that the more the legislature asked for (of the Permanent Fund draw), the less likely they would get it.

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Co-Chair Stedman asked for more detail on the definitions of absolute return and risk parity.

Mr. Allen explained that absolute return was more commonly known as hedge funds, which indicated strategies where funds were not invested to generate equity returns or fixed income returns, but instead investments were used to generate stable returns over time. The strategy was sophisticated and involved leverage and derivatives, and had relatively high fees. He summarized that the strategy overall was relatively low risk, with a return expectation somewhere between that of fixed income and equities. Importantly, the hedge funds were not correlated with the equity and bond markets. He cited that the Permanent Fund's absolute return portfolio was up by 6 percent the previous year while its fixed income portfolio was down about 12 percent and its equity portfolio was down by approximately 17 percent.

Co-Chair Stedman understood that the method would involve making money on a stock or shorting a stock and trying to lock in a spread.

Mr. Allen agreed. He used the example of a typical trade being bullish on Exxon stock and bearish on BP stock. He discussed locking in differences between securities as opposed to what was happening in the securities market as a whole.

Co-Chair Stedman asked Mr. Allen to address risk parity.

Mr. Allen explained that risk parity was popularized in the early 2000s, and was another way of investing in the public markets. He explained that instead of having 80 percent of risk in an equity bond portfolio, one used leverage to increase the bond exposure to generate the same amount of risk as the equities. The result was a more balanced portfolio that generated a return similar to a stock/bond portfolio. He noted that the risk parity was a very small allocation at one percent and was one of the worse performance parts of the portfolio in 2022.

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Mr. Allen referenced slide 26, "APFC FY Target versus Large Public Funds," which showed a chart that plotted the Permanent Fund's target allocations in each asset category in the context of public funds. He thought the information was important in understanding the performance of the Permanent Fund versus public funds. He cited that the first

bar represented the range of large public funds over \$1 billion. He observed that the Permanent Fund had less public equity and less private equity compared to public funds.

Mr. Allen showed slide 27, which showed the same graph as the previous slide, but for endowments. He argued that the Permanent Fund was both a public fund and an endowment. The fund was public money but not a pension fund. Endowments were able to take more risk, had a longer time horizon, had a smaller draw relative to the asset, and had very different asset allocations. He noted that the Permanent Fund's asset allocation was the same for both the previous and current graph, but observed that where the fund ranked in the distribution was different.

Mr. Allen observed that as compared to other endowments, the fund had one of the higher public equity allocations. In private equity, the fund was below the median. On average, endowments had more private markets and private equity than the Permanent Fund, and less public funds. He described the Permanent Fund as a "tweener." When showing performance of the Permanent Fund for the board and staff, Callan showed the fund against endowments and also against public funds, as there were different results.

Co-Chair Stedman asked Mr. Allen to discuss different ranges of payouts from endowment and foundations. He wondered if other funds used a smoothing mechanism.

Mr. Allen thought it was important to note that there were very few endowments that were as large as \$80 billion. He mentioned the Yale Endowment, which was not even close to \$80 million. He thought the typical endowment had a similar formula for payout, with a smooth derivative of an average market value over time. He considered that using five of the first six years was a great formula that was good for planning purposes. There were other endowments that used corridors and changed with the rise and fall of the market. The industry standard was some derivative of an average of the previous three to five years of market value times a percentage. The amount was usually between 4.5 and 5 percent.

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Co-Chair Stedman asked Mr. Allen to get back to the committee to discuss the range of draws and the numbers included in the range. He mentioned the 50/50 chance of achieving the desired draw from the Permanent Fund and thought many would prefer better odds.

Mr. Allen commented that there would be a much better chance of achieving a 3 percent draw.

Co-Chair Stedman agreed but thought the state would not be able to meet its obligations with a 3 percent draw.

Senator Wilson had thought the Permanent Fund was not invested in so much private equity due to public use of funds and transparency. He asked Mr. Allen to address the topic.

Mr. Allen relayed that there were many upsides and downsides with private equity. He highlighted that it was not possible to get the level of transparency with private equity as it was with public equity. He commented that the Federal Trade Commission (FTC) had made a bigger burden each year on public companies to be more transparent and more fair about information getting to markets. Private companies were not subject to the same level of scrutiny by regulators, and a lot of managers of private companies felt that it was an important competitive advantage to not be as transparent. He summarized that one gave up transparency into the operations of the underlying companies when investing in private equity.

Mr. Allen highlighted slide 28, "APFC FY 2023 Total Fund Policy Target," which showed a pie chart entitled 'APFC Total Fund Target' and listed the projected return and standard deviation for the Permanent Fund. He summarized that the slide translated the fund's policy mix into return and risk. He cited that while the expected return was 7.25 percent, there was a 13.3 percent standard deviation. The expected real return was 4.75 percent, which was just above what was viewed as the long-term draw that resulted from the formula.

Co-Chair Stedman referenced information the Permanent Fund put together on historical returns, and expectations if the fund hit a return of 7.25 percent. He asked if Callan put together the data for the Permanent Fund.

Mr. Allen affirmed that Callan provided the Permanent Fund a range of expected returns including the total return and the statutory return, which was the statutory net income divided by the value.

Co-Chair Stedman asked if the information was available on the historical data sheets on the Alaska Permanent Fund Corporation (APFC) website.

Mr. Allen affirmed that the information was listed on a projection sheet.

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Mr. Allen looked at slide 29, "Constrained Efficient Frontier Analysis 40% Private Assets," and discussed efficiency of the Permanent Fund portfolio, in terms of whether the fund was generating the maximum return for the amount of risk being taken. He mentioned a tool called the 'Efficient Frontier,' which was illustrated by a graph on the slide. He highlighted that the blue line represented various investment mixes from conservative to more aggressive. He noted that each mix on the line generated the highest return possible per unit of risk.

Mr. Allen continued to address the graph on slide 29 and pointed out a green triangle below the blue line that represented a 75-25 equity-fixed portfolio. He discussed the spread between the green triangle and the orange triangle above the blue line, which in Callan's view was due to the use of asset classes like real estate, private equity, private credit, and absolute return. The classes were all diversifiers that allowed for a little more return for the same amount of risk as public markets. He summarized that the Permanent Fund portfolio was efficient.

Mr. Allen addressed slide 30, "Range of Projected Returns," which showed the range of expected ten-year returns looking forward. He cited that there was a 10 percent chance that the fund could generate a 13 percent annual return over the next 10 years. Callan also thought there was a 10 percent chance the return could be as low as 1.7 percent. He pondered that the chance of the return being over 7.5 percent was only 48 percent. Considering the previous five years, there was about a 51 percent chance of making the 7.5 percent return.

Co-Chair Stedman discussed an analogy of rolling dice and losing in half the scenarios.

Mr. Allen thought it was important to put "losing" in context. In most scenarios, "losing" would mean the state would not be able to make the whole draw. He thought it might be a good time to address the ERA.

Co-Chair Stedman reminded that he had prepared the presenters to anticipate the topic of the PCE Fund, diversification, ERA sensitivity and meeting the obligation to the citizens. He did not think the topic of state finances had permeated the building as it should.

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Mr. Allen wanted to address the subject of a pure endowment before addressing the ERA. He described that in a pure endowment there was spending rather than focus on putting money in the principal and never touching it again. In an endowment there was not a two-account structure, and the purchasing power of the principal would erode. He thought the 50 percent chance that the returns would cover the draw was good enough for most endowments. He continued that the Permanent Fund's two-account system was fairly unique, by which there was an endowment model for spending, but a historical construct of the ERA and inflation-proofing. He cited that there was an absolute limit of when if the ERA went to zero, the payout went to zero. When the ERA got smaller as a portion of the fund, it was closer to "hitting the cliff," where the draw might be missed entirely.

Mr. Allen recalled the time in 1998 when the year started with zero in the ERA. He thought the two-account system had the "nuclear option effect." He recalled that the previous year there was a pretty big ERA balance, but when the downward market in 2022 wiped out some of the unrealized gains in the account. He qualified that the ERA was sensitive to how much was moved into the principal, and how much was paid out.

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Mr. Allen continued that the ERA was also sensitive to market activity. The account had to be replenished via income from bonds or by selling securities at a realized

gain, both of which were volatile. In the current year, Callan had expected realized income to be around \$4.5 billion. Through December 31, the amount was only coming in at about half of what was expected. The numbers were all explainable, but statutory net income was volatile and could not be absolutely controlled. He thought for the previous three years the system had been fine because of the large ERA balance.

Mr. Allen mentioned the high inflation rate of the previous year, and noted that when applied to the principal it resulted in an approximately \$4 billion inflation-proofing appropriation for the end of the fiscal year. He thought the Permanent Fund was in good shape as an endowment, but that the ERA was fragile and had the potential to wipe out the draw if it was reduced to zero. He understood the dynamic that when the ERA was too big, discipline was needed; while at the same time if the ERA was too small it would bring the draw to zero. He thought the ideal situation would be to get rid of the two-account system and put the draw into the constitution. He did not know if the solution was possible. He mentioned a second solution of keeping the ERA as big as possible and not bringing the debt scenario into play.

Co-Chair Stedman relayed that the previous year the committee had pondered another transfer from the ERA to the corpus. The year previous to that the committee had made an additional \$4 billion transfer, and the year previous had made a transfer of \$4.9 billion. He offered the context of the two checks in the committee room. The previous year, the committee had decided not to do the transfer as the committee felt there was too much risk exposure to the ERA with the downdraft in the market that seemed to be continuing, as well as a war starting in Europe. He considered that many legislators did not want to liquidate the fund, but rather save it for future generations. He emphasized the critical nature of the ERA and the need to inflation-proof the fund, as well as keeping a balance of the two needs.

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Senator Wilson wondered if Callan had run the numbers to keep the state in the 75th percentile of likelihood of keeping a healthy ERA balance.

Mr. Allen relayed that he had run a model and offered a caveat that he only had data through from December 31 through June 30. It appeared that even if the legislature made the \$4 billion appropriation required by the formula, there was less than a five percent probability that over the next three years it would impede the draw. If the model was extended ten years, there was about a ten percent chance. He thought the real risk to the Permanent Fund, with the current ERA balance, was not one bad year but rather a number of years in a row with low returns. He viewed that the state was in a relatively healthy position given the current \$13 billion in the ERA.

Mr. Allen qualified that as long as statutory net income kept up with the draw plus inflation-proofing, the account would stay in the same place. He reiterated that the only way to replenish the ERA was through statutory net income. He summarized that the ERA balance could stay healthy if the state was able to generate \$4.5 billion \$5 billion in statutory net income - without any extreme inflation.

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Co-Chair Stedman recalled that two years previously the state's statutory net income was \$7.8 billion or \$7.9 billion, after earnings of about \$5 billion, which were both related to real estate sales. He thought the real estate sales after a long holding period could skew the numbers.

Mr. Allen explained that the income from bonds, dividends from stocks, and rents on real estate were relatively stable even with rates going up. The volatile piece of the income was the realized gains. He mentioned sales of some big real estate properties with giant gains. He described that private equity companies had been sending cash back to the Permanent Fund at an amazing clip in 2019. Between the real estate sales, private equity returns, and some rebalancing, the state had some very high years of statutory net income that had contributed to a much higher reserve balance than historically seen. The same type of activity was not present in the current year, which explained the statutory net income running at \$1 billion.

Senator Bishop asked if what Mr. Allen described was indicative of higher interest rates.

Mr. Allen relayed that higher interest rates would be helpful in creating more statutory net income going forward, but because the Permanent Fund was only 20 percent in bonds, it would only affect that part of the portfolio. The extra \$500 million in income would help, but the fund needed to realize gains from sales to achieve the previous levels.

Senator Bishop clarified that he had been referring to the higher interest rates on some of the equities for real estate investments, and whether it went down due to higher interest rates.

Mr. Allen relayed that there was some relation in what Senator Bishop described. He qualified that when interest rates went up quickly, stock prices went down and private equities could not go sell companies in the market.

[10:25:16 AM](#)

Co-Chair Hoffman referenced the deposits to the Permanent Fund symbolized by the two large checks in the committee room. He pondered that the legislature had pre-paid for inflation. He asked if it was the same case for the second appropriation.

Mr. Allen pondered whether the call funding inflation-proofing or just a special appropriation. He did not know specifically how the legislature thought about the appropriations, but when adding the amounts, he thought the appropriations were a little ahead of keeping up with inflation.

Co-Chair Hoffman clarified that when the legislature had made the appropriations, for the next couple of years there was money to spend because the inflation proofing was pre-paid.

Mr. Allen thought Co-Chair Hoffman had a reasonable way of looking at the matter.

Co-Chair Stedman recalled that when the appropriation was done for \$4.9 billion of inflation proofing, it was discussed as a new concept in the building. He mentioned the second appropriation of \$4 billion and thought the value of the transfer had been recognized by many legislators. Co-Chair Stedman emphasized that the

fundamental discussion was amongst senior members. He referenced expenditure of savings that had shocked himself and others. He discussed the importance of building reserves and using another mechanism to disallow spending down the funds.

Co-Chair Stedman continued his remarks. He explained that he was trying to come up with another mechanism versus just building the ERA to an unlimited amount, because there was concern that the funds were an easy spending target. He mentioned that the reason the appropriation did not happen the previous year was due to the risk.

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Co-Chair Hoffman thought Co-Chair Stedman's point was well taken. He wanted to make the point that putting aside \$10 billion did not originate from the administration or the Permanent Fund Board, but rather from the Senate Finance table. He asserted that the protection of the Permanent Fund to enable it to grow over \$80 billion was a result of the commitment of the members in the Senate Finance Committee.

Co-Chair Stedman mentioned that everyone had voted for the budget that included the appropriations. He mentioned the political winds of the time.

Senator Merrick thought it sounded as though Mr. Allen was advocating for moving away from the ERA model. She asked if there was a downside to moving to more of a one-account endowment model.

Mr. Allen explained that if the state was to move to an audit model, yet have draws on an ad hoc basis, it would be worse than the current model. He thought an endowment model with a constitutionally set draw was a good option.

Co-Chair Stedman relayed that there had been serious discussion of a ten percent draw two years in a row. He shared that some members had been alarmed at the proposition.

Mr. Allen wanted to remark on the legislature not doing inflation-proofing in 2022. He commented that the inflation going into the year had been low, and the inflation-

proofing appropriation would have been small and did not put the fund too far behind.

Co-Chair Stedman relayed that the calculations would be done and brought to the committee by the Legislative Finance Division when the budget cycle began.

[10:34:12 AM](#)

Mr. Center advanced to slide 34, "APFC Total Fund Historical Returns," which showed a bar graph. He referenced his presentation to the Permanent Fund Board the previous day. He noted that Callan compared the fund's performance on an ongoing basis against a couple different benchmarks, including the total fund target. He explained that the total fund target was a blend of the various benchmarks that were representative of the strategies used by the Permanent Fund, and was considered by Callan to be the best benchmark of the fund. He cited that the previous year the fund returned negative 6.37 percent, which was ahead of its total fund target of down by 9.15 percent.

Mr. Center continued that Callan also compared the Permanent Fund to the Consumer Prince Index (CPI) plus 5 percent objective and recommended looking at the comparison over long periods. He cited that over the last year CPI plus 5 was up 11.47 percent. He considered the last 3 to 5 to 7 years and noted that the Permanent Fund's performance was ahead of its total fund target over all the trailing time periods, but got closer to the CPI plus 5 goal the further out in time. Looking out 10 to 20 years, the fund had exceeded the CPI plus 5 goal.

Mr. Center explained that over the long term, the investment team at APFC had done a very admirable job of implementing their investment strategy.

Mr. Center addressed slide 35, "APFC Total Fund Cumulative Return vs CPI + 5%," which showed a line chart as a visual representation of the long-term goal. The orange line showed inflation plus 5 percent, while the blue line showed the Permanent Fund's performance over time, with a time span of 20 years ending December 31. While it had volatility over time, the fund outperformed CPI plus 5 percent. He observed that there were periods of downturn, which lined up with the global financial crisis in 2007-2008, and the Covid-19 "snapback" in 2020.

[10:37:40 AM](#)

Mr. Center spoke to slide 36, "APFC Total Fund Ranking versus Large Public Funds," and noted that slide 36 and slide 37 compared the Permanent Fund to the "peer groups" of large public funds (retirement plans), which was one of two large groups that Callan compared the fund to. He observed that in the near term, over the last year, the fund vastly outperformed most retirement plans, because most U.S.-based public funds had a higher allocation to the public equity market, which was the worst performing space during 2022. Over longer time periods, the Permanent Fund also compared very favorably to other public funds, primarily due to the fund's use of private assets, which tended to be higher than most U.S.-based public retirement systems. He mentioned that most U.S.-based public retirement systems had higher payouts than the Permanent Fund, and as a result needed to have higher liquidity.

Co-Chair Stedman asked about pension plans with higher liquidity and asked how risk tolerances were connected to projected returns.

Mr. Center explained that risk tolerances among U.S.-based public retirement systems varied widely. He continued that a lot of the variation had to do with funded status, and the state's ability to fund the pension plan. For some states, pension plans were very well funded and resultantly did not have as high of a risk appetite. Some states had unfunded liability in the pension plans and tended to take on a higher degree of risk in hopes of earning enough returns on assets to pull up the funded status. He went on that overall risk appetite had to do with funded status rather than overall outflow. The outflow had a bigger impact on the need for liquidity. There were a lot of different forces at play for public retirement plans relative to a typical endowment fund focused on a steady payout.

Mr. Center looked at slide 37, "APFC Total Fund Ranking versus Large Public Funds," which was the same as the previous slide but looked at performance relative to large endowment funds. He commented that over the last 10 years, the Permanent Fund's asset allocation had looked more like an endowment than a public retirement system. He considered the twenty-year bar on the far right of the graph, and

observed that the Permanent Fund had far more in fixed income and public equities than most endowments and foundations. He continued that for the previous 1-year, 5-year, and 10-year comparison, the fund looked more like an average endowment fund and ranked in the median for performance.

[10:41:31 AM](#)

Mr. Allen moved to slide 38, "Concluding Observations":

- Total Fund has outperformed performance benchmark over most short-term and longterm periods ended December 31, 2022.
- Total Fund has underperformed the long-term performance objective of CPI +5% over short-term periods, but modestly outperformed over long-term periods.
- Total Fund performance has been competitive with that of large public pension funds and large endowments and foundations over most time periods ended December 31, 2022.
- Asset allocation of Total Fund looked more like that of a large public fund up until about 5 years ago.
- Asset allocation of Total Fund has evolved to look more like a large endowment and should perform increasingly in line with that universe over time.

Mr. Allen summarized that from Callan's perspective, the permanent Fund had done extremely well and had beat every benchmark in almost every asset category in a one-year, three-year, five-year and longer time horizon. He thought it was important to recognize that the staff at APFC had done a good job throughout a great deal of turnover. He thought APFC had not taken excess risk. He thought that equity portfolios were one of the best performing around. He affirmed that asset allocation was important, but additionally having a capable staff to address matters over time was important.

Co-Chair Hoffman inquired about past recommendations by the APFC Board.

Mr. Allen was reticent to speak to the actions of the board. He noted that the board had made resolutions supporting the POMV model.

Co-Chair Hoffman asked about recommendations to combine the ERA and the Permanent Fund.

Co-Chair Stedman asked Mr. Center and Mr. Allen to get back to the committee with any additional information. He suggested that the APFC could respond regarding any resolutions and the timetable.

Co-Chair Stedman thanked the presenters.

Co-Chair Stedman discussed the agenda for the following Monday, at which time the committee would consider the governor's budget amendments.

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ADJOURNMENT

10:46:59 AM

The meeting was adjourned at 10:46 a.m.