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THE CASE FOR INTERNATIONAL DIVERSIFICATION

International diversification of an investment portfolio can provide four benefits: reduction in the volatility of the portfolio; an increase in the return; an increase in the marketability of the portfolio as a whole; and protection against an unexpectedly high rate of inflation in the United States.

1. Protection from Inflation

Diversification into markets of different countries with different economic cycles and different rates of inflation reduces the risk that an entire portfolio will show a low real rate of return. The return of the international element of the portfolio will not be impaired by an unexpectedly high level of inflation in the United States. Indeed it will tend to benefit since the growth of the inflation differential is likely to be reflected in exchange rates so that overseas holdings will rise in terms of the United States dollar. A rise in the exchange rate of the United States dollar might lead, on the other hand, to the returns on overseas investments not matching those on United States investments. Any fall in the United States rate of inflation would, however, be highly beneficial to the performance of United States investments. Since the proportion invested in overseas markets would likely be relatively small, the overall performance of a portfolio with 90 per cent invested in the United States and 10 per cent in overseas markets would still be quite satisfactory during this period of low domestic inflation. International diversification protects the assets of a fund in that it provides a higher return on overseas securities at the time it is most needed - when the rate of domestic inflation is unexpectedly high.

2. Reduced Volatility

The prices of different shares in any one market tend to move fairly closely together, but the correlation between share price movements in different markets is low.

Correlation coefficients between United States and Foreign Stock Markets 1970-1979.

United States	1.00
United Kingdom	.54
Japan	.52
Germany	.51
France	.48
Hong Kong	.45

One study has indicated that the reduction in volatility for the period 1959 to 1979 for a portfolio with 90 per cent invested in the Standard & Poor's Composite Index and 10 per cent equally divided among the equity markets of France, Germany, Japan, and the United Kingdom (as represented by the Capital International Index for each of these markets) from the volatility of a portfolio invested wholly in the Standard & Poor's Composite Index would have been nearly half that which would have been obtained by holding 10 per cent of the portfolio in cash equivalents. International diversification thus leads to a substantial reduction in volatility.

3. Greater Return

The rate of return in the years 1959 to 1979 was generally greater in the major markets outside North America than in the United States. A study made by InterSec Research Corporation shows the rates of return achieved by investment in the Capital International Indices of the markets of Canada, France, Germany, Japan, and the United Kingdom and in the Standard & Poor's Composite Index in the United States over four periods (1959 to 1979, 1965 to 1979, 1970 to 1979, and 1974 to 1979), after taking account of dividend yield and adjusting for fluctuations in exchange rates. The returns in every period were higher in each of the overseas markets than in the United States except in the case of the French market in the longest period. The rate of return of a portfolio divided equally among the four markets outside North America would have been higher by about 70 per cent in the first period, 150 per cent in the second period, 160 per cent in the third period and 85 per cent in the final period. The investment of even a small proportion of a United States portfolio in international markets would, therefore, have resulted in a significant increase in the return of the whole portfolio.

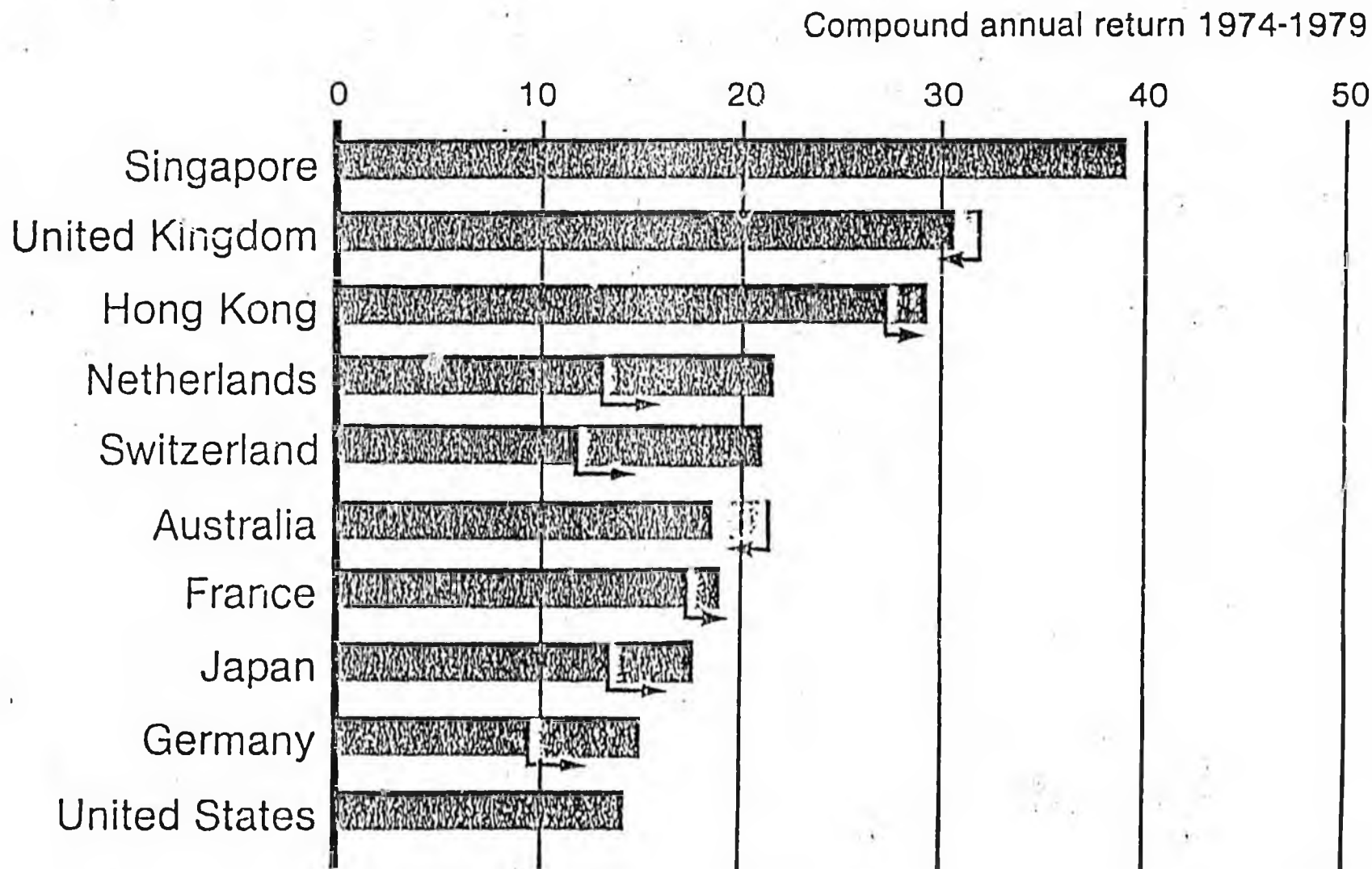
4. Increased Marketability

Capital International has published figures for turnover in 1979 in 14 stock markets in Europe and the Far East. Turnover in these 14 markets amounted to \$220.7 billion, over 86 per cent of the turnover of the United States and Canadian equity markets in the same year. Capital International has also published figures for the market capitalization of equities on 16 stock exchanges outside North America. At the end of 1979 the total amounted to \$755 billion, almost 71 per cent of the combined market capitalizations of the United States and Canadian stock markets at that time. The size of markets outside North America is thus considerable, and turnover forms a larger proportion of market capitalization in them, taken as a whole, than in North America. Moreover, there were 127 companies listed on these 16 markets outside North America with a market capitalization which was greater than that of the 200th largest listed United States company at the end of 1979. There is thus considerable opportunity for large scale investment in markets outside the United States and Canada.

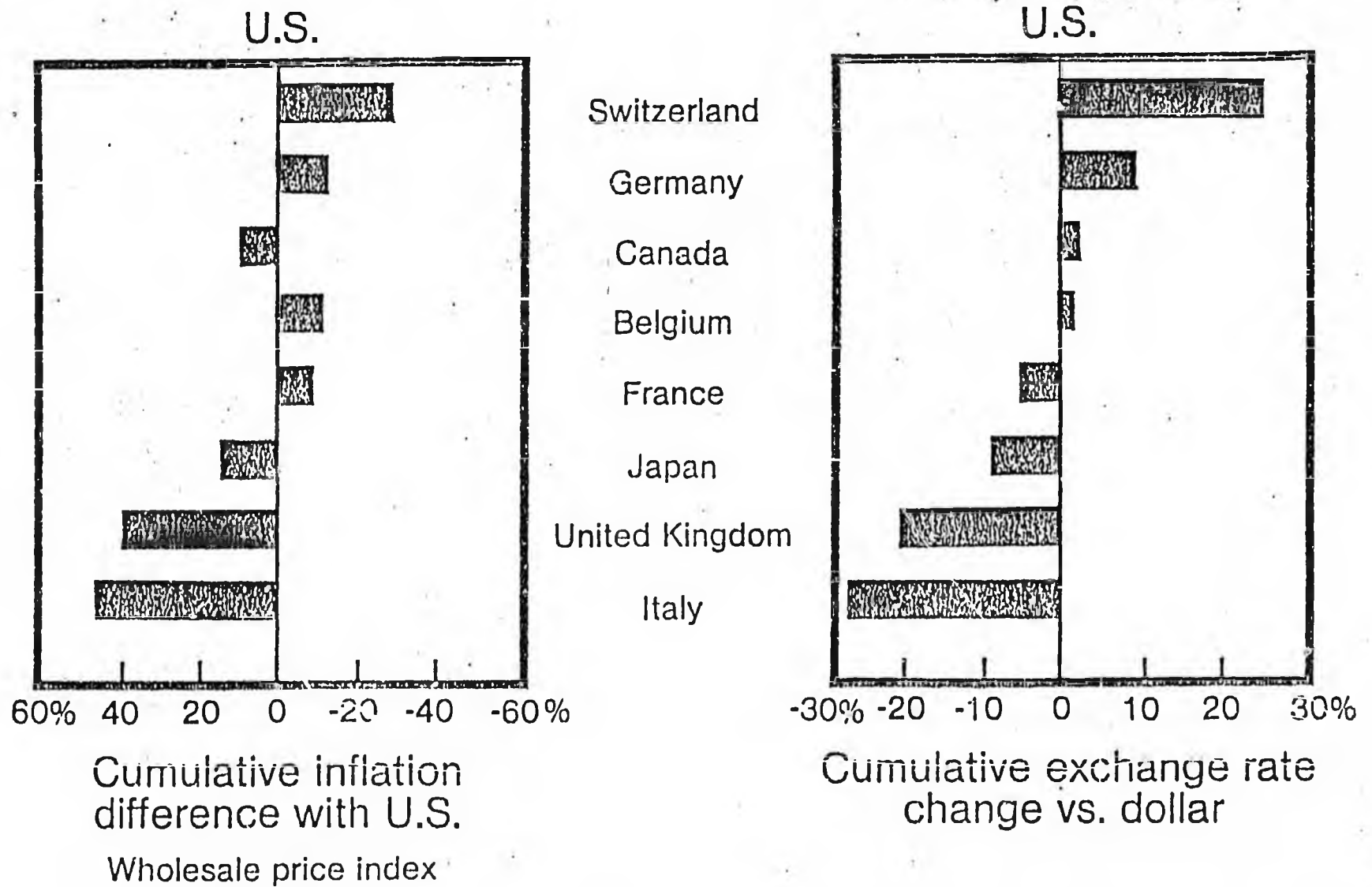
5. Investment in International Bond Markets

The total capitalization of the Eurobond market and the nine national bond markets of Australia, Denmark, France, Germany, Japan, the Netherlands, Sweden, Switzerland, and the United Kingdom at the end of 1979 was about \$1,414 billion. By comparison, the taxable bond market in the United States had an estimated capitalization of about \$1,400 billion and that of Canada a capitalization of about \$105 billion. The large size of international bond markets provides United States investors with a further means of benefiting from international diversification, but with a lower degree of volatility than that involved in equity investment.

Some return comes from currency exchange rate changes.

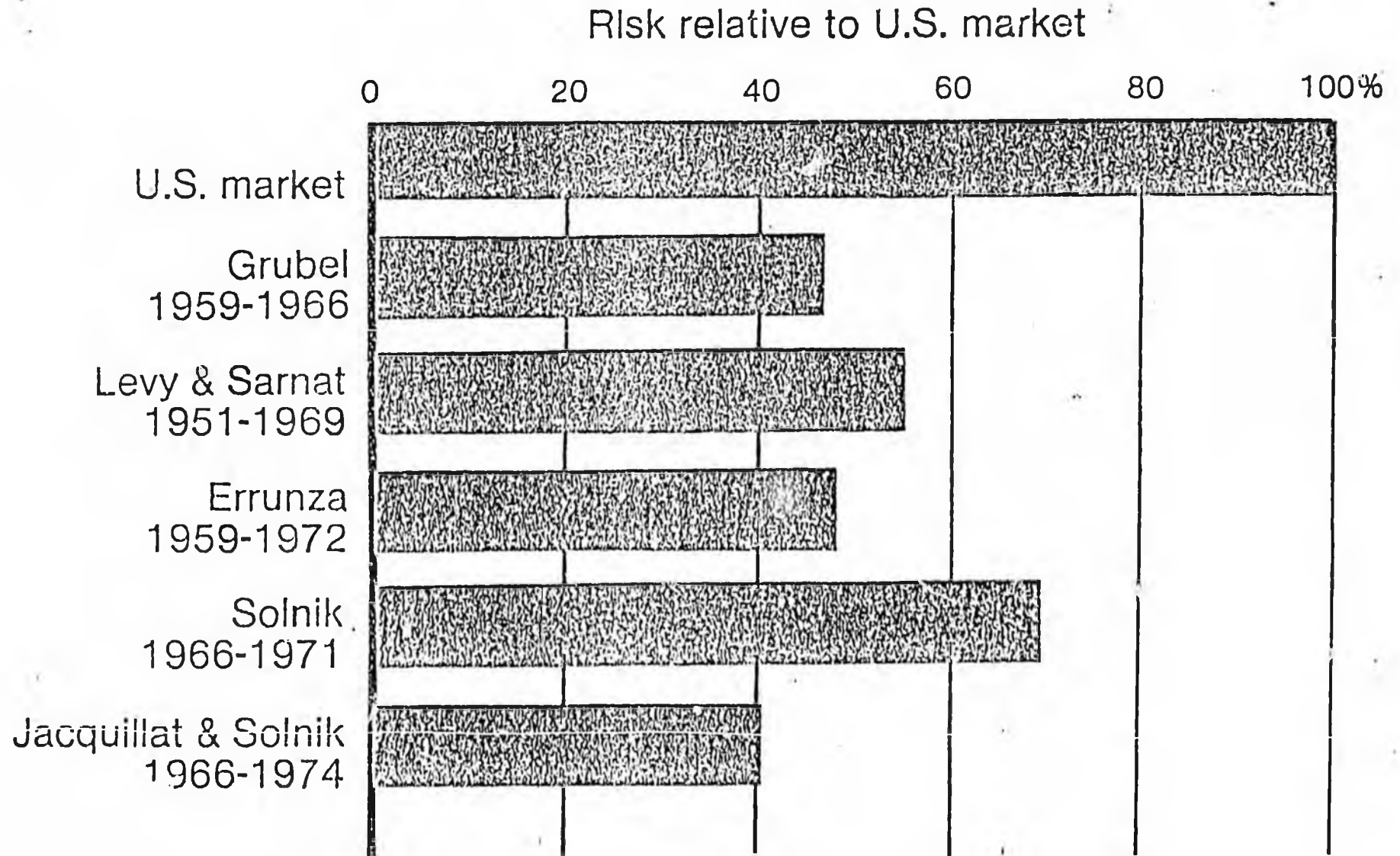


Currency exchange rates (longer term) depend on differences in inflation rates.

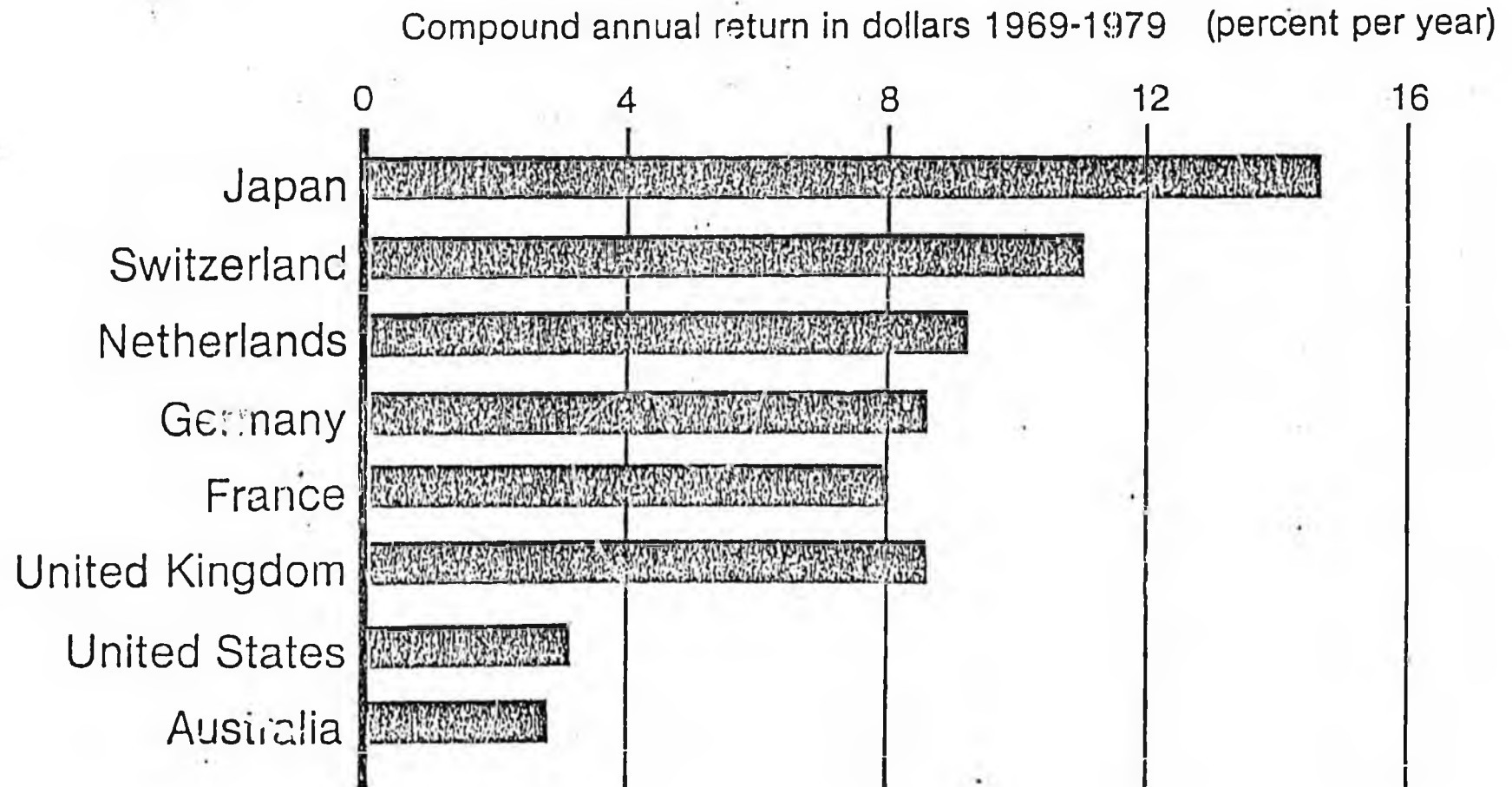


Source: Kemp Period: March 1973-December 1976

Studies show that international diversification reduces risk substantially.

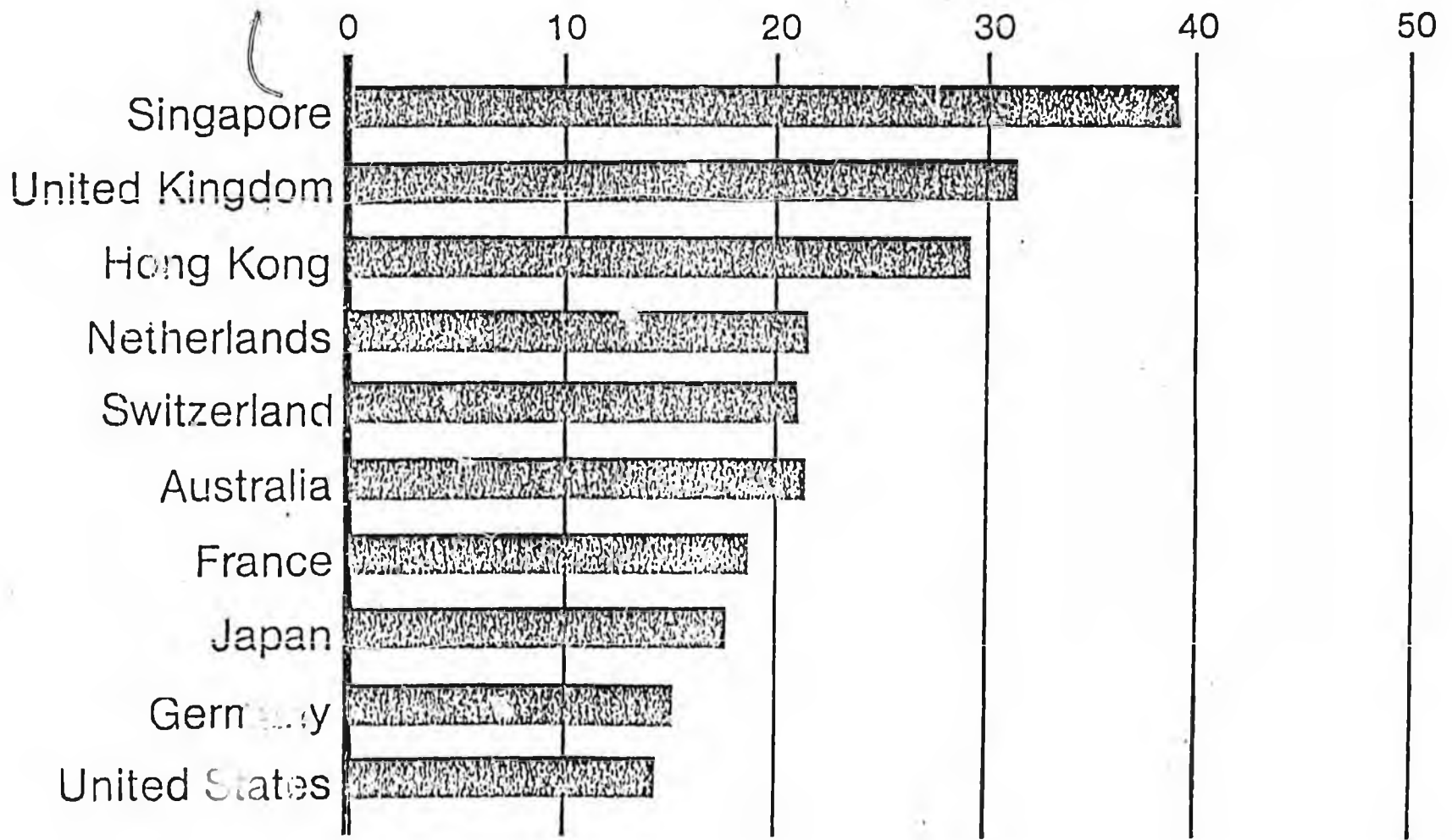


Foreign markets have shown better returns than the U.S. market for the past ten years.

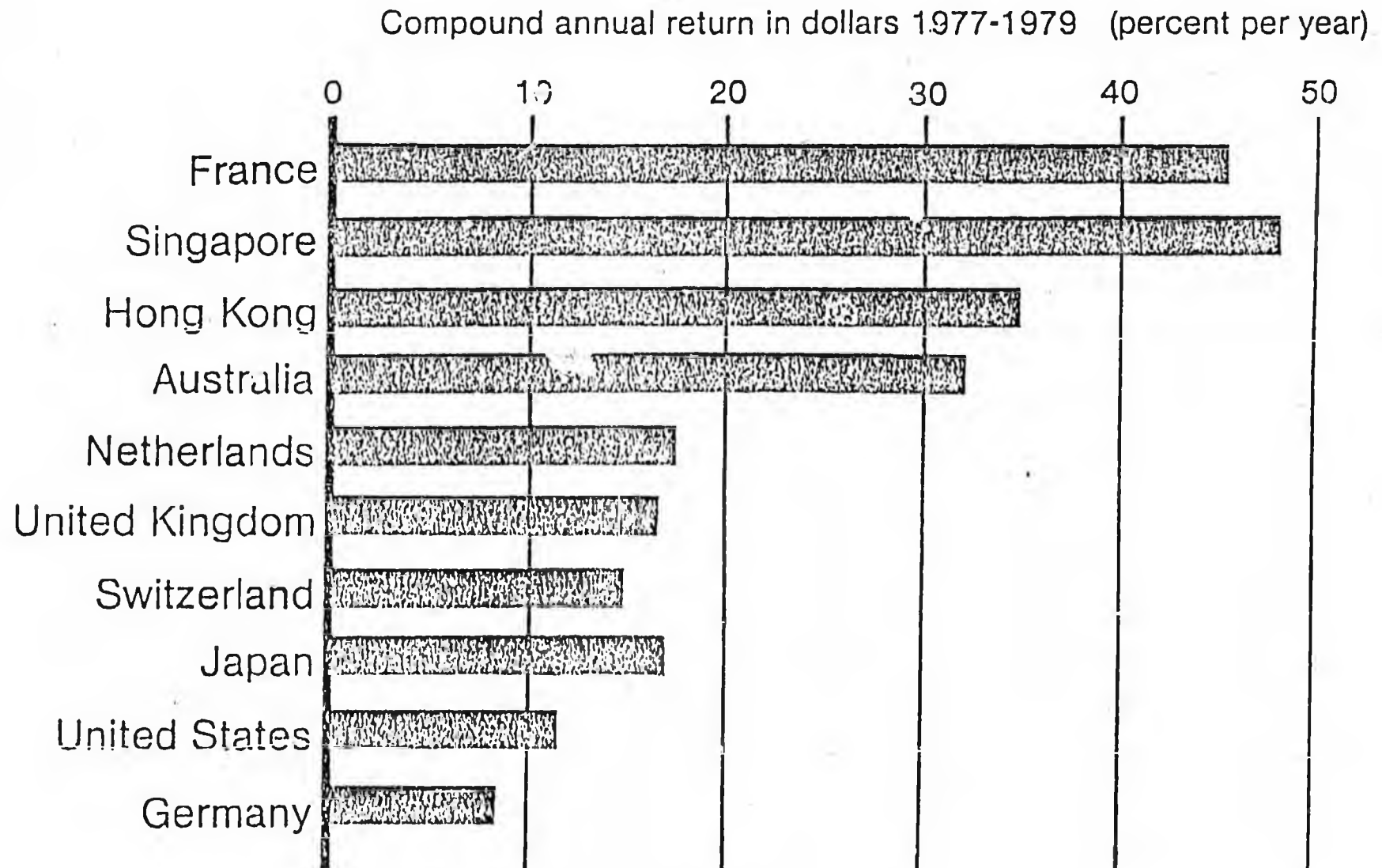


Foreign markets have shown better returns than the U.S. market for the past five years.

Compound annual return in dollars 1974-1979 (percent per year)



Foreign markets have shown better returns than the U.S. market for the past two years.





TOTAL RETURNS ON INVESTMENT FROM MAJOR WORLD STOCK MARKETS
BEFORE AND AFTER U.S. INFLATION FOR THE FIVE YEARS 1974-'78+

	TOTAL RETURNS LOCAL CURRENCY	TOTAL RETURNS U.S. \$ TERMS	INFLATION in U.S.	TOTAL RETURNS AFTER U.S. INFLATION
U.S.	4.29	4.29	7.94	-3.38
Japan	9.48	17.72		-9.06
U.K.	14.54	11.61		3.40
Germany	11.85	21.04		12.14
France	6.70	10.13		2.03
Switzerland	1.37	16.84		8.25
Australia	9.92	4.44		-3.24
Canada	5.40	1.93		-5.57
EAFE*		12.11		3.86

*Europe, Australia, Far East Indices of sixteen markets, weighted according to their size. Prepared by Capital International, Geneva.
+ percent per annum, compounded.



INTERSEC RESEARCH CORP.
Registered Investment Advisers

Consultants on International Diversification
for Pension Managers

TOTAL RETURNS ON INVESTMENT FROM MAJOR WORLD STOCK MARKETS
BEFORE AND AFTER U.S. INFLATION FOR THE THREE YEARS 1976-'78+

	TOTAL RETURNS LOCAL CURRENCY	TOTAL RETURNS U.S. \$ TERMS	INFLATION in U.S.	TOTAL RETURNS AFTER U.S. INFLATION
U.S.	6.92	6.92	6.86	.06
Japan	24.49	30.73		22.33
U K.	17.12	17.42		9.88
Germany	3.82	19.49		11.82
France	10.28	12.93		5.68
Switzerland	2.34	20.76		13.00
Australia	10.31	7.16		0.28
Canada	14.77	9.13		2.12
EAFE*		18.39		10.79

*Europe, Australia, Far East Indices of sixteen markets, weighted according to their size. Prepared by Capital International, Geneva.
+ percent per annum, compounded.

250

225

200

175

150

125

100

75

50

MORGAN GUARANTY INTERNATIONAL EQUITIES FUND
COMPARATIVE PERFORMANCE-JAN. 1974 = 100 : DIVIDENDS
REINVESTED

— INTERNATIONAL EQUITIES FUND
- - - CAPITAL INTERNATIONAL INDEX-EUROPE,
AUSTRALIA AND FAR EAST
+ + + S&P 500

1974

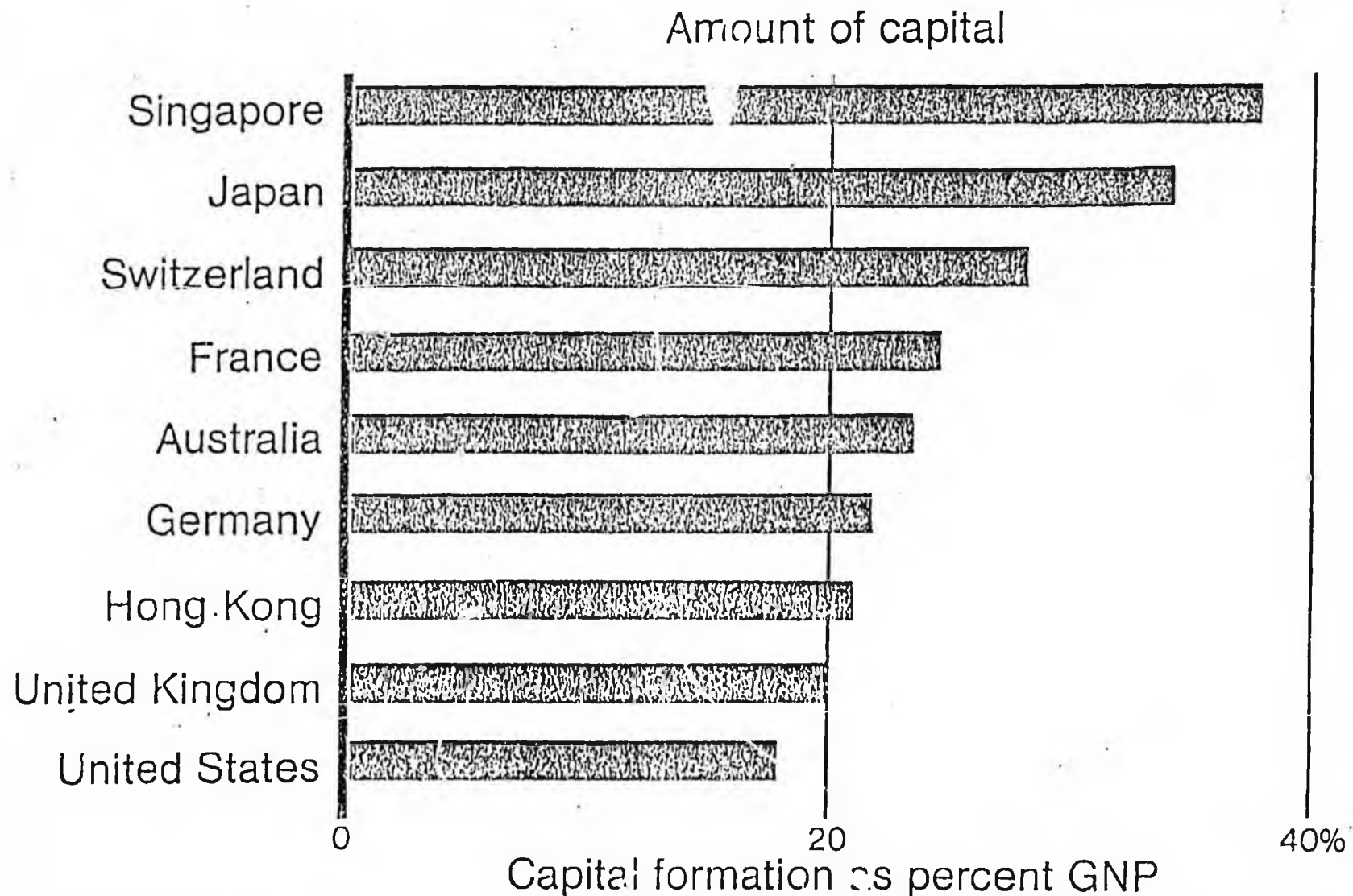
1975

1976

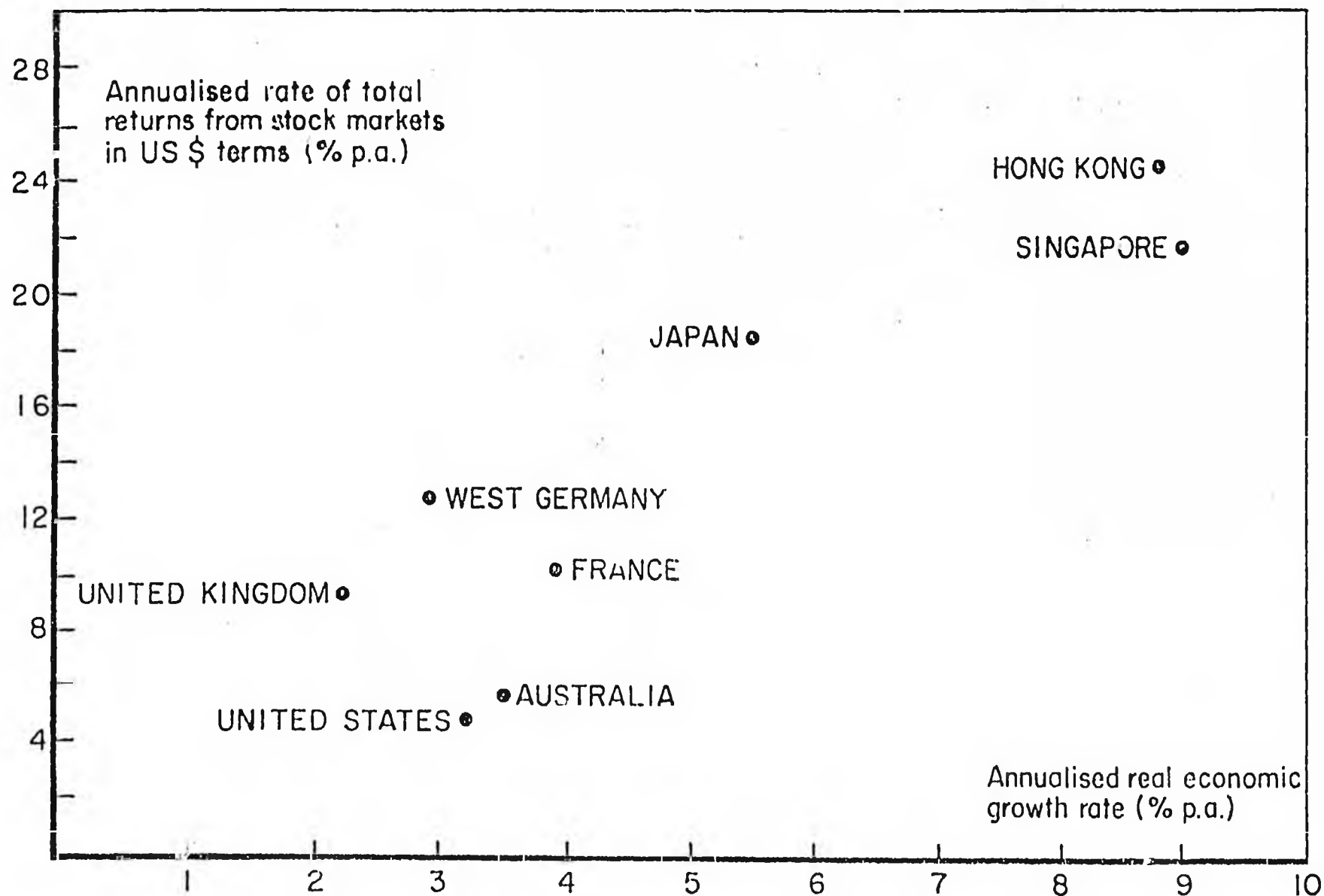
1977

1978

Greater capital formation in foreign countries leads to greater economic growth.



I. RELATION BETWEEN REAL ECONOMIC GROWTH AND STOCK MARKET RETURNS 1970-1979

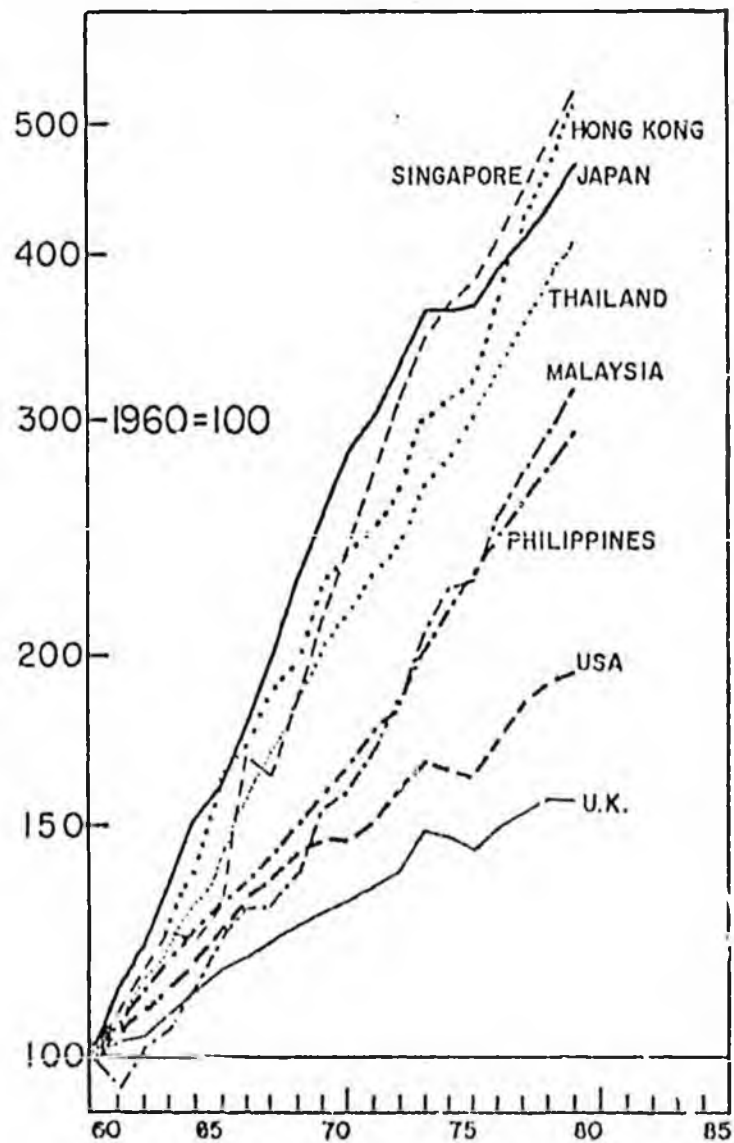


V. PROSPECTS FOR PROSPERITY IN THE 1980's

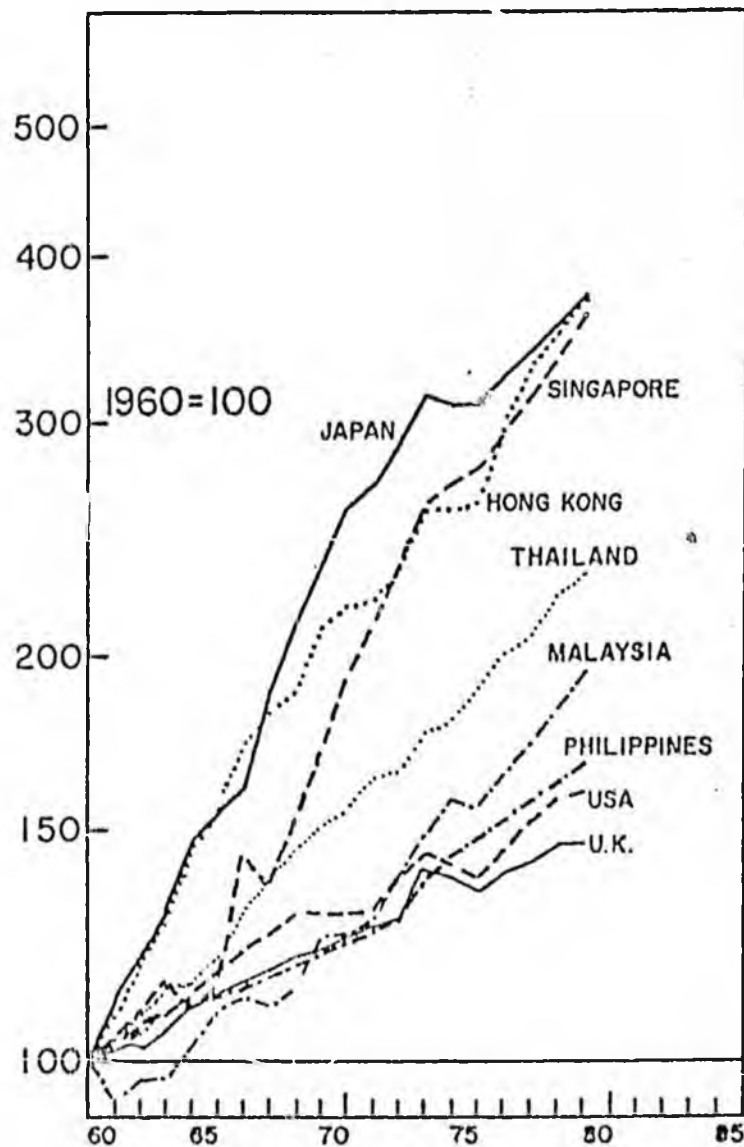
<u>GOVERNMENT CONSUMPTION AS % OF GNP IN 1978</u>	<u>SAVINGS RATE IN 1977</u>	<u>PRIVATE FIXED CAPITAL FORMATION AS % OF GNP IN 1978</u>
UNITED STATES 20.5	JAPAN 21.5	SINGAPORE 22.9
UNITED KINGDOM 20.2	FRANCE 16.1	WEST GERMANY 22.9
WEST GERMANY 20.0	WEST GERMANY 14.0	JAPAN 20.4
AUSTRALIA 16.9	UNITED KINGDOM 13.9	HONG KONG 18.2
FRANCE 15.3	UNITED STATES 5.1	UNITED STATES 15.5
SINGAPORE 11.1		AUSTRALIA 14.1
JAPAN 9.5		UNITED KINGDOM 9.7
HONG KONG 6.0	Not Available: Australia, Hong Kong, Singapore	Not Available: France

IV ECONOMIC PROGRESS IN THE FAR EAST

GROSS DOMESTIC PRODUCT GROWTH IN ASIA



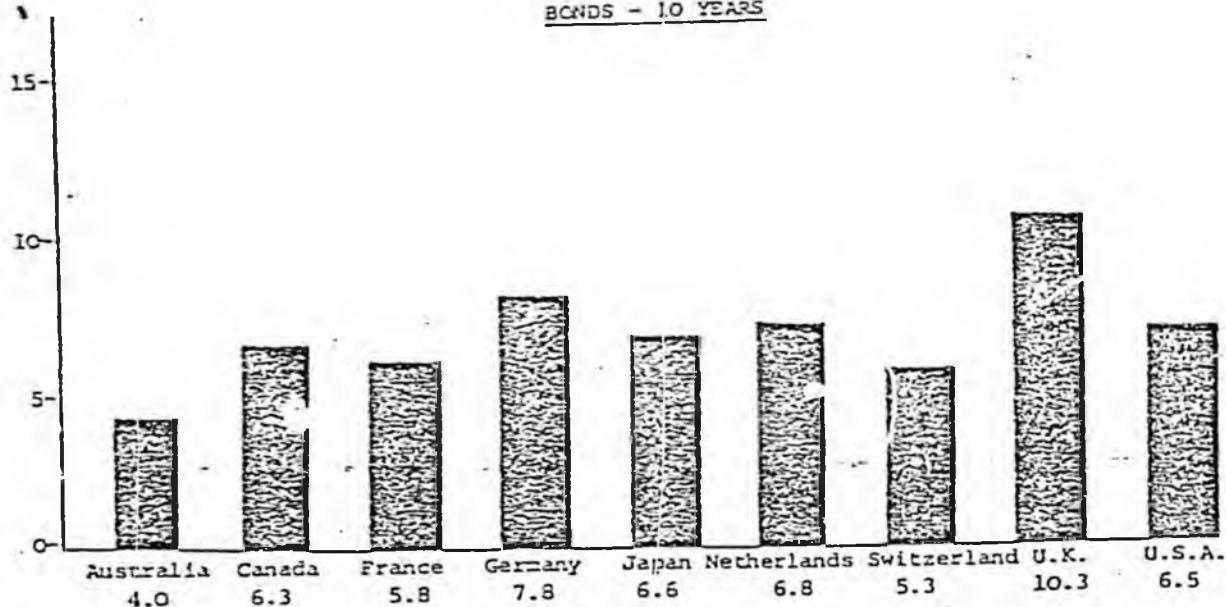
REAL PER CAPITA GDP IN ASIA



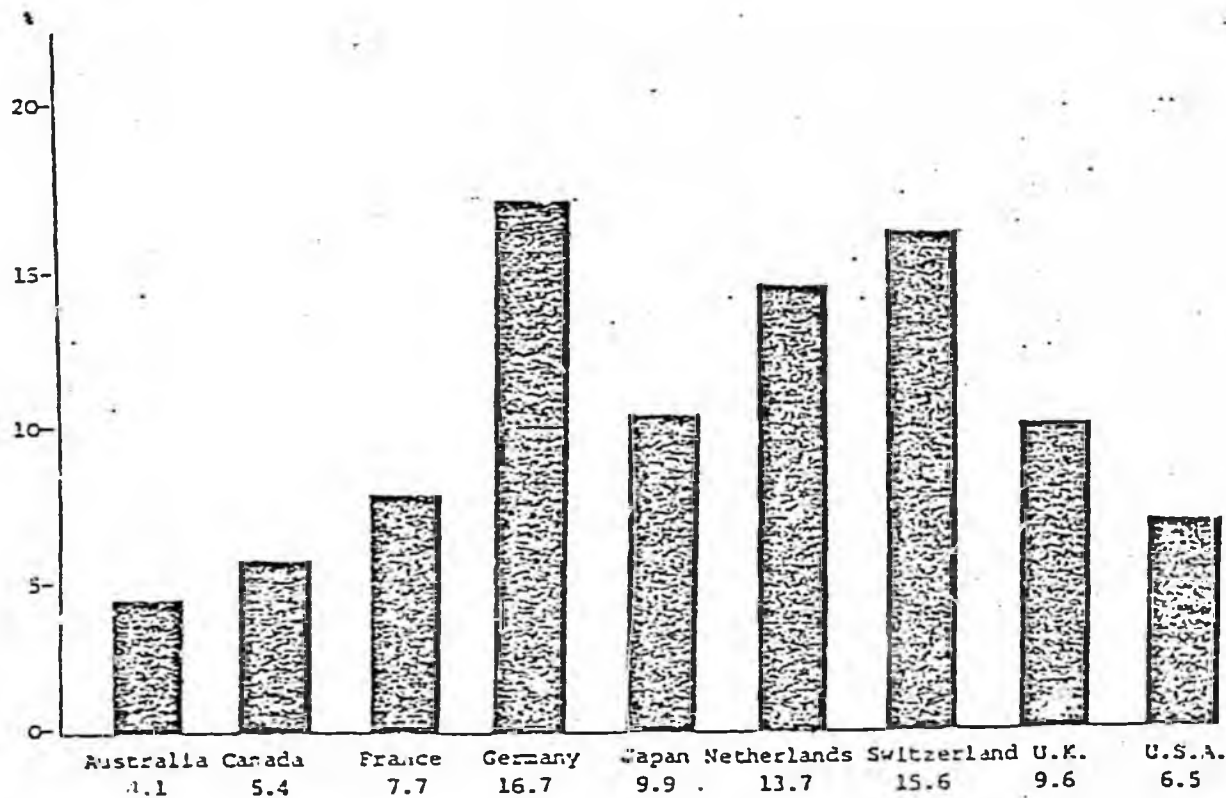
Average Annual Rates of Total Return
Bond Markets - No Currency Adjustment

1970-1979

BONDS - 10 YEARS



Average Annual Rates of Total Return
Bond Markets - Adjusted for Currency Movements relative to Dollar

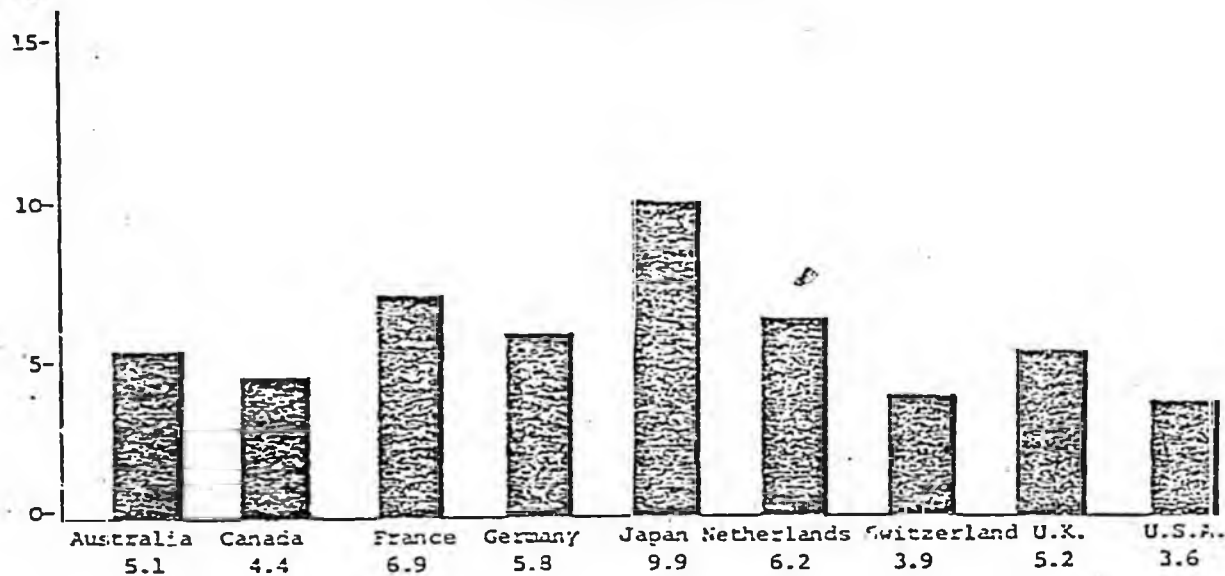


Source: Kleinwort, Benson Ltd., London

Average Annual Rates of Total Return
Bond Markets - No Currency Adjustment

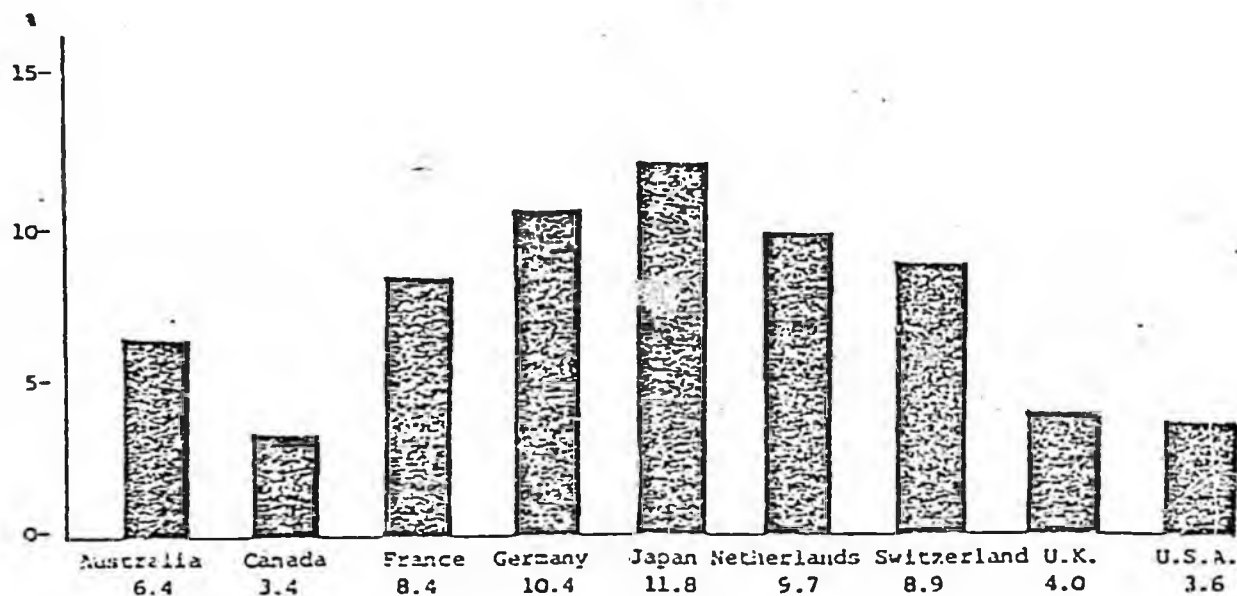
1960-1979

BONDS - 20 YEARS



Average Annual Rates of Total Return
Bond Markets - Adjusted for Currency Movements Relative to Dollar

1960-1979



Source: Kleinwort, Benson Ltd., London

THE CASE FOR EURODOLLAR DEPOSITS AND C. D.s

Eurodollar time deposits and Eurodollar certificates of deposit are time deposits denominated in U. S. dollars and accepted or issued by the London branches of major European, United States, Canadian, and Japanese commercial banks as well as the international subsidiaries of United Kingdom clearing banks. The Eurodollar deposit and C. D. markets grew rapidly in the 1960's in response to measures taken by the United States to restrict the outflow of dollars. Significant growth is also attributable to the tight money periods of 1966 and 1969 when short term rates in the United States rose above the maximums U. S. commercial banks could pay on domestic time deposits in accordance with Regulation Q. This forced U. S. banks to borrow heavily from their branches abroad where interest rates were not regulated.

As the result of recurrent balance of payments problems during the 1960's, such foreign investment controls as the Interest Equalization Tax, Voluntary Foreign Credit Restraint Guidelines, and Overseas Foreign Direct Investment Regulations were instituted. Although these controls effectively closed the U. S. capital markets to foreign borrowers and prevented U. S. firms from transferring capital abroad, they contributed significantly to the development of an active market for U. S. dollars on deposit outside the U. S. In early 1974, these control programs were all eliminated. Many observers thought that the Eurodollar market as a result would disappear. However, since no reserve requirements were levied on these deposits, the continued growth of the Eurodollar market was assured. The lack of reserve requirements enabled banks to pay higher interest on deposits while at the same time charging a lower rate on loans and still to increase profits. The volume of outstanding Eurodollar negotiable C. D.s continued to grow to its present size of approximately \$32 billion while the much larger Eurodollar deposit market has grown to an estimated \$425 billion.

Most Eurodollar negotiable C. D.s are issued with maturities up to one year by prime international banks. Banks usually quote rates for three, six, and twelve month maturities, corresponding to their loan rollover requirements, rather than for all maturities as in the United States. U. S. purchasers of Eurodollar C. D.s include commercial bank portfolios and trust departments, corporations, insurance companies and various other institutions. In addition, a large number of foreign entities are active participants in the Eurodollar C. D. market. Investors generally receive an additional 1/8 to 1/4% in yield over domestic C. D.s of the same issuer and maturity while a holder of a non-negotiable Eurodollar time deposit normally picks up still an additional 1/8 to 1/4%. These spreads may change as the result of the recent (November 13, 1980) requirement that U. S. and foreign agency banks hold 3% reserves against their net balances due to foreign branches. It is still too early to determine what the likely impact of this reserve requirement on the Eurodollar markets will be.

Many investment bankers and commercial banks actively trade Eurodollar C. D.s providing liquidity to these investment instruments. The standard trading units are multiples of \$1,000,000. The trading volume of Eurodollar

C. D.s has grown steadily from a monthly average turnover of about \$2.1 billion in 1974 to more than \$12 billion in mid-1979 with trades of \$20 to \$25 million not uncommon. Trading activity in the market is influenced not only by normal seasonal pressures affecting the domestic C. D. market but also by periodic loan rollover pressure and foreign exchange developments which may have a significant impact on rates, thereby presenting opportunities for the investor.

With regard to credit risk, the deposits are general obligations of the issuing bank under the laws of England where they are issued and payable. Holders of these deposits are creditors of the entire bank and not just the issuing branch. If a branch failed to pay a C. D. because of insolvency, it could be enforced against the head office of the bank. A depositor or C. D. holder could be negatively affected by government action in two ways. One would be an action of the English government such as its imposition of currency controls or interest limitations and the other would be by the action of the bank's head office. This could take the form of modification or termination of the issuing bank's liability regardless of where the holder sought payment. The chances of such governmental action are viewed as highly unlikely.

**Yields of Three and Six Month-Eurodollar Certificates of Deposit
and their Yield Spreads above U.S. Prime Certificates of Deposit**

<u>First of Month</u>	<u>Yields-</u> <u>Eurodollar C.D.</u>		<u>Yield Spreads-</u> <u>Euro \$ vs. U.S. C.D.s</u> <u>(In Basis Points)</u>	
	<u>Three</u>	<u>Six</u>	<u>Three</u>	<u>Six</u>
	<u>Month</u>	<u>Month</u>	<u>Month</u>	<u>Month</u>
1974-Jan.	10.00%	10.00%	+ 80	+150
Apr.	9.81	9.81	+ 6	+ 51
July	13.31	13.31	+121	+151
Oct.	11.69	11.75	+ 89	+105
1975-Jan.	9.63	9.44	+ 53	+ 74
Apr.	6.55	6.94	+ 46	+ 54
July	6.50	7.00	+ 20	+ 30
Oct.	7.63	8.25	+ 53	+ 20
1976-Jan.	5.63	6.25	+ 13	+ 30
Apr.	5.31	5.88	+ 11	+ 28
July	5.88	6.50	+ 14	+ 30
Oct.	5.56	5.75	+ 21	+ 25
1977-Jan.	4.88	5.00	+ 23	+ 20
Apr.	5.06	5.31	+ 16	+ 16
July	5.63	5.81	+ 25	+ 21
Oct.	6.69	6.94	+ 29	+ 24
1978-Jan.	7.00	7.25	+ 20	+ 25
Apr.	7.20	7.50	+ 35	+ 20
July	8.35	8.70	+ 25	+ 15
Oct.	9.30	9.60	+ 40	+ 35
1979-Jan.	11.45	12.00	+ 55	+ 50
Apr.	10.35	10.82	+ 35	+ 32
July	10.40	10.38	+ 60	+ 51

Volume Outstanding of U.S. and Eurodollar Certificates of Deposit
and Secondary Market Turnover of Eurodollar Certificates of Deposit
(Billions of U.S. Dollars)

Mid-month (Approx.)	U.S. C.D.s	Eurodollar C.D.s	
	Total Outstanding (1)	Total Outstanding (2)	Secondary Market Turnover (3)
1974-Jan.	65.6	11.1	2.3
Apr.	71.8	13.7	2.0
July	83.0	13.0	1.4
Oct.	88.7	12.5	2.5
1975-Jan.	91.4	11.6	3.3
Apr.	85.2	11.2	2.2
July	80.9	11.8	2.1
Oct.	83.3	12.4	3.7
1976-Jan.	79.1	13.3	5.1
Apr.	69.9	14.1	4.6
July	69.5	14.9	5.0
Oct.	64.6	15.7	5.4
1977-Jan.	82.8	15.9	6.2
Apr.	59.9	17.0	5.7
July	62.5	19.0	6.3
Oct.	68.5	21.7	6.1
1978-Jan.	75.8	21.9	7.4
April	80.7	21.9*	7.5
July	87.3	22.0	4.7
Oct.	90.0	23.5	0.8
1979-Jan.	96.5	27.5	11.8
Apr.	86.5	28.1	9.3
July	79.3	32.2	12.4

REAL ESTATE INVESTMENT MARKET & REAL ESTATE EQUITY POOLS

Until the early 1960's the real estate investment market in the United States was primarily controlled by the real estate developer and the small investor or investor group. There were few large real estate projects and those that were built were either financed or owned by one of a few insurance companies purchasing for their own investment account. Industrial property was usually owned by the corporate user or leased from local investors. The market place was highly fragmented and very much an activity at the local level. Developers had small organizations and essentially seat-of-the pants entrepreneurs.

The 1960's saw an explosive demand for manufacturing, warehousing, retail, commercial and office facilities. The larger industrial and office park concepts were created and the increasing demand for capital led most corporations to a leasing posture. This was appropriate for warehousing and office facilities as a way to conserve capital for business and as a strategy which allowed reaction to changing markets. Family formation growth led to rapid residential suburban growth and as residential developments grew so did retail and commercial developments. The shopping center grew from infancy to maturity as regional enclosed mall centers creating a mini-downtown which had a major impact on residential and commercial growth patterns. During this period a very few pension funds began to acquire industrial and commercial properties for investment. At the same time, more insurance companies began to add properties to their investment portfolios. The institutional real estate investment market began to take on the characteristics of a regional and in some cases a national market.

As we moved into the 1970's real estate projects increased rapidly in size and complexity demanding a broader range of professional skills. The size of real estate development organizations expanded to handle regional as well as national areas as well as a national market.

The 1974-1976 recession dampened much corporate involvement in real estate but the demand and growth for investment grade real estate product remained intense. Demand for pension fund real estate investments during the latter part of the 1970's drove down the current cash return on investments. Appreciation in value and rapidly rising rental rates created even more demand as real estate appeared attractive as an alternative pension investment vehicle.

As we move into the 1980's, commercial and industrial grade real estate will become more and more an institutional market. The long term mortgage market is likely to see a radical change necessitating substantial equity to be raised for larger real estate projects. This will squeeze the smaller developers or will force them to sell or joint venture their projects with institutions and pension funds. The very large development projects will become exclusively an institutional and pension fund market.

Consequently, the demand for real estate facilities from the user side is currently very strong and promises to remain so during the 1980's and beyond. The demand for quality investment grade real estate by institutions and pension funds will be even stronger. This will predictably result in lower current returns and stretched out

periods to realize long term return on investment objectives. The demand from both the user and investor side combined with the effects of inflation and government regulations will continue to push real estate up at a substantial rate. Commercial and industrial real estate investments should continue to provide superior long-term returns on investments.

In the last 10 years many trust, pools or funds have been established to participate in the advantages of real estate investments. They consisted of larger mortgage companies, banks, brokerage houses and insurance companies to name a few. Insurance companies led the way since in many cases they had been involved in real estate lending or purchasing for their portfolio for the past 100 years or longer.

Real estate is not a passive investment. It is a highly complicated field requiring creative ability, qualitative as well as quantitative analysis, and most of all experience. Owned real estate has its own risk parameters quite different from those of other investments. Once purchased, it has to be managed properly. Real Estate is susceptible to vacancies, demographic change, imbalance of income to expenses, and overbuilding to name a few. Major insurance companies have the expertise as well as offices all over the country, and this is a major advantage not available to most other managers. Real Estate pools offer protection against downside risk due to vacancies or rapidly escalating operating costs. Prudently selected and maintained Real Estate can be considered a viable supplement to other portions of a portfolio.

Funds accepted for real estate pools are limited to the properties available for purchase in any given period. You advise them of your intention to join and give them an indication of the amount you would like to deposit. They will accept your funds on a quarterly basis only, and then only if they have sufficient properties in line for purchase the following quarter. They will not guarantee acceptance of your funds in a specified time frame. They will not purchase unqualified properties just because funds are available.

Just as it is sometimes difficult to get in a real estate pool, it also takes time to withdraw. It must be realized that real estate investments are relatively illiquid and should be considered long term investments. They will not force sell a property just because you want to withdraw your funds. Most pools require 90 days written notice prior to any quarterly date. This allows them time to find other investors who want to invest in the pool, thus allowing you to withdraw. However, if cash available in the pool is sufficient to allow your withdrawal earlier, they will honor your request.

We're sure everyone will agree that any investment portfolio, pension fund or permanent fund in this case, should have the ability to diversify its investments. We have all witnessed the ups and downs in stock and bond markets over the years. Good real estate on the other hand on average has always increased in value. Investment decision makers have finally been convinced that real estate deserves a place in a well diversified portfolio. We believe that the current trend toward real estate as a major investment asset is both justified and of growing importance.

Many investment managers have been aware of the advantages of real estate investing but were discouraged from participating in real estate due to the lack of liquidity and risk characteristics associated with outright ownership. Real estate pool investments are designed to overcome these problems. Pool investment offers well managed diversification characteristics tailored to meet the risk to expected return and liquidity requirements of participants. The pools offer the investment advantages of a portfolio of high quality real estate, diversified by property type, lease term, tenant type and geographic location, combining a potential for capital appreciation with an attractive level of current income.

That last sentence says it all and deserves expanding upon:

Advantages

Real Estate equity pools are designed to deliver all of the advantages investors seek from real estate, without the complexities of outright ownership.

Return Potential

Over the years, carefully selected real estate has demonstrated a consistent ability to produce attractive yields.

Inflation Hedge

A rapid increase in real estate values has become increasingly evident in recent years as escalating construction costs have exerted upward pressure on the replacement cost of commercial and industrial properties. An attractive hedge against inflation.

Portfolio Diversification

Real estate assets produce very positive diversification characteristics when introduced into the typical portfolio of stocks, bonds, mortgages and money market investments to name a few.

A real estate pool also provides diversification of property types such as shopping centers, apartment and office buildings, motels, hotels, industrial and warehouse buildings, etc. Geographic diversification is provided through purchases of property from coast to coast including Alaska.

As more and more investors become aware of the advantages of diversification and returns available on these pools, the demand has been increasing. With this demand there has been an increasing number of pools going on line, which makes good real estate investments harder to find.

The better real estate pools do not speculate as Real Estate Investment Trusts (REIT's) did back in the late sixties and early seventies. Real Estate Investment Trusts began in 1960 when Congress passed the Real Estate Investment Trust Act.

The purpose was to provide more capital to satisfy the growing demand for long term investment money by opening the field to individual investors. The mortgage type REIT created the surge of popularity between 1969-71. Underwriters encouraged banks and others to establish trusts because the shares were easily sold and good fees were to be made. The REIT's borrowed heavily from banks and others to support their demand for more money to lend construction and development projects. Serious problems began to surface in 1974 when the prime rate soared past 12% and some construction loans reached 18% to 20%. Many could not pay and projects could not be completed and many failures resulted. Insurance company pools do not sell shares to the public, do not get involved in development projects until completed, and best of all do not borrow money to purchase real estate investments.

The insurance companies described on the following pages, in our opinion, are among the best in the industry. Other pools are available, some managed by non insurance companies, and other insurance companies also have pools. We presently have retirement systems funds in the pools with companies used as examples.

PRUDENTIAL INSURANCE COMPANY OF AMERICA

Prudential is the largest private real estate investor in the United States. As of June 1980 their estate investment department employed a professional staff of almost 500 persons located in Prudential Corporate Headquarters and 71 field offices in the United States and Canada. They manage nearly \$18 billion of real estate investments, including \$14 billion in mortgages, \$3 billion in wholly owned properties and over \$1 billion in joint ventures throughout the United States.

Because of their nationwide structure, the real estate department has established direct working relationships with regional and national real estate developers, brokers, managers, and investors. These relationships allow Prudential to consider property opportunities on a national basis.

Prudential Property Investment Separate Account (PRISA)
 (\$2 billion) Annual Historical Performance

<u>Year</u> <u>Ending</u>	<u>Gross</u> <u>Return</u>	<u>Net</u> <u>Return</u>	<u>Breakdown of</u> <u>Net Return</u>	
			<u>Income</u>	<u>Appreciation</u>
12-31-79	25.4%	23.9%	8.8%	15.1%
12-31-78	20.9	19.5	9.0	10.5
12-31-77	12.0	10.7	7.8	2.9
12-31-76	9.3	8.5	7.5	1.0
12-31-75	9.5	8.3	7.0	1.3

Geographical Location

<u>As of 6/30/80-%</u>	<u>Regions (30 States)</u>
22%	West
20%	South
18%	Mid-West
40%	East

Property Diversification

39%	Office Buildings
23%	Industrial Buildings
16%	Hotels & Motels
19%	Shopping Centers
3%	Apartments

AETNA LIFE INSURANCE COMPANY

Aetna's Real Estate Department has been in operation for over 100 years, and in the last 10 years has established an equity unit responsible for buying and managing equity real estate. Aetna's real estate and mortgage portfolio exceeds \$5 billion. The real estate department is comprised of 130 employees with a variety of backgrounds in real estate. The department utilizes both correspondents and direct lending capabilities. They are affiliated with over 85 mortgage bankers in major metropolitan areas who are under contract to produce real estate and mortgage investments. Their internal National Accounts unit deals directly with major real estate development companies which operate on a national basis.

Aetna Real Estate Separate Account
(\$300 MM) Annual Historical Performance

	<u>Yield</u>	<u>Appreciation</u>	<u>Total Return</u>
Jan.-Dec., 1978	7.73%	.82%	8.55%
Jan.-Dec., 1979	9.03%	3.54%	12.57%

Geographic Distribution

<u>As of 6/30/80-%</u>	<u>Regions</u>
30%	Rockies
16%	South
18%	Mid West
3%	East
33%	West

Property Diversification

45%	Retail Buildings
2%	Land
20%	Office Buildings
19%	Industrial
14%	Warehouse Buildings

JOHN HANCOCK MUTUAL LIFE INSURANCE COMPANY

The John Hancock's Real Estate Department has been in existence for over 100 years and currently manages a portfolio of commercial and agricultural real estate and mortgages of all types in excess of \$4 billion. In addition to a staff of in-house professionals including 50 mortgage investment officers, they have advisory and origination capability from a network of 58 mortgage banking firms and their branch offices located in major metropolitan cities from coast to coast. They also have eight agricultural loan agencies in the major farm areas of the country, and maintain extensive contact with major property developers as well as the mortgage and real estate brokerage community.

(\$350 MM) Equity Real Estate Account (ERA)
Annual Historical Performance

	<u>Yield</u>	<u>Appreciation</u>	<u>Total*</u> <u>Return</u>
Jan. - Dec., 1977	9.1%	1.2%	10.3%
Jan. - Dec., 1978	9.3	2.5	11.8
Jan. - Dec., 1979	10.2	8.8	19.0

Geographic Distribution

<u>As of 6/30/80-%</u>	<u>7 Regions (21 States)</u>
11%	New England
13%	Middle Atlantic
15%	Southeast
30%	Midwest
5%	Southcentral
13%	Mountain/Southwest
13%	Pacific

Property Diversification

32%	Industrial Buildings
8%	Hotel
28%	Warehouse Buildings
13%	Office Buildings
17%	Shopping Centers
3%	Retail Stores

EQUITABLE LIFE ASSURANCE COMPANY

Equitable's Real Estate Department has been in operation for over 115 years and has been involved in equity real estate ownership and management for over 25 years with over \$3 billion under management. The real estate department presently has a staff of over 500 full-time real estate professionals. The department utilizes both correspondents and direct lending capabilities with their own nationwide network of 40 offices. They are also the investment advisor to Equitable Life Mortgage and Realty Investors, a Boston based real estate investment trust listed on the New York Stock Exchange.

Equitable's Equity Real Estate Account
(\$1 billion) Annual Historical Performance

<u>Year</u> <u>Ending</u>	<u>Yield</u>	<u>Appreciation</u>	<u>Total</u> <u>Return</u>
12-31-75	9.8%	(2.2%)	7.6%
12-31-76	8.7%	1.5%	10.2%
12-31-77	9.1%	2.2%	11.3%
12-31-78	9.2%	4.7%	13.9%
12-31-79	9.3%	5.5%	14.8%

Geographic Distribution

<u>As of 6/30/80-%</u>	<u>Regions</u>
32%	Southern
29%	Central
15%	Western
14%	Mid-Atlantic
10%	Northeastern

Property Diversification

64%	Retail
16%	Office
15%	Industrial
2%	Hotels
2%	Land

PERFORMANCE FIGURES - POOLED REAL ESTATE ACCOUNTS

INVESTMENT RETURN NET OF INVESTMENT FEES

<u>YEAR</u>	<u>INSURANCE COMPANY</u>			
<u>Ending 12/31:</u>	<u>Prudential PRISA</u>	<u>Aetna</u>	<u>John Hancock</u>	<u>Equitable</u>
1979	23.9%	12.6%	17.8%	13.9%
1978	19.5	8.6	10.8	14.4
1977	10.7	--	9.3	10.0
1976	8.5	--	--	8.9
1975	8.3	--	--	6.3
Assets at Market 12/79 (000)	\$1,493.70	\$184.75	\$180.02	\$903.09

THE CASE FOR COMMON STOCK

One investment paradox is that common stock can be used to reduce portfolio risk. For example, adding small amounts of common stock to bond portfolios will usually reduce the standard deviation of total portfolio returns. This is due to the "magic" of diversification. In many years, such as 1979-80, stock prices go up while bond prices go down and stocks thereby provide a cushion against bad bond markets. To make this point even more specific, Salomon Brothers reports that an average which they maintain of a variety of both short and long term debt, securities provided total returns of 1.2% in 1979 and .1% in the first nine months of 1980. By contrast, the Standard & Poor's Composite Index produced total returns of 18.2% and 20.6% for the respective periods. Listed below are the total returns for common stock management achieved by Alliance Capital Management Corporation for the Alaska Teachers' Retirement System for the past six calendar years.

Performance Review

Yearly Summary	Rate of Return
1980 through Sept. 30	27.5%
1979	18.5%
1978	7.8%
1977	-3.4%
1976	23.4%
1975	28.8%
1974	-17.5%

Cumulative Return Since Inception - 106.5%

Even though there has been seemingly endless streams of negative news including ever-higher oil prices, the Iran crisis, continued double digit inflation, and rising interest rates, there are good reasons for viewing the common stock market as affording a good, long term investment opportunity.

The common stock of many companies is selling well below book value at a time when replacement costs are rising more rapidly than general price levels. At a time when diamonds, paintings, and condominiums in California have reached record levels, the assets of many American corporations are still selling at a fraction of their replacement value. From an earnings standpoint, the progress of American corporations, notwithstanding two recessions, has been dramatic. From 1969 to 1979, the Standard & Poor's 500 was flat. Corporate profits during the same period tripled.

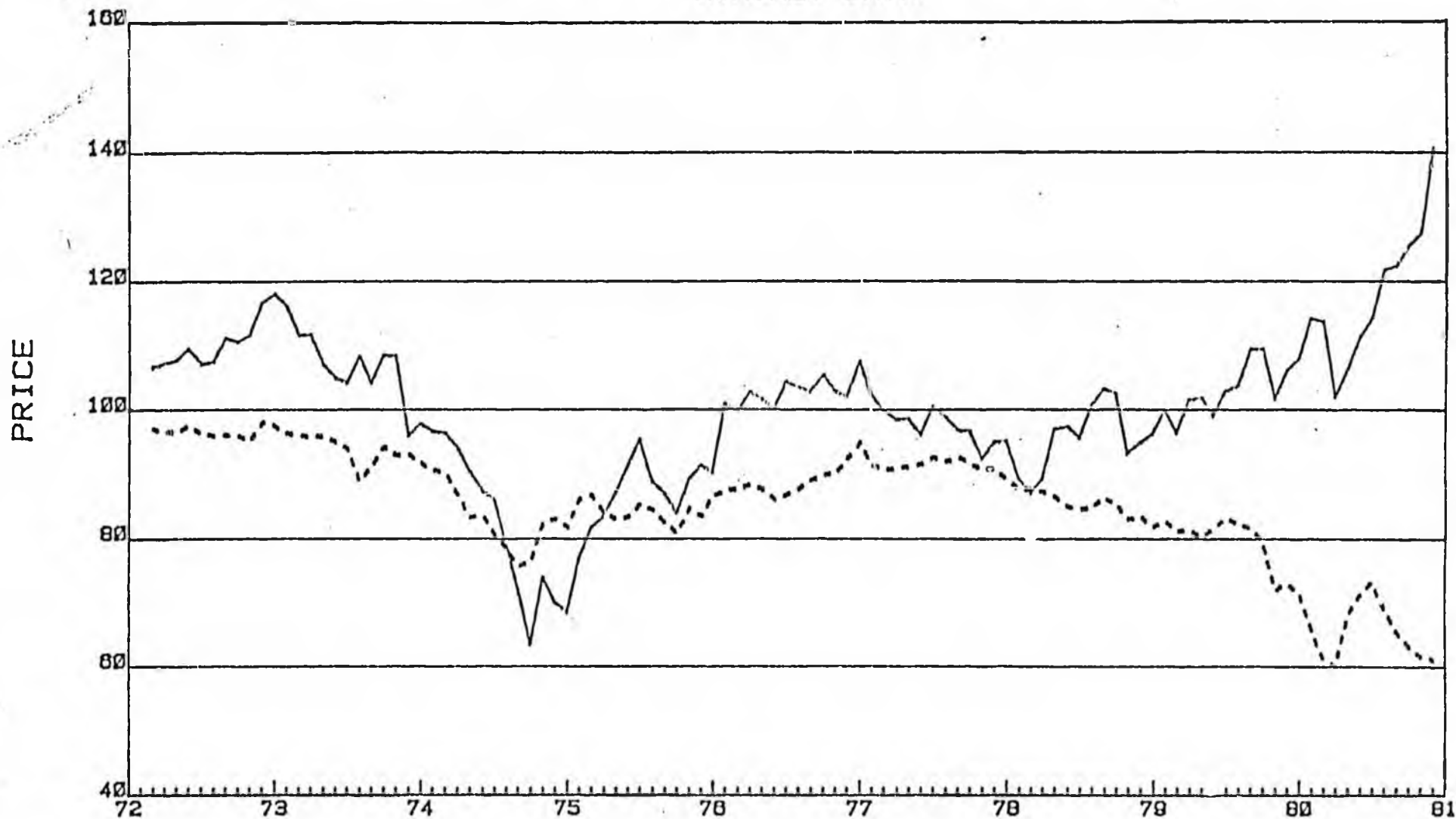
Since 1969, private pension funds have substantially reduced their holdings in common stocks. Insurance companies have reduced their equity positions to extreme low points. For example, fire and casualty companies hold only 12% of their assets in equities. Foreigners likewise hold a

record low percentage of their funds in U. S. common stocks. While foreign investors commitments to the U. S. market have fallen, their assets in gold and other currencies have multiplied many times, making their potential purchases extremely large. Japanese pension funds have been recently authorized, for the first time, to hold up to 20% of their assets in foreign securities. Individuals are another potential source of demand, having been net sellers of stock for years. On the other hand, there are estimates that \$30 billion in common stock have been taken off the market in recent years through direct corporate purchases. Given the right set of circumstances, perhaps moderating inflation, or improved tax treatment of dividends and capital gains, and a generally more favorable attitude towards capital formation this obvious potential demand could well be converted into real purchasing power producing substantially higher valuations for common stocks in general.

It is also true that over the long-term the best rates of return have been provided by the common stock market. From 1926-1979 common stocks as represented by the Standard & Poor's Composite Index have provided a 6.1% real rate of return while long-term corporate bonds have provided a real rate of return of only 1%. The cumulative impact of these differentials is graphically displayed in "Wealth Indices of Investments in the U. S. Capital Markets 1926-1978".

PRICE PROFILE

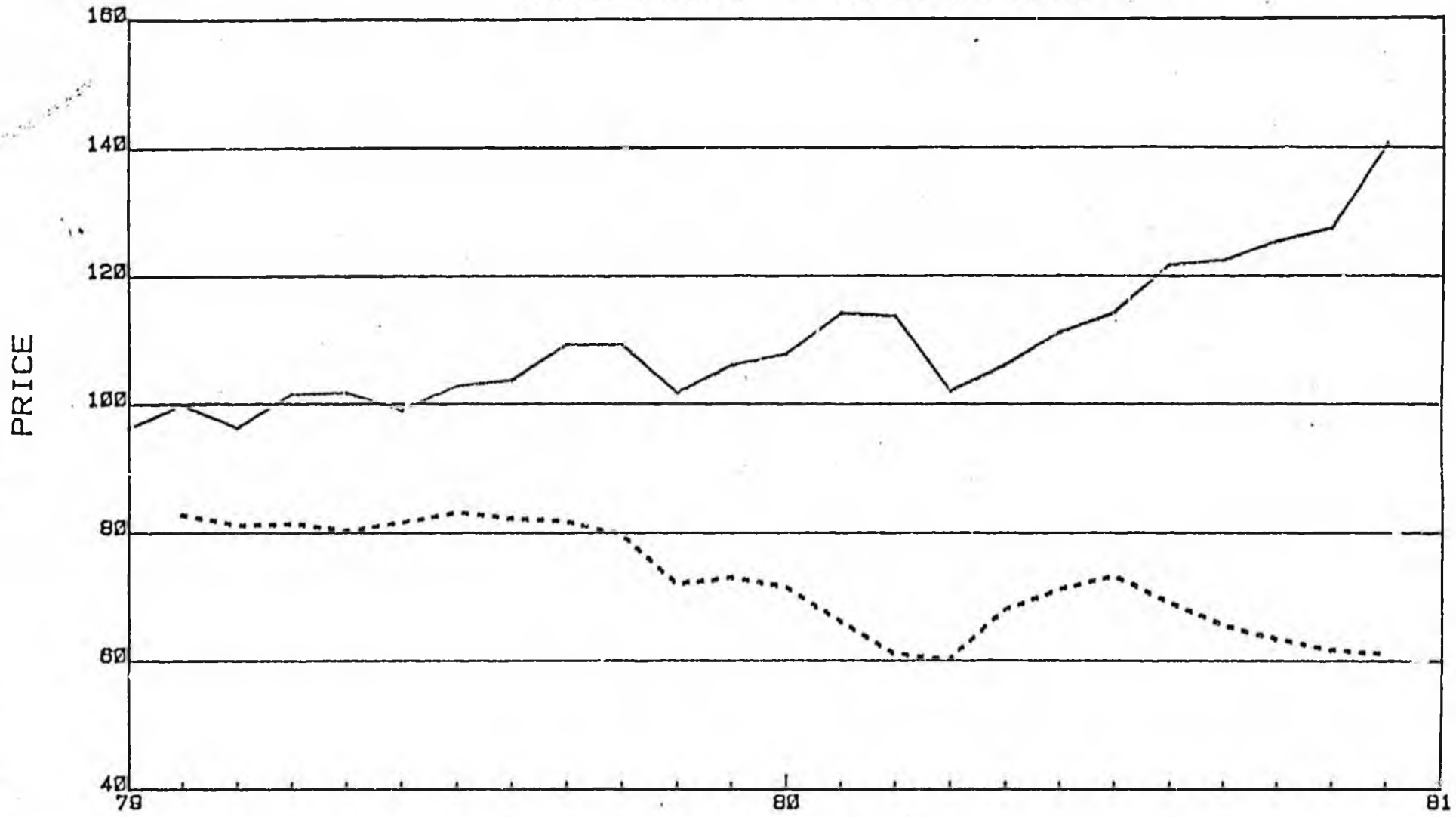
PREPARED FOR THE STATE OF ALASKA
MONTHLY DATA



— S&P 500
- - - SALOMON BOND INDEX

PRICE PROFILE

MONTHLY DATA - 12/78 TO 12/80



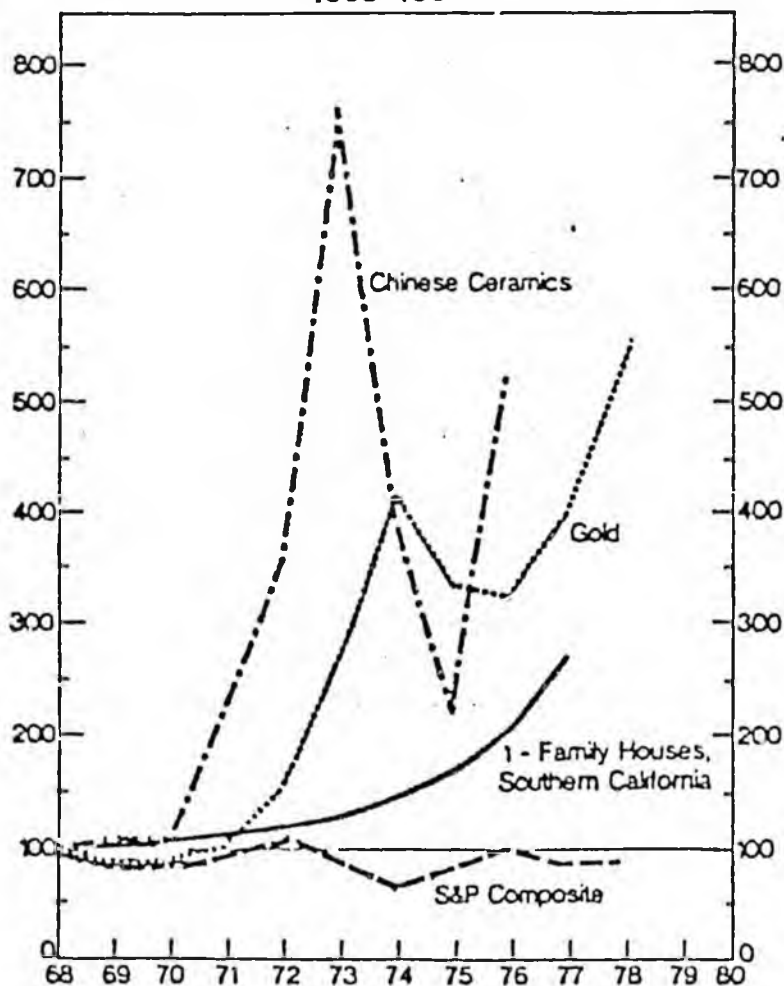
— S&P 500
- - - SALOMON BOND INDEX.

ALLIANCE CAPITAL MANAGEMENT CORPORATION

INFLATION IMPACT

	<u>1975-1979</u>	<u>9 MOS. 1980</u>
CONSUMER PRICE INDEX	47.9%	9.6%
STANDARD & POORS 500	99.9	21.0
ALLIANCE EQUITY FUND COMPOSITE	141.1	28.0

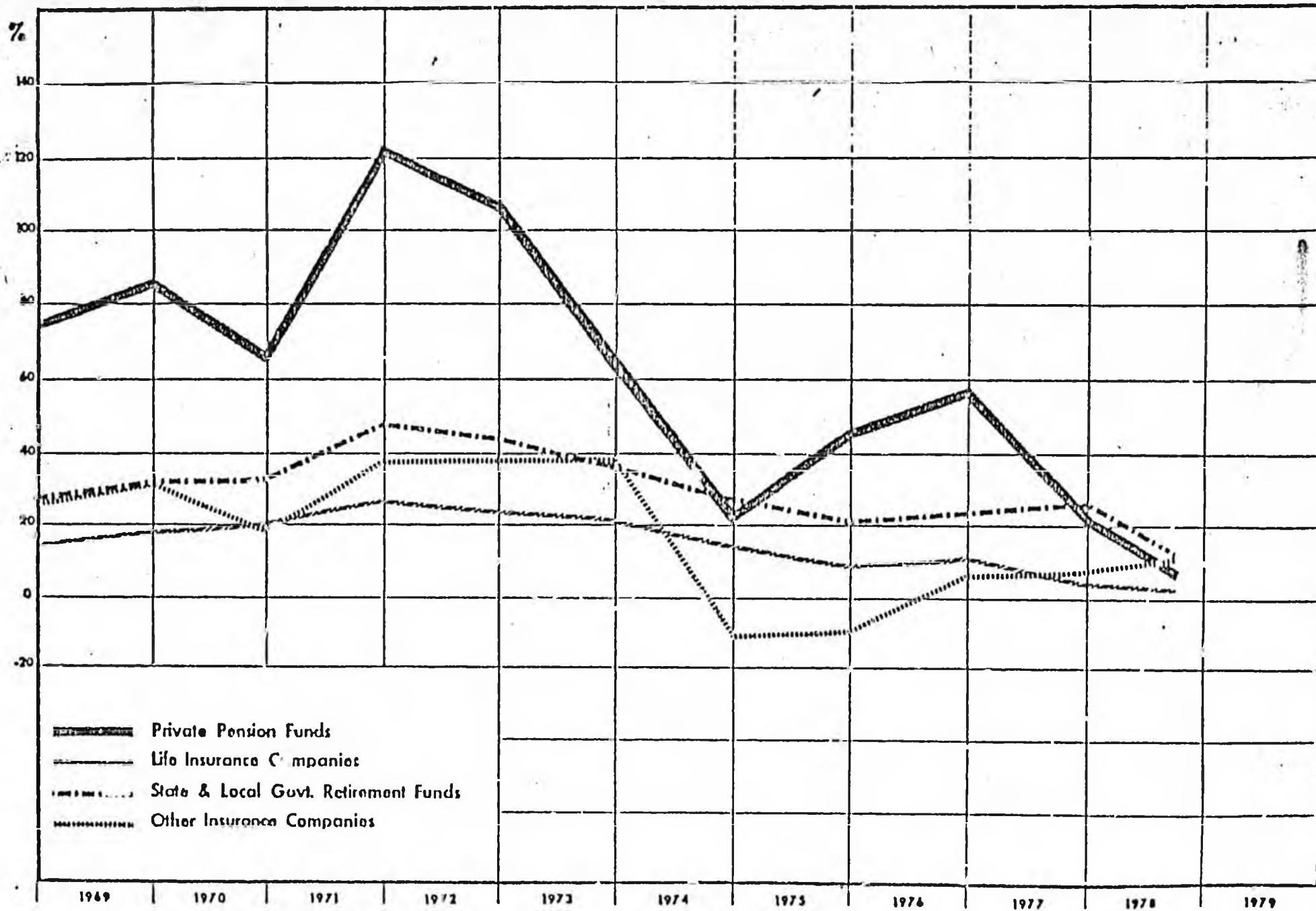
MOVEMENT OF TANGIBLE ASSET INDICES
1968=100



Source: Lehman Brothers Kuhn Loeb Research, Commodity Research Bureau, Real Estate Research Council of Southern California, Sotheby's and Parke-Bernet.

	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978
Gold	100	84	90	104	155	268	417	336	322	395	541
Year to Year % Change		-16	7	16	49	73	55	-19	-4	23	45
Chinese Ceramics	100	110	111	229	359	762	391	223	530	N/A	N/A
Year to Year % Change		10	1	106	57	112	-49	-43	137	N/A	N/A
1-Family Homes So. Cal.	100	105	109	114	119	128	146	168	205	267	N/A
Year to Year % Change		5	4	4	5	8	14	15	22	30	N/A
S&P Composite	100	84	85	93	110	89	63	83	98	86	90
Year to Year % Change		-14	-1	10	18	-19	-29	32	18	-10	2

Net Purchases of Equities as a Percentage of Cash Flow



STOCKS, BONDS, RISK FREE ASSETS & INFLATION

COMPOUND GROWTH RATES: 1926 - 1979

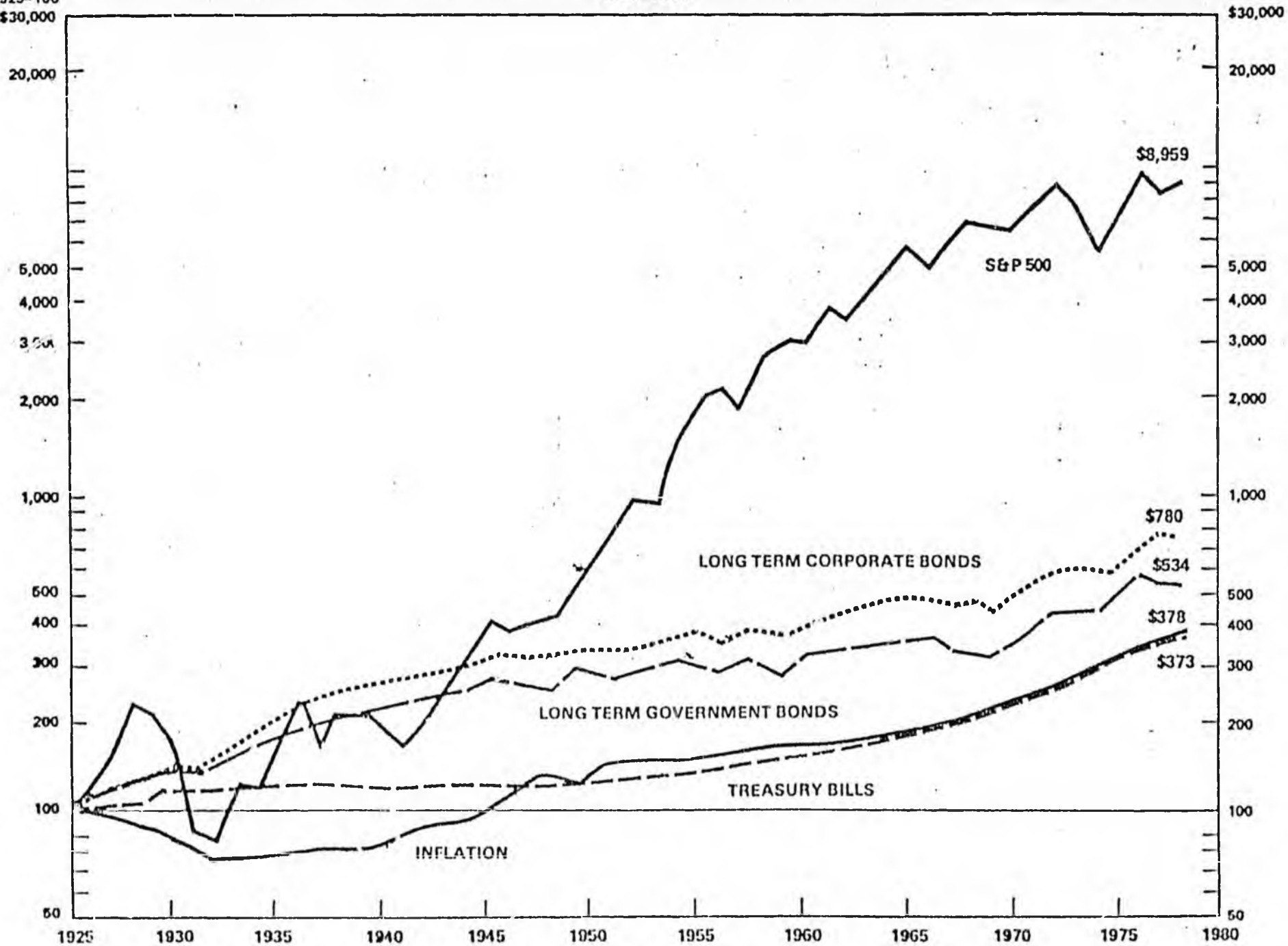
	NOMINAL	REAL
COMMON STOCKS (S & P 500)	9.0%	6.1%
LONG-TERM CORPORATE BONDS	3.8%	1.0%
TREASURY BILLS	2.7%	(0.1%)
INFLATION	2.7%	-----

Source: Ibbotson-Sinquefeld

WEALTH INDICES OF INVESTMENTS IN THE U.S. CAPITAL MARKETS

1926-1978

Index:
1925=100
\$30,000



Prepared by Alliance Capital Management Corporation based upon data presented in Stocks, Bonds, Bills and Inflation: The Past (1926-1976) and The Future (1977-2000) published in 1977 by the Financial Analysts Research Foundation.

ALASKA PERMANENT FUND CORPORATION

POUCH SB - JUNEAU, ALASKA 99911

TELEPHONE 907-463-2351

BOARD OF TRUSTEES:

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ROBERT W. WARD

RESPONDENT ADDRESS

TO: Senator Mulcahy, Chairman
Senate Labor and Commerce Committee

FROM: James B. Rhode, Special Assistant to the Trustees
Alaska Permanent Fund

DATE: March 12, 1981

SUBJECT: Sectional Analysis of Sponsor Substitute for SB 684

PREFACE

Nearly one year ago, the Trustees of the Alaska Permanent Fund and the Special Liaison Committee of the Legislature, chaired by Senator Sturgulewski, began a series of seminars and work sessions on the future of the Fund.

From the first, it was agreed to explore the issues in the context of how all the oil revenues were, or might be, spent. This was to insure that any new role for the Fund would be consistent with its fundamental purposes and, too, would be more suitably lodged in the Fund than elsewhere.

Meeting at various points in the state, the group examined the ideas of economists, financial specialists, major Alaskan interests, and the general public. This is further described in the Annual Report of the Fund (pp. 3, 5-7). The analysis offered by various professionals is soon to be published under the heading of The Trustee Papers. A special edition, including formal statements from various groups and citizens, has been compiled for the committees of referral for this bill.

SUMMARY

SB 684 contains three key proposals: (1) having the public members comprise the majority of the Trustees to slow the effects of a change of administration or a change in political moods; (2) revising the list of permitted investments to be the same as for the pension funds (with some added restrictions and excepting gold, which does not produce direct income), as holding the best hope for long-term rates of return that exceed inflation without sacrifice of safety; and (3) reinvesting one-half the Fund's earnings to protect the buying power of the Fund's principal and income from inflation, and providing that the remaining earnings be paid over on the basis of a five-year average with, in effect, a reserve to keep those payments as stable as possible for state planning.

ANALYSIS

Section 1. The replacement of a commissioner by a public member in the composition of the Trustees has the dual effect of giving the public members the working majority and requiring that majority to have special qualifications for their office. In the discussion of this provision, it was felt that the Commissioner of Revenue, as the State's chief fiscal officer, must be formally accorded the role that he will always exercise in Administration decisions on the Fund. As well, this insures the Administration will be directly informed of the views of the Trustees. The provision to eliminate one commissioner was to recognize the growing demands placed upon the cabinet in recent years. While noting the advantage of having three commissioners during the organizational phase of the Fund, it was felt that it would be difficult to expect that many to be able to devote the necessary time indefinitely.

Sections 2 and 3 have the practical effect of staggering terms so that a governor will only be able to select all of the Trustees by the last year of his term. This gives a greater measure of independence to the board over existing law (where the next governor would have chosen a majority within six months of taking office), but also mitigates the deletion of existing language (p. 2, lines 2-3) which, on the basis of a decision of the Alaska Supreme Court, does not permit confirmation by the Legislature without constitutional amendment.

In like manner, section 4, requiring that a governor remove only for good cause, is designed to replace the check in the existing statute where the Legislature, by vote, can halt a removal.

Section 5. A majority of the Trustees felt that an annual fee for members of the board was justified on several grounds: The management of a fund of this size will involve working subcommittees and considerable travel to meet with outside fund managers, with financial advisors, and with senior officials in similar institutions. Assuming the likely stature of the public members, it was thought just to compensate them for the significant loss of income entailed by their work, and wise to prevent appointees from stating that personal circumstances limited the amount of time which they could devote. The annual fee, here tied with the salaries of legislators, is to be on the order of \$20,000 a year, which is the sum typically paid by leading corporations to outside directors. This figure was consciously set to be insufficient to draw potential appointees for the sake of the fee alone.

Section 6 adds to the list of permitted investments for the Fund with the dual aims of improving long-term, real earnings and giving needed diversity. At present, the Fund is essentially a large "money market" account of the kind now open to many private individuals. However, a number of financial specialists have pointed out that, on average over the decades, these securities have only matched inflation or have been somewhat negative in terms of real earnings. The situation of the past two years, with as much as 6% return above inflation, happened but once before in this century: 1931. Interest rates were then at a bare 1% but price levels had fallen 5%, thus giving a real income of 6%. Based on this historical data, our existing investment list promises few years in which earnings can exceed inflation. In contrast, the investment areas proposed to be added (stocks, income property, and foreign assets) have brought yields in line with the long-term real growth of the United States, 2 to 4% beyond inflation and, in some years, particularly in Japan and the strongest economies of Europe, the gains have been more substantial. To be sure, not all of these investment areas have performed well in every period owing to economic cycles, political and other events, and changes of investor preference. Indeed, our advisors have stressed that no guarantees against fluctuations can be offered for any class of investments, not even the highest grade of U. S. Government securities. (Actually, in recent years, the latter have swung more sharply and more often than other instruments). Hence, the necessity of having, now, a wider selection of proven investment options so that adjustments can be timely and of enough size to win better returns while avoiding reverses - both in a manner consistent with safety of principal.

It would be well to note here that section 7 places limits on the extent to which investments, other than fixed income securities, can be made and the limits are more severe than for the pension funds. The lack of a limit on fixed income securities is not because they afford markedly greater safety; in certain markets, they do not. Rather, the projected growth of the Fund, even with declining revenues, is such that it could, absent restraints, cause these markets to rise and fall by the very fact that it was buying and selling. Further, the limits are proposed by the Trustees as part of their commitment to gain experience in these new areas on a gradual, deliberate basis.

Ironically, our present investment list is not truly "conservative," in the sense of protecting either the current dollars or real worth of the Fund's corpus and income. Our list, by the standards of comparable institutions and court rulings, is more accurately described as "traditional". Most participants in the drafting of this bill were stunned to learn that a \$10

billion fund, earning 15% a year, suffering 10% inflation, and paying over all of its returns, would shrink in 30 years to less than \$250 million in value. The goods and services that could be purchased with the income of this fund would collapse in the same ratio, from \$1.5 billion at today's prices to \$89 million in three decades. Or, more graphic still, a dividend of \$1,500 would then buy what \$89 will buy today. Accordingly, whether one believes that the Fund's principal should be conveyed intact to the next generation or the Fund's income should be conveyed equally to present and future Alaskans, a portfolio that loses to inflation will serve us at the expense of those who follow. (Please see Appendix A for a more detailed analysis of the financial sections.)

Section 10, 11. Broadly, these sections provide that one-half the net earnings of the Permanent Fund shall be retained in principal and the balance is available for distribution on a five-year average, with any excess to be used to raise payments in a year they would fall below the average. The first is to sustain the real earnings power of the Fund; the second is to give the Legislature a stable income on which to plan.

More specifically, the Fund's earnings can be expected to rise steadily over the next decade as the result of regular contributions and competent management. During this period, more income will be made than is necessary to meet the five-year average, and the excess and the interest on it will build up in the "undistributed income account." In the first year if that income were to fall below the average, the reserve would be drawn upon. In the event that it was judged that reserves were ample, a larger dividend could be declared or, perhaps, the extra sums could be applied to other purposes by the Legislature.

Section 12 simply provides that the Fund's expenses will be met from the Fund's earnings (as "program receipts"), however, no money may be spent except as provided by the budget. Although the control of the Legislature is not altered in any way, this approach plainly shows what it has cost to make our income, thus allowing the public and legislators to better assess the worth of these expenses. This practice is virtually universal in the accounting of similar private institutions.

Section 13 is to allow the Legislative Budget and Audit Committee to be selective as to which financial and operational reports it prepares, or has prepared, in the light of circumstances. For example, this language would permit the Fund and the Committee to reach mutual agreement on a firm to assess performance in different areas of investment and, further, to reach mutual agreement on definitions of terms,

the proper sample of statistics, and the like. This "ground rules" approach will aid fuller disclosure of the Fund's activities while at the same time reduce temptations for either side to craft reports that are merely designed to attack or defend the Fund.

Section 14 brings the Permanent Fund into conformity with the law governing most other boards and commissions.

BUDGETARY NOTES

The Trustees ask that SB 684 be considered together with the Governor's budget request to achieve independent status for the Permanent Fund, and with the fiscal note which provides for outside, specialized firms to carry out the new investment authority under this bill.

Independence for the Permanent Fund has been the clear preference of public and legislative sentiment to date. (Please see the paper on the relevant legislative history prepared by Trustee Peter B. McDowell.) The case for independence, in brief, is that special interests pressing the Fund to win concessions will be more visible in their attempts and that your Trustees can be held to fuller account if they choose their own servants. The last point is not meant to reflect on the present Commissioner of Revenue or the staff of the Treasury. On the contrary, their ready cooperation has been frequently noted in the record of the Trustees. But it has been the consistent advice of professional managers that "... those committed to investing must have their operations separate from those committed to spending ...", especially given the "... great, tempting size ..." of the Fund. In the wealthiest state in the nation, California, where state and local pension assets exceed \$30 billion, such a separation has always been maintained.

Still, after independence has been attained, the Fund will have less freedom than any independent board or commission in present law. For the Fund has the most definite charter in state government, is not permitted to spend, does not lend directly to any borrower, and is subject to all the oversight that is applied to a line agency.

As for the fiscal note, the Trustees have agreed that outside managers are best suited to execute the new investment authority in this bill. In addition to our remoteness from the markets involved, there are numbers of reputed firms that can do this work more efficiently, and for less cost, than it can be done internally.

APPENDIX A

ANALYSIS OF FINANCIAL SECTIONS

SSSB 684

Peter A. Bushre

Deputy Commissioner of Treasury

Department of Revenue

Current law provides the corporation with the authority to place funds in direct obligations of the United States Treasury, federal agency securities, certificates of deposit, high-grade corporate bonds, quality short-term investments, and federally guaranteed loans. Management is directed to give preference to Alaska investments as long as they meet the standards of quality set out in the bill. Specifically, deposits can be made in Alaska banks, mutual savings banks, savings and loan associations, and credit unions. Residential real estate (owner-occupied single family dwelling, duplexes, and condominiums) may also be purchased if the mortgage is privately insured by a company doing business in Alaska.

The permanent fund statute has a minimum of investment restrictions yet provides a very definite and certain framework. It does not authorize investments in stock or bullion, restricts the purchase of corporate bonds to 25% of the Fund's total investments, and limits the purchase of loans and mortgages to 25% of the total. Purchases of residential mortgages may be a further 15% of total assets. The statute allows the Fund to use the futures market to protect investments

from severe declines in value that are being suffered today. These futures contracts, however, may be used only to hedge and not to speculate. The statute also prohibits the Fund from either borrowing or guaranteeing the obligations of others.

Section 6 of the bill would amend the present investment list by adding five categories currently authorized for the State pension funds and by conforming other language to the retirement system law. The additional investments are:

1. Commercial mortgages - loans secured by a first lien on commercial properties such as shopping centers, office buildings, etc. The corporation may purchase uninsured loans if the originating financial institution retains at least 25%, or insured loans which meet requirements currently in effect for the pension funds.

2. The common stock of U. S. corporations which have paid dividends in each of the immediately preceding three years.

3. Stocks and bonds that are denominated in foreign currencies or Eurodollars, provided that they are of the same quality as their U. S. counterparts.

4. Bank deposits that are denominated in foreign currencies or Eurodollars, provided that they are readily negotiable or that the issuing bank has capital and surplus of at least \$500 million.

5. Equity interests in commingled pools of real estate.

Section 7 of the bill reduces the limit on loans and mortgages to 15% and restricts the investment in foreign securities and bank deposits to the levels which currently prevail in the retirement systems. Common stock and corporate debt are together limited to 50%; both are more restrictive than the pension funds. The bill further limits the permanent fund to no more than 5% of the voting stock of any one corporation, and domestic stocks, with the exception of insurance companies and banks, must be listed on an exchange registered with SEC. Both are identical to current limitations on pension fund investments.

Section 8 would standardize the collateral requirements for deposits with all types of financial institutions, and require them to pledge U. S. government securities, corporate bonds, or mortgages if their certificates of deposit are not freely negotiable.

NOTE REGARDING THE FOLLOWING FRAME ON MICROFILM:

COMPLETE DOCUMENT IS AVAILABLE IN ORIGINAL FILES
IN ALASKA STATE ARCHIVES. TITLE PAGE ONLY HAS
BEEN FILMED.

Remarks to the Alaska Permanent Fund
Board of Trustees

October 22, 23, 1981

GROUPS

Commonwealth North
Resource Development Council For Alaska
Fairbanks Homebuilders Association Inc.
Alaska Municipal League
Alaska State Chamber of Commerce (includes follow-up letters)
Interior Mortgage and Housing Association, Inc.
Alaska Association of Realtors
Alaska Home Builders Association, Inc.
Alaska Public Interest Research Group
Alaska Mortgage Assurance
FREE Committee

INDIVIDUALS

Gregg Erickson (transcript excerpts)
Arlon Tussing (transcript excerpts)
Scott Goldsmith
John Havelock (transcript excerpts)

COMMENTS TO THE
TRUSTEES OF THE PERMANENT
FUND

by

DR. HARRY DONAHUE
Representing Commonwealth
North
October 22, 1981

COMMENTS TO THE PERMANENT FUND TRUSTEES
OCTOBER 22, 1981, 9 am
Captain Cook Hotel

THANK YOU MR. CHAIRMAN, TRUSTEES OF THE PERMANENT FUND,
AND LEGISLATORS.

WE APPRECIATE THE OPPORTUNITY TO OUTLINE SOME OF THE
CONCLUSIONS REACHED BY THOSE OF US IN COMMONWEALTH NORTH WHO
HAVE BEEN STUDYING THE WISE USE BY THE STATE OF ALASKA OF
ITS REVENUE STREAM AT THIS FORTUNATE TIME IN OUR HISTORY.

IN NOVEMBER 1979, A COMMITTEE WAS FORMED OF 15
OUTSTANDING ALASKANS TO WORK ON MANY OF THE ISSUES THAT YOU
ARE ADDRESSING. THE GROUP WAS CHAIRED BY BILL SHEFFIELD AND
INCLUDED TWO FORMER COMMISSIONERS OF REVENUE, RON RETTIG AND
ERIC WOHLFORTH.

THE GROUP MET WITH AND TESTIFIED BEFORE THOSE
LEGISLATORS WHO WERE DESIGNING THE PERMANENT FUND STATUTE.
WE OPPOSED WHAT WAS THEN KNOWN AS SB 1 AND URGED THAT THE
STATE NOT FALL INTO THE TRAP OF BECOMING AN ENORMOUS LENDING
INSTITUTION.

AND YET WE FELT THERE WAS A ROLE FOR OUR GOVERNMENT TO
PLAY IN INVESTING WITHIN THE STATE IN THOSE PROJECTS THAT
COULD STRENGTHEN THE LONG-TERM ECONOMIC HEALTH OF ALASKA.

IN APRIL OF 1980 THE LEGISLATURE PASSED A BILL WHICH AVOIDED THE PITFALLS OF SB 1 AND WAS PRUDENT IN ITS CONSERVATIVE APPROACH, ^{in favor of} FAVORING A SAVINGS/INCOME PHILOSOPHY.

OUR REACTION TO ^{the} THIS LEGISLATION WAS POSITIVE. BUT TWO ISSUES HAD BEEN LEFT ON THE TABLE:

1. ^{first,} HOW ^{would} THE INVESTMENTS ALLOWED BY THE FUND ~~WOULD~~ KEEP PACE WITH INFLATION, AND
2. ^{second,} ^{how would the state make} INSTATE INVESTMENTS IN THE CAPITAL INFRASTRUCTURE.

OUR COMMITTEE MEMBERS FELT THAT THE INCOME FROM PERMANENT FUND INVESTMENTS SHOULD NEITHER BE DISTRIBUTED TO THE POPULACE NOR WHEN THE STATE HAS SUFFICIENT REVENUE FOR ITS NEEDS, ^{should be} SIMPLY BE ADDED TO THE GENERAL FUND, BUT ^{rather it} REINVESTED IN THE PERMANENT FUND ITSELF, SO THAT THOSE DOLLARS TRULY BECOME A RENEWABLE RESOURCE.

IF THE TRUSTEES DECIDE THAT MAKING LOANS IS A PROPER ROLE FOR THE PERMANENT FUND, WE WOULD OPPOSE DIRECT LENDING... ^{We are, instead,} URGING A COMMITMENT TO SECONDARY LENDING ONLY. USING PERMANENT FUND MONEY IN THIS MANNER WOULD RECEIVE OUR SUPPORT IF THE YIELD TO THE FUND IS AT AN ACCEPTABLE LEVEL.

FURTHERMORE, OUR COMMITTEE SUGGESTED THAT INVESTMENTS BY THE PERMANENT FUND BE BROADENED TO INCLUDE APPRECIABLE ASSETS, ^{in order} TO HELP STAY AHEAD OF INFLATION.

it makes little sense

TO CONVERT AN EQUITY ASSET ^{that is} (RAW OIL IN THE GROUND THAT CAN ^{or} AND WILL APPRECIATE OVER TIME) INTO A FIXED INCOME ASSET WITH LITTLE OR NO APPRECIATION POTENTIAL ~~MAKES LITTLE SENSE.~~

SOME OF THESE FUNDS SHOULD BE INVESTED IN ASSETS THAT CAN PRODUCE INCREASING INCOME. ONE EXAMPLE OF THIS STRATEGY MIGHT BE MAJOR PROPERTY INVESTMENTS, AS THE UNIVERSITY OF WASHINGTON HAS ^{invested in this manner} ~~DONE SO~~ SUCCESSFULLY FOR DECADES. RENTS ARE ADJUSTED OVER THE YEARS TO OFFSET THE INROADS OF INFLATION.

RAILROAD CARS AND OIL TANKERS COULD BE OTHER EXAMPLES. DIVIDENDS ON COMMON STOCKS HAVE HISTORICALLY INCREASED EVEN DURING PERIODS OF WEAKNESS IN THE MARKET. THERE ARE MANY SUCH EXAMPLES, MOST OF WHICH HAVE THE ADDED ATTRACTION OF BEING ABLE TO INCREASE IN VALUE AS WELL.

→ TO ENCOURAGE INVESTMENT WITHIN THE STATE IN CAPITAL PROJECTS, WE FIRST THOUGHT THAT THE PERMANENT FUND SHOULD TAKE THE LEAD. *in order*

WE TALKED TO A NUMBER OF LEGISLATORS AND INDIVIDUALS THROUGHOUT THE STATE AND CAME TO THE CONCLUSION THAT THIS ^{at least} WOULD BE DIFFICULT TO ACHIEVE POLITICALLY. THE PUBLIC VOTED FOR THE PERMANENT FUND CONSTITUTIONAL AMENDMENT IN 1976 SO THAT IT WOULD, INDEED, BE A PERMANENT FUND. THAT SENTIMENT CONTINUES.



Resource Development Council

for Alaska, Inc.

444 West 7th Avenue, Anchorage, Alaska 99501
Box 516, Anchorage, Alaska 99510 - 907/278-9615

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Paula P. Easley

October 22, 1981

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The Resource Development Council has been asked to study the potential investment activity of Alaska's Permanent Fund. As you are aware, the existing law requires 25% of royalties and bonuses on oil and gas leases to be placed in a permanent fund. This rate will increase to 50% on all future sales by statute. Due to the investment restrictions placed upon the fund, investments are primarily made outside the state of Alaska. Our state has few investments which will meet the fund's existing criteria. Currently one-third of it is invested in intermediate term instruments while the balance is short term.

It is our belief that the funds should be invested within the state. Investment outside allows the fund a relatively low-risk return on investment but does little for the average Alaskan. The first priority of the fund is that it should be used for residential mortgages, and secondly for commercial real estate mortgages. This will provide the Fund with an average rate of return on its investment and would allow Alaska to participate directly from our oil wealth.

Underwriting criteria for mortgage loans are standardized and this will allow for proper credit underwriting, thus insuring loan portfolio quality. We advocate a 10% mortgage rate net to the borrower. This rate will allow for an investment return but will more importantly create a stable secondary market for loans which will assist permanent home construction statewide. Any rate of return calculation must reflect all of the costs incurred by the investment activity. The true yield of our present investing is less than currently indicated as the state is absorbing a portion of the costs.

The fund would be used to purchase loans from existing financial institutions located in the state. An underwriting and servicing agreement with the respective institutions would allow for proper underwriting and file maintenance.

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This would allow private sector involvement utilizing existing personnel thus eliminating the need for another layer of underwriting. Direct purchase of loans would not only alleviate duplicative underwriting but would eliminate the need for costly bond sales to fund the purchases.

Alaska has the capital, and to enter the public market place at current high rates subsidizes the investors or bondholders to the detriment of all residents. The fund would be used for single family, then commercial mortgages with refinances and assumptions allowed at low cost.

The permanent fund belongs to all ^{the} residents of the state. Any program for ^{the} distribution may be classified as inequitable and perhaps inflationary by some groups. However, we have discussed many types of investments and have determined the mortgage program as discussed herein as the most beneficial. We feel that ^{the} mortgage demand should be satisfied by the fund first and any surplus ^{the} remaining should be invested in money market instruments or other prudent investments.

^{and Shacks}
Respectfully submitted, *by*

John D. Shackelford *our Chairman*

For the RDC Permanent Fund Committee

(Members: Tom Fink
Bill Purrington
Perry Eaton
Roger Haxby
John Shackelford



Fairbanks Homebuilders Association Inc.

P. O. BOX 80215 - FAIRBANKS, ALASKA 99708

October 20, 1981

Clai Porter
118 East International Airport Road
Anchorage, Alaska 99502

Dear Clai;

After discussing the Permanent Fund with the Board of Directors of the Fairbanks Association, the following was decided to be our official position:

The impact of the housing industry on the state economy is great and far-reaching. Not only does the stability of the industry affect the small nucleus of contractors and their employees, but has a much farther reaching affect. It affects the lives and livelihoods of the suppliers and subcontractors who provide materials and labor into each house, the banker who processes the construction and long term loans, the appraiser who calculates the value, the insurance agent who insures the property, the title company who insures the title, and the real estate agent who assists in the sale of the finished product. The construction of a new home, increases the tax base of the city or borough, and creates new ongoing business for the utility companies that service each new home.

To own a home is the American dream, it is big business and it affects the livelihoods of a great variety and a large network of Alaskans. We believe in this industry, one of the backbones of the American Economy.

As you are certainly aware of, Alaska Housing Finance Corporation must go to the Bond Market to procure funds for housing loans in Alaska. Not only does the State of Alaska have to subsidize the interest rate in order to bring housing loans to Alaskans at a reasonable rate, but we are forced to sell bonds at current interest rates, which AHFC has no control over.



Fairbanks Homebuilders Association Inc.

P. O. BOX 80215 · FAIRBANKS, ALASKA 99708

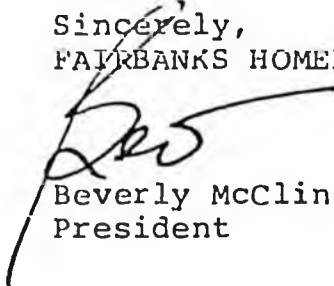
If part of the Permanent Fund could be used to finance the AHFC housing bonds, the return to the Permanent Fund could be consistent with what the return is today on existing investments with the added advantage of keeping the money in the State of Alaska, and providing jobs and prosperity for Alaskans, and better housing for ourselves and generations to come.

Stability in the housing industry is desperately needed, and with funding from the Permanent fund, this sought after stability could be brought to the industry to benefit the citizens of Alaska today and tomorrow.

Would you please see this is read or given to the Trustees at the hearing in Anchorage on October 22, and 23rd. It could be incorporated into the Building Industry Position if it is compatible.

Thank you for your help.

Sincerely,
FAIRBANKS HOMEBUILDERS ASSOCIATION



Beverly McClintock
President

Remarks of TED LEHNE, President of the Alaska Municipal League and member of the City Council, City of Fairbanks, Alaska

To the Alaska Permanent Fund Corporation, Anchorage, Alaska, October 22, 1981

Mr. President and Trustees. My name is Ted Lehne, I am President of the Alaska Municipal League, ^{The Alaska Mun. League is} a statewide association of 52 Alaska cities and boroughs ^{which} representing over 90% of the state's population. I ~~am~~ ^{happy to be} also a member of the City of Fairbanks City Council.

The League appreciates the opportunity to meet with you today. ^{at the beginning} I feel compelled to ^{make a few} ~~begin with some~~ disclaimers. I ~~do not~~ ^{don't} claim to have great wisdom about investments. I still have to stop and think which is which when people refer to bull and bear markets. But I know there's hope ^{for me.} I was raised far from an ocean and am not nautical. ^{and I have figured out} ~~But I finally learned~~ the difference between port and starboard.

^{also have it} I must be upfront and admit I'm a politician. Frankly, I do so somewhat sheepishly. I heard recently of the person who was visiting a cemetery and read a gravestone which said "Here lies a politician and an honest man." He turned to his companion and said "I wonder how they got two people in that narrow grave."

^{Well,} But despite those handicaps I think I and the League can contribute to your dialogue. ^{Today.}

In local government we believe in the wisdom of the saying that government is more responsive the closer it is to the citizen. We appear to have an ally in the White House, and another in the Executive Mansion in Juneau. But like so many these days we seem on the verge of being loved to death by those who believe in us but really don't understand us. Let me tell you something about local government in Alaska.

First, ^{it's} it is alive and well. Some think it is a bit too alive, but that attitude is ^{not} held by ^{everybody} most citizens. An Outside taxpayer group reported

earlier this week that Alaska led the nation in the amount, ^{that} its state and local government spent per capita. State government spending was five times the national average and local government spending was twice the national average. ^{I should have to point out} ~~We should keep in mind~~ that the State of Alaska plays a much bigger role in education than probably any other state and that probably accounts for an important part of the reason why state government spending is so high compared to the national average.

In fiscal year 1980 local governments in Alaska raised from local sources about ^{million} \$248,000,000. In that fiscal year State shared revenues and municipal assistance amounted to about ^{million} \$30,000,000 and federal shared revenue was about ^{million} \$25,000,000. There was about another ^{million} \$10,000,000 in various other outside aid programs.

That means that in fiscal year 1980 local governments had about ^{million} \$310,000,000 available to spend (not counting state education or capital monies) and about 80% ^{that money} of it came from local taxpayers.

I should pause here for one additional qualification. Throughout this discussion I will omit ^{referring to} state aid to education. It is substantial and growing. The state provides both operating funds and capital construction funds as well as monies this fiscal year for school debt retirement.

These funds are enormously important in keeping down local taxes.

I omit discussion of them, not because they are not important, ^{But} simply because others in the educational community can discuss that aspect of state aid much more intelligently and thoroughly than I can.

To return, I had indicated that in fiscal year 1980 local governments had about ^{million} \$310,000,000 to spend and raised about 80% of it locally. The state's share was about ^{million} \$30,000,000.

By fiscal year 1981, after taking a hefty supplemental appropriation into

account, state municipal assistance and municipal revenue sharing had increased to about \$97,000,000^{million}. Many municipalities reduced taxes or at least avoided increasing them any, despite inflation.

In the current 1982 fiscal year the amount in those two programs reached just under \$140,000,000^{million}.

Now I'm going off into the realm of speculation^{a bit} to make a point.

Lets assume that on average municipalities in Alaska balanced their local budgets in fiscal year 1980 - in other words that they in total spent the \$310,000,000^{million} they had available to spend. We have to

speculate here because there simply are no good figures^{for} about total expenditures of local government^{around the State}. If we assume 10% annual inflation,

then the total expenditures in fiscal year 1981 were about \$340,000,000^{million} with 63% raised locally. And the total expenditures in fiscal year 1982 will be about \$375,000,000^{million} with 55% raised locally.

By the way, our taxpayer study group^{what} I referred to earlier said local governments in Alaska spent about \$910 per capita last year. And that's pretty close to the \$340,000,000^{million} we^{from} extrapolated~~in~~ in this example.

Here's the point. Some people^{new} feel that because state aid has risen so dramatically in the last few years that we should not have local taxes any more. My point is that municipalities, in this macro example, are still faced with raising about 55% of their revenues locally. As with any average, there are some municipalities that have actually cut back on the size of government and who raise much less than 55% locally. There are others who raise more.

^{Now,} Fifty-five percent of local government expenditures is about \$200,000,000^{million}.

If the State of Alaska wanted to do away with the need for any local revenue collection - property taxes, sales taxes, user fees, fines, etc^{and so forth} it would have to increase operating revenue shared with local governments

from about \$140,000,000^{million} to about \$340,000,000^{million} this ~~fiscal year~~. *And, of course*

That number will move with inflation. By the way, we are assuming that the additional \$35,000,000^{million} will continue to come from federal and other similar sources, and that may not be a safe assumption down stream.

Let's move on
~~New I would like to move~~ from the ^{area} arena of operating monies to talk *a little bit* about capital construction funds, ~~a bit~~.

Until the legislature adopted HB 60 last year, and HB 50 and SB 166 this year, municipalities either paid for capital improvements out of local taxes, issued general obligation or revenue bonds, or did without. *House Bill Senate Bill*

And I think we all know that most municipalities exercised the "did without" option much more often over the years than ~~any~~ others.

Because of that there were many unmet needs - what we have referred to as the necessity to improve our infrastructure. In the last two years we have gone a long way toward meeting many of those needs. The capital construction job is far from through; ^{though} It will take several years more of higher than normal levels of construction funds to meet the needs of multiyear projects in particular. Then, to keep up with growth and to avoid developing a great gap in the future, there will need to be some ongoing construction in most municipalities.

There have been two very useful characteristics of the state's approach to capital construction funds. First, it has made a point of not providing unlimited operating monies. This means the local taxpayer is faced with an important decision. Is he willing to accept the long term operating and maintenance costs of a capital project, if there are such costs? Some municipalities have shied away from projects with a high O & M price tag - my own municipality of Fairbanks is one. The total of

^{of} all the capital projects ^{that} we have approved to date will actually decrease our O&M costs, not increase them. At least that's what our staff tells us.

The second element of the approach specifies the mechanism by which the voter is asked his opinion - the feature of SB 168 that requires approval by ballot for new projects over \$1 million and renovation projects over \$5 million. Even though the City of Fairbanks was one of the few municipalities that had a major project turned down in local elections earlier this month, I still believe that ^{that's} ~~is~~ a useful requirement for large state-funded capital projects.

The state's participation in capital funding is important to local tax payers and rate payers. The \$40 million in the current fiscal year budget to retire school construction debt will significantly reduce the interest and principal payments of many boroughs. And projects built from scratch with grant funds ^{of course,} carry no debt service.

With that background, I would like to offer ^a ~~one~~ broad suggestion and two specific ones.

I have noticed as I have served on national boards that in many parts of the country local and state governments don't get along all that well.

In fact, I have come to feel that Alaska is fortunate that we have an emerging partnership between our levels of government within the state. With the increasing federal emphasis on returning control and money to states and localities it appears that at least in the immediate future this kind of cooperation is a real asset.

One of my major goals ^{this year} as President of the ~~Alaska~~ Municipal League is to foster this developing relationship.

^{It} I would like to suggest today that this partnership be expanded to include the Alaska Permanent Fund Corporation. It ^{is} clear that your

corporation can play an increasingly important role in the lives of our citizens as time goes by, ^{particularly as the Chairman says if permanent really means permanent,} I think everyone in the state will be better off if state government, local government and the Permanent Fund Corporation develop effective and ongoing communication, cooperation and trust.

Specifically, I think the Alaska Permanent Fund Corporation can help municipalities and the citizens served by them in two ways. First is by serving as the vehicle for endowing local education and municipal operating costs. A year ago I appointed a task force of the Alaska Municipal League to work with the legislature to further this concept. ^{New} We have not made much progress in the last year, not because it is not a good idea, but because there were other greater priorities for the income the legislature had to spend. And, frankly, I think legislators were somewhat awed by the amount of ^{money} required for such an endowment fund. Many support the concept but did not see the revenues to set it up. One told me, "with the amounts ^{of money} going into the Permanent Fund I just don't see where the money will come from."

^{Well,} If the Permanent Fund Corporation would take the lead in setting up such endowments, I believe many in the legislature would support additional deposits to the Permanent Fund - deposits beyond statutory requirements - to help those funds grow. The League would welcome the chance to work for such a concept.

Second, municipalities have a problem in the bond market. I'm sure that statement is ^{not a} surprise to anyone ^{body}. High interest rates force municipalities to postpone projects or accept higher debt service. For utility revenue bonds the current interest rates usually require ^{substantial} rate increases contributing to our high cost of living.

I believe we should aggressively explore a partnership here, too. I envision

the Alaska Permanent Fund Corporation investing in municipal general obligation and revenue bonds. Municipalities would repay the principal plus an interest rate that would be considered reasonable in more normal times - say six to eight percent. But I do not feel ^{that} the subsidy in the interest rate should come from the Permanent Fund. I propose that the third partner, state government, pay to the Permanent Fund the difference between what it would normally earn on such investments and the lower rates paid by municipalities. I believe this approach would require much smaller general fund appropriations than the current bond bank. It would hold harmless the Permanent Fund while permitting the investment of some of these funds in Alaska, and would keep down the cost of government and utility rates.

^{How} These are just two examples of how the partnership ^{that} we are advocating might work. It may not be possible to achieve these specifics. But I hope you will adopt the general premise. I believe a full partnership between Alaska's state government, local governments and this Alaska Permanent Fund Corporation can be a vital element for our future. I pledge the full cooperation of the Alaska Municipal League. Because the ones who will benefit are all of Alaska's citizens ^{that all} we serve.

Thank you.

ALASKA STATE CHAMBER OF COMMERCE'S COMMENTS ON THE PERMANENT FUND FOR THE OCTOBER 22, 1981 HEARING:

THE CHAMBER ENCOURAGES THE TRUSTEES TO WORK WITH THE LEGISLATURE IN DEVELOPING A PLAN ON ALL OIL INCOME, AND IN THAT PLAN ESTABLISH GOALS ON THE USE OF THE PERMANENT FUND MONIES SO THERE IS NOT OVER LAPPING SUCH AS IN LOAN PROGRAMS. THE STATE PLAN SHOULD FOLLOW THE SPENDING LIMITATION CONCEPT WHICH REQUIRES ALL EXCESS REVENUES FLOW TO THE PERMANENT FUND.

THERE MUST BE AN ANALYSIS OF THE USE OF THE FUND IN THE PLAN. THIS PLAN SHOULD LOOK AHEAD 1-5-10 YEARS IN SCHEDULING PROJECTS AND PROGRAMS.

THE CHAMBER SUPPORTS THE CONCEPT THAT THE FUND MUST KEEP UP WITH INFLATION, AND IS THEREFORE, OPPOSED TO ONE-HALF OF THE EARNINGS GOING TO THE GENERAL FUND.

THE CHAMBER ENCOURAGES THE RESTRUCTURING OF THE PERMANENT FUND TRUSTEES.

REPLACE ELIMINATE TWO COMMISSIONERS WITH PRIVATE SECTOR PERSONNEL PERSONNEL ON THE BOARD, SO THAT CANNOT APPOINT, IN EFFECT, FOUR MEMBERS THE YEAR HE IS ELECTED.

FOR THE CHAMBER SUPPORTS THE INVESTMENT POLICIES THAT DERIVE THE FUND A MAXIMUM RATE OF RETURN ON ITS INVESTMENTS, NOT JUST A MAXIMUM INTEREST

RATE, ~~NOT~~ TAKING INTO CONSIDERATION THE MULTIPLYING EFFECT OF THOSE DOLLARS IN
THE ALASKAN ECONOMY.

THE CHAMBER SUPPORTS THE CONCEPT OF STRIVING FOR INSTATE INVESTMENTS THAT
DO NOT HAVE AN ADVERSE IMPACT ON THE PRIVATE SECTOR.

THE CHAMBER SUPPORTS DEPOSITS IN ALASKAN FINANCIAL INSTITUTIONS IN
A PRUDENT MANNER.

THE CHAMBER SUPPORTS THE CONCEPT OF BUYING MORTGAGES AT VARIABLE RATES AND
SUPPORTS THE "DUE-ON-SALE" CLAUSE.

THE CHAMBER ALSO SUPPORTS THE CONCEPT OF EXTRACTION OF EQUITY AS IT
MAY LEAD TO THE MOST PRODUCTIVE USE.

THE CHAMBER IS OPPOSED TO SUBSIDIZING LOAN INTEREST RATES AND
FEELS A SUBSIDY IS AN INEQUITABLE WAY OF DISTRIBUTION OIL WEALTH.

THE CHAMBER IS UNABLE TO TAKE A POSITION ON THE DIVIDEND DISTRIBUTION CONCEPT
AS IT IS GOING TO THE SUPREME COURT, BUT IF THE DECISION DOES NOT ALLOW
THE DISTRIBUTION, THE CHAMBER SUPPORTS THE CONCEPT ^{OF} THE MONEY BEING USED
IN INFRA-STRUCTURE, NOT CASH DIVIDENDS.

THE CHAMBER IS CONCERNED ^{THAT} ~~THAT~~ THE PERMANENT FUND MAY BECOME A LARGE
CAPITAL POOL AND MANAGED BY THE TRUSTEES WITH LITTLE BENEFIT TO THE
RESIDENTS OF ALASKA, AND URGE THAT THE MAXIMUM USE BE MADE TO BENEFIT
ALASKA AND ITS ECONOMY.

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October 23, 1981

Senator Vic Fischer
221 East 7th Avenue, # 204
Anchorage, AK 99501

Dear Senator Fischer:


At the Permanent Fund Hearing on October 21, you asked for examples of instances where the Permanent Fund might be used to compete unfairly with the private sector. Rather than hypothesize a list of possible illustrations, permit me to answer by drawing to your attention a recent instance of just that kind of interference by the State with the operation of the free market.

When the Kenai Fish Processing Company ran into financial problems, AARC took over direct ownership of the plant and proceeded to compete with other private sector fish purchasing and processing operations in the Kenai area. This incident resulted in one business having an easier economic burden than all others operating in the same business at the same place and time. We regard this as unfair.

We do not feel that it would be possible to provide the Committee with a specific road map as to which investments can and cannot be fairly made from the Permanent Fund, but we strongly urge that as a matter of policy the impact of any investment on the competing businesses in the same market be weighed when attempting to decide whether the investment properly responds to the mandate that the oil wealth of the State be dedicated to the benefit of all Alaskans equitably.

I hope that these comments are helpful. If I may be of further assistance in this regard, please do not hesitate to call on me.

Very truly yours,


J. P. Tangen, Vice Chairman
Alaska State Chamber of Commerce

JPT/mks
cc: The Permanent Fund Committee

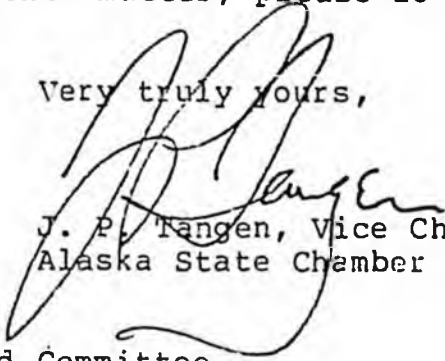
ROBERTSON, MONAGLE, EASTAUGH & BRADLEY

Senator Arliss Sturgulewski
Representative Samuel R. Cotten
October 23, 1981
Page Two

many of our members benefit directly from such loans, and therefore, do not take a formal position on this question. It is the position of the Chamber, however, that if the legislature chooses to make such subsidized loans, the subsidized aspect of the program be made clear to all and that this subsidy be made as a matter of policy determined by the State to be in the public interest.

I hope these comments are helpful. If I may be of further assistance in this matter, please do not hesitate to call on me.

Very truly yours,



J. P. Tangen, Vice Chairman
Alaska State Chamber of Commerce

JPT/mks
cc: The Permanent Fund Committee

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October 23, 1981

Senator Arliss Sturgulewski
2957 Sheldon Jackson
Anchorage, AK 99504

Representative Samuel R. Cotten
P. O. Box 296
Eagle River, AK 99577

Dear Senator Sturgulewski and Representative Cotten:

At the Permanent Fund Hearing on October 21, you inquired as to the position of the Alaska State Chamber of Commerce on subsidized loan programs. I fear that my answer may have been incomplete and possibly misleading and request this opportunity to clarify our position.

First, our comments are directed solely at the dedication of Permanent Fund resources. We are opposed to the Permanent Fund making any subsidized loans whatsoever, because we believe that such programs do not adequately safeguard the Fund and do not permit it to grow as it would with more prudent investments. Furthermore, we believe that such loans benefit the borrower primarily, which, in turn, results in an inequity toward non-borrowers. Even conceding that the increased economic activity which may come about because of such a loan program, it still remains the case that only a small group of Alaskans benefit from money that should be used for the good of all Alaskans.

Second, with regard to subsidized loan programs supported by appropriations from the General Fund, we note that

Interior Mortgage & Housing Association, Inc.

P.O. Box 168 • Fairbanks, Alaska 99707

October 22, 1981

My name is Evelyn Campbell and I am President of Interior Mortgage and Housing Association, Inc. of Fairbanks. Our group consists of all facets of the housing industry, from Realtors and lenders to contractors and appraisers.

We have seen the position paper published by the Alaska Board of Realtors and we, too, want to see the Permanent Fund as a legacy for future generations of Alaskans. However, we would like to see some of the income from its investments used for productive investments which provide benefits for the present.

Two items we see as imperative are safety for the fund and diversified investments.

As mentioned in Elmer Rasmuson's memorandum of September 10, 1981 to the Trustees of the Permanent Fund, a portion of the Fund could be used in housing as a means of benefitting a large cross section of Alaskans.

We would like to see some of the income from the Fund invested in the Alaska Housing Finance Corporation. AHFC now has a AA bond rating, which, it has always been said, had to be a prerequisite before the Permanent Fund could purchase their bonds.

The advantages we see for AHFC include better stability for the program and a safer risk for a typical investor if a portion of the issue were purchased directly by the Permanent Fund.

Using some of the income produced by the Fund would make it more acceptable to Alaskans since a great number could derive direct benefit by being able to purchase a home below market rates. Hopefully this would encourage an increasingly better lifestyle for everyone.

Investing in AHFC would allow more diversification for the fund in case short term markets falter. Thirty year bonds with a ten year amortization should be acceptable to AHFC and they could feasibly become a self-perpetuating entity. It is estimated that the typical mortgage loan in Alaska pays off in approximately five years because of the transient population.

There is investment potential within this state whereby these long-term bonds could have a direct effect on residents being able to invest in real estate, which puts capital into the economy and has the multiplier effect. It is said that for every \$1 invested in the base industry, \$4 goes into the private sector, which helps promote continued, steady growth for the State.

AHFC is rated as one of the best State loan programs in the nation. It is not without problems; however, and needs work to make it a stable, long-range program beneficial to a wide cross-section of Alaskans each year.

Each fiscal year the housing industry must wait to see what the Legislature will do in the way of funding to AHFC. Since the Fiscal Year end falls during the height of the construction season around the State it causes hardships to everyone involved in planning construction for that summer. Housing shortages have arisen because contractors and lenders are unable to plan ahead without knowing if funds will be available to pay off construction loans.

AHFC projects their program will reach \$1.2 billion in volume in 1982. So far this year over 1000 families have benefitted from its financing in Fairbanks alone.

Alaska Housing Finance Corporation can offer suggestions for ironing out the mechanics necessary for realizing the greatest potential by using some of the income from the Fund to keep this very beneficial program going.

Currently AHFC is going Outside on the national level to raise money on the Bond Market, paying 19-1/8% and yet we have a Permanent Fund investing Outside with a yield at approximately 14 1/2%. We feel the advantages from that Fund should be given to Alaskans and yet be a sound investment. We think investing in Alaska Housing Finance Corporation is a way to do that. The AHFC Board would probably be more than willing to accept direct investment or bond purchases.

We of Interior Mortgage and Housing Association offer our services in compiling data and statistics or in giving suggestions in any way possible.

Thank you for allowing us to be on your schedule today.



REALTOR[®]

ALASKA ASSOCIATION OF REALTORS[™]

1818 W. Northern Lights Blvd., Suite 104 • Anchorage, Alaska 99503
Telephone 907-272-8016

October 20, 1981

Board of Trustees
Alaska Permanent Fund Corporation
Anchorage, Alaska 99501

Gentlemen:

Enclosed herewith are copies of two Position Papers from our Association concerning recommendations for investment of the Permanent Fund. Due to the fact that I have a previous commitment on behalf of our Association, I have asked Mr. Kenneth Jay Gain, one of our past Presidents and the principal author of the Position Papers, to make the presentation of our Position Papers to you at your meeting on October 22nd.

As you can see from examination of the attached Position Papers, the Alaska Association of Realtors totally supports the concept of the Permanent Fund as well as an investment program which will protect it from erosion in value through inflation. Although we recognize the importance of diversification in the management of "trust type investments", we believe that a substantial portion of Permanent Fund assets should be invested in housing mortgages in Alaska. By adopting our recommended "2% Solution", the Permanent Fund will receive a reasonable return on money invested, provide for immediate benefit of Alaska's citizens and its economy, and satisfy the need to "Alaskanize the Permanent Fund".

Thank you in advance for your consideration. If you would like to meet with myself or other members of our Association in formulating the final investment strategy of the Permanent Fund, please feel free to call on me.

Sincerely,

ALASKA ASSOCIATION OF REALTORS

Bruce E. Winton
President

Enclosures

KJG:lbk



At the current time, the interest cost to borrowers would be approximately 13% (10% + 3%). Although this rate is greater than the financial capacities of many families, these families would still have the opportunity of availing themselves of the State Assisted Mortgage Program administered by the Alaska Housing Finance Corporation. As discussed in our earlier paper, there are still many unmet housing needs under existing programs. Loans from the Permanent Fund could fill this gap.

To eliminate the need for establishment of a new bureaucracy, this program could be easily administered through purchase of qualified loans originated and serviced by the State's existing financial institutions.

Although it is possible that our recommended program can be implemented immediately without the need for change in legislation, we will support changes in the law governing the investment policies of the Permanent Fund to specifically authorize investment of a reasonable share of the total assets of the Permanent Fund in such mortgages.

The advantages of our recommendation for investment of the Permanent Fund over other recommendations are as follows:

1. The purchasing power of the principal in the Permanent Fund will be protected from erosion in value due to inflation.
2. The investments in mortgages will always yield a positive 2% return which can be utilized for dividend programs or other purposes.
3. The immediate investment of a significant portion of the Permanent Fund in Alaska will provide immediate benefits for the citizens of Alaska and help to expand the economy, tax base, and tangible wealth of the State.
4. Our plan is quite simple and can be easily understood by most Alaskans.
5. Our plan is ultimately fair in that borrowers will pay an interest rate on their mortgages equal to the historical cost of such long-term mortgages, therefore, those citizens of Alaska who do not choose to borrow from the Permanent Fund will not see their share of the money used to subsidize others.
6. Since our plan specifies that only a portion of the Permanent Fund's assets be invested in this program, there still remains the opportunity to apply the "prudent man rule" to diversification of the investments.

7. A major advantage of our proposal is that it provides a rational compromise to the political issues now facing the Alaska Permanent Fund.

In summary, it is the belief of our Association that if our recommendation is adopted, the Trustees will be complying with the original mandate of the people of Alaska when they established the Permanent Fund as well as providing current benefits to the citizens of the State while at the same time expanding our wealth, tax and economic base. The Alaska Association of Realtors, therefore, urge that you "Alaskanize the Permanent Fund" by adoption of the "2% Solution".

POSITION PAPER OF THE
ALASKA ASSOCIATION OF REALTORS
IN REGARD TO THE
ALASKA PERMANENT FUND

It is the belief of the Alaska Association of Realtors that the Alaska Permanent Fund, if properly administered and invested, will be one of the greatest legacies that this generation of Alaskans can leave to Alaskans of the future. Our perception of the Permanent Fund is a fund in which we deposit savings from our current income to be invested to provide future benefits. As is true in most personal lives, we anticipate that there will be a time when income of the State of Alaska declines. At that time, resources of the Permanent Fund can be tapped to provide continuation of an acceptable life style.

Since we believe that there are some similarities in philosophy between the Permanent Fund and an individual saving for his own future, we believe that an examination of the philosophies of those who are successful in their personal lives, and those who are not, may provide some guidance for the philosophy of the Fund.

The first criteria for a successful savings/investment program is to be certain that all income is not used for today's consumption. By law, the people of Alaska have provided that some of today's income will be saved in the Permanent Fund and the last two sessions of the Alaska Legislature have made additional contributions to that Fund. To that extent, the current approach to the Permanent Fund has successfully completed the first step essential to a successful savings/investment program.

The next step in a successful savings/investment program is to invest money saved at rates that will grow faster than the rate of inflation and, therefore, grow in real value. As all financially astute people are now aware, a mere savings account which earns interest at rates less than the inflation rate will decrease in real value and will ultimately result in financial failure. An examination of the reported financial returns on the Permanent Fund indicate that, to date, it has earned a return greater than the rate of inflation.

A truly successful savings/investment program is one in which the first two steps are followed but, in addition, one in which investments are made in a manner that can provide some current benefits and a foundation for accumulation of real wealth. The common denominator between all persons who have accumulated real wealth is the fact that they invested a major portion of their savings in productive investments

such as homes, real estate, and businesses which not only provided returns substantial enough to accumulate real wealth, but also provided some current benefits to themselves and their families while being invested. To date, the Permanent Fund has not succeeded in this respect.

A fourth and final step to financial success is an on-going reinforcement of the belief that the program is worthwhile and merits continued support. That is to say, the program, in addition to being successful, must be perceived as being successful or eventually the saver/investor will lose interest and discontinue the program. At the present time, the Permanent Fund does not really have a "constituency". In fact, most Alaskans perceive it only as a device to keep the "money bins" of the Bank of America full. If there is to be continued political support by the citizens of Alaska for making additional voluntary contributions to the Permanent Fund, it is essential that they soon begin to perceive some benefits.

It is the belief of the Alaska Association of Realtors that if the Alaska Permanent Fund is to be acknowledged as a successful savings/investment program, immediate efforts must be taken to correct the deficiencies in steps three and four of the wealth building process. The solution to these deficiencies is so simple that it can be summarized in the slogan "Alaskanize the Permanent Fund". While there are those who believe that the entire Permanent Fund should be invested in Alaska, it is the opinion of our Association that it would be impossible to invest the entire Permanent Fund in the State without causing serious economic inflation and without making low quality investments which would fail to meet the objective of a true growth in value. Nevertheless, it is our belief that a prudent, conservatively managed program of investing a significant portion (say 25% to 40%) of the assets of the Fund in the State of Alaska would provide the opportunity for expanding the economic base and the tax base which will be needed when the oil money runs out. We further believe that such an investment program in the State of Alaska is ultimately the most prudent way of building a constituency.

We recognize that there is currently on the books a law which would acquire a constituency for the Permanent Fund by making direct dividend distributions to the citizens of Alaska. Even if this plan should be approved by the Supreme Court of the United States, we have some serious reservations about its success in establishing a truly successful savings/investment program. First of all, no savings and investment program can be successful unless it retains its purchasing power by growing at a rate at least equal to the rate of inflation. Therefore, the only money which should

be considered for withdrawal from the fund for the purposes of distribution for present day consumption would be that portion that constitutes true profit (i.e., percentage rate of return which is in excess of the underlying rate of inflation). While everyone would like more money and while the members of our Association recognize that distribution of dividends will increase spendable income and thereby the current economy, we oppose any level of distributions which is greater than the "true earnings" on the fund. While the prudent person will utilize the after tax portion of his distribution to supplement his own savings/investment program and thereby help to build the underlying private wealth in the State of Alaska, that will not be true in all cases.

It is the opinion of our Association that a program of loans at reasonable interest rates which will allow Alaskan families to purchase homes, build and expand businesses, and develop the underlying economy will eventually provide a more solid constituency for the Permanent Fund and will have a greater long term benefit for the State of Alaska and its citizens than a program of dividend distributions. A program of investment in the people and communities of Alaska will provide the broadened tax base which will be necessary to support our government in the late 20th and early 21st century.

It is important to stress at this point that our Association is not proposing that the Alaska Permanent Fund become the sole source of financing in the State of Alaska nor are we proposing that any loan be made which would not meet the "prudent man rule". We would also oppose loans at a rate of return to the Permanent Fund which does not provide for a positive growth rate on the investment. On the otherhand, we do not believe that loans and investments in Alaska should be at the "highest rate that the market will bear". It must be remembered that the ultimate benefit from a program of investing in Alaska will be in establishing a broad economic and tax base for the future - not upon the current rate of return. Again, using our example of private wealth building, it must be recognized that few successful investments in homes and businesses are made based upon obtaining the highest current rate of return available. Long term wealth building takes a long term commitment. We believe that long term loans to Alaskans at rates in excess of the underlying inflation rate but "less than the maximum rate that the market will bear" will ultimately provide the greatest long term accumulation of wealth to the citizens of the State of Alaska. If the Permanent Fund can develop a constituency through providing loans and investments within the State as opposed to current distribution of dividends, it will have greater sums of money which can be invested outside of Alaska at "the maximum rate that the market will bear" and, therefore, ultimately result in a much larger Permanent Fund.

Because of uncertainty about the future of inflation, we recognize that there is a hesitancy on the part of some investment advisors to recommend investment in long term fixed rate investments. However, it must be remembered that rates of inflation and investment go down as well as up and in a few years, investments at rates below the current market could be perceived as being wise investments. In any event, it is not the position of our Association that investments in business and housing loans should be made only at fixed rates but it is rather our position that such investment decisions should be made with a long term outlook in mind, recognizing that the ultimate and greatest benefit will be in developing an economic and tax base not totally dependent upon oil revenues.

While our Association strongly endorses the program of business and economic loans and investments, our primary expertise is in the field of housing and, therefore, the balance of this paper will be addressed to how the Permanent Fund can assist in meeting the housing needs of Alaskans while at the same time meeting the four rules for developing a successful savings/investment program.

Next to air, water, food, and clothing, the most basic of all human needs is the need for adequate shelter. This is particularly true in an environment as harsh as that of Alaska. If the satisfaction of that basic need can be coupled with one of our fundamental rights as American citizens, namely the right of each individual to own property, and, if that can be a tangible benefit of the State's wealth available to Alaskans, then it will be a positive step toward strengthening the third and fourth criteria for a viable savings/investment program outlined earlier in this testimony.

In addition, the social climate of communities of homeowners as compared to neighborhoods of tenant occupancy can be documented historically with regard to both increased community amenities and reduced welfare needs. From the standpoint of the prudent investment, the resulting economic base can be perceived as a source of future tax dollars in rather than future dollars out of the State's treasury to support social programs.

Although the current mortgage loan programs administered by the Alaska Housing Finance Corporation have been quite successful in meeting current needs for the purchase of single-family homes in most areas of the State, the program still has serious limitations and is still not comprehensive enough to meet the total housing needs of Alaska's citizens. The deficiencies in the current housing programs are as follows:

1. There is no program currently in existence to assist in the construction of rental housing other than duplexes. As a result, there currently exists a critical shortage of rental housing in most areas of the State and unless a program is implemented or unless rents rise to a sufficient level (approximately 50% above current levels) to justify new construction with mortgages at "the maximum rate that the market will bear", this shortage will become more acute.
2. The current program is in reality only a temporary year-to-year program in that each year it is dependent upon appropriations from the Legislature to continue its existence. As a result, the cost of housing is increased due to the inability of builders to make long term commitments for land, materials, and labor. Costs are also increased because other supporting occupations and services such as bankers, Realtors, surveyors, title companies, are also unable to make long range plans.
3. The program is currently funded through the sale of securities to the traditional capital markets with an appropriation made by the State of Alaska being utilized to reduce interest rates paid by borrowers to an affordable level. Since the last sale of these securities was at a rate substantially greater than the current earnings on the Permanent Fund, the State of Alaska is now in the unenviable position of borrowing high and investing low.

It is our belief that many of the housing needs of Alaska can be met through the implementation of programs such as general obligation bonds for Veterans loans, sale of tax-exempt bonds for qualifying loans to lower income persons, use of junior Deeds of Trusts in conjunction with assumable loans, and other programs more fully outlined in our position paper, "A Proposal to Meet Alaska's Housing Needs" which was released earlier this year. Nevertheless, the use of a substantial portion of the proceeds of the Alaska Permanent Fund to purchase the securities of the Alaska Housing Finance Corporation or other agencies established to administer housing loan programs, could provide for the much needed stability to these programs and could eliminate the true loss of capital to the State of Alaska which currently occurs due to the sale of mortgage bonds at a rate greater than current earnings on the Permanent Fund.

Should the Trustees of the Alaska Permanent Fund decide that they would like to utilize a portion of the Permanent Fund to invest in Alaska to build a long term economic and tax base and thereby develop a constituency of Alaskan voters who would then have a real perceived "stake in the Permanent Fund", then our Association would like to assist in developing such a program. There are numerous forms of "creative mortgage programs" which can be utilized to provide the Permanent Fund a positive return in excess of inflation while at the same time providing the opportunity to Alaskans to acquire housing at an affordable cost. Because the types of mortgages are quite complex in nature, they have not been addressed in detail in this testimony. Rather, the purpose of this paper is to advocate a philosophy of investing a portion of the Alaska Permanent Fund in meeting the housing needs of Alaska's citizens. Should the Trustees decide to pursue such a course of action, our Association and its members will be happy to assist in any manner possible.



FINANCING HOMES FOR ALASKANS
A ROLE FOR THE ALASKA PERMANENT FUND

A Proposal by the Alaska State Association of Home Builders

In response to the invitation of the Board of Trustees of the Alaska Permanent Fund, the Alaska State Association of Home Builders is pleased to submit the following proposal for a role for the Alaska Permanent Fund in providing mortgage money for homes and residential real estate in Alaska.

There are several basic investment goals for the Permanent Fund. These choices have been described in various ways. Most recently, the chairman of the Board of Trustees of the Alaska Permanent Fund, Elmer Rasmuson, in a September 10, 1981 memorandum to the trustees set out the choices as the "Savings - Income Approach" and the "Full-Scale Development Approach."

Even though we believe that the Homebuilding Industry is of great importance to the social and economic well-being of all Alaskans, we also recognize that the constitutional role of the Permanent Fund must be, by virtue of its limited and discreet goals, essentially different from that of the General Fund. It is clearly evident that the General Fund which receives about 90% of total state revenues is more suited for achieving a greater variety of goals.

The six trustees of the Permanent Fund are not elected officials. Nor are they constitutionally endowed with the authority to legislate policy. The legislature's decision on statutory guidelines for investment of the roughly 10% of state revenues automatically flowing in the Permanent Fund (as well as additional "voluntary" appropriations by the legislature) should be in accordance with a clearly defined investment strategy.



Above all, we would agree with Chairman Rasmuson that Alaskan investments of the Permanent Fund should not be doled out on a political basis or be the dumping ground for questionable proposals. Nevertheless, there is a proper and necessary role for the fund to play in the Alaska economy which is consistent with the "Trust" or "Savings-Income" concept and a prudent investment portfolio.

Before discussing further what some of the specific Alaskan investments could be to fit within this "Trust" or "Savings-Income" approach, it should be pointed out that there has been for some time confusion and conflict over what should be done with the earned-income of the Permanent Fund and how our choices in regard to this income dramatically effect the investment strategy. Presently, goals of the Permanent Fund are described statutorily in A.S.37.13.020 as follows:

1. A corporation (the Alaska Permanent Fund Corporation) should provide a means of conserving a portion of the state's revenues from mineral resources to benefit all generations of Alaskans;
2. the corporation's goal should be to maintain safety of principal while maximizing total return;
3. the corporation should be used as a savings device managed to allow the maximum use of disposable income from the corporation for purposes designated by law.

One of the purposes designated by law is set forth in the Permanent Fund Dividends Program (A.S.43.23.010-100) which provides that 50% of the income of the Fund earned during the previous fiscal year be deposited for distribution under the program. While the fate of the Dividend Programs remains in the hands of the U.S. Supreme Court, this scheme and ones like it will lead to the inevitability of the Permanent Fund falling into the same trap which has caught a great number of endowments like the Rockefeller and Ford Foundations. These endowments while



increasing in nominal terms have experienced a dramatic shrinkage of real earnings.

Rather than encouraging wise and prudent investments the challenged dividend program could well be a strong incentive to an imprudent investment strategy. If the "Policy, Purposes, and Findings" contained in section 1, Chapter 21, SLA. 1980 have any validity then the stated policy and purposes could have just as well been achieved by disbursements from the General Fund. As is the case now, when all of the earnings of the fund are paid out of the Permanent Fund rather than being reinvested, the Fund will ultimately suffer substantial erosion of its real principal. Fixed-income instruments continue to dominate the Fund's investment portfolio, but none of that income is reinvested in the Fund. Equity investments could, of course, help to preserve the real principal of the fund. Similarly, if dividends are to be paid out they should be paid out only from the real income of the Fund.

Before deciding to assign any role to the Permanent Fund in helping to provide Alaskans with mortgage money for homes, the beneficial impact of ^{the} home building ^{industry} on all sectors of the Alaska economy should be understood. The purpose of pointing out this beneficial impact is ^{not} to argue that social considerations should prevail over a hardnose investment strategy to maximize "return". It is only to say simply that the Permanent Fund like any other source of investment capital also must contribute, in the long run, to a healthy and "relevant" economy. Investment decisions by private institutions, individuals and institutions like the Permanent Fund should result in a beneficial and efficient use of resources. For the sake of the health of our economic system, the concept of "return" from investments must include ^{much} more than just ^{the} rate of current



earnings. The concept of return must also include the cost and benefits to ^{all the people} the people over an extended period of time of any investment activity.

Traditionally, home mortgages have been viewed as a long-term investment, when in fact they are, ^{not} at most, ^{they are} a medium-term investment which in Alaska are usually cashed out between the ^{five} ~~five~~ and seventh years.

The basic premise of the Permanent Fund participation in Alaska home mortgages is that there is no conflict between the trust or savings concept and a significant commitment of ^{an} the fund to this type of investment.

The current vitality and activity in the Alaska ^{and we all} economy is, in large part, due to construction activity, over 30% of which relates directly to construction of new homes. ^{home building}

Traditionally, as well as today, new homes benefit Alaska's local economies - they become a good investment for everyone. ^{there is no reason} The impact of new homes on the local economy more than offsets the additional cost for new utility hookups and expanded services.

The construction of 4,000 new homes and apartments generates on the average directly and indirectly 8,000 jobs. The total economic impact of direct construction dollars on the state's economy is over \$650 million. In addition, the spin-off purchases generate almost \$25 million for household goods and services.

There is no reason why the Alaska Permanent Fund could not participate more meaningfully in the interest earnings on Alaska home mortgages (and perhaps equity returns as well).

The following are some of the advantages of an Alaskan Permanent Fund



investment commitment to building homes for Alaskans:

1. These investments are secure, and relative to risk, produce a high rate of income. Typically, it is the biggest and most important investment individual Americans will make. Even in economic downturns it tends to be the very last debt that individuals will default ~~on~~ upon.
2. The rate of return is competitive with any relatively secure medium or long-term investment.
3. This type of investment will build an Alaskan constituency for the Permanent Fund in a more positive way than will the Dividend Program.
4. These investments will have a definite and positive impact on the Alaska economy. Home building means jobs - it puts people to work. The industry not only provides work for the homebuilder and his employees, but also a living for the sub-contractors, the suppliers, the freight handlers, the lenders, the insurance company employees, the realtors, the title company people, land developers, road builders, municipal employees, engineers, architects, surveyors, draftsmen, and the list goes on and on.
5. In balance with other investments, home mortgages are not only a good diversification for the Permanent Fund portfolio, but also would constitute a badly needed diversification of sources of Alaskan mortgage money. Presently, nearly all single family and duplex financing is provided by Alaska Housing Finance Corporation.

Once the Permanent Fund trustees and the legislature determine that the Alaska Permanent Fund should become involved in Alaskan mortgages in a more significant way than it is now, the question then becomes on what basis and to what extent.

There are many new methods of mortgage-financing which may or may not be workable for Alaska. The present ^{situation} disaster in the ^{rest of the} housing industry in the lower 48 suggests that the shared-appreciation or variable rate mortgages have not helped much.



Despite the scarcity of affordable home mortgage ^{money} in the lower 48, home prices in many cities in the U.S. are higher in comparison ^{than the} to Anchorage home prices. ^{We believe} Over the long run, it is the supply of houses and the demand for housing which will have the greatest impact on the price of homes.

While a fixed interest rate for the entire life of ^{the} a mortgage may not be possible, a jump in interest rates during a building season injects a great deal of uncertainty and instability into the market. A jump in interest rates during ^{the current} a building season ^{has created} often eliminates (in accordance with fairly rigid underwriting requirements) people who would otherwise still choose to be home buyers. This makes the builder and developer very cautious in building new homes and increases costs by lengthening the time the higher-rate interim financing must await "permanent financing". Whatever mortgage financing programs the various state funds might be involved in, programs which stabilize interest rates, even if only for a year, would help promote more cost-efficient building.

The Association of Home Builders urges adoption of regulatory and statutory changes necessary to enable the Permanent Fund to become ^a more meaningfully ^{source of} mortgage funds involved in home mortgages. This involvement could take the form of new mortgage instruments such as shared equity and variable rate mortgages (guided and adjusted according to an indexing standard). However, we believe that a revolving loan fund or account within the Permanent Fund could better supply the stability to the housing market while at the same time giving the Permanent Fund a good rate of return.



ALASKA PUBLIC INTEREST RESEARCH GROUP

Post Office Box 1093/Anchorage, Alaska 99510/(907) 278-3661

October 21, 1981

STATEMENT BEFORE THE BOARD OF TRUSTEES OF THE ALASKA PERMANENT FUND

Questions before us today really begin with a definition of the basic goal of the Permanent Fund. With that issue settled, we then must ask how big the fund should be and how it can be managed in a way that meets the goals and encourages public oversight of the Fund, which has been called a potential "fourth branch of government."

Our major points are these:

- * The Permanent Fund was established as a savings account to provide an endowment for the future and it should remain so.

- * It should be big, receiving annual appropriations above the minimum.

- * It should not be transformed into an Alaskan Development Fund. The political pressures for investing in projects of questionable value in the name of supporting the private economy will be too great to resist. The Board is not structured to deal with such pressures. The legislature is and that is where those issues should be considered and decided.

- * Thus, the Board's duty should be exclusively fiduciary not political.

- * The Fund should be managed on a basis that maintains the principal in the face of inflation before any income is dispensed.

- * Policies which give the public a visible link between Permanent Fund Management and public benefits will help ensure fiscal responsibility by both the Board and the legislature.

To embrace the Permanent Fund as an Alaskan Development Fund, we would need answers to two basic questions. Is Alaska's basic economic problem a capital shortage and, if so, is the Permanent Fund the place to turn?

Those who suggest an Alaskan Development Fund model for the Permanent Fund begin with the concern we all share for a healthy economy here in Alaska. The fundamental question is what, if anything, the state can and should do to promote a healthier economy? Ironically, proponents of "alaskanizing" the Permanent Fund have failed to learn the lesson trumpeted from Washington D.C. every day now. If just throwing money at social problems doesn't work, why will throwing capital at economic problems work any better?

Whether there is an Alaskan capital shortage is still under debate, but the second issue is more straightforward. Even if there is a capital shortage, the Permanent Fund is not the proper place to turn for Alaska's capital needs.

First, it's not necessary. The Fund by constitutional mandate receives 25% of all royalties, which works out to about 10% of total state revenues. There are quite simply tremendous resources outside the Permanent Fund available for ending any Alaskan capital shortage. To turn to the Permanent Fund to end any capital shortage is to say that having 90% of state revenues available is not enough to deal with whatever capital shortage exists. Is the shortage that drastic? Does a wise response to any shortage there is require so much capital so soon?

Second, ^{the idea of...} it's inconsistent with the intent of the Fund. As the House Special Committee on the Permanent Fund reported after extensive public hearings and consultation with experts:

The main goal of the permanent fund is permanence; what is, the fund's primary purpose is to preserve the money put into it. This dictates that investment risk be minimized, that permanent fund investments be as secure as possible.

Second, fund investments must produce income the committee decided that permanent fund investments must meet market rates and terms to insure, insofar as possible, their security and ability to produce income....

In making these decisions the committee realized that it was ruling out many types of investments, including highly speculative and subsidized investments. It also realized, however, that the permanent fund is only one of several financing vehicles available to the state and that it was unnecessary, as well as unwise, to try to design a permanent fund to do all things.

Wise policy and simple prudence dictate that the state use different tools to achieve different goals. To provide an endowment for the future, use the Permanent Fund. To provide loan monies, use the general fund. To provide money for capital improvements, use the capital budget. The capital budget could be funded by a constitutionally dedicated source such as Commonwealth North, has proposed. But the purpose of the Permanent Fund should not be subverted by changing the investment list to disguise state spending.

Third, it is ironic that some groups which are set to turn the Permanent Fund to their own preferred uses are simultaneously calling for a limit on state spending. Support for a spending limit is a recognition that there are revenues in excess of current needs, revenues which might otherwise be wasted due to simple political pressures. What should be done with those excess revenues? The House Special Committee on the Permanent Fund found that the public viewed the Permanent Fund "as a depository for mineral revenues in excess of current state needs." Many of the proposed uses of the Permanent Fund are basically schemes for spending state money without calling them "spending." If one agrees that there are revenues in excess of current state needs, (hence the need for a spending limit), how can one justify using the Permanent Fund for further spending?

Fourth, the Permanent Fund is not structured to manage investments like those proposed for an Alaskan Development Bank. The impressive list of special interests here today hoping to meet some of their perceived needs, the Permanent Fund should be a warning signal. Serving special interests with Permanent Fund investments would be disastrous. Do not complain about the isolation and the lack of scrutiny of the legislative process in Juneau. Delegating a legislative function to the Permanent Fund Board of Trustees, only worsens the public's ability to hold its government accountable.

The circumscribed financial investments now allowed help remove the Trustees from politics. Changing the investment list to a development

bank model throws the Board in the midst of politics with little accountability. The Board's duty should continue to be fiduciary not political. A circumscribed investment list should be maintained, ^{however} ~~but~~ that does not mean that the present list could not be broadened and still be consistent with prudent management. We do not feel we can comment on the relative risks of various investments. We only urge that relatively low risk be a criterion in portfolio selection.

With respect to ~~another~~ other issues, there has been concern about the Fund's ability to keep ahead of inflation. The Permanent Fund is funded by irreversibly depleting one of the world's most profitable investments--petroleum in the ground. If the Fund is to be an endowment to future generations of Alaskans, the legacy we give them should reflect the opportunity they lose by our actions. The Board should endo. setting a target real rate of return and endorse a policy that at minimum conserves the principal of the Fund after inflation.

A final issue concerns the accountability of the Fund's Board and of state policy-makers in general. If the public sees a clear link between the size and management of the Permanent Fund on the one hand and benefits to the public on the other, the public will want to ensure fiscally responsible policies by both the Fund's Board and state policy-makers. And if the public starts howling, both the Board and state leaders will start listening.

The Fund we hope will have income beyond that required to maintain the real value of the principal. That income should be used in a way that provides the public a clear link between their benefits and management of the Fund (including its size).

We are not prepared to comment fully on the relative merits of Permanent Fund Dividends versus endowing certain state expenditures. However, any policy that sets out a greater link than is now evident will help the public enforce fiscal accountability on the Board and public leaders.



October 22, 1981

Mr. Elmer Rasmuson, Chairman
Board of Trustees
Alaska Permanent Fund Corporation
Pouch SB
Juneau, Alaska 99811

Dear Sir:

Thank you for this opportunity to suggest some direction on the important policy decisions before you today.

We encourage you to suggest to the governor that the range of allowed investment opportunities be expanded. Specifically we feel that at least 3 areas should be included as approved investments: adjustable rate mortgages, improved real estate, and common stocks.

It may be important at this point to remind you of our function in loan origination. We issue private mortgage insurance on conventional residential real estate loans, which insure the lender-servicer and investor in the mortgage. Today most of the loans we insure are sold to AHFC, although some are purchased by other secondary markets including the Permanent Fund. We do provide insurance for adjustable rate mortgages. We prosper when excellent quality conventional loans are made, but frankly it makes no difference to us if the ultimate holder is the Permanent Fund or some other entity.

I will restrict my thoughts in this letter to addressing the items we feel you should consider before making a recommendation that the investment opportunities be expanded in the area of adjustable rate mortgages. I have discussed this topic with the senior officers of Republic Mortgage Insurance Company. We all reviewed copies of the Permanent Fund enabling legislation, the last four months financial statements, and all appropriate regulations and guidelines. Included in these meetings were members of the secondary

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ALASKA MORTGAGE ASSURANCE

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October 22, 1981

Page 2

marketing department, who arrange the purchase and sale of numerous mortgages and portfolios on an ongoing basis. We reviewed the following advantages of investment in adjustable rate mortgages indicated by the Chairman of the Fund recently, and we agree with them:

1. This program buys individual mortgages rather than bonds, and deals with exiting lenders and servicers.
2. It ensures a consistent flow of mortgage money that the builders, agents, and lenders can count on.
3. It is not a subsidized rate, but a fair rate, because of an interest rate cap which limits increases or decreases to 2 percent per year.
4. It conforms to the "prudent man" rule.
5. It has reasonable inflation protection.
 - a. If the mortgage contains the "due on sale" clause, the life of Alaskan mortgages may well get back to the historical 7½ year period.
 - b. With adjustable rates, the investment return tracks with the market.
6. It is fair to all Alaskans.
 - a. There need be no dollar limit on the mortgage.
 - b. It could be used to extract equity, finance rental housing and refinance homes. If there should be a demand for this money greater than the fund formula allows, preference could be given to new, owner-occupied housing.

We note two additional advantages and two disadvantages for your further consideration.

ADDITIONAL ADVANTAGES

1. Selection of an index closely tied to inflation would allow these funds to be invested without the need for any significant management on the part of the Fund. This could be an extremely stable core of investments for the Fund.
2. Every borrower under this program has a vested interest in reducing inflation, since the payment varies downward in times of reduced inflation.

DISADVANTAGES

1. In Alaska, as long as some subsidy exists for relatively lower priced homes through the current AHFC programs, the loans submitted to the Permanent Fund will probably be on the more expensive homes. Less expensive loans can readily be acquired, but probably not from within Alaska at this time.
2. Mortgages insured by private mortgage insurance companies are reasonably safe investments, but do not carry the benefit of guaranty by the Federal Government through their VA and FHA programs.

We believe the advantages of investing in ARMS should be pursued and the following legislative or regulatory changes adopted:

ADJUSTABLE RATE MORTGAGE LOANS.

Under AS 37.13.120 (i) the corporation will, in its discretion, purchase insured conventional residential loans which bear interest at rates to be adjusted annually or otherwise as deemed by the corporation to be in their best interest under the following provisions:

1. the loans must be for one to four unit dwellings, and
2. the loan-to-value ratio must be no more than 90 percent for one-to-four unit owner occupied dwellings, and 80 percent for non-owner-occupied dwellings.
3. The mortgage must, under AS 37.13.120 (g) (16), be insured by a private mortgage insurance corporation which is authorized to do business in Alaska and is an approved Federal National Mortgage Association private mortgage insurer. The minimum coverage shall be those minimum requirements established by Federal National Mortgage Association.
4. The mortgage shall be tied to an index widely published, readily verifiable to the borrower, and approved by the Federal National Mortgage Association.

We believe that an index can be selected that will suit the Permanent Fund very well, and will return a true net yield above inflation.

We would like to discuss the merits and weaknesses of several indices in a work session of the Permanent Fund or the Fund's staff if this is desired by any member of the Board, and we offer the attendance of our secondary market staff and senior officers of RMIC at such a session.

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In conclusion, we have reviewed the existing investment opportunities available to the Fund, and we recommend the expansion in at least 3 areas: adjustable rate mortgages, improved real estate, and common stock.

The adjustable rate mortgages will allow your funds to be invested with very modest management requirements on the part of the Fund, and should yield a true return greater than inflation.

Thank you for your consideration of these items, and we look forward to working with you in the future.

Sincerely,

A handwritten signature in cursive script, appearing to read "R. P. Bannon".

ALASKA MORTGAGE ASSURANCE
ROBERT P. BANNON

RPB/paw

Copies: All Board Members
Jim Rhodes
Sen. Arliss Sturgelewski

FREE

Federation's Role in our Enterprise Economy

NOVEMBER 11, 1981

RECEIVED
NOV 23 1981

ALASKA DEPARTMENT OF REVENUE
TREASURY DIVISION
JUNEAU

CHAIRMAN AND MEMBERS OF THE BOARD OF TRUSTEES
OF THE PERMANENT FUND
ALASKA PERMANENT FUND CORPORATION
POUCH SB
JUNEAU, ALASKA 99811

DEAR SIRs:

WE ARE PLEASED TO PRESENT THE ATTACHED POSITION PAPER FOR YOUR CONSIDERATION. AS YOU KNOW, WE EXPRESSED SOME OF OUR CONCERNS REGARDING THE USE AND INVESTMENT OF THE PERMANENT FUND AND ITS EARNINGS AT YOUR OCTOBER 22, 1981 MEETING. FOLLOWING EXTENSIVE RESEARCH AND DISCUSSION OF MATERIAL FROM NATIONAL, STATE AND LOCAL SOURCES, THIS ATTACHED PAPER ADDRESSES THOSE CONCERNS AND PROPOSES SOME CONSTRUCTIVE SUGGESTIONS REGARDING THE INVESTMENT OF ALASKA'S NEW FOUND WEALTH.

WE WOULD BE PLEASED TO DISCUSS OUR IDEAS WITH YOU. WE WILL MAKE A COPY OF THIS REPORT AVAILABLE TO EACH LEGISLATOR.

RESPECTFULLY SUBMITTED,

PRISCILLA THORSNESS AND MYRLE NECRASON, CHAIRPERSONS
FREE ENTERPRISE AND ECONOMIC DEVELOPMENT SUB-COMMITTEES

MEMBERS:

PAMELA LAMBE
SARA SCHIERHORN
MARYLIN PAINE
DOROTHY DAVENNY

MARLENE RAPP
CISSIE BRAUND
MARIANNE HELMS
EVELYN LYON

FREE COMMITTEE
ANCHORAGE WOMAN'S CLUB

THE BOARD OF TRUSTEES OF THE ALASKA PERMANENT FUND HAS REQUESTED THE PUBLIC TO EXPRESS THEIR FINDINGS AND OPINIONS CONCERNING THE INVESTMENTS OF THE PERMANENT FUND AND ITS EARNINGS. SPECIFICALLY THEY ASKED FOR INPUT ON QUESTIONS SUCH AS:

HOW LARGE SHOULD THE PERMANENT FUND BE?

WHAT SHOULD BE THE INVESTMENTS OF THE FUND AND WHERE?

WHAT SHOULD BE DONE WITH THE INCOME OF THE FUND?

THE BOARD HAS EXPRESSED A CONCERN THAT THE TYPES OF INVESTMENTS ARE TOO LIMITED TO RETURN A SUFFICIENT MARGIN OF PROFIT TO HEDGE AGAINST INFLATION. THE TRUSTEES SHOULD APPOINT AN INVESTMENT ADVISORY COUNCIL CONSISTING OF NATIONAL AND INTERNATIONAL CONSERVATIVE FINANCIAL LEADERS WHO COULD BID FOR POSITIONS ON THE BASIS OF THEIR PAST PERFORMANCES. WE SHOULD RECOGNIZE THAT THE STATE IS NOT AN EXPERT IN THE WORLD OF FINANCE AND THAT THE PERMANENT FUND IS LARGE ENOUGH TO WARRANT OBTAINING EXPERT ADVICE ON INVESTMENT STRATEGY. THE FUND SHOULD NOT BE INVESTED ENTIRELY IN ALASKA, FOR WE BELIEVE THE PERMANENT FUND SHOULD NOT BECOME THE BASIS OF THE ALASKAN ECONOMY.

WE HAVE COME TO THE CONCLUSION THAT ANY DISCUSSION OF THE PERMANENT FUND MUST FIRST ADDRESS ALL THE OIL WEALTH, AS THIS IS THE SOURCE FOR THE FUTURE NEEDS OF OUR STATE. AT PRESENT, ONLY 10% OF THE STATE REVENUES GOES INTO THE PERMANENT FUND, PLACING 90% INTO THE GENERAL FUND. THE STATE IS CURRENTLY SPENDING LARGE AMOUNTS ON PROJECTS WITH NO REAL PLAN FOR THE FUTURE. UNLESS THE STATE PLANS FOR THE FUTURE, THIS REMAINING 90% MIGHT BE SPENT ON UNWARRANTED AND/OR EXTRAVAGANT PROJECTS AND SPIRALING STATE BUDGETS. THIS COULD RESULT IN DEPLETION (BY LEGISLATIVE INVASION) OF THE REMAINING 10% IN THE PERMANENT FUND.

IN OUR OPINION, THE STATE MUST CONSTRUCT A LONG RANGE PLAN FOR BUDGET, CAPITAL IMPROVEMENT AND INFRASTRUCTURE NEEDS, AND STATE INVOLVEMENT IN ENCOURAGING ECONOMIC DEVELOPMENT. THIS PLAN SHOULD INCLUDE SHORT AND LONG TERM PROJECTIONS. THE STATE

MUST THEN REVIEW REVENUE CAPABILITIES TO ENSURE THE VALIDITY OF THESE PROJECTIONS.

CRITICAL TO THIS PLAN IS ESTABLISHING A LIMIT TO STATE SPENDING. IF THE STATE BUDGET CONTINUES TO ESCALATE AT ITS PRESENT RATE WE WILL SOON FIND OURSELVES WITHOUT SUFFICIENT FUNDS. WE BELIEVE THE FIRST ORDER OF BUSINESS FOR THE PRESENT LEGISLATURE SHOULD BE TO REDUCE THE 1982 BUDGET, BRINGING IT INTO ACCORDANCE WITH THE SPENDING LIMITATION LEGISLATION.

AT PRESENT, THE EXCESS FUNDS FROM THE GENERAL FUND REVENUES THAT ARE NOT SPENT HAVE BEEN APPROPRIATED TO THE PERMANENT FUND. WE RECOMMEND THAT THESE EXTRA FUNDS SHOULD BE SET ASIDE IN AN INVESTMENT FUND SIMILAR TO THE PERMANENT FUND THAT COULD BE USED FOR CAPITAL IMPROVEMENTS AND INFRASTRUCTURE PROJECTS. (SEE ATTACHED CHART)

WE WOULD PROPOSE THAT A CONSTITUTIONAL AMENDMENT BE TAKEN TO THE VOTERS TO ESTABLISH A CAPITAL IMPROVEMENTS AND ECONOMIC INFRASTRUCTURE FUND. THE PERMANENT FUND RECEIVES "25% OF ALL MINERAL LEASE RENTALS, ROYALTIES, ROYALTY SALE PROCEEDS, NET PROFIT SHARES UNDER AS 38.05.180 (f) AND (g), AND FEDERAL MINERAL REVENUE SHARING PAYMENTS RECEIVED BY THE STATE FROM MINERAL LEASES ISSUED ON OR BEFORE DECEMBER 1, 1979 AND 25% OF ALL BONUSES RECEIVED BY THE STATE FROM MINERAL LEASES ISSUED ON OR BEFORE FEBRUARY 15, 1980" AND 50% OF THE ABOVE SUBSEQUENT TO THE DATES INDICATED). WE WOULD PROPOSE THAT THE OTHER 75% AND 50% RESPECTIVELY OF THESE REVENUES BE PLACED IN THIS CAPITAL IMPROVEMENTS AND ECONOMIC INFRASTRUCTURE FUND. WE WOULD ALSO PROPOSE THAT ALL CAPITAL PROJECTS OVER \$1 MILLION BE FUNDED BY THIS FUND. INFRASTRUCTURE PROJECTS SHOULD BE BUILT ALLOWING EACH OF THE JURISDICTIONAL DISTRICTS ONE LARGE CAPITAL IMPROVEMENT PROJECT COMPLETED BEFORE ANOTHER DISTRICT QUALIFIES FOR A SECOND PROJECT.

THE FUND WOULD BUY BOTH GENERAL OBLIGATION AND REVENUE BONDS FROM THE STATE FOR USE IN CAPITAL IMPROVEMENT AND INFRASTRUCTURE PROJECTS. GENERAL OBLIGATION BONDS WOULD FUND CAPITAL

PROJECTS SUCH AS ROADS, BRIDGES, ETC. WHICH DO NOT GENERATE REVENUE; REVENUE BONDS WOULD FUND THE LARGE INFRASTRUCTURE PROJECTS SUCH AS RAILROADS, DAMS, AIRPORTS, ETC. WHICH WOULD BE EXPECTED TO PAY FOR THEMSELVES. THE FUND MIGHT ALSO BUY CORPORATE BONDS FOR INVESTMENT IN LARGE PRIVATE PROJECTS (PIPELINES, ETC.). WE MUST CAUTION THAT WE DO NOT WANT THE STATE TO COMPETE WITH OR REPLACE FREE ENTERPRISE. HOWEVER, CERTAIN PROJECTS ARE SO LARGE IN SCOPE THAT THE PRIVATE SECTOR HAS DIFFICULTY COMING UP WITH THE NECESSARY CAPITAL TO FUND THE PROJECT. WE BELIEVE THE STATE COULD HAVE A ROLE IN THESE TYPES OF PROJECTS WHICH WOULD BENEFIT ALL ALASKANS. THE USE OF THE BONDING INSTRUMENT IS IMPORTANT. THOUGH THE STATE HAS THE FUNDS TO APPROPRIATE THE DOLLARS FOR A PROJECT, THE BONDING SYSTEM FIRMS UP THE ECONOMIC RESPONSIBILITY FOR PROJECTS AND REQUIRES VOTER APPROVAL.

THIS PORTION OF THE ROYALTY AND BONUS REVENUES ALLOCATED TO A CAPITAL IMPROVEMENT AND ECONOMIC INFRASTRUCTURE FUND WILL ENSURE PERMANENT BENEFITS TO ALASKA. A FUND OF THIS TYPE IS OUR HEDGE AGAINST INFLATION; BUILDING CAPITAL THAT WILL BENEFIT THE STATE 50 TO 100 YEARS FROM NOW. THE REVENUE GENERATED THROUGH SEVERANCE, CORPORATE INCOME AND OTHER TAXES SHOULD BE MORE THAN SUFFICIENT TO PROVIDE FOR THE DAY TO DAY GOVERNMENT OPERATIONS WITHIN A SPENDING LIMITATION BUDGET.

THE PERMANENT FUND SHOULD REMAIN AS ORIGINALLY DESIGNED, WITH THE FOLLOWING SUGGESTED CHANGES;

1. THE REVENUE EARNED ON THE PERMANENT FUND INVESTMENTS SHOULD BE REINVESTED IN THE PERMANENT FUND. IT SHOULD NOT REVERT TO THE GENERAL FUND AS THE LAW NOW PROVIDES.

2. CERTAIN CHANGES SHOULD BE MADE IN THE STRUCTURE OF THE BOARD OF TRUSTEES. CURRENTLY, THE BOARD OF TRUSTEES IS MADE UP OF THE COMMISSIONER OF REVENUE, TWO OTHER COMMISSIONERS AND THREE MEMBERS FROM THE PRIVATE SECTOR WHO HAVE EXPERTISE IN FINANCE, ALL APPOINTED BY THE GOVERNOR. THIS STRUCTURE PLACES TOO MUCH CONTROL IN THE HANDS OF THE GOVERNOR. WE PROPOSE THE BOARD BE CHANGED TO INCLUDE THE COMMISSIONER OF REVENUE AND FIVE MEMBERS OF THE PRIVATE SECTOR, WHO HAVE LONG STANDING

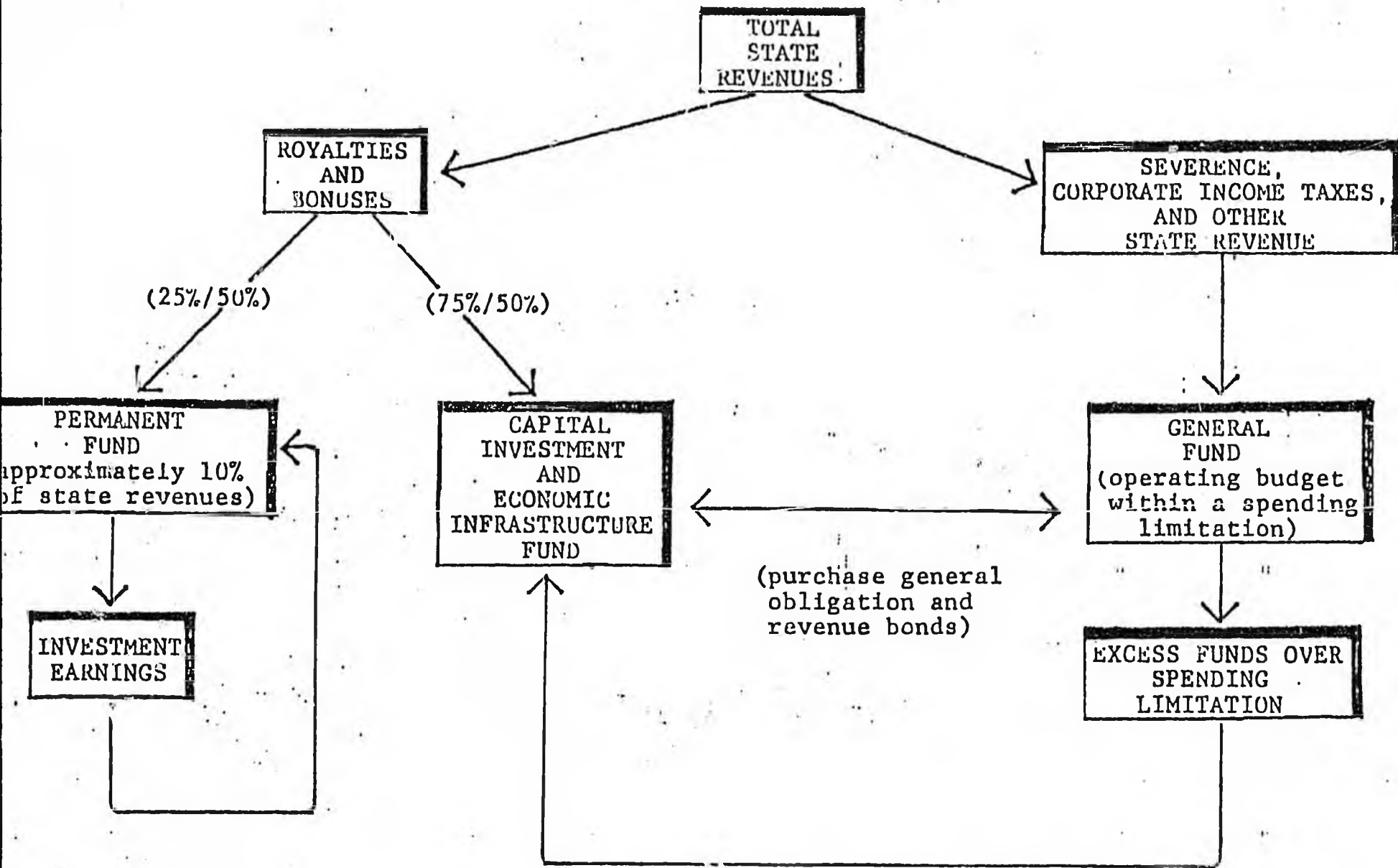
SOLID FINANCIAL BACKGROUNDS, TO BE APPOINTED BY THE GOVERNOR AND APPROVED BY THE LEGISLATURE. IN ADDITION, THE COMMISSIONER OF REVENUE ALSO SHOULD BE CONFIRMED BY THE LEGISLATURE. THESE INDIVIDUALS WOULD SERVE STAGGERED TERMS.

CERTAIN SUGGESTIONS HAVE BEEN MADE REGARDING THE USE AND INVESTMENT OF THE PERMANENT FUND AND ITS REVENUES. WE DO NOT BELIEVE THAT CASH PAYMENTS SHOULD BE MADE TO THE PEOPLE OF ALASKA. THIS TYPE OF "SOMETHING FOR NOTHING" DISTRIBUTION WHERE THERE HAS BEEN NO RISK INCURRED OR WORK PERFORMED IS NOTHING MORE THAN A FORM OF WELFARE AND PROBABLY WILL DO LITTLE TO INSTILL MUCH INTEREST IN THE WORKINGS OF THE PERMANENT FUND BY THE RECIPIENTS. MORE IMPORTANTLY, CASH DIVIDENDS WILL ATTRACT THE ATTENTION OF OTHER STATES TO THE DETRIMENT OF ALASKA'S ECONOMY, CAUSING "OUTSIDERS" TO COVET ALASKA'S OIL WEALTH.

THE PERMANENT FUND SHOULD NOT BECOME INVOLVED IN ANY REAL ESTATE INVESTMENTS, IN CORPORATE STOCK OWNERSHIP OR IN ANY OTHER INVESTMENT THAT COMPETES WITH FREE ENTERPRISE.

THE PERMANENT FUND INVESTMENTS SHOULD YIELD THE MAXIMUM RETURN WITHIN THE CONSTRAINTS OF THE SCOPE OF THE INVESTMENT MARKET ESTABLISHED BY STATUTE. THE STATE SHOULD NOT USE THIS FUND TO SUBSIDIZE THE HOUSING MORTGAGE MARKET OR INVEST IN ANY OTHER SUBSIDY PROGRAM

WE WOULD APPRECIATE SERIOUS CONSIDERATION BE GIVEN TO OUR RECOMMENDATIONS FOR CHANGE BY BOTH THE BOARD OF TRUSTEES OF THE PERMANENT FUND AND THE PRESENT MEMBERS OF THE STATE LEGISLATURE.



2 MR. ERICKSON:

3 Certainly, Mr. Chairman. Mr. Chairman, Trustees, Legislators.
4 This is the first time I've had an opportunity to talk to you
5 and it may be a little presumptuous but I'd like to ask you
6 a favor. I'd like to ask you when you go home tonight or
7 some other time when you have a few moments to sit down and
8 put on a piece of paper your perceptions of what we who live
9 here now in Alaska should try to achieve in this State in the
10 next five years, in the next ten years. Just make a list.
11 You might want to put down elimination of poverty. You might
12 want to put down the restraint of government growth. I know
13 one thing that would be on my list would be the development of
14 an economy for the State of Alaska that will sustain itself
15 after the oil is gone so that my children and my grandchildren
16 will be able to live here and have the kind of good life that
17 I think I've had in Alaska. After you've made that list, I'd
18 like you to write the number \$37,000 alongside of it and I'd
19 like you to ask yourselves how many of these goals or these
20 priorities would not be achieved if every one of the 100,000
21 Alaskans who are here now received a check tomorrow for
22 \$37,000. The number \$37,000 doesn't come out of a hat. It's
23 the present value, discounted at 4 percent in eliminating
24 inflation, of the 75 percent of Prudhoe Bay royalties that are
25 not dedicated to the Permanent Fund. In effect, if the State

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1 were to give every Alaskan their share, their undedicated
2 share, of Prudhoe Bay royalties it's one measure of what that
3 piece of paper, that share, might be worth. One might ask
4 why am I bringing this idea which really is peripheral in a
5 sense to the Permanent Fund before you. Well, one reason is
6 that the notion really came home to me as the consequence of
7 reading the papers of Professors Coffman and Fry and Gordon
8 and Arrow which were commissioned by you and which seem to me
9 to make a compelling, albeit, very theoretical argument for
10 direct distribution of Permanent Fund -- or of all the oil
11 revenues that are being received by Alaska and financing of
12 government by taxing those revenues back to the extent that
13 the people of Alaska were willing to allow that to occur. I
14 think there's another reason why it's important for the
15 Trustees of the Permanent Fund to be concerned about this
16 kind of broad social issue. That is, as you are well aware,
17 and as you've heard for months now, the notion of saving the
18 Permanent Fund is, if not under attack, at least being sniped
19 at. And I think that difficulty, that dissanctity of the
20 Permanent Fund, and your ability to act as Trustees in the
21 real sense of the word, is going to be challenged by the ever
22 increasing needs of government growth and the special subsidies
23 that people have come to expect from our government and,
24 perhaps, from unexpected declines in oil revenues which may
25 make it doubly important to consider these kinds of proposals

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1 that are really already before you in the papers that I've
2 just mentioned. Now, as I said, the idea of direct distribution
3 is theoretically very appealing but it hasn't received what
4 we might call the flushing out that would be necessary to
5 really stimulate public discussion of the idea. Let it be
6 understood that I'm not suggesting that this is necessarily
7 the right way to go and I'm not suggesting that the Permanent
8 Fund Trustees should, at this point, endorse such an idea.
9 But what I am suggesting is that you have raised a extremely
10 exciting issue, I think, in commissioning those papers that I
11 referred to earlier and that it behooves you to follow up on
12 that and to answer some of the practical questions that that
13 kind of proposal raises. I think the way that you might
14 consider doing this is to commission a study by a nationally
15 known accounting firm, Peat, Marwick or Ernst and Ernst or
16 Arthur Anderson, and ask them to look at the kind of questions
17 that this proposal raises. For example, they might look at
18 the families in Texas who suddenly got rich back in the 1920s
19 as a consequence of oil being discovered on their land. Dirt
20 poor farmers. And they might ask have those families stayed
21 -- have those households stayed rich or was it an ephemeral
22 thing that drifted away? They might ask the question, how
23 will this money affect immigration and outmigration from
24 Alaska and to Alaska? I would note that one of the real
25 advantages of this one-shot kind of distribution is that it

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1 doesn't create the kind of incentives to move into the State
2 that one finds with the dribbling-out approach to Permanent
3 Fund dividends. I would also note that there's a qualitative
4 difference between giving people \$1,000 a year or even \$2,000
5 a year and giving them a real lump of capital upon which
6 private wealth can be established. Now, I have a good friend
7 who, when I discussed this idea with him, said -- told me a
8 story, said -- this friend is from a family that is quite
9 rich, apparently, and he and his brothers and sisters
10 inherited a great deal of wealth and he said, you know, Gregg,
11 that's just immoral. I have seen what money that you didn't
12 have to work for did to my sister. And I thought about that
13 and I thought, well, you know, he is right. There is a risk
14 in giving people these kinds of resources who maybe haven't
15 had the opportunity to learn how to deal with them. But you
16 know, I'm much more willing to accept that risk than I am
17 to continue down the path that we're going right now in which
18 the -- you know, Mr. Chairman, you spoke about tradition a
19 little bit ago and it occurred to me that the traditional
20 image of what Alaska is all about has been the rugged
21 individualist, the fisherman, the prospector, the pioneer.
22 Well, that image continues to be the image of Alaska outside
23 but for those of us that are here we are becoming aware that
24 the real Alaskan is becoming the lobbyist and the special
25 pleader. Now, you've heard a lot of compelling arguments, I

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1 think for things that might be classed as special pleading
2 and I think that the people who have spoken to you have a
3 point and their point is that that wealth that supposedly
4 belongs to all of us isn't doing the people of this State much
5 good and they're trying to grasp for ways to find that -- how
6 that benefit which they see there can get to the people. I'm
7 not sure that the study that I mentioned would achieve --
8 would result in any kind of consensus but I am sure that the
9 arguments for direct distribution are so compelling in their
10 theoretical formulation that it simply would be a tragedy
11 not to look into the practicalities of the issue and there are
12 a great many. I'm through.

9 PROFESSOR TUSSING:

10 I suggested he go in my place because I had to go for a few
11 minutes but I think the way the discussion progressed was
12 rather than giving my prepared statement it might make more
13 sense just to take off from where he left off and rather than
14 beginning at the beginning, begin at the end by saying first
15 that I don't see any particular urgency for revising the
16 Permanent Fund statute or the way in which it's governed.
17 The money that has been dedicated to the Permanent Fund is
18 not needed for any urgent instate use now. The General Fund
19 as it exists after the \$1.8 billion appropriation and after
20 the statutory minimum is the biggest per capita pork barrel
21 in any democratic political jurisdiction in the world and
22 if the various social causes, the various programs for State
23 capital spending can't find enough money in that pork barrel,
24 I think there's something very, very wrong. And there are a
25 number of things that are very, very wrong. But not with the

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1 Permanent Fund - not with the Permanent Fund. I'd deal with
2 two of the -- two criticisms of the Permanent Fund concept
3 or the way in which it's managed and try to do it very
4 briefly. First, the notion that investment in interest-
5 bearing securities is particularly vulnerable to inflation,
6 that the investments don't keep up with inflation and I think
7 that's purely a -- that's the viewpoint of a speculator rather
8 than an investor. Over the long haul safe investments do
9 yield a real rate of return above inflation. Safe invest-
10 ments do not yield 8, 10, 12, 15, 25 percent above inflation
11 but they do replace the erosion that takes place as a result
12 of the reduction in the value of money and those who make
13 this criticism have been looking at the experience of the
14 '70s where the monetary authorities in the United States
15 were inflating the money supply at such a rate that we did
16 have, for a period of time, eight to ten years, negative real
17 interest rates. And those who put their money into ten-year
18 interest-bearing securities back in the early 1970s did lose, as I
19 say, that's a speculator's point of view. In the long run,
20 these securities do maintain their value. And at -- right
21 now the interest rates show the highest spread above
22 inflation rates at any time since the great depression. This
23 is above all the time in which there's an enormous opportunity
24 to make a killing in the bond market and the idea that the
25 criticism that the earnings aren't sufficient is very badly

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1 timed. First, there's no urgency. There's nothing, no
2 demand that's not being served on the State's money that's
3 so urgent that it requires a raid of the Permanent Fund and,
4 second, there is an opportunity for the Permanent Fund not
5 only to maintain its value but to make substantial earnings
6 now. The whole notion that it should be speculative -- that
7 we -- criticising the management of the money from the
8 speculative point of view leads to the kind of situation we
9 had with the 1969 bonus money where the State Department of
10 Revenue put it into the stock market at the very top of a
11 ten year cyclical peak and lost a couple hundred million
12 dollars within a couple months.

13 SENATOR STURGULEWSKI:

14 No. \$14 million.

15 PROFESSOR TUSSING:

16 Fourteen million, was it?

17 MR. RASMUSON:

18 We're trying to narrow the parameters here a little bit.

19 PROFESSOR TUSSING:

20 And if the State had really put its money into gold at the
21 time that most people thought that it had put it into gold,
22 there would have been enormous loss. I was aware that that
23 move was taken at the very top of the gold price cycle too.
24 Anyway, the -- in principle, I believe the Permanent Fund
25 ought to be able to invest in equities. In practice, once

1 that door is opened in Alaska, the pressure to invest on
2 other grounds than strict business grounds is so great that
3 the only way in which the ability to invest in equities
4 would be consistent with prudence was if the law allowed the
5 Permanent Fund to invest in any equity except Alaska equities.
6 And that would probably be harder than maintaining the status
7 quo so I'm in favor of maintaining the status quo and as far
8 as I can tell that the fiscal management of the monies in
9 trust, the fund has been very good to date and the criticisms
10 that are applied to the Alaska -- to the Alberta Heritage
11 Fund are not appropriate in this case. The Permanent Fund --
12 getting back to the last discussion between Chairman and
13 Gregg Erickson. I think the argument for the Permanent Fund
14 and the argument for direct distribution are the same
15 argument. That is that there is -- that legislative appro-
16 priations have no efficiency -- economic efficiency test
17 whatsoever. They're not tested in the market and they tend
18 -- the allocation of funds from the Legislature tends to be
19 determined on a basis of peoples' personal notions -
20 legislators and the people who talk to legislators - notion of
21 what is important. And on a whole series of half-baked and
22 untested theories of economic development. There is no --
23 the value of both the direct distribution and putting the
24 money in the Permanent Fund is that there is at least some
25 market test, some efficiency test, of how the money is disposed

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1 of. The best thing -- I think the biggest contribution to
2 the Permanent Fund -- or one of the biggest contributions to
3 the Permanent Fund and is simply the fact that it prevents the
4 money from being spent now and in answer to Senator
5 Sturgulewski's question, there's probably nothing - there's
6 probably no way of spending this money that enhances the
7 long term viability of the non-oil economy in Alaska. That
8 in effect the money will, on the average, do what the gold
9 from South America did to the Spanish economy, that is create
10 an inflation that devastated it. Spain and Portugal were
11 the most advanced countries in Western Europe in the 15th
12 century. As a result of the influx of gold and silver they
13 were able to buy everything they needed outside and the gold
14 financed -- gold and silver financed the industrial revolution
15 in England and the low countries. By the time the gold was
16 gone, the -- both agriculture and industry in Spain and
17 Portugal were devastated and they never recovered. We have
18 a similar thing occurring now in some of the oil rich
19 countries. I think the example of Iran which was probably
20 well -- it had the preconditions for the great leap to
21 modernization. It had the kind of infrastructure, it had an
22 entrepreneurial class. It had the preconditions such as many
23 of the countries of East Asia had prior to their leap to
24 industrialization and modernization. The oil money simply
25 diverted it. It went into the government. It diverted not

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1 only the government money itself but private entrepreneurship,
2 talent, and private capital, into those industries that were
3 chosen by the government and those that had the favor of the
4 particular factions in the bureaucracy, factions in the royal
5 family. And it's left really nothing. It survived the demise
6 of the Shah and the serious reduction of the country's oil
7 income. The same thing is happening in Mexico today. Mexican
8 oil income is going into the government sector. The
9 government is building steel mills and petrochemical plants
10 at much higher cost than they could buy steel or petrochemicals
11 abroad. They're dissipating this money earned by a comparative
12 advantage in producing oil in a -- in industries that have
13 no comparative advantage in Mexico. But a private enterprise
14 in Mexico would postpone for many, many decades because
15 development of small-scale modern agriculture, of small
16 manufacturers that can take advantage of the abundant labor
17 force and the climate and excellent growing conditions in
18 some part of the country would have a far higher rate of
19 return. If that oil money in Mexico went into -- went
20 somehow into directly to the people and allowed -- allowed the
21 people just through their spending to provide a market in
22 Mexico in the villages for more locally produced goods of
23 small industry and agriculture in Mexico the contribution to
24 development would be much greater. What's going to happen in
25 Alaska is that we're going to have a very inefficient

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1 grandiose, socialist economy in which there's a large quasi
2 private sector that depends entirely upon the expenditure of
3 State money for its sustenance and I think the Legislature's
4 direction on hydro is the epitome of this. That we -- the
5 other fallacy I'd like to draw upon is that -- to mention is
6 that the State's provision of services is efficient because -- as
7 compared to the distribution of money because the federal
8 government doesn't get a cut out of it. Now, it is inefficient
9 if you distribute money directly to the people or, for that
10 matter, reduce their taxes -- their State taxes because, on
11 the average, the federal government gets some 30 percent of
12 it. Let's look at the provision of electric power. Talk
13 about public power being cheap. Well -- and the Northwest
14 being an example. Well, public power was cheap in the
15 Northwest because they had the Columbia River and they had
16 very cheap government money. But once that's been exhausted,
17 the public utilities in the states of Oregon and Washington
18 are building nuclear plants that most independent analysts
19 said were unnecessary to serve their demand but these are
20 unregulated, nonprofit enterprises whose main reason for
21 existence is to grow. And they are building some nuclear
22 plants which, if they ever go on stream, will cost more than
23 twice as much as plants of a comparable size and timing built
24 by profit-making private enterprises, by private utilities
25 elsewhere in the lower 48 that had to face a public utilities

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1 commission to justify their rates and had to face the bond
2 market to justify their construction schedules. These are --
3 and so I suspect that Alaska is well on the road to replacing
4 for the railbelt the cheapest thermal power in the whole
5 world except for Kuwait with the most expensive hydro and
6 calling it cheap because the State's going to sink its
7 entire -- its entire oil heritage in this on the theory that
8 this is one way of getting it -- of getting the benefits to the
9 people and having those benefits not taxed away. Well, it
10 isn't going to be cheap and the problem is -- I don't know
11 whether hydro is -- hydro is in principle -- whether Susitna
12 is in principle going to be cheaper than combustion turbines
13 for Cook Inlet Natural Gas. The Legislature has appropriated
14 over a million dollars for Battelle to look at it. I suspect
15 that absent a market test, absent the bond buyers leaning
16 over the shoulder of the power authority seeing that you've
17 got competent project management, that you've got -- that the
18 contractors that are going to complete the project on schedule
19 and reasonably within cost, that this is going to be a
20 fantastic boondoggle, not because there's anything wrong with
21 hydro but because State enterprise that pretends what is very
22 expensive is very cheap is guaranteed to make it even more
23 expensive and to hear -- it's almost -- it's ironic that all
24 this is being pushed by people who consider themselves
25 business conservatives and who are building -- I think in

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1 Alaska probably the most wasteful socialist government in
2 North America simply because there is no efficient way of
3 getting the benefits to the people and that's . . .

4 MR. RASMUSON:

5 Mr. Tussing, I've got to call time because this is why I
6 always urge that there be the discipline of prepared remarks
7 ahead of time. Now, I've got four more people and that four
8 more in an hour, that's fifteen minutes and I know with your
9 excellent presentation here there's going to be some comments
10 by the Legislature. Could you give us five minutes?

11 Legislature? Or do you all agree with Arlon? Mr. Cotten.

12 REPRESENTATIVE COTTEN:

13 Yeah. I'll be real quick here. You started out, Arlon,
14 saying that you didn't think any changes were necessary to
15 the statutes that affect the Permanent Fund. Maybe I
16 misunderstood that. And then you suggested that the invest-
17 ments that -- the fund was receiving more than beat inflation
18 but as you know there's no requirement that we replace the
19 money to the fund so would you continue to say that you don't
20 need any statutory changes or how would you react to a
21 proposal that would require reimbursement of the fund or
22 reinvestment into the fund in that amount that was depreciated
23 by inflation?

24 PROFESSOR TUSSING:

25 Well, I think in principle it's a good idea. Just like in

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1 principle the Trustees of the fund ought to have the option
2 to go into -- I'm very afraid of what happens if you open up
3 the whole question of the statutory structure of the fund
4 that it's going to be very -- I would favor the greatest
5 possible contribution to the fund at this time although in
6 principle I believe that there ought to be a direct distribu-
7 tion, by far the second best is to limit the amount of money
8 available for expenditure in what are probably counterproductive
9 of general and capital programs. So that the easiest way
10 the Legislature simply to handle that is next time make it
11 more than a billion, eight. Make it more than required by
12 the budget limit. Just put everything conceivable into that
13 fund. If the long-term interest of the State that's provided
14 by putting the money into the fund is that the -- since the
15 State expenditures are creating an inflated economy and
16 encouraging the development of capital programs that are
17 going to have to be maintained in the future and basket case
18 industries that couldn't be maintained without the oil money,
19 the more money that goes in the Permanent Fund now, the less
20 the citizens are going to have to be squeezed in taxes to
21 support all these boondoggles after the money that was
22 available for the pork barrel runs out. Putting a lot of
23 money in the Permanent Fund is, in a sense, the other side of
24 the coin to these capital programs and these programs to
25 subsidize infant industries as it means that the people

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1 -- the shock, the landing is going to be not quite as hard
2 when the oil money does begin to diminish.

The Three Basic Policy Questions
Concerning the Permanent Fund

Remarks Made Before the Board of Trustees
of the Alaska Permanent Fund
October 22 1981

Scott Goldsmith
Associate Professor of Economics
Institute of Social and Economic Research
University of Alaska

A. Prologue

There are three policy questions concerning the Permanent Fund, each of which I would like to address in turn. They are as follows:

How much should we save?

What investments should our savings go into?

What shall we do with the income from our investments?

First, however, I want to touch on the more fundamental question concerning the wealth currently controlled by the state. Should the State of Alaska be a wealth holder at all, or should all revenues not currently necessary to fund government be distributed to current Alaskans? Several economists have appeared before this group suggesting that the best thing to do with our wealth would be to distribute it immediately and completely to the private sector. One cannot argue that this course of action is best for current Alaskans since it maximizes individual freedom of choice. This may not be the best course of action for Alaska though because complete privatization of the wealth would result in most of the wealth immediately leaving the state. Benefits would go to individuals, but not necessarily to Alaskan individuals.

If Alaska is more than the sum of individuals who are currently residents, then what is "best" for individuals may not be what is best for Alaska. The best solution may be for the state to save the majority of our wealth and use the earnings generated from that wealth to create a steady, stimulative force for economic growth and development for generations to come.

B. How Much Should We Save?

It is easier to deal with this question if we stand it on its head and ask how much we want to spend--not only this year but also in future years. From that, we can calculate how much we need to save to meet our spending target. Obviously, the initial spending decision would need to be changed if it did not leave enough savings for future years. Back-of-the-envelope calculations suggest that we should be putting a much larger proportion of our current income into savings than the 10 percent that now goes into the Permanent Fund.

A simple example should demonstrate this. The state gets virtually all of its revenues from Prudhoe Bay petroleum production activities. ^{and} In a very real sense, there is a bank ^{up there} on the North Slope--The First National Bank of Prudhoe Bay--and the State of Alaska has a major account there, ^{which is} A rough estimate of the balance in the state's account made last spring was \$80 billion. Today, its value ^{may well be} might be only \$70 billion in 1981 dollars due to the softening of the world oil market. Each year, the state makes a forced withdrawal ^{to make a} from its bank account as it collects the various petroleum-related revenues and royalties. Some of this forced withdrawal is interest, but principal is taken as well.

If we adopted the conservative rule, "never spend principal," we would have a very simple spending rule as well as a rule for determining how much of our petroleum revenues should be set aside in the Permanent Fund each year. ^{assuming} With a 2 percent real rate of return on the

bank account
\$70 billion, \$1.4 billion in 1981 dollars could be spent annually. We could spend that *\$1.4 billion every* amount each year *in possibility* and still have \$70 billion in the bank. Any petroleum revenues over and above \$1.4 billion would be saved in the Permanent Fund. In time, of course, the oil would be all gone and the principal would be *in* the Permanent Fund, which would amount to \$70 billion in 1981 dollars. At our current savings rate of 10 percent, we are clearly eating into *that* principal.

Now There is one important argument against the "never spend principal" rule, and it is directed specifically at the assumption underlying the rule that Alaska will not be richer in the future than it is today. As a nation, we have tended to reject such an assumption in favor of the idea of continuous material progress, with each generation being richer than the previous one because of technological improvements. Consequently, we feel that we don't need to save and deprive ourselves for the benefit of future generations, because we believe that our descendants will be better off *individually* than we are today. (This does not mean, however, that all individuals or regions of the country will share in this *material* progress, as the declines in the fortunes of Appalachia and New England readily attest.)

Unfortunately, the evidence to indicate that Alaska has or is developing an independent source of wealth to maintain a continuously increasing flow of dollars after Prudhoe Bay is *not* non-existent. *Just as an example* Consider the corporate income tax, our largest source of revenue even partially independent of petroleum, which in the fiscal year just

ended produced \$35 million in revenues. Assuming a continuation of the historic growth rate in receipts (10.8 percent), it will be over 35 years before it will generate an annual income of \$1.4 billion. Or consider coal--this year's glamour resource. > The current annual production of about 1 million tons directly accounts for less than four-thousandths of one percent of our revenues (\$200,000, or .004 percent). If the state could get 30 cents in royalties for every ton of coal mined, 4.7 billion tons--which is just about all of our current reserves (4.8 billion tons)--would need to be extracted annually to ^{every year in Alaska} put \$1.4 billion into the treasury. So even if it were physically or technically possible to mine this much coal in one year, it only provides one year of revenues.

> As we debate the merits of coal or agriculture or petrochemicals, time is inexorably running out on finding an alternative to petroleum. Of the 9.4 billion barrels of recoverable oil originally estimated at Prudhoe Bay, 7.1 ^{billion} remain. Almost one-fourth, 2.2 billion barrels (24 percent), has already flowed through the pipeline and out of the state.

What this suggests to me is that history will repeat itself, and Alaska will be relatively much poorer in the future when the petroleum boom has passed. The only way to prepare for that day is by following the simple rule: "never spend principal."

C. What Investments Should Our Savings Go Into?

The choice is between those investments which will earn a market rate of return and maximize income (government securities, corporate stocks, and real estate, for example) and investments made below the market rate of return which result in subsidies to particular activities that are deemed to be socially desirable or that will allegedly produce other economic benefits.

It is clear what we get by following the first approach: a return on investment with no side effects. The results of the second approach are more complicated, but usually the state makes a tradeoff in which it gives up revenues in exchange for immediate job creation and short-run increases in personal incomes, or for infrastructure development that presumably will, in turn, stimulate economic development. Previous reports to the Trustees have pointed out the two difficulties with the latter approach--first, economic activity in the private sector is distorted away from the goal of profit maximization toward the dubious goal of subsidy maximization (in Columbia, this has resulted in a new "ism" in memory of the pyramids--Pharaohism!); and, second, the benefits of the programs go to a small portion of the population. (These attributes mean that subsidies are really just like taxes in the sense that they cause distortions of the private economy and impact the pocketbooks of certain groups, and, consequently, their use should be determined by an open political process.)

One version of the subsidization approach is to invest in Alaska mortgages at interest rates below the market. The benefits claimed to result from this type of investment include a positive rate of return on investment, job creation, improvement of the quality of the housing stock, and a form of wealth distribution that will remain in Alaska and be widely shared. In addition to the obvious revenue loss, there are two problems with this use of our wealth which have not been explored. First, in terms of job creation, these subsidies are like a narcotic. In response to the initial subsidy, there is a rush of construction activity and job creation as people scramble for the cheap mortgages before the increase in housing prices offsets the subsidy and monthly housing costs return to their pre-subsidy level. This rush is followed by a contraction of activity and a return to normal levels of construction and employment. To get a larger number of construction jobs again, another "fix" is necessary, but this time the price is higher. The subsidy must be increased each season to get the same stimulation in the industry. The construction industry rapidly becomes an addict with an ever-increasing fix necessary to satisfy its habit.

Second, the benefits of this method of wealth distribution may not remain in Alaska. In the short run, they do, as rising real estate prices, benefit all Alaskan property owners (and penalize renters). (Incidentally, the "bang per buck" for this program in terms of houses built is very small. If \$100 million in subsidies was

allocated, and this resulted in 1,000 housing starts that would otherwise not have occurred, then each housing start cost the state \$100,000!) ^{Housing} If there is a post-Prudhoe economic bust, however, three factors will combine to produce the unthinkable--a fall in housing prices. (Residents of the Lower 48 are discovering that unthinkable as it may be, this is clearly not impossible.) First, property taxes, which have declined in recent years as the state has picked up a larger share of funding of local government, will have to be increased to provide for such basic government services ^{with the} as education and highway ^{of} maintenance. ^{etc.} Second, the promise of future mortgage subsidies will evaporate. ^{taken together} These two factors will combine to have exactly the opposite effect that they are having today. They will drive up the monthly cost of owning a home and ^{drive} drive down the price. Third, the demand for housing will fall as higher taxes and less government subsidization of the private sector combine to contract the economy and result in a decline in population. Under this ^{grim} grim scenario, the benefits of the housing subsidy program will clearly go to those who sell out while housing prices are high and head South. Those who remain behind in Alaska will see their housing assets depreciate in value and their share of Alaska's wealth disappear.

Thus, while a housing mortgage subsidy program has some appeal, as a job creating device that distributes Alaska wealth to a large group, it suffers from the same shortcomings that affect other subsidy programs.

A final point on subsidies: If the subsidization approach to investment is chosen, it must be based upon explicit criteria for evaluation just as regular investments can be evaluated on the basis of their rate of return. Specifically, subsidized investments must demonstrate the capability of generating tax revenues. If those revenues do not materialize, then this approach should be abandoned.

D. What Shall We Do with the Income from our Investments?

In the early years, all ^{PF} income should be plowed back into the Fund to build up its principal in anticipation of the day when it will ^{the fund may} be the primary source of revenue to the state. The "never spend principal" rule requires that the annual spending of \$1.4 billion ⁱⁿ 1981 dollars eventually come from Permanent Fund earnings. ^{however} Current residents are benefiting from Alaska's wealth, and it seems fair that the next generation of Alaskan residents, our children, should get their share. We, today, are already benefiting from the abolition of the income tax, low property taxes, subsidized loan programs, and massive government expenditures to improve the quality of life in the state. Future generations should not be denied their benefits because of the premature distribution of Permanent Fund earnings only to current residents. ^{the}

Looking toward the long run, permanent fund earnings should go into a special escrow account for Alaska residents against the day when the state may need to reintroduce the personal income tax. For every year that a person remains a resident, his account would be

credited with his per-capita share of fund earnings. All money would remain in this account until the tax was ^{well} reintroduced, at which time individuals could pay their taxes each year out of their share of the balance in the account. If a person left the state, his share would revert to the Permanent Fund and increase its principal.

Such a plan has ^{several} four attractive features. First, its benefits would be 100 percent targeted to Alaskans because only Alaskans pay Alaskan income taxes. Second, it would reward those who had been living in the state longer with larger benefits. Third, it would reward a broad population group. And, fourth, it would minimize any "false boom" resulting from a large cash distribution, which would stimulate in-migration of non-Alaskans seeking cash handouts. With such a plan, there would be no need to discriminate against our children, who are bonafide residents. ^{as well as adults.}

Some people will argue that the state personal income tax is gone forever, in which case this escrow fund would never be used and the benefits never realized. They could be right, although there is as yet no solid evidence that this is the case. To handle this possibility, a special stipulation ^{of the fund} would allow for distributions to begin after five years, ^{but only on the condition that a} target of ²⁵ percent of government expenditures could be financed at that time ^{by} renewable revenues. ^{This stipulation would create a} clear target toward which state policy could aim as well as a clear incentive for Alaskans to work to ensure the future economic viability ^{of} our state.

2 MR. HAVELOCK:

3 Thank you, Mr. Chairman. I'm flattered by that billing. I've
4 never been introduced as that before. That'll do, although
5 maybe I'd be more comfortable now that your right hand has
6 left I could go over and ease into that chair and give you
7 opinions on the legal side. I have three ranges of concerns
8 that I want to address today. The first is the institutional
9 arrangement. The relationship between the Permanent Fund and
10 other forms of government activity. The second is the question
11 of voter intent - what the voters meant and since that's been
12 discussed at some length here already I'm not going to belabor
13 that. The third is a question of distributional equity which
14 I've heard very little on today although perhaps that was
15 addressed this morning. I think that with respect to these
16 propositions the first thing I do is congratulate the
17 Chairman on his memorandum of September 10th which I think
18 contains most of the economic principles which I think the
19 Permanent Fund ought to operate on even though it in many
20 senses flies in the face of what is at least proclaimed as
21 the popular position on those things. I'm afraid that the
22 slogan "Invest in Alaska," unless it is tied to orthodox
23 standards of investment, and I heard a call earlier today for
24 unorthodox standards, is bad economics, bad political science,
25 bad social policy even if it's super politics. As the

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1 Chairman has indicated and there is no indication of a general
2 capital shortage in the State. There is no indication of
3 anything but a very limited need for capital generally.
4 Thirdly, you can't make submarginal economic prospects
5 profitable by throwing money at it and it is, again, kind of
6 interesting to see some of the people who criticised various
7 governments for throwing money at problems now being ready
8 to throw money at the problem of economic development in
9 this state. The investing in Alaska at preferred interest
10 rates to promote economic activity is the most grossly
11 inequitable manner in which distributions of this money could
12 be made and I think prima facie every Alaskan has equal stake
13 in the oil largess. Lastly, the investment of getting the
14 State involved in building the State's economy as its
15 primary function and purpose is likely to bring about an
16 entanglement of government in private enterprise which will
17 ultimately result in a loss of economic and personal freedom
18 and that I associate myself with what Arlon said on the same
19 subject. Starting on this entanglement proposition, let's
20 take a quick look at what the voter intention did mean.
21 All the publicity I remember on the occasion involved in the
22 popular discussion was about putting money away for a
23 rainy day. I did not hear anybody advance the argument that
24 the Permanent Fund was established to be a large semi-public
25 bank, nor that it was to provide benefit programs. It was

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1 argued that it was a device to meet the problem of a revenue
2 balloon that the government did face and that would provide
3 funds at a much later time to support basic services when --
4 since the tax base for the State was not otherwise there.
5 I've mentioned the popularity of positions involving investing
6 in Alaska and getting the Permanent Fund involved in -- into
7 social programs. It seems to me that is entirely a province
8 for the Legislature and not for the Permanent Fund.
9 Certainly there is a major need for public education on some
10 of the basic economic principles that the Chairman has
11 espoused and I would encourage you to hang tough on your
12 orthodox line to the extent you're willing to stay
13 orthodox. And let me make a comment about the nature of
14 public opinion on this issue which is that I think public
15 opinion supports orthodox positions on the Permanent Fund but
16 once you open the door - once you -- if you decide you're
17 going to let housing in and to a preferred position, then
18 every citizen is going to see that his only chance of getting
19 a share of this is to get his feet in the same trough so
20 you're going to have an erosion in terms of public opinion
21 which would support a conservative and orthodox approach to
22 Permanent Fund activity. The Permanent Fund is not set up.
23 Its accountability structure is wrong to engage in social
24 programs and I include housing policy as one of the social
25 programs which I hear being dabbled with today and I think the

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1 Legislature can independently address housing but don't suck
2 in the Permanent Fund. I see nothing wrong with the Permanent
3 Fund buying Alaska mortgages at established market rates
4 meeting the market test but not getting into the subsidy
5 business. I suppose if you do decide to get into that
6 business, you ought to think about amending the statute to
7 put representatives of renters stitutions on the Board and
8 all the things that go along with a social policy in terms of
9 representation in the making of a policy. The Legislature is
10 there to address the social needs, whether of the economy or
11 of private persons and that kind of management belongs in the
12 political arena, not with the Permanent Fund, which, once it
13 starts into that, poses a danger of becoming a competing
14 government with the established government. Therefore, as
15 far as Permanent Fund policy recommendations, first, only in
16 Alaska, only in prudent investments and even then one need
17 be careful about investing in prudent investments to the point
18 where the Permanent Fund becomes the dominant financial
19 institution in the field. You have a risk, then, of that
20 extending. Secondly, you definitely should accumulate earnings
21 sufficient to account for the depreciation of your assets
22 caused by inflation. And thirdly, I would say that with
23 respect to your real income, don't mess with it. Let the
24 Legislature decide what it wants to do with it. If you
25 concentrate on just producing that income, there's your

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1 accountability and what you have produced with that. If you
2 get involved in social policies, it'll foul up the
3 accountability of the Permanent Fund management. Now, as a
4 last point, let me say I assume that it may be impossible for
5 you to do that. You may get sucked into things like dividend
6 programs which -- or distributions which are not strictly
7 involved in earnings. And, indeed, I suppose the Legislature
8 independently has to address some of those things. I, unlike
9 a speaker you've already -- or a number of speakers, I don't
10 think that direct cash benefits are desirable. I think they
11 would have a highly adverse effect in terms of national
12 policies which influence our funding if we get in the business
13 of handing out dough. I do think that there's a potential,
14 and here I'm really talking to the Legislature rather than
15 the Permanent Fund because I don't think Permanent Fund
16 managers ought to get into this business, but I think there's
17 a chance to make a fresh start in terms of encouraging
18 consumer choice. I feel uncomfortable, but in this sense I'm
19 in somewhat allying myself with Milton Friedman in the sense
20 of there are a lot of consumer choices that can be made in
21 terms of the distributions that you make rather than doing
22 government bureaucracies of establishing warrants -- I mean
23 I heard Arlon and others talk about making some kind of
24 distribution. Do it in case of warrants and do it, as far
25 as I'm concerned, to meet needs which are already established

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1 as governmental needs, not for fresh types of government
2 entitlement. That way there's a double benefit. Not only
3 does the person get to exercise his consumer choice in
4 pursuing what that might be, let's say, but also it will
5 help me because that person will be buying into an activity
6 which otherwise I may be called upon to support through
7 taxation. Further, you must -- I do think you should consider
8 the federal taxability of distributions. I don't think
9 there's any doubt that a direct cash distribution is federally
10 taxable and I think that there are a number of needs which
11 could be met, maybe among the first of which is a need for a
12 supplemental retirement benefit which would be taxable when
13 received but not taxable immediately and I regret that the
14 existing dividend program is not framed as a retirement
15 program because I think it would be much more likely to be
16 upheld constitutionally than the program now before the
17 Court. Having been run into by uninsured motorists twice
18 within the last year and finding that uninsured motorist
19 coverage does not include the damage to my car, I think it's
20 possible for you to set up a distributional benefit program
21 which would allow people to acquire some basic minimum of
22 insurance which would be an equitable way and probably a non-
23 taxable way of distributing a benefit. The same thing applies
24 to things like a health insurance and we're already into that
25 partly in terms of the educational program. Housing is among

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1 the worst programs that you could get into, but if you did I
2 certainly wouldn't want you to do it on the basis that is
3 involved. To give you a -- it is the worst in terms of the
4 distributional inequity that is involved in that kind of
5 distribution. It's only a small number of people at any
6 particular year that are going to be able to get in and I
7 look around at my friends getting into this market -- to some
8 extent we are compelled to get into it because you've got to
9 take advantage of the subsidy that's there. I think you will
10 find it is not people that don't have housing that are moving
11 into the housing market. It is people that are already well
12 housed but decide that they want to move into a new house.
13 I would suppose to illustrate the -- what would happen if you
14 made it an equitable program, I suppose you could issue a
15 certificate with warrants for a shelter allowance and those
16 people that wanted to take that warrant or certificate and
17 pledge it to a housing lender so that they could build a
18 house would be welcome to do so and others of us that didn't
19 feel or were happy with the house we now have but would love
20 to have a shelter allowance would clip the coupon and just
21 simply collect an equivalent to that. That would be a more
22 equitable way to do it and I think at the moment it's a very
23 damaging. I guess that's probably enough. I think you should
24 look at what would happen if you got into -- once you open
25 the door and relate that to the ceiling on expenditures which

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1 is being adopted. If the ceiling is adopted and you open the
2 door, you're going to find the Legislature is going to crowd
3 in all other kinds of social purposes as they feel the
4 pressure from the ceiling lid. Lastly, I think one of the
5 things wrong with the Permanent Fund was the amount of
6 dedication that was involved. It failed to reflect what
7 people didn't know at the time was going to be a very large
8 balloon at the beginning and that that balloon would graduate
9 out and I think a much larger proportion of the oil revenues
10 should be dedicated in these earlier years but I guess that
11 can only be done by legislative action and probably only
12 annually. Thank you, sir.