

**SB**

**245**




**Alaska Permanent Fund Corporation**

P.O. Box 25500 Juneau, Alaska 99802-5500  
(907) 465-2047

**MEMORANDUM**

**DATE:** December 27, 1993

**TO:** William H. Scott  
Executive Director

**FROM:** Pete Jeans   
Real Estate Investment Officer

**SUBJECT:** Elimination of 40% restriction on real estate acquisitions

This memorandum should be attached to the memorandum dated November 18, 1993 to the Board of Trustees as additional information.

The following three investment opportunities are examples that were lost by APFC during the past three months due to the 40% restriction on real estate acquisitions.

1. Park 227  
Industrial Property  
Kent, Washington

This proposal was received from the L & B Group. The proposed investment included 39 acres with 5 industrial buildings, 100% leased. The total purchase price was \$26,500,000 and the initial cash on cash was 9% after fees.

After preliminary review, APFC decided to move forward and hired Saylor Capital to perform in-depth due diligence. APFC was considering 40% and the Public Employees Retirement Association of Colorado (PERA) was considering the remaining 60%. The due diligence was completed by both APFC and PERA and the decision was made to proceed with documentation. During this process, APFC and its attorneys could not negotiate acceptable buy-sell arrangements and were forced into backing out of this investment. PERA is proceeding to do 100%. The interesting thing on this investment is that it was presented to the APFC first, and we recommended PERA to the L & B Group as a potential partner.

Mr. William H. Scott  
December 27, 1993  
Page 2

2. 278 Post Street  
San Francisco, CA  
(Retail Property on Union Square)

This proposal was received from LaSalle Advisors. The property is being converted to Nike Town and other upscale retail. The cash on cash is projected to be over 9% after the renovation. The total investment was \$34,600,000. The same situation occurred as above and PERA is doing 100%.

3. Sequoia Station Shopping Center  
Redwood City, CA

This proposal was received from TCW Realty Advisors. The total purchase price was \$33,725,000. The initial cash on cash after fees was 9.33%. The proposal was presented to APFC toward the end of October and the seller required a closing by December 15, 1993. We looked at the property and were interested in proceeding. TCW was unable to locate co-investors that could close by the December deadline. As a result, we lost the opportunity to consider this investment.

As more institutional dollars are made available for real estate, it is going to become more and more difficult for APFC to become involved in the better investments unless we can control the investment. In order to do this, we need to have the flexibility to go up to 100% on some of the smaller investment opportunities.



**Alaska Permanent Fund Corporation**

P.O. Box 25500 Juneau, Alaska 99802-5500  
(907) 465-2047

January 6, 1994

The Honorable Randy Phillips  
Chairman, Legislative Budget & Audit  
Room 103, State Capitol Building  
Juneau, AK 99801-1182

Dear Senator Phillips:

As you requested last week, please find enclosed proposed draft legislation (Attachment #1) which would amend the Permanent Fund's list of authorized investments to provide for up to 100 percent ownership in real estate investments. I would suggest the bill be titled, "An Act relating to real estate investments of the permanent fund; and providing for an immediate effective date."

I appreciate the opportunity to appear before the Legislative Budget & Audit Committee next week to request introduction of the bill. For the information of the members, I am enclosing a number of supporting documents which collectively present the rationale for seeking this legislative change.

Attachment #2 is the Board of Trustees resolution dated December 6, 1993 in support of this proposed change. The Trustees adopted this resolution unanimously.

Attachment #3 is a memorandum dated November 18, 1993 addressed to the Board of Trustees from our Real Estate Investment Officer, Pete Jeans. It explains the need for the change from an historical perspective.

Attachment #4 is a letter dated November 9, 1993 addressed to Mr. Jeans from the Corporation's outside real estate consultant, Paul Saylor. This letter provides the consultant's fiduciary opinion in support of the change.

January 6, 1994  
Senator Randy Phillips  
Page 2

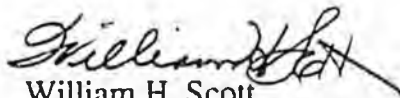
Attachment #5 is a letter dated November 16, 1993 addressed to Mr. Jeans from the Corporation's real estate legal counsel, Morrison & Foerster, which also provides a fiduciary opinion in support of the proposed change.

Finally, Attachment #6 is a copy of an article which appeared in the July 1993 issue of *The Institutional Real Estate Letter*. The article, I think, makes a compelling case from an uninterested but expert third-party perspective that the concept of co-investing as currently practiced by the Alaska Permanent Fund Corporation is not necessarily in the Fund's best long-term interest.

We are seeking this change primarily because we are convinced it will help us to do a better job protecting and enhancing the Permanent Fund.

Thanks very much for your willingness to support this proposal, and we look forward to addressing this issue at the upcoming LB&A meeting on January 12.

Sincerely,



William H. Scott  
Executive Director

WHS:JK:ly

Attachments

**DRAFT LEGISLATION FROM DEPARTMENT OF LAW:**

**Section 1.** AS 37.13.120(g)(16) is amended to read:

(16) equity interests in, and debt obligations secured by mortgages granting a first lien on, real estate improved by completed and substantially rented buildings and located in the United States [, IF THESE INVESTMENTS ARE MADE

(A) IN A CORPORATION, PARTNERSHIP, TRUST, OR OTHER ENTITY IN WHICH, AT THE CONCLUSION OF EACH INVESTMENT TRANSACTION, AT LEAST 60 PERCENT OF THE BENEFICIAL OWNERSHIP INTEREST ARE HELD BY OTHER INSTITUTIONAL INVESTORS, AND WHICH IS ORGANIZED AND OPERATED FOR THE PURPOSE OF MAKING REAL ESTATE INVESTMENTS BY A BANK, INSURANCE COMPANY, OR OTHER MANAGER OF INSTITUTIONAL FUNDS THAT HAS HAD AT LEAST FIVE YEARS OF EXPERIENCE IN THE MANAGEMENT OF REAL ESTATE INVESTMENTS OF INSTITUTIONAL INVESTORS; OR

(B) WITH CORPORATIONS, PARTNERSHIP, TRUSTS, OR ENTITIES IN WHICH, AT THE CONCLUSION OF EACH INVESTMENT TRANSACTION, AT LEAST 60 PERCENT OF THE BENEFICIAL OWNERSHIP INTERESTS IN THE CO-INVESTING ENTITY OR ENTITIES AS A WHOLE ARE HELD BY INSTITUTIONAL INVESTORS, AND IF

(i) AT THE TIME OF INVESTMENT THE FUND HAS NO MORE THAN A 40 PERCENT BENEFICIAL OWNERSHIP INTEREST IN THE REAL ESTATE INVESTED IN AS A WHOLE;

(ii) THE RIGHTS AND OBLIGATIONS OF THE FUND ARE SUBSTANTIALLY SIMILAR TO THOSE OF THE OTHER INSTITUTIONAL INVESTORS, EXCEPT FOR THE PERCENTAGE INTEREST IN THE PROPERTY; AND

(iii) THE PROPERTY IS MANAGED AND OPERATED BY AN ENTITY THAT HAS HAD AT LEAST FIVE YEARS OF EXPERIENCE IN THE MANAGEMENT OF REAL ESTATE INVESTMENTS OF INSTITUTIONAL INVESTORS];



Attachment #2

**Alaska Permanent Fund Corporation**

P.O. Box 25500 Juneau, Alaska 99802-5500

(907) 465-2047

RESOLUTION OF THE BOARD OF TRUSTEES  
OF THE ALASKA PERMANENT FUND CORPORATION  
PERTAINING TO LEGISLATIVE CHANGES IN THE ALASKA STATUTES  
RELATING TO REAL ESTATE INVESTMENTS BY THE  
ALASKA PERMANENT FUND CORPORATION

**RESOLUTION 93-11**

WHEREAS, the Fund is limited in directing business decisions on real estate investments as a 40% participant; and

WHEREAS, the Alaska Permanent Fund Corporation is impaired in its ability to reach its targeted real estate asset allocation within current parameters; and

WHEREAS, the Alaska Permanent Fund Corporation has lost opportunities to acquire high return, low risk real estate investments;

NOW, THEREFORE, BE IT RESOLVED, THAT the Board of Trustees unanimously directs staff to seek legislative changes to provide for up to 100% ownership in real estate investments.

PASSED AND APPROVED by the Board of Trustees of the Alaska Permanent Fund Corporation, this 6th day of December, 1993.

A handwritten signature in cursive script, likely belonging to the Chairman of the Board of Trustees.

Chairman, Board of Trustees  
Alaska Permanent Fund Corporation

ATTEST:

A handwritten signature in cursive script, likely belonging to the Corporate Secretary.  
Corporate Secretary

**Alaska Permanent Fund Corporation**  
P.O. Box 25500 Juneau, Alaska 99802-5500  
(907) 465-2047

**MEMORANDUM**

DATE: November 18, 1993

TO: Board of Trustees  
Alaska Permanent Fund Corporation

FROM: Pete Jeans *PJ*  
Real Estate Investment Officer

THROUGH: William H. Scott  
Executive Director

SUBJECT: Recommended Legislative Changes, Real Estate

I am recommending a change to Title 37, Chapter 13, Section 37.13.120, the Alaska statute that authorizes the Fund's investments in real estate. The reference to real estate investment responsibilities of the Board of Trustees will be changed to read:

(g)(16) equity interest in, and debt obligations secured by mortgages granting a first lien on, real estate located in the United States.

(16)(A) deleted

(16)(B) deleted

(16)(B)(i) deleted

(16)(B)(ii) deleted

(16)(B)(iii) deleted

This change removes the 40% restriction on real estate acquisitions. The real estate "investment list" is stricken from the Statute and transfers to the Board of Trustees, the responsibility for establishing prudent investment standards and guidelines through the annual real estate resolution.

In order to justify this recommendation it is necessary to give a brief description of the Fund's real estate experience over the past ten years, along with my views on the changes that are taking place in the industry.

In 1983, the year the Alaska Permanent Fund Corporation made its first investment in real property, the Board of Trustees had allocated 6% of the \$3 billion Fund to real estate. The Board of Trustees hired a real estate consultant to assist

in selecting three real estate advisors. From 1983 through 1987, the Fund took a passive role in real estate investing and relied almost exclusively on the recommendations of the consultant and advisors. Additionally, the 40% co-investment requirement created a high comfort level for the Trustees. By co-investing with larger, more sophisticated pension funds and endowments, the Permanent Fund took advantage of their expertise and leadership in real estate investing. During this period, control and involvement in property decisions were not priorities for the APFC.

In the later part of the 80's, there was a turnover in Permanent Fund real estate staff. Soon after, the Fund employed new real estate consultants and attorneys, all of which resulted in a more directive approach to real estate investing. The Fund has become more involved in the real estate investment process, from requiring certain controls and buy-sell arrangements on each real estate transaction to initiating disposition activities. Even as a 40% player, the Fund has been able to negotiate either equal or favorable terms and receive coequal treatment from larger investors.

Historically, market conditions played an important role in negotiations for favorable terms. During the recent market decline in the industry, many pension funds sat on the side lines, offering little competition for deals. Now that the market has shown signs of recovery, pension funds are re-entering the markets. Like the APFC, our institutional partners are gaining knowledge and confidence in their abilities to control investments and they no longer allow us to participate as an equal partner in a 40/60 deal. The only way to secure the same level of control that the Fund historically obtained with past investments is to acquire an equal or majority interest.

Control is by far the greatest benefit of holding a majority position in an investment. Timing of major capital events, such as a property sale or the funding of a mall redevelopment designed to head off new competition, is often crucial to enhancing returns on a property. The inertia of some institutional partners has caused numerous missed opportunities for the Permanent Fund in the past.

Other advantages also exist. The real estate asset allocation set by the Board of Trustees will be more easily attainable. Unless a single deal is exceptionally large, the acquisition of a single property will not materially affect the diversification strategy. Through resolution, the Board of Trustees will continue to maintain control over the diversification goals.

Legal costs will be reduced substantially by eliminating or decreasing the negotiations over control issues in partnership agreements. Complications in replacing investment advisors are directly correlated with the number of partners in a deal. The replacement process is simplified in a 50/50 to 100% investment.

Board of Trustees  
November 18, 1993  
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By having the option to take 100% of an investment, we anticipate an increase in deal flow. With only one or two investors involved, advisors will be more likely to propose acquisitions to us, particularly those with short closing time frames.

This proposed change to the Statute will give the Board of Trustees the flexibility to direct the real estate staff by board resolution. Attached is a letter from our legal counsel and real estate consultant recommending these changes.

RECEIVED

DEC 6 1993

ALASKA PERMANENT  
FUND CORPORATION

*SAYLOR PROPERTY CAPITAL, INC.*

EIGHT PIEDMONT CENTER  
SUITE 320  
ATLANTA, GEORGIA 30305

TEL: (404) 261-8049  
FAX: (404) 261-0271

Attachment #4

NEW YORK OFFICE  
437 MADISON AVENUE, 40TH FLOOR  
NEW YORK, NEW YORK 10022-7380  
TEL: (212) 754-6260  
FAX: (212) 754-6264

PAUL H. SAYLOR

November 9, 1993

Mr. Pete Jeans  
Investment Officer  
The Alaska Permanent Fund Corporation  
801 West Tenth Street  
Suite 302  
Juneau, AK 99801

RE: Proposed Legislation

Dear Pete:

You have asked that I give a few thoughts why I am in favor of a legislative change to allow you to take up to a 100% interest in an investment.

1) *Control*

Although co-investment documentation is evolving to the point where a minority investor will not necessarily be disadvantaged as to influence or control, there is no such thing as a 40% gorilla. In other words, it would be preferable for the APFC to invest on a basis that would allow it to control major investment, management and divestment decisions in its own best economic interests, rather than be influenced by one or more investors which may, at least over time, have differing objectives.

While I believe the APFC has been advantaged by retaining discretion over major investment, management and divestment issues, it is currently required to be totally aligned with one or more partners in order for activities which best serve it to occur. Examples include the inability to close recent transactions because of (what I consider) minor differences with a 60% partner, and your lack of influence in matters associated with Boston Real Estate Counsel assets in a situation where at least one of your partners was lethargic and bureaucratically hamstrung from acting in all partners' best interests.

2) *Maximum New Opportunities*

As property markets turn back in favor of sellers, the APFC will receive

increasingly fewer high quality investment opportunities, as investment managers will be less in need of the APFC's capital and wish to conclude transactions with either one investor or a commingled format over which they have discretion. Currently, it is relatively complicated for a transaction originator to identify an asset for the APFC with the condition the APFC will only pursue due diligence or the consummation of a transaction once a compatible investment partner has been identified. Recently, transactions have gone elsewhere to avoid this process.

Additionally, there are increasing concerns regarding potential incompatibility of APFC requirements with those of certain other active investors. Although the multi-asset co-investment opportunity which we have collectively pursued for the last several months will go a long way to establish levels of overall compatibility among several investors and standardized processes, sellers or transaction originators generally attempt to avoid the unknowns associated with due diligence and documentation requirements of multiple investors.

3) *Management Changes*

Since the APFC appropriately exercises rights of management oversight, it is more likely to recognize management program weaknesses and to move to correct them than most other institutional investors. Existing assets and portfolios need to be intensively managed in order to improve their performance and occasionally to position assets for sale. Managers who are ineffective should be replaced, and manager replacement is most difficult to accomplish for the APFC as a minority investor especially since most partners of the APFC are required to live with an "approved list" of investment managers.

I do not at all advocate that the APFC should only pursue acquisition of full interests in individual assets and portfolios, but I believe a change of legislation to allow you to do so is most important. It is my view that the immediate effect of such change will not be termination of your co-investment programs, but rather a gearing up of the process contemplated by your co-investor conference this past April. Your ability to be a major partner, rather than (always) a minor partner is most important to the achievement of your objectives set forth for the asset class of real estate and to your competitiveness in the marketplace.

Yours very truly,



Paul H. Saylor

CC: Llewellyn Lutchansky

Attachment #5

## MORRISON &amp; FOERSTER

LOS ANGELES  
SACRAMENTO  
ORANGE COUNTY  
PALO ALTO  
WALNUT CREEK  
SEATTLE

ATTORNEYS AT LAW  
  
345 CALIFORNIA STREET  
SAN FRANCISCO, CA 94104-2673  
TELEPHONE (415) 677-7000  
TELEFACSIMILE (415) 677-7522  
TELEX 34-0154 MORSN FOERS SFO

NEW YORK  
WASHINGTON, D.C.  
DENVER  
LONDON  
BRUSSELS  
HONG KONG  
TOKYO

November 16, 1993

DIRECT DIAL NUMBER  
(415) 677-7048

VIA FACSIMILE

Mr. Pete Jeans  
Real Estate Investment Officer  
Alaska Permanent Fund Corporation  
P.O. Box 25500  
Juneau, Alaska 99802-5500

Dear Pete:

You have asked us to review the proposed legislative amendments to Section 37.13.120(g) of the Alaska Statutes in the context of our experience as investment counsel for the Alaska Permanent Fund Corporation (the "APFC"). We understand that the legislative amendment to be reviewed by the Board would modify subsection (g)(16) of Section 37.13.120 to provide:

(g) Subject to the limitations contained in this section, the board may invest fund assets at the competitive national market rates or prices that are applicable to each investment only in

. . .

(16) Equity interests in, and debt obligations secured by mortgages granted a first lien on, real estate located in the United States.

We believe that this proposed amendment would be beneficial in carrying out the investment policies of the APFC for several reasons. First, it would allow the APFC to effect real estate investments that fulfill its investment objectives without imposing legal constraints that may not be relevant to ensuring that the investments are prudent. Second, the existing provisions of Section 37.13.120 that would remain unchanged by this legislative proposal ensure that sufficient fiduciary safeguards are present in connection with the acquisition of real estate by the APFC. Third, and perhaps most significantly, the proposed

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## MORRISON &amp; FOERSTER

Pete Jeans  
November 16, 1993  
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amendment would allow the APFC to invest in real estate on terms that are comparable to the terms available to ERISA-regulated corporate and Taft-Hartley (union) retirement plans and a majority of governmental retirement systems. By adopting the standards utilized by most tax-exempt institutional investors, the APFC will be poised to compete more effectively with such investors for real estate opportunities and to exert the degree of control that many of such investors have viewed as conducive to maximizing return and minimizing risk in their real estate portfolio investments.

The current provisions of Section 37.13.120(g)(16) include specific limitations that mandate, among other requirements, that the APFC not hold greater than a 40 percent beneficial ownership interest in a real estate investment at the time of acquisition, that the real estate investment is improved by completed buildings and that such buildings are substantially leased. These types of restrictions are typically referred to as "legal list" statutes and were commonly used in state statutes applicable to public and private retirement plan investments prior to 1974.

The enactment of the federal ERISA statute in 1974 eliminated the applicability of these legal list statutes to private corporate and union retirement plans. ERISA imposed general fiduciary standards applicable to all types of investments. The foundation of these fiduciary standards is the prudence and diversification rules of Section 404 of ERISA. These rules are incorporated into Sections 37.13.120(a) and (c) of the Alaska Statutes and are fully applicable to the APFC's real estate investments.

The drafters of ERISA abandoned the legal list statutes in favor of general rules of prudence and diversification for two reasons. First, to the extent that a restriction found in a legal list is a restriction appropriate to effecting a prudent and diversified investment, the legal list restriction is merely duplicative with the general fiduciary standards. Moreover, to the extent that the restriction was unnecessary to ensuring that appropriate fiduciary caution was exercised in effecting an investment, the legal list restriction was viewed as impeding the plan's ability to pursue prudent acquisition opportunities.

## MORRISON &amp; FOERSTER

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Since the enactment of ERISA, a majority of public retirement systems have adopted legislative changes that substitute general fiduciary standards for legal list statutory restrictions. The rationale underlying these changes has been similar to the legislative intent of Congress in enacting ERISA, that the legal list restrictions are either duplicative with the general standards of prudence and diversification, are obsolete interpretations of such standards or are general examples of such standards that may not be appropriate in specialized investment contexts.

It would be beneficial to the APFC to pursue investment opportunities in real estate under standards similar to the fiduciary standards applicable to the majority of institutional investors competing for these investment opportunities. Because the APFC will be fully obligated to pursue real estate investments that satisfy the prudence, diversification and other standards applicable under Section 37.13.120, to the extent that the legal list restrictions of current subsection (g)(16) are appropriate to ensure prudence or diversification, these restrictions will still apply to real estate investments of the APFC. Thus, for example, if a purchase of more than forty percent of the beneficial ownership of a particular real estate investment would not be consistent with the standard of maintaining a reasonable diversification among investments, the "forty percent rule" would continue to apply. If, however, it was not only prudent and consistent with diversification standards to invest in a larger percentage of a particular real estate investment, but would allow greater controls with respect to operating budgets, leasing decisions and other control features determined relevant to enhance the APFC's investment return, the forty percent rule would operate to limit potential investment returns in the APFC real estate portfolio.

In summary, the legal list restrictions of subsection (g)(16) are generally redundant with the prudence and diversification standards of sections (a) and (c) of Section 37.13.120. In those instances where these restrictions do not duplicate the general standards, but provide more onerous restrictions, it is difficult to justify rules that do not further the standards of prudent real estate acquisitions or may impede such acquisitions.

It is widely recognized that the current real estate acquisitions market demands a greater scrutiny of

## MORRISON &amp; FOERSTER

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current income opportunities than was the case in years where capital appreciation in real estate could be more easily projected. It is significant to note that the APFC's ability to control decisions that are economically relevant to both income and potential capital appreciation is limited by its current inability to acquire a majority interest in its real estate investments. By allowing the board and, to the extent delegated by the board, the APFC staff, the ability to balance the economic benefits of control against the costs of such a percentage acquisition, the APFC will be able to maximize its investment objectives in a context relevant to each particular investment opportunity it reviews for potential acquisition.

Please contact me if we can be of further assistance in this matter.

Very truly yours,

*Rachel Markun pmd*

Rachel Markun

RM:pmd

# THE INSTITUTIONAL REAL ESTATE LETTER

The Information Source For Industry Insiders

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## PROSPECTUS

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## SECURITIZATION

by Steve Bergsman

# REITs On a Tear

## Déjà Vu—Have We Been Here Before?

*Real estate investment trusts have been on a tear. For the first quarter of 1993, REITs posted returns of 19.1 percent, easily outdistancing the S&P 500 which only managed a 4.3 percent return. This was an even faster start than in 1992 when REITs*

*blistered the market for a 20.7 percent return, again showing up the S&P 500 which only notched a decent 7.7 percent return.*

It's not just the market performance of REITs that has caught the eye of the investor—last year, the REIT market raised \$6.6 billion, nearly \$2 billion greater than the previous record year of \$4.8 billion. More than half of that \$6.6 billion was raised by existing REITs which were extremely active in the real estate market, acquiring \$2 billion worth of properties. REITs suddenly became the Japanese of the Nineties. The paradox is, after mugging the U.S. real estate market with a seemingly inexhaustible supply of capital, the Japanese have disappeared. Will the same thing happen

*Continued, Page 5*

## CO-INVESTMENT

by Steve Bergsman

# The Dark Side Co Investment May Be Trendy, But It's Not All Wine and Roses

*The concept of co-investing has been around for decades, but recently, it seems to have become the "in" thing to do.*

*Increasingly, over the past three years, investors and investment managers alike have been dressing their portfolios up with*

*co-investments—the institutional investment community's analog of the "grunge" look.*

The "grunge look"—ripped jeans and flannel shirts—may be popular in some circles today, but it certainly isn't for everyone. Neither is co-investment. Even if co-investment is particularly well-suited to the needs of your fund, there are numerous issues which must be considered to make sure your beneficiaries don't end up in rags and tags.

Like the grunge look, the trendsetter for co-investment came out of the Pacific Northwest. Since the mid-1980s, the **Alaska Permanent Fund**—a \$15 billion endowment organized for the benefit for

*Continued, Page 15*

COVER STORY

## Co-Investment

### *Trendy, But It's Not All Wine and Roses*

*Continued from page 1*

all the citizens of Alaska and funded by taxes on mineral extraction revenues—has been the leader in the U.S. co-investment movement.

The reason? As always, necessity is the mother of invention. By statute, the maximum interest the Permanent Fund can hold in any single property is 40%. This means that, in order to make separate account investments work—and the Alaska Permanent Fund's Real Estate Investment Officer, **Pete Jeans**, very much wants his fund to be a separate account investor—the Fund has no choice but to co-invest (join with other tax-exempt funds to make a purchase).

As a result, for the last eight years, Jeans has made co-investment after co-investment, bringing into his real estate plays more than 100 pension fund investment partners. The approach has worked well for the Alaska Permanent Fund, and now Jeans has come south to spread his gospel throughout the "Lower 48." (More than 40 pension, foundation and endowment funds recently attended a private conference on co-investment in Dallas, sponsored by the Alaska Permanent Fund and its advisors.)

Obviously, Jeans is having some success spreading the word. He credits this success to the discontent so many pension plans have been feeling over the real estate investment programs in which they invested during the early to mid-1980s. During those formative years, Jeans explains, the institutional investor community enthusiastically embraced the concept of blind pool commingled fund investing. With this approach, a group of tax-exempt investors would invest their capital in a specified group trust, insurance company separate account or limited partnership organized and managed by an investment manager in order to enable those investors to acquire a diversified portfolio of real estate assets. The problem with these funds, says Jeans, is that investment decisions and management responsi-

bilities were left in the hands of a third party who had ultimate discretion over the funds—and who almost always had significant conflicts of interest. To make matters worse, when the real estate market collapsed, funds trying to escape the calamity discovered they were blocked by poorly conceived exit strategies.

Today, pension plans, still tangled in the webs of commingled funds but anxious to get in on the buying opportunity of a lifetime, are looking for new paradigms—alternative forms of real estate investment that can offer greater control and liquidity. Of course, the ultimate control results when a pension fund acquires properties directly with no partners. Some funds are unable or disinclined to go that route, however, which, according to Jeans, is what makes co-investment so appealing today.

If one considers investment structures on a continuum, notes **Allen Andersen**, a Principal with the Dallas office of **Arthur Andersen Real Estate Service Group**, they will fall somewhere between sole ownership and commingled funds. Where on the continuum co-investment lies—especially in regards to the control issue—is still subject to debate. Andersen, for one, says he would place co-investment closer to commingled funds on the spectrum, rather than placing it squarely in the middle.

Of the many forms of co-investment, the least popular have been those which require advisors, operating partners or developers to put their own capital at risk alongside the investors. While some investors now require such arrangements, others shy away because of the obvious inherent conflicts of interest. (As **Bob Burke**, a Principal of **AMB Institutional Realty Advisors** likes to point

out, the investment management industry appears to have come full circle. The real estate investment management industry really took off, explains Burke, when the Employee Retirement Income Security Act of 1974 (remember ERISA?) mandated that pension funds interject a fiduciary between pension plan assets and deal promoters. Today, notes Burke, pension funds requiring their advisors to co-invest effectively are requiring them to become promoters—creating, once again, precisely the kind of conflicts the provisions of ERISA sought to eliminate.)

An examination of many of these structures also will reveal that the advisor/developer/operator often stands to receive back in fees during the first few years of the investment, an amount equal to or exceeding the capital it generally committed to the partnership. In such cases, the pension fund's coinvestment "partner" may have little or no capital at risk after the first few years.

To make matters worse, warns **Allen Andersen**, when the other partner is not a tax-exempt fund there usually is a disproportionate level of investment. The tax exempt investor typically funds something akin to 90-95% of the investment and the advisor, 5-10%. Those kinds of splits don't

***Of the many forms of co-investment, the least popular have been those which require advisors, operating partners or developers to put their own capital at risk alongside the investors.***

really do what the pension fund wants them to do.

When pension funds do require their investment managers to put their own capital at risk in the deal, adds **Jim Curtis**, a Principal with San Francisco-based workout specialist **The Bristol Group**, they typically are seeking to align the interests of their partners with their own. The hope, explains Curtis, is that, by having their capital at risk alongside the pension fund's capital, the operating partner will be more attentive to the management of the pension fund's investments. "That's the hope,"

*Continued, Next Page*

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notes Curtis. "We've learned, however, that people can make equally as bad investment decisions with their own money as with somebody else's." Clearly, therefore, having capital at risk is no guarantee that things will go well.

Curtis also cautions that frequently the partner doesn't even have its own capital at risk. "They raise it from other sources or they borrow it. The problem is, when the capital contributed is non-recourse, the investment manager or promoter really isn't at risk at all. In such cases," warns Curtis, "all that these co-investment requirements really create is the *illusion* of comfort."

In addition, an incompatibility of incentives often exists in these types

of investments, according to **Ron Karp** of the Summit, NJ-based consulting firm **Ronald A. Karp & Associates**. Karp notes that there is a mismatch in the long-term stability and financial staying power of the pension plan versus the investment advisor or operating partner. "If the investment gets into trouble, who is going to fund the losses? Obviously, it's going to be the pension plan. And that is going to create a problem when it comes to decision-making."

**... co-investments ... are nothing more than a commingled fund warmed over.**

The most popular form of co-investment, however, is between similar investors with similar objectives and resources, such as two or more pension plans. Even here, however, there are variations and concerns. One type of co-investment, for example, relies on an advisor who brings together investors with a common investment strategy. The advisor then executes transactions accordingly. A second type of co-investment occurs when investors unite under their own initiative—when the co-investment is investor-driven, rather than manager-driven.

The principal feature of every co-investment, however, is that it in-

volves more than one investor (the typical co-investment involved between three to five investors). Therein lies co-investment's strength—and its weakness. For a smaller pension plan, co-investment offers the opportunity to participate in transactions larger than those the plan otherwise would be able to execute on its own. "Small funds may not be able to invest in large projects simply because their allocation is insufficient," explains **Terry Ahern**, a Principal with the Cleveland-based **Townsend Group**. It also enables a larger investor to achieve more diversification than otherwise would be possible by investing directly. According to its Chief Real Estate Investment Officer, Grayson Sanders, for example, the Ameritech Pension Trust has assembled a roughly \$1.2 billion real estate portfolio over the past ten years. Sanders notes, however, that because it has acquired much of that

portfolio by co-investing with other tax-exempt funds, Ameritech's \$1.2 billion position is covered by a portfolio of more than \$14 billion in real estate assets.

Investors who have done co-investments often say they like being involved with other participants with similar goals because there is a comfort with being associated with other entities that have the same investment strategy. Or, as **Andy Smith**, President of **L&B Real Estate Counsel Inc.** says, "There is a warm and cozy feeling about doing a large investment with others." Why? For one thing, there is a lot more due diligence, explains Smith. Each partner gets to scrutinize the deal; there are more checks and balances so it's less likely there will be any surprises.

Despite the lack of surprises, there also is going to be a lot more work—and fiduciary liability—for the co-investors. By co-investing rather than commingling, for example, tax-exempt investors not only have to review the potential investments, but also must participate in the decision to acquire. In addition, they must be

involved in decisions concerning the ongoing management of the property, and when and how eventually to divest. The problem is, without a third party fiduciary to share the risks, a pension fund subject to ERISA provisions must shoulder the fiduciary liability associated with making these decisions alone.

Despite the extra work and liabilities, however, this is precisely the kind of control that was lacking in the commingled funds, and precisely the kind of control that many tax-exempt investors now want. When investors were passively investing in commingled funds, advisors and managers made those decisions. When advisors became promoters, and began structuring funds as partnerships to avoid being subjected to fiduciary liability under ERISA, they still made the decisions, but investors no longer enjoyed any insulation from fiduciary liability. When investors realized they weren't going to receive any fiduciary insulation, they started questioning why they should give up control. This issue, and this issue alone, is the primary driving force behind the co-investment trend. "Investors were very concerned about the lack of control in commingled funds," explains Alaska's Pete Jeans. "They wanted to be part of the process. Co-investment gives the investor more control."

Or does it?

**LESSONS  
LEARNED**

The old axiom of real estate used to be "location, location, location." But, counters **Tim Getz**, Investment Officer with the **Ohio Public Employees Retirement System**, the axiom really should be "control, control, control. You're not going to get that control," warns Getz, "by sharing your decision-making power." Getz speaks from experience—his fund was a pioneer in both the early commingled fund and co-investment movements. "One of the lessons that we learned from commingled funds was that the investor didn't make portfolio decisions. The decisions were always being made by someone else. When things got difficult, it was impossible to achieve consensus." Getz warns that the problem is no different with co-investments, which he says are

"nothing more than a commingled fund warmed over."

As noted before, one of the strengths of co-investment is the added layer of scrutiny. This also is a weakness, however, because it often can be difficult if not impossible to get multiple parties to come to a decision. And, since co-investors don't always have equal shares, by definition, someone is bound to end up with a minority interest. Obviously, that can be a real problem if the majority investors have a different point of view than the minority investors.

"Co-investment complicates every single aspect of a transaction," says **Susan Hudson-Wilson**, Director of Portfolio Strategy for Boston-based **Aldrich, Eastman and Waltch**. "All of a sudden there are two or more parties—very interested parties—that need and ought to be satisfied on every single aspect of the investment." As Hudson-Wilson points out, however, a hot button for one co-investor may not be so hot for another. This can make it extremely difficult to structure a transaction.

Once a co-investment has been completed, however, there essentially are five decisions upon which co-investors have to agree: leasing; capital improvement; budget; sale; and an exit strategy. In a co-investment, the way for the investors to feel their way through those processes, says L&B's Smith (who has been putting together co-investment deals since the 1970s) is to make sure that one participant never has more than 50 percent of the vote. To make a co-investment program work, explains Smith, a reasonable level of democracy must be established.

**Michael Evans**, National Director with **Ernst & Young's** Real Estate Advisory Services in San Francisco, counters that co-investment adds another, unneeded level to problem solving over the life of the asset. "When there are decisions to be made by different investors who have changing objectives and strategies, there is always going to be the potential for conflicts of interest."

Hudson-Wilson concedes that co-investment may be a great way for a small pension plan to participate in larger investments, but reiterates that, "there is true lack of control when you need it most." At the point when you

most need and want to do something big—like invest more or reduce the size of your investment—you discover that your options aren't much different than if you had invested in a commingled fund.

### A FORMULA FOR SUCCESS

Co-investors typically try to avoid the problem of potential conflicts of interest by finding other investors with similar investment objectives. "The big key to success in co-investment is picking your partners," admits Jeans. "It does little good to find a partner who wants to hold properties for the long term, if you want to sell after three years."

**Cab Grayson**, Managing Director of **CB Commercial Realty Advisors**, feels that establishing a pre-existing association for co-investment can greatly enhance the success of the co-investment. "These associations of like-minded investors agree in advance to a defined real estate investment strategy, acquisition process, standardized contracts covering the decision-making powers of investors and transferability of interests, and pre-negotiated investment management fees that are performance-based and aligned with the investors' interests. The associations and the predefined process allow the investment manager to move quickly and to better negotiate with the seller." CB completed its first co-investment in 1981 and has created an active co-investment association of like-minded investors. **Scott Tracy**, Grayson's partner at CB Commercial, adds that, "The association prompts the co-investors to address most of the issues beforehand, and minimizes the difficulties in gaining consensus. Investors agree that, once the initial acquisition decision has been made, the advisor is given a defined level of discretion on operating decisions, thereby reducing disputes.

When constructing the co-investment, it is critical that the rights of the co-investors be stated clearly and definitively. "You must have a mechanism for resolving disputes among the participants," warns **Jim Snyder**, President of **Kennedy Associates Real Estate Counsel**, a Seattle-based advisor that has been putting together co-investments for the past 15 years.

Snyder explains that the problem-solving process among the co-investors should be formalized as a general part of the co-investment agreement. Sometimes the process could be as simple as a majority vote among the co-investors, but it also should include a way to allow an unhappy investor to exit the co-investment. As noted, liquidity is one reason why pension plans are looking at co-investment. Investors, therefore, need to be assured that there is an easy out if they want to leave.

"Our experience," says Jeans, "has been that, if we're having a problem or disagreement with a partner, we call a meeting and sit down together face-to-face. Ninety-nine percent of the time we can solve the problem. In those few instances where it absolutely doesn't work out, the partner can leave." According to Jeans, that usually means the other partners will buy out the disgruntled party.

The **New York State Teachers Retirement System** also has been involved in co-investment transactions in the past, but none recently. "We're not saying we won't do anymore, but when we have a choice, we prefer to invest on our own," notes **Jim Campbell**, Assistant Real Estate Officer at NYSTRS. The Fund wants to control its own destiny, Campbell explains, and it is tougher to do that when hooked into other investors. "It can be frustrating to be in a deal with an investor who has a shorter term horizon or is handicapped by political decision-making processes."

The bottom line is, co-investment is a little like "the Force"—that wonderful source of power that Luke Skywalker discovers in George Lucas' *Star Wars*. Like the Force, co-investment can be either of great benefit, or great harm to the user—depending on how you approach it. And, as with all sources of power, investors must not forget that co-investment has its dark side. ♦

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**Steve Bergsman** is a freelance real estate writer in Mesa, Arizona.

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**Alaska Permanent Fund Corporation**

P.O. Box 25500 Juneau, Alaska 99802-5500

(907) 465-2047

January 13, 1994

Senator Randy Phillips  
Legislative Budget & Audit Committee, Chairman  
State Capitol Building, Room 103  
Juneau, AK 99801-1182

Dear Senator Phillips:

Thank you for providing us with Ibbotson's report on the asset allocation of the Alaska Permanent Fund Corporation (APFC). We are pleased to provide this initial response to the report. Communication on this issue will continue as the board commences its annual review of APFC's asset allocation at the February 3 meeting in Juneau.

Since April 1993, the APFC has been involved with a significant portfolio restructuring program under the direction of the Board of Trustees. Upon completion, the APFC will place significantly less emphasis on passive investment and more on active management of the equity securities portfolio. This program has been undertaken with our investment consultant, Callan Associates, Inc. (Callan), providing recommendations and advice at each step of the program. Once completed, a number of the issues mentioned in the Ibbotson Associates Asset Allocation study will have been addressed.

After reading the Ibbotson report, Callan made the following observations:

1. Recent performance has been good because the board and staff have done a good job of adopting sound strategic allocation policies and employing good managers.
2. Movement toward current strategic targets at an accelerated pace may be particularly important since much of the strong performance over the past several years is attributable to extraordinary bond returns which are unlikely to continue given the current low level of interest rates. Obviously, we all agree with this

assessment and you, through significant funding of global portfolios in recent months, have already essentially reached the strategic target allocations.

3. Diversification within the domestic equity portfolio could be improved with a greater commitment to the small and mid-cap sector. Callan shares this view and your staff recognizes the under-representation in this area and plans to address it through the hiring of two small/mid-cap domestic equity managers in the first half of 1994.
4. Diversification within the fixed-income portfolio could be improved with explicit allocations to major segments such as mortgages. As discussed at length at our recent meeting, the effects of statutory limitations on fixed-income management must be carefully considered. The use of derivative securities, lower-rated bonds and non-US\$ denominated bonds are all influenced by current (statutory) restrictions. In addition, managing liquidity to meet annual dividend requirements is increasingly affecting the fixed-income portfolio. Nonetheless, broader diversification of the fixed-income effort warrants further discussion and already has been scheduled for the upcoming board meeting. As an aside, I was pleased to see that Ibbotson recognized the fee savings and good performance that has been achieved to date. It also is important to note that at least over the past several years an allocation to mortgages would have hindered performance.
5. Ibbotson's expected equity returns are extraordinarily high relative to the firm's expected bond returns. While I sincerely hope that they are correct, the very large premiums and the high absolute levels may result in an underestimation of near-term risk associated with more aggressive strategies. Relatedly, we, staff and the board have all acknowledged that heavier equity commitment would result in greater expected returns over the long run but we all also recognize that shorter-term consistency in returns is particularly important to the Fund since the annual dividend is potentially at issue. Finally, it is important to note that the "aggressive" alternative suggested results in full utilization of the statutory equity maximum of 50%.
6. Ibbotson very clearly advises that the board control asset allocation at a more micro level than it has in the past. Specially, the study advises that the board set specific allocations within the fixed-income and domestic equity areas and make extensive use of specialists in the international area. The directions suggested are contrary to the board's movement toward providing less restrictive guidelines to its managers, particularly the global managers. I think that this is an important issue that already has been discussed at length during 1993 and warrants continued close monitoring

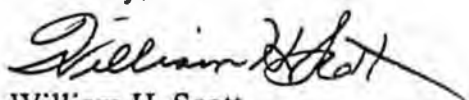
January 13, 1994  
Senator Randy Phillips  
Page 3

and review as we gain experience with the current structure. My current view is that the board's basic asset allocation plan, while theoretically vulnerable to the actions of the managers, will not be adversely affected. Each manager has indicated that it is highly unlikely that they would make sudden dramatic shifts from domestic to international portfolios. We, therefore, will be able to identify any potential problem before it undermines the program. You are continuing to use some specialists internationally and are planning to add specialists in domestic mid-cap securities. In sum, Ibbotson's management structure comments are important and I agree that the structure, particularly the domestic structure, should be on the board's agenda for 1994.

The staff of the APFC agree with Callan's remarks. Should the Legislative Budget & Audit Committee (LB&A) like to discuss in greater detail these conclusions, we recommend that myself and a representative of Callan Associates, Inc. be invited to appear before the Committee. The APFC would be pleased to make the necessary arrangements.

We would like to express our appreciation for LB&A's efforts and those of Ibbotson in conducting this review. It is always helpful to receive more than one independent view of this most important subject of asset allocation. In addition, we would be pleased to have Ibbotson present their report to the Board of Trustees at its meeting on February 3, 1994 at the APFC offices in Juneau.

Sincerely,



William H. Scott  
Executive Director



**Alaska Permanent Fund Corporation**

P.O. Box 25500 Juneau, Alaska 99802-5500

(907) 465-2047

**MEMORANDUM**

**DATE:** February 1, 1994

**TO:** Senator Loren Leman  
Chairman, Senate State Affairs Committee

**FROM:** William H. Scott  
Executive Director

**SUBJECT:** Senate Bill 245

In response to the concerns you voiced at last Friday's committee meeting, here are two workable amendments to SB 245.

1. Remove the 40% ownership limitation on all real estate investments under \$50 million (thus providing the Fund with the flexibility to go up to 100% on those investments).
2. Change the 40% ownership limitation on all real estate investments to a 67% ownership limitation on real estate investments in excess of \$50 million.

These changes are less than we would like, but we recognize the Legislature's prerogative to exercise control over the Permanent Fund's investment authority. *We would like to make it clear, however, that even though these amendments would be an improvement over the status quo, the Alaska Permanent Fund Corporation would prefer that the committee move the bill as originally introduced.*

Why should the Legislature eliminate the current 40% limitation?

The primary reason your Fund managers are seeking changes to the existing real estate statute is to gain increased management control over the Fund's real estate investments – both for the old as well as the new investments which the Fund will make in the future. A 40% ownership

interest clearly does not provide control; 51% would provide a majority interest, but the Fund would not likely find a partner willing to buy only a 49% interest. A 60% interest would provide control in some cases, but only a 67% ownership, or greater, provides a super-majority interest which would guarantee control in every instance.

There are other advantages to 100% ownership, however, besides control. Primary among them is that by providing such flexibility, the Legislature will be enabling the Board of Trustees to reach their real estate asset allocation target.

As of December 31, 1993, your Permanent Fund had a market value of \$15.6 billion - \$1.1 billion of which is invested in real estate. That means real estate investments equal less than 7% of the total value of the Fund. The Legislature in 1983, when it originally approved real estate investments for the Fund, authorized the Board of Trustees to invest up to 15% of the Fund in real estate; the Trustees, meanwhile, have instructed staff to invest 10% of the Fund in real estate. We have been trying to reach that target for about five years and have never come much closer than we are today. In the view of many of the Trustees and the staff, the Fund will never reach its desired real estate asset allocation unless there is some relief provided from the 40% rule.

The Fund needs the flexibility to purchase real estate in larger dollar amounts than is currently possible under that rule, and part of that flexibility can be provided by allowing the Fund to purchase 100% interests, at least in real estate investments under \$50 million.

Fifty million dollars is a lot of money, but it is a much smaller number when compared to the \$1.1 billion real estate portfolio which the Fund holds at present; it is a much smaller number when compared to the \$750 million which the Fund needs to invest in real estate over the next three years just to reach the Board's current 10% asset allocation target; and it is a much smaller number when compared to the more than \$1.5 billion additional money which the Legislature has already authorized the Fund to invest in real estate.

I have attached a list of Permanent Fund real estate investments for you to review. Please note that 47 of the Fund's 68 existing direct investments are under the \$50 million mark. You will note that the vast majority of these properties are apartments and industrial parks. It would be

possible, however, to add some office buildings and retail centers to that list if the Fund had the requested flexibility. Also note that a \$20 million limitation, for example, would rule out two of the four asset types in which the Fund currently invests.

Besides the control issue and the need to make greater investments in real estate in order to reach the asset allocation targets, there are other reasons to allow your Permanent Fund managers to purchase up to 100% ownership in properties. The first is that the Fund sometimes loses excellent investment opportunities simply because sellers are unwilling or unable to wait for the Fund to identify a co-investment partner, or because our co-investment partner ultimately decides to take the entire investment himself. The attached APFC memorandum from Pete Jeans to William H. Scott addresses this issue.

Another reason for choosing no dollar limitation (or at least the \$50 million number) is that the market values that you see on the attached list of investments only reflect current prices – and real estate in the U.S., as you know, is currently at or near the bottom of its market cycle. As prices rise in the future (which they will) a lower-dollar-amount limitation will increasingly disadvantage the Fund.

The reason the Fund invests in real estate is to maximize the risk and return benefits of diversification. There is nothing in the bill (or the amendments) which would hinder that, and much that would enhance it. On behalf of the Board of Trustees, I request that you give their concerns serious consideration.

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*60% ownership limitation*

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Alaska Permanent Fund  
Real Estate Portfolio  
Direct Investments

Property	Permanent Fund Ownership	Number of Partners	Permanent Fund Investment	Cost of 100% of Investment
1 Hampton Woods	19.6%	6	1,242,642	6,333,549
2 Williamsburg Apartments	19.6%	6	1,617,407	8,243,666
3 Chatham's Mark	19.6%	6	1,676,581	8,545,264
4 Avalon Park Apartments	40.0%	2	3,444,725	8,611,812
5 Logan's Mark	19.6%	6	1,696,305	8,645,796
6 Park at Wells Branch Apts	19.6%	6	1,814,652	9,248,992
7 Amberwood Apartments	39.4%	2	3,742,210	9,500,407
8 Lemay Lake Apartments	19.6%	6	1,893,550	9,651,122
9 The Springs Apartments	19.6%	6	1,913,275	9,751,654
10 Brookstone Apartments	19.6%	6	1,932,999	9,852,187
11 Hunt's View Apartments	19.6%	6	1,972,448	10,053,252
12 Plaza Port West	13.4%	5	1,370,297	10,241,381
13 Goldbelt Building	40.0%	2	4,161,831	10,404,576
14 Zia Vista Apartments	40.0%	2	4,165,180	10,412,950
15 Conservatory Apartments	19.6%	6	2,366,938	12,063,902
16 Tree Tops Apartments	40.0%	2	4,955,649	12,389,122
17 Tri-County Corp. Center	33.3%	3	4,130,595	12,391,786
18 Eastridge Apartments	40.0%	2	4,985,158	12,462,895
19 Royal Farms Apartments	40.0%	2	5,432,099	13,580,247
20 Bridgewater Apartments	33.3%	3	4,965,889	14,897,666
21 Overlook Apartments	40.0%	2	5,973,706	14,934,266
22 Skyler Ridge Apartments	40.0%	2	6,126,795	15,316,988
23 Innesbrook Apartments	40.0%	2	6,349,682	15,874,204
24 Villages of Forest Ridge	33.3%	2	5,467,086	16,401,257
25 MNTX Business Center	40.0%	2	7,130,326	17,825,816
26 Club at Tanasbourne	40.0%	2	7,210,300	18,025,750
27 Waterford Place Apts.	40.0%	2	7,401,600	18,504,000
28 Bank of California Center	40.0%	2	8,014,113	20,035,281
29 Amador Oaks Apartments	39.7%	3	8,105,813	20,417,665
30 Siesta Key & Cedar Key	16.7%	2	3,455,269	20,733,686
31 Bristol Place Apartments	40.0%	2	8,535,550	21,338,875
32 Riverbend Apartments	40.0%	2	9,505,718	23,764,295
33 Mill Pond & Conifer Creek	40.0%	2	9,662,512	24,156,280
34 Paragon Building	25.0%	2	6,513,231	26,052,926
35 Crystal Creek Apartments	40.0%	2	10,779,871	26,949,678
36 Lakefront Apartments	40.0%	2	11,024,930	27,562,325
37 Arboretum Lakes	40.0%	2	11,255,740	28,139,349
38 37 West 57th Street	40.0%	2	11,441,158	28,602,896
39 Island Club Apartments	40.0%	4	13,491,470	33,728,676
40 Blue Ash Business Park	23.7%	5	8,155,945	34,485,734
41 Club Apartments	33.3%	2	12,363,540	37,090,620
42 Alameda Industrial Prop.	40.0%	2	15,098,981	37,747,453
43 Dallas Industrial Port.	40.0%	4	15,393,732	38,484,330
44 Frontier Building	19.0%	8	8,171,630	42,963,352
45 Westwood Place	31.8%	2	14,141,683	44,442,748
46 One Corporate Plaza	40.0%	3	17,934,596	44,836,490
47 Danada Centers	40.0%	3	18,400,000	46,000,000
48 MIW-OPUS Properties	33.1%	4	17,940,559	54,213,859

Property	Permanent Fund Ownership	Number of Partners	Permanent Fund Investment	Cost of 100% of Investment
49 Oakwood Mall	16.7%	3	9,964,000	59,784,000
50 ARA Reading Center	31.4%	3	18,785,746	59,851,424
51 Ontario Place	40.0%	4	23,960,000	59,900,000
52 Beaverton/Redmond Tech.	40.0%	2	25,259,853	63,149,632
53 Walnut Building	38.2%	3	24,933,348	65,235,707
54 Fiesta Mall	40.0%	4	26,232,300	65,580,750
55 919 North Michigan	40.0%	3	28,554,686	71,386,714
56 Harman International	40.0%	2	32,014,143	80,035,357
57 South Park Tower	40.0%	2	32,045,962	80,114,906
58 University Square Mall	21.0%	6	19,509,524	93,011,894
59 One O'Hare Center	40.0%	6	38,551,026	96,377,564
60 Owings Mills	25.3%	4	25,491,300	100,955,644
61 IBM's SWMD Headquarters	40.0%	2	41,416,084	103,540,209
62 St. Louis Center	16.6%	5	18,494,089	111,449,115
63 McKinley Mall	10.6%	4	15,037,838	141,363,617
64 Monroeville Mall	17.1%	3	26,000,927	152,058,063
65 1818 Market Street	16.1%	7	25,724,266	159,829,672
66 135 East 57th Street	22.7%	3	37,573,374	165,322,851
67 Westside Pavilion	12.3%	7	29,796,506	242,186,977
68 Tysons Corner Center	38.0%	6	145,049,462	381,709,112

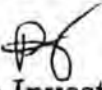


**Alaska Permanent Fund Corporation**  
P.O. Box 25500 Juneau, Alaska 99802-5500  
(907) 465-2047

**MEMORANDUM**

**DATE:** December 27, 1993

**TO:** William H. Scott  
Executive Director

**FROM:** Pete Jeans   
Real Estate Investment Officer

**SUBJECT:** Elimination of 40% restriction on real estate acquisitions

This memorandum should be attached to the memorandum dated November 18, 1993 to the Board of Trustees as additional information.

The following three investment opportunities are examples that were lost by APFC during the past three months due to the 40% restriction on real estate acquisitions.

1. Park 227  
Industrial Property  
Kent, Washington

This proposal was received from the L & B Group. The proposed investment included 39 acres with 5 industrial buildings, 100% leased. The total purchase price was \$26,500,000 and the initial cash on cash was 9% after fees.

After preliminary review, APFC decided to move forward and hired Saylor Capital to perform in-depth due diligence. APFC was considering 40% and the Public Employees Retirement Association of Colorado (PERA) was considering the remaining 60%. The due diligence was completed by both APFC and PERA and the decision was made to proceed with documentation. During this process, APFC and its attorneys could not negotiate acceptable buy-sell arrangements and were forced into backing out of this investment. PERA is proceeding to do 100%. The interesting thing on this investment is that it was presented to the APFC first, and we recommended PERA to the L & B Group as a potential partner.

Mr. William H. Scott  
December 27, 1993  
Page 2


2. 278 Post Street  
San Francisco, CA  
(Retail Property on Union Square)

This proposal was received from LaSalle Advisors. The property is being converted to Nike Town and other upscale retail. The cash on cash is projected to be over 9% after the renovation. The total investment was \$34,600,000. The same situation occurred as above and PERA is doing 100%.

3. Sequoia Station Shopping Center  
Redwood City, CA

This proposal was received from TCW Realty Advisors. The total purchase price was \$33,725,000. The initial cash on cash after fees was 9.33%. The proposal was presented to APFC toward the end of October and the seller required a closing by December 15, 1993. We looked at the property and were interested in proceeding. TCW was unable to locate co-investors that could close by the December deadline. As a result, we lost the opportunity to consider this investment.

As more institutional dollars are made available for real estate, it is going to become more and more difficult for APFC to become involved in the better investments unless we can control the investment. In order to do this, we need to have the flexibility to go up to 100% on some of the smaller investment opportunities.



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**ASSET ALLOCATION STUDY**  
**FOR**  
**THE ALASKA PERMANENT FUND**

Prepared by Ibbotson Associates, Inc.  
January, 1994



## Summary of Recommendations

Currently, the Alaska Permanent Fund is a well diversified portfolio that has enjoyed tremendous success in recent years. This success is mainly due to the Board's knowledge of the importance of asset allocation and its commitment to diversification. This has resulted in the Fund earning high rates of return at relatively conservative levels of risk. The Fund is well positioned to reap the benefits of diversification, having made investments in many different asset classes, both domestic and international. Also, the Fund appears to be efficiently managed, employing reputable and capable managers for both its equity and fixed income assets. The Fund has been able to manage its substantial fixed income portfolio entirely in-house, keeping administrative costs and outside management fees to a minimum. Several important issues must be addressed, however, in order to ensure the Fund's continued success.

Our analysis suggests the Permanent Fund should alter its asset allocation policy in order for the Fund to enjoy returns similar to those it has earned in recent years. Specifically, the Board should consider the following actions:

- ▶ Revise its current three-year target asset mix to include a larger allocation to domestic mid and small capitalization equities, European, Pacific Rim and emerging market equities, and mortgage-backed securities.
- ▶ Adopt a more aggressive investment style by allocating a larger percentage of Fund assets to equity assets and real estate.
- ▶ Revise its equity management plan by setting specific allocations for international and domestic mid and small capitalization equity managers.
- ▶ Set specific target allocations across fixed income sectors.

By implementing these changes, the Board can help ensure that the Permanent Fund will achieve the highest expected return for its chosen risk level. This will help the Board achieve its statutory goals of maximizing total Fund return and providing the maximum amount of disposable income to Alaska's citizens.

This report presents recommendations concerning the Alaska Permanent Fund. The first section provides background information on the procedures we used to perform the asset allocation study. The second section suggests improvements for those portfolios, and outlines a third portfolio suited to a more aggressive investment philosophy. The final section provides guidance on several important implementation issues.

## I. Analyzing an Investment Portfolio

A first step in analyzing an investment portfolio is determining whether the portfolio adequately compensates the investor for taking risk. Ideally, the portfolio is *efficient* in providing return to the investor; i.e., the portfolio provides the most return possible for the amount of risk taken. In reality, however, few portfolios accomplish this objective.

### *Defining Asset Classes*

In order to analyze the Fund's portfolio, we had to decide which assets to include in the Fund's investment universe. Currently, the Fund invests in 12 different asset classes that comprise six main categories. The benchmarks used to represent each asset class in our analysis are listed in Appendix A at the end of this report. The asset classes used in our study are as follows:

#### U.S. Equity Assets

Large Capitalization  
Mid/Small Capitalization

#### Non-U.S. Equity Assets

Canada  
Europe  
Pacific  
Emerging Markets

#### Other Assets

Real Estate

#### Non-U.S. Fixed Income Assets

Intermediate-Term Government/Corporate Bonds  
Long-Term Government/Corporate Bonds  
Mortgage-Backed Securities

#### Non-U.S. Fixed Income Assets

Non-U.S. Government Bonds

#### Cash

U.S. Treasury Bills



### *Forecasting Return*

We also had to forecast three estimates for each asset class: expected return, expected risk (as measured by standard deviation), and expected return correlation between assets. Summary tables of our forecasts are provided in Appendix B. It is important to note that our return, risk, and correlation forecasts are *long-term* -- they apply to an investment horizon of 10 years or more. Our forecasts are passive in nature and, therefore, would not change dramatically if we were to recalculate them a year from now. Consequently, the portfolio allocations we recommend will remain stable over a very long time period, and will require few changes over a long-term investment horizon.


The basis for our equity return forecasts is the risk-free rate of return and the historical premium, called an equity risk premium, that is demanded by investors for holding risky assets. We use the historical premium because the amount by which common stocks have outperformed risk-free government bonds has been consistent over time. The long-term equity risk premium for large capitalization domestic equities over the period January 1926 to September 1993 was 7.25 percent. Also, many researchers have found that, as the risk of an investment increases, so does its expected return. For this reason, we forecast the expected return of other equity asset classes, such as domestic small capitalization equities and international equities, to have greater expected returns.

The basis of our fixed income return forecasts is the current risk-free rate of return, as proxied by the current yield on a risk-free government bond with a maturity matching the investment time horizon. Currently, this rate is 6.31 percent, the current yield on 20-year U.S. Treasury bond. To this rate, we add the appropriate maturity premium (additional return required by investors for relinquishing the use of their money for long time periods) and default premium (additional return that compensates investors for buying bonds that have default risk, such as corporate bonds) for each class of bonds for which we are forecasting returns.

For international fixed income assets, we forecast returns as if the assets were denominated in U.S. dollars. Since currency fluctuations are expected to average to zero over time, any short-term currency gains or losses will not affect the long-term return on international assets. Currency fluctuations do increase risk, however, and are accounted for in our risk forecasts of non-U.S. fixed income assets.

### *Forecasting Risk*

When forecasting the risk of an asset, we typically assume that the future will equal the past. Therefore, we forecast risk by calculating the historical standard deviation using a long time period over which we have reliable data, and data that is representative of possible future scenarios. Although investment risk can be quantified in a number of



ways for asset allocation purposes, we believe that risk is best modeled as the annual volatility of returns, and standard deviation provides an estimate of how much actual returns may deviate from the average, expected return over time. We use shorter time periods only when we can identify a permanent and dramatic process shift in the behavior of an asset class, such as the late 1960s when bond market volatility increased noticeably from its observed volatility during the previous 40 years.

#### *Forecasting Return Correlation*

Return and risk are not the only factors that determine how a portfolio performs. The correlation between the returns of two assets also plays an important role in portfolio performance. Correlation measures how much the returns of two assets tend to move together or move separately. If the returns move together, the assets are positively correlated. If they move in opposite directions, the assets are negatively correlated. If no pattern can be detected in the way the assets' returns move, the assets have a return correlation of zero.

Portfolios comprised only of assets that have high, positive correlations with each other are not well diversified. This tends to exaggerate both upside and downside volatility, and the risk of the portfolio. On the other hand, portfolios with assets that have low or negative return correlations will provide more stable returns because, even though some assets may perform poorly, other portfolio assets will perform better, serving to reduce portfolio volatility. The benefits of diversification, therefore, are a direct result of relatively low return correlations among portfolio assets.

When forecasting return correlation, we again typically assume that the future will equal the past. The basis for our forecast of return correlation is, therefore, the historical correlation between assets, observed over the longest time period for which reliable data is available.

#### *Determining the Fund's Current Allocation*

The amount of the Fund currently allocated to each asset class was determined by using information in the Fund's 1993 Annual Report, with supplemental information provided by William L. Means, the Fund's Chief Investment Officer. Market values of all investments came from the Annual Report, while Mr. Means provided clarification regarding the amount currently invested in equities of domestic companies with capitalizations larger than \$1 billion (large capitalization equities), the amount currently invested in equities of companies with capitalizations of \$1 billion or less (mid and small capitalization equities), and the amount currently invested in domestic government and corporate bonds with maturities ranging from one to seven years (intermediate-term),



and more than seven years (long-term). The Fund's current allocation, and its expected return and standard deviation is given on page 5.

*Determining the Fund's Three-Year Target Allocation*

The Permanent Fund's investment manual provided information regarding the three-year target allocation, although some guidelines were too broad for our purposes. For example, the manual lists a 10 percent target allocation for international equities, but gives no country-specific allocations. In this case, we assumed the Fund would increase its international equity exposure to 10 percent, while maintaining the current proportion invested among sectors. Also, the target allocation constrains the amount invested in non-domestic fixed income assets to 10 percent or less, but provides no specific number. We assumed the amount invested in international debt would decrease in proportion to the total decrease in the amount allocated to all fixed income assets. The Fund's three-year target allocation, and its expected return and risk, is listed on the following page.

## Current and Three-Year Target Portfolios

Asset Class	Current Allocation (%)	3-Year Target Allocation (%)
U.S. Large Capitalization Stocks	21.17	24.00
U.S. Mid/Small Capitalization Stocks	0.65	6.00
Canadian Stocks	0.03	0.04
European Stocks	2.54	4.28
Pacific Region Stocks	2.94	4.97
Emerging Market Stocks	0.42	0.72
Real Estate	6.69	10.00
Cash	4.64	0.00
Intermediate Govt/Corp Bonds	30.86	25.32
Long-Term Govt/Corp Bonds	25.27	20.74
Mortgage-Backed Securities	3.94	3.24
Non-U.S. Government Bonds	0.85	0.69
<b>Expected Return (%)</b>	<b>8.53</b>	<b>9.93</b>
<b>Standard Deviation (%)</b>	<b>7.57</b>	<b>9.91</b>



## II. Asset Allocation Recommendations

The next step in our analysis was to improve the Fund's current and target portfolios by increasing their expected return while keeping expected risk at a constant level.

### *Allocation with Risk of the Current Portfolio*

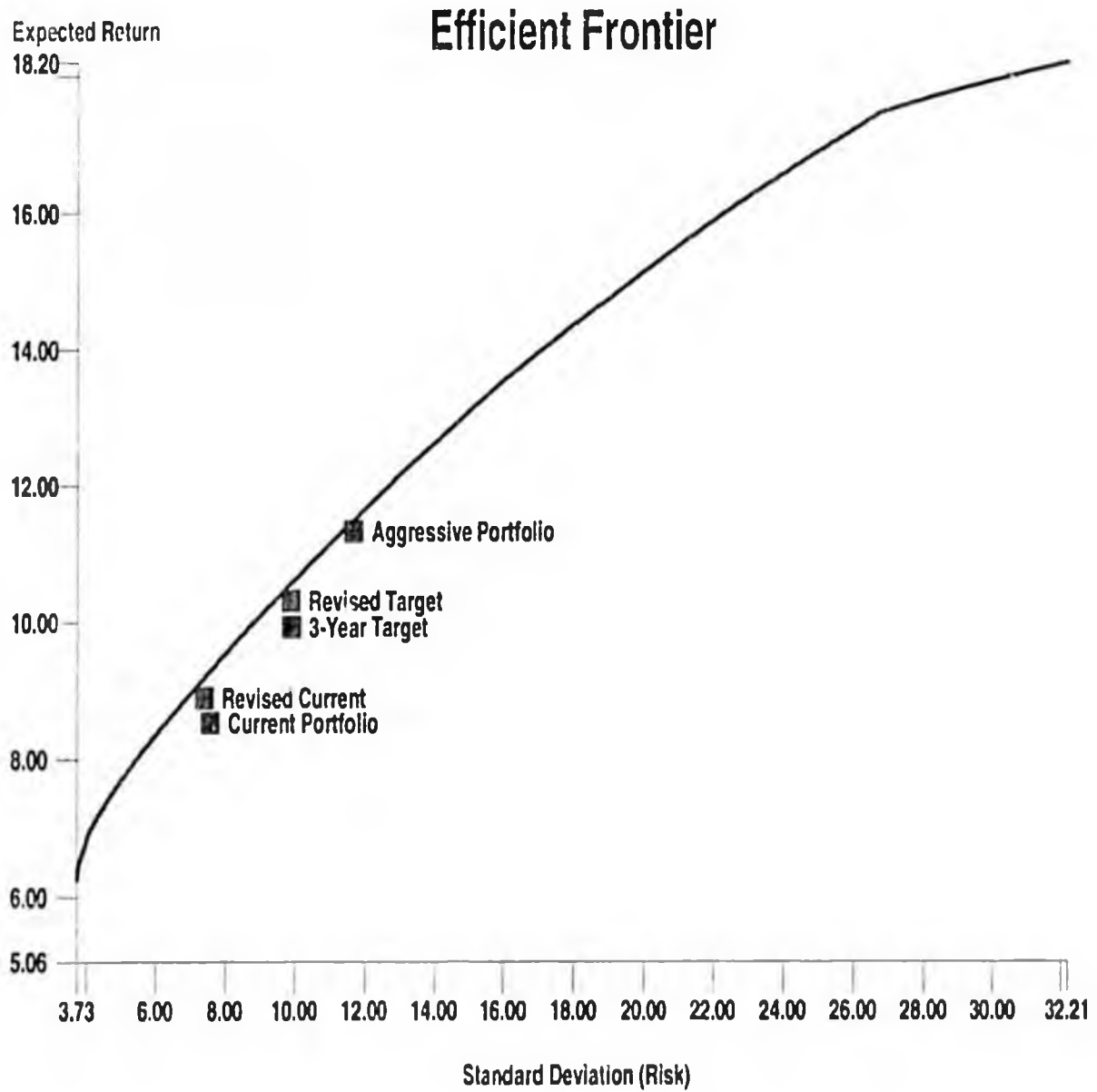
As shown in the graph on page 7, the Fund's current portfolio does not provide the maximum amount of expected return for the amount of risk taken. For example, the portfolio labeled "revised current" provides a higher expected return and slightly less risk than the current portfolio. (The graph is titled "Efficient Frontier" because the line in the graph represents those portfolios which are the most efficient in providing return to the investor; i.e., those portfolios provide the maximum return for a given level of risk.) The allocations for both the current and revised portfolios, as well as their expected returns and standard deviations, are shown on page 8.

The current portfolio need not be drastically changed in order to achieve a higher expected return. In fact, the percent of the portfolio invested in equities (approximately 35 percent, including real estate) and in fixed income assets (approximately 65 percent), is the same in both the current and revised portfolios. Rather, the composition of the equity and fixed income portions need only change. By shifting part of the equity portion from large capitalization stocks to mid and small capitalization and international stocks, and part of the fixed income portion from cash and long-term bonds to intermediate-term bonds and mortgage-backed securities, the Fund can achieve a higher expected return while taking less risk.

Although these changes represent shifts from safer assets to more risky ones, the overall risk of the portfolio actually decreases. This is because domestic mid and small stocks, mortgage-backed securities, and international stocks have low correlations with many of the other portfolio assets.


### *Allocation with Risk of the Target Portfolio*

The graph on page 7 shows that the Fund's target portfolio also does not provide the highest possible expected return for the amount of risk taken. Although both the allocations of the target and revised target portfolios are equally divided between equity and fixed income assets, the revised target portfolio has a significantly higher expected return and less risk. The composition of both portfolios, along with their expected returns and standard deviations, is given on page 8.



## Current and Recommended Portfolio Allocations

Asset Classes	Allocations				
	Current Portfolio (%)	Revised Current (%)	3-Year Target (%)	Revised Target (%)	Aggressive Portfolio (%)
U.S. Large Cap Stocks	21.17	11.00	24.00	16.00	18.00
U.S. Mid/Small Cap Stocks	0.65	4.00	6.00	8.00	10.00
Canadian Stocks	0.03	0.00	0.04	0.00	0.00
European Stocks	2.54	3.50	4.28	6.00	7.50
Pacific Region Stocks	2.94	4.00	4.97	7.00	10.50
Emerging Market Stocks	0.42	2.50	0.72	3.00	4.00
Real Estate	6.69	10.00	10.00	10.00	10.00
Cash	4.64	1.00	0.00	1.00	1.00
Intermediate-Term Govt/Corp Bonds	30.86	40.00	25.32	30.00	18.00
Long-Term Govt/Corp Bonds	25.27	12.00	20.74	5.00	6.00
Mortgage-Backed Securities	3.94	12.00	3.24	14.00	15.00
Non-U.S. Govt Bonds	0.85	0.00	0.69	0.00	0.00
<b>Expected Return</b>	<b>8.53</b>	<b>8.89</b>	<b>9.93</b>	<b>10.31</b>	<b>11.33</b>
<b>Standard Deviation</b>	<b>7.57</b>	<b>7.40</b>	<b>9.91</b>	<b>9.89</b>	<b>11.69</b>



The superior tradeoff between risk and return of the revised target portfolio can be accomplished by shifting a larger portion of Fund assets into domestic mid and small capitalization stocks, international stocks, mortgage securities, and real estate. Again, these riskier assets have low correlations with many other portfolio assets, and therefore provide enhanced diversification benefits.

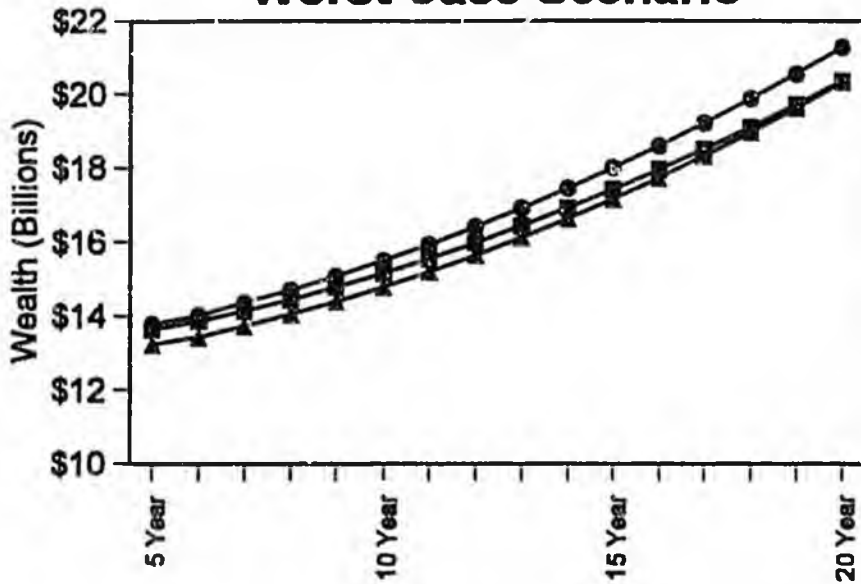
#### *Allocation of a More Aggressive Portfolio*

Although we have analyzed and suggested improvements to both the current and target portfolios, we have not yet commented on whether either portfolio is appropriate for the Fund. Ideally, a portfolio provides enough return to meet the goals of the investor while maintaining a level of risk that is comfortable for the investor. By setting a three-year target portfolio that has an increased allocation to equity assets, the Board has indicated that it is comfortable with a more aggressive investment philosophy. In our opinion, such an aggressive investing strategy is appropriate and necessary for achieving the Fund's statutory goals of maximizing total return and providing the maximum amount of disposable income to the citizens of Alaska. Consequently, we believe the Fund should consider the benefits of investing in the "aggressive portfolio," also shown in the graph on page 7.

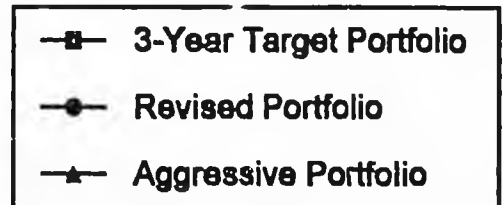
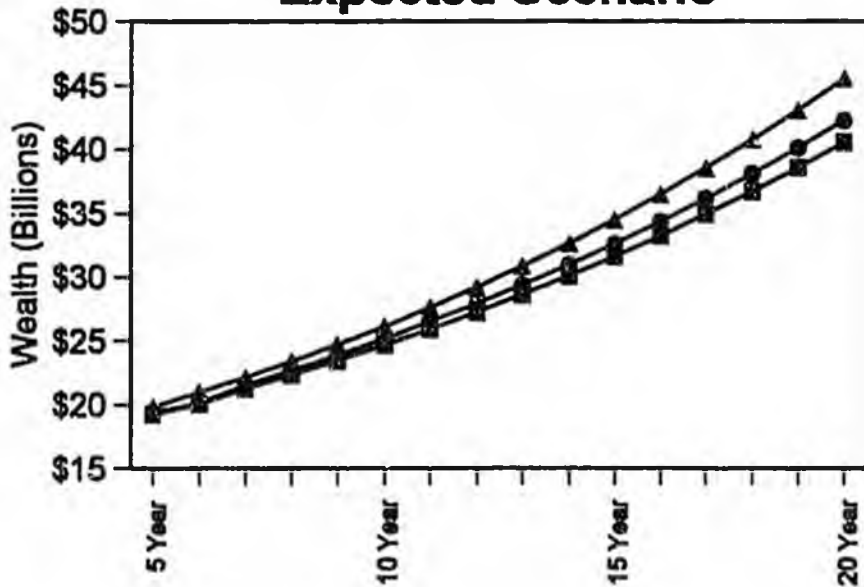
In recent years, the Fund has enjoyed relatively high returns, particularly on its fixed income investments. These high returns were due, in part, to rather unique market conditions, such as a dramatic decline in U.S. interest rates. These market conditions, however, are not expected to continue in the future, as evidenced by the returns expected on the current and target Fund portfolios. The potentially lower returns earned by both these portfolios are important factors to consider, because such low returns will inevitably lead to lower dividend payments to Alaskans. Our recommended aggressive portfolio, however, with its significant allocations to international equities and mortgage-backed securities, has an expected return in the range of the Fund's recent returns. The allocation of this aggressive portfolio, along with its expected return and standard deviation, is provided on page 8.

The graphs on the following page can help to compare the expected performance of each portfolio. The graphs show expected wealth values under the target, revised target, and aggressive portfolios for five-, ten-, and twenty-year investment horizons. Although the Board may consider the aggressive portfolio too risky, the graph shows that the majority of this portfolio's volatility is due to its broad range of possible high, *positive* returns, not negative ones. For all investment time horizons, the aggressive portfolio has a higher expected wealth value under the best- and expected-case scenarios. Only under the worst-case scenario does the aggressive portfolio underperform the target portfolio, while the revised target portfolio performs better than the target portfolio in *all* cases.

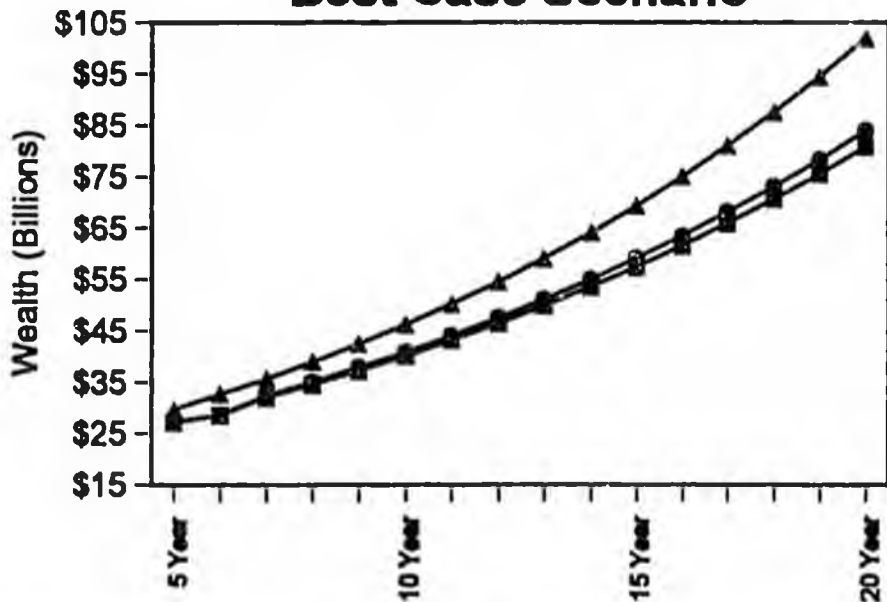
### Worst Case Scenario




### Expected Scenario



### Best Case Scenario





### *Testing Our Recommended Portfolios*

To ensure the validity of our recommended portfolios, we tested those portfolios and the Fund's current and target portfolios for *stability*. A stable portfolio is one that performs well under a variety of possible future market conditions; i.e., the portfolio provides adequate return for the amount of risk taken under conditions that differ from our forecasts. We tested the portfolios using "worst-case" scenarios where the return of one or more assets is lower than expected and the risk is higher than expected. The following scenarios were used, both individually and in combination, to test our recommended portfolios:

- U.S. equity risk premium decreases to 5 percent
- Mid and small capitalization equity return decreases to 15 percent
- Europe equity return decreases to 10 percent
- Europe equity standard deviation increases to 26 percent
- Pacific equity return decreases to 10 percent
- Pacific equity standard deviation increases to 34 percent
- Emerging market equity return decreases to 10 percent
- Return between long-term and intermediate-term bonds increases to 1 percent
- Intermediate-term bond standard deviation increases to 6 percent
- Mortgage-backed securities return decreases to 6 percent
- Mortgage-backed securities standard deviation increases to 11 percent
- Real estate standard deviation increases to 25 percent
- Correlation between U.S. stocks and U.S. bonds increases 30 percent
- Correlation between U.S. stocks and non-U.S. stocks increases 30 percent

Under these scenarios, our recommended portfolios provided higher returns with less risk than either the Fund's current or target portfolios. For example, the improved target portfolio had 10 basis points more return and less risk than the current target portfolio when tested under the assumption that all international markets had the lower returns and higher risks outlined above. This indicates that the revised portfolios will perform better over the long run, despite possible extreme underperformance of some markets.



### III. Implementation Issues

Whichever portfolio the Board chooses, several issues must be addressed by the Board to ensure maximum Fund performance. The single most important issue is the degree of adherence to the chosen allocation. Research has suggested that the asset allocation decision accounts for over 90 percent of the variability of returns on a portfolio, and is the single largest determinant of portfolio performance.<sup>1</sup> Consequently, individual security selection and active security management, the two factors commonly assumed to contribute the most to the return of a portfolio, actually account for only a small amount of portfolio return variability. Therefore, adherence to the chosen allocation is *crucial* to the future performance of any investment portfolio, including the Permanent Fund. Accordingly, the Board must decide whether the current investment strategy of the Fund accommodates a strict adherence to the chosen allocation. We address this issue separately for equity and fixed income assets in the following two sections.


#### *Equity Assets*

As of April 1993, the Board decided to use active managers only for domestic mid/small capitalization stocks and all international equities. Since our recommended portfolios are based on passive benchmarks, we believe that the long-term performance we forecast can be achieved through the use of passive managers, although it is certainly possible for active managers to meet or exceed that performance. For this reason, we believe the Board's decision to retain active managers is appropriate, *as long as each manager is given only that portion of Fund assets that is recommended in the chosen allocation, and is required to invest those assets in the specific, recommended asset class.*

This stipulation is in direct contrast to the Board's new global investment strategy as outlined in the Fund's 1993 Annual Report. The new strategy allows active international equity managers to decide when and where to invest Fund assets, essentially shifting the asset allocation decision from the Board to the manager. As mentioned earlier, asset allocation, not security selection or active market timing, is the largest determinant of portfolio performance. Under the planned strategy, the Fund's equity allocation will shift continuously, violating the most crucial aspect of strategic asset allocation: maintaining a stable asset mix which was chosen based on long-term forecasts and needs of the fund. For this reason, we suggest a slightly modified strategy where the Board hires managers that have a specific style of investing. For example, under this modified strategy, the European equity allocation would be managed by a manager who specializes in European equities. This type of management strategy would allow the Board to retain control over the equity allocation of the Fund.

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<sup>1</sup> Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower, "Determinants of portfolio performance II: An update," *Financial Analysts Journal*, May-June 1991.




The Fund's domestic equity managers also have similar control over the asset allocation decision. Currently, the performance of each domestic equity manager is evaluated by using a benchmark portfolio that consists of 80 percent large capitalization equities and 20 percent mid and small capitalization equities. The equity managers, however, are not specifically required to invest 80 percent of their Fund allocation in large capitalization stocks and 20 percent in mid and small capitalization stocks. A manager could alternate between large cap and mid and small cap stocks, and still *average* an 80 percent large cap and 20 percent mid and small cap investment. This manager could potentially be 100 percent invested in large cap stocks when the return in the mid and small cap market is high, and vice-versa. Again, this causes the overall equity allocation of the Fund to change continuously, and shifts control of the asset allocation decision to individual managers. Because the asset allocation decision is so important to the overall performance of the Fund, we feel the Board should set specific domestic equity allocations, and select managers who specialize in each asset class. This will ensure the maximum expected return for the Fund's equity investments.

#### *Fixed Income Assets*

Currently, the Fund's fixed income assets are passively managed in-house by the Fund's Chief Investment Officer, and are generally treated as a single asset class. Our analysis, however, treats the fixed income category as five distinct asset classes, because each contributes unique benefits to the overall portfolio. Treasury bills, for example, provide more liquidity than the other assets, and are, consequently, the least risky. Also, mortgage-backed securities perform differently from government or corporate bonds. For this reason, each fixed income asset class must be considered separately in the asset allocation decision.

Currently, the Board treats all fixed income assets as a single asset class and provides only a broad allocation directive. This essentially shifts the asset allocation decision to the fixed income manager. While the current allocation across fixed income assets may be appropriate when viewed in isolation, that same allocation may be inappropriate when viewed in the context of the overall portfolio. The Board has a comprehensive perspective on the Fund and, as such, should determine the Fund allocation to each asset class. For this reason, we suggest that the Board set specific target allocations for fixed income asset classes. In this way, the Board maintains control over the Fund's asset allocation and ensures maximum overall Fund performance.

Prior to beginning our study, several Board members and senators voiced concern over the Fund having only one manager for the entire fixed income portfolio. We feel that a single, capable manager, such as the current manager, can manage a large, passive fixed income portfolio with few problems, as long as that portfolio has only a small allocation to mortgage-backed securities. However, if a larger proportion of funds was invested in



mortgage-backed securities (as is our recommendation), it may be required to hire additional staff. This is because mortgage-backed securities are more complex to analyze, and the holders of mortgage securities continually receive principal and interest payments which must be accurately recorded. All our recommended portfolios contain substantial allocations to mortgage-backed securities. Consequently, we suggest that the Board hire an outside manager to manage the mortgage portfolio, or, at the very least, hire additional support staff.

### **Conclusion**

Although the Permanent Fund has an excellent performance history, the Fund faces new and uncertain investment challenges in the coming years. The Board, realizing the importance of asset allocation to overall Fund performance, has created a target allocation to meet those challenges. However, as our analysis reveals, the Board can implement a better allocation for the Fund, one that has higher expected return and less risk than the Fund's target portfolio. Also, the Board can implement a new investing policy, one emphasizing an adherence to the chosen allocation. By doing so, the Board will help ensure the maximum expected performance of the Fund over the long-term investment horizon, thereby providing the highest possible income to the State's citizens and fulfilling its obligation to those citizens.



## Appendix A: Benchmarks Used in Asset Allocation Study

<u>Asset Class</u>	<u>Benchmark Description</u>
U.S. Large Capitalization Equity	<b>S&amp;P 500:</b> A market capitalization-weighted index of 500 of the largest stocks of companies domiciled in the United States.
U.S. Mid/Small Capitalization Equity	<b>Russell 2000 Index:</b> A market capitalization-weighted index of the stocks of the bottom two thirds of the largest 3,000 publicly traded companies domiciled in the United States.
Canada Equity	<b>Morgan Stanley Capital International Canada Total Return Index:</b> A market capitalization-weighted index of 81 large Canadian stocks.
Europe Equity	<b>Morgan Stanley Capital International Europe Total Return Index:</b> A market capitalization-weighted index of large stocks from Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Spain, Sweden, Switzerland, and the United Kingdom.
Pacific Equity	<b>Morgan Stanley Capital International Pacific Total Return Index:</b> A market capitalization-weighted index of large stocks from Australia, Hong Kong, Japan, Malaysia, New Zealand, and Singapore.
Emerging Markets Equity	<b>IFC Emerging Market Composite Index:</b> A broad-based, market capitalization-weighted index of stocks listed in countries with a per capita GDP below an annually-disclosed figure. Currently, 20 countries are represented in the Composite index.
Cash	<b>U.S. 90-Day Treasury Bills:</b> Published by Salomon Brothers in <i>International Bond and Money Market Performance</i> .



**IT Govt/Corp Bonds**

**Lehman Brothers Intermediate-Term Government/Corporate Bond Total Return Index:** A portfolio of U.S. government issues (>\$100 million par value) and investment grade corporate debt (>\$50 million par value) with an average maturity of 4.42 years as of November 29, 1993.

**LT Govt/Corp Bonds**

**Lehman Brothers Government/Corporate Bond Total Return Index:** A portfolio of U.S. government issues (>\$100 million par value) and investment grade corporate debt (>\$50 million par value) with an average maturity of 10.81 years as of November 29, 1993.

**Mortgage-Backed Securities**

**Lehman Brothers Mortgage-Backed Securities Total Return Index:** An index of all fixed-rate securities backed by mortgage pools of the Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FNMA). The index has an average maturity of 5.39 years.

**Non-U.S. Bonds**

**Salomon Brothers Non-U.S. 1+ Bond Index:** A market capitalization-weighted index of bonds from Australia, Canada, Germany, Japan, Netherlands, Switzerland, and the United Kingdom with one year or more to maturity. The average maturity of bonds in the index is 6.95 years.

**Real Estate**

**Wilshire Real Estate Securities Total Return Index:** A market capitalization-weighted index of approximately 85 real estate investment trust and real estate operating companies.



## Appendix B: Forecasts Used in Asset Allocation Study

### Forecasts of Expected Return and Standard Deviation

Asset Class	Expected Return	Standard Deviation
U.S. Large Cap Stocks	13.56	20.61
U.S. Mid/Small Cap Stocks	18.03	32.95
Canada Stocks	13.73	24.64
Europe Stocks	13.98	22.69
Pacific Stocks	15.11	28.24
Emerging Market Stocks	21.38	47.00
Real Estate	9.90	13.63
Cash	4.61	2.73
IT Govt/Corp Bonds	5.89	4.10
LT Govt/Corp Bonds	6.37	7.22
Mortgage-Backed Securities	7.45	9.28
Non-U.S. Govt Bonds	6.01	14.75

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## CS FOR SENATE BILL NO. 245(STA)

IN THE LEGISLATURE OF THE STATE OF ALASKA

EIGHTEENTH LEGISLATURE - SECOND SESSION

BY THE SENATE STATE AFFAIRS COMMITTEE

Offered:

Referred:

Sponsor(s): SENATE RULES COMMITTEE BY REQUEST OF THE LEGISLATIVE BUDGET AND  
AUDIT COMMITTEE

## A BILL

## FOR AN ACT ENTITLED

1 "An Act relating to investments of the permanent fund involving equity interests  
2 in and debt obligations secured by mortgages on real estate; and providing for  
3 an effective date."

4 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

5 \* Section 1. AS 37.13.120(g)(16) is amended to read:

6 (16) equity interests in, and debt obligations secured by mortgages  
7 granting a first lien on, real estate improved by completed and substantially rented  
8 buildings and located in the United States [,] if the total value held by the fund in  
9 each investment does not exceed \$20,000,000, and, if the total value held by the  
10 fund in each investment exceeds \$20,000,000, these investments are made

11 (A) in a corporation, partnership, trust, or other entity in which,  
12 at the conclusion of each investment transaction, at least 40 [60] percent of the  
13 beneficial ownership interests are held by other institutional investors, and  
14 which is organized and operated for the purpose of making real estate

1 investments by a bank, insurance company, or other manager of institutional  
2 funds that has had at least five years of experience in the management of real  
3 estate investments of institutional investors; or

4 (B) with corporations, partnerships, trusts, or entities in which,  
5 at the conclusion of each investment transaction, at least 40 [60] percent of the  
6 beneficial ownership interests in the co-investing entity or entities as a whole  
7 are held by institutional investors, and if

8 (i) at the time of investment the fund has no more than  
9 a 60 [40] percent beneficial ownership interest in the real estate  
10 invested in as a whole;

11 (ii) the rights and obligations of the fund are  
12 substantially similar to those of the other institutional investors, except  
13 for the percentage interest in the property; and

14 (iii) the property is managed and operated by an entity  
15 that has had at least five years of experience in the management of real  
16 estate investments of institutional investors;

17 \* Sec. 2. This Act takes effect immediately under AS 01.10.070(c).

# FISCAL NOTE

**STATE OF ALASKA**  
**1994 LEGISLATIVE SESSION**

**BILL NO.** Senate Bill No. 245

Revision Date: \_\_\_\_\_

Dept. Affected: Department of Revenue

Title: "An Act relating to investments of the permanent fund involving equity interests in and debt obligations secured by mortgages on real estate; and providing for an effective date."

BRU: APFC

Component: APFC

Sponsor: Senate Rules Committee by Request of the LB&A Committee

Requestor: Senate State Affairs

COMPONENT SERIAL NO. 109

**Expenditures/Revenues:**

(Thousands of Dollars)

OPERATING	FY95	FY96	FY97	FY98	FY99	FY00
PERSONAL SERVICES	-0-	-0-	-0-	-0-	-0-	-0-
TRAVEL	-0-	-0-	-0-	-0-	-0-	-0-
CONTRACTUAL	-0-	-0-	-0-	-0-	-0-	-0-
SUPPLIES	-0-	-0-	-0-	-0-	-0-	-0-
EQUIPMENT	-0-	-0-	-0-	-0-	-0-	-0-
LAND & STRUCTURES	-0-	-0-	-0-	-0-	-0-	-0-
GRANTS, CLAIMS	-0-	-0-	-0-	-0-	-0-	-0-
MISCELLANEOUS	-0-	-0-	-0-	-0-	-0-	-0-
<b>TOTAL OPERATING</b>	-0-	-0-	-0-	-0-	-0-	-0-

<b>CAPITAL:</b>	-0-	-0-	-0-	-0-	-0-	-0-
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<b>REVENUE FUND SOURCE:</b>	-0-	-0-	-0-	-0-	-0-	-0-
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**FUNDING:**

(Thousands of Dollars)

1002 Federal Receipts	-0-	-0-	-0-	-0-	-0-	-0-
1003 GF Match	-0-	-0-	-0-	-0-	-0-	-0-
1004 GF	-0-	-0-	-0-	-0-	-0-	-0-
1005 GF/Program Receipts	-0-	-0-	-0-	-0-	-0-	-0-
1006 GF/MHTIA	-0-	-0-	-0-	-0-	-0-	-0-
Other	-0-	-0-	-0-	-0-	-0-	-0-
<b>TOTAL</b>	-0-	-0-	-0-	-0-	-0-	-0-

**POSITIONS:**

FULL-TIME	-0-	-0-	-0-	-0-	-0-	-0-
PART-TIME	-0-	-0-	-0-	-0-	-0-	-0-
TEMPORARY	-0-	-0-	-0-	-0-	-0-	-0-

Estimate of current year (FY94) Impact: \$ -0-

**ANALYSIS:** (Attach a separate page if necessary)

Prepared by: William H. Scott, Executive Director *WHS*  
 Division: Alaska Permanent Fund Corporation  
 Approved by: Darrel J. Rexwinkel, Commissioner *DJR*  
 Commissioner: \_\_\_\_\_  
 Agency: Department of Revenue

Phone: 465-2047  
 Date: January 31, 1994  
 Date: 1/31/94

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Tom Cooke

8-LS1492A

Draft CS

SENATE BILL NO. 245

IN THE LEGISLATURE OF THE STATE OF ALASKA

EIGHTEENTH LEGISLATURE - SECOND SESSION

BY THE SENATE RULES COMMITTEE BY REQUEST OF THE LEGISLATIVE BUDGET AND  
AUDIT COMMITTEE

Introduced: 1/14/94  
Referred: STA, L&C, JUD, FIN

A BILL

FOR AN ACT ENTITLED

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2 in and debt obligations secured by mortgages on real estate; and providing for  
3 an effective date."

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6 (16) equity interests in, and debt obligations secured by mortgages  
7 granting a first lien on, real estate improved by completed and substantially rented  
8 buildings and located in the United States [, IF THESE INVESTMENTS ARE MADE

9 (A) IN A CORPORATION, PARTNERSHIP, TRUST, OR  
10 OTHER ENTITY IN WHICH, AT THE CONCLUSION OF EACH  
11 INVESTMENT TRANSACTION, AT LEAST 60 PERCENT OF THE  
12 BENEFICIAL OWNERSHIP INTERESTS ARE HELD BY OTHER  
13 INSTITUTIONAL INVESTORS, AND WHICH IS ORGANIZED AND  
14 OPERATED FOR THE PURPOSE OF MAKING REAL ESTATE

SB0245a

-1-

SB 245

COMMITTEE COPY

New Text Underlined (DELETED TEXT BRACKETED)

40%

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21

INVESTMENTS BY A BANK, INSURANCE COMPANY, OR OTHER  
MANAGER OF INSTITUTIONAL FUNDS THAT HAS HAD AT LEAST  
FIVE YEARS OF EXPERIENCE IN THE MANAGEMENT OF REAL  
ESTATE INVESTMENTS OF INSTITUTIONAL INVESTORS; OR

(B) WITH CORPORATIONS, PARTNERSHIPS, TRUSTS, OR  
ENTITIES IN WHICH, AT THE CONCLUSION OF EACH INVESTMENT  
TRANSACTION, AT LEAST 60 PERCENT OF THE BENEFICIAL  
OWNERSHIP INTERESTS IN THE CO-INVESTING ENTITY OR ENTITIES  
AS A WHOLE ARE HELD BY INSTITUTIONAL INVESTORS, AND IF

40%

(i) AT THE TIME OF INVESTMENT THE FUND  
HAS NO MORE THAN A 40 PERCENT BENEFICIAL OWNERSHIP  
INTEREST IN THE REAL ESTATE INVESTED IN AS A WHOLE;

60%

(ii) THE RIGHTS AND OBLIGATIONS OF THE  
FUND ARE SUBSTANTIALLY SIMILAR TO THOSE OF THE  
OTHER INSTITUTIONAL INVESTORS, EXCEPT FOR THE  
PERCENTAGE INTEREST IN THE PROPERTY; AND

(iii) THE PROPERTY IS MANAGED AND  
OPERATED BY AN ENTITY THAT HAS HAD AT LEAST FIVE  
YEARS OF EXPERIENCE IN THE MANAGEMENT OF REAL  
ESTATE INVESTMENTS OF INSTITUTIONAL INVESTORS];

\* Sec. 2. This Act takes effect immediately under AS 01.10.070(c).

\$90 million → limit

Alaska Permanent Fund  
Real Estate Portfolio  
Direct Investments

Property	Permanent Fund Ownership	Number of Partners	Permanent Fund Investment	Cost of 100% of Investment
1 Hampton Woods	19.6%	6	1,242,642	6,333,549
2 Williamsburg Apartments	19.6%	6	1,617,407	8,243,666
3 Chatham's Mark	19.6%	6	1,676,581	8,545,264
4 Avalon Park Apartments	40.0%	2	3,444,725	8,611,812
5 Logan's Mark	19.6%	6	1,696,305	8,645,796
6 Park at Wells Branch Apts	19.6%	6	1,814,652	9,248,992
7 Amberwood Apartments	39.4%	2	3,742,210	9,500,407
8 Lemay Lake Apartments	19.6%	6	1,893,550	9,651,122
9 The Springs Apartments	19.6%	6	1,913,275	9,751,654
10 Brookstone Apartments	19.6%	6	1,932,999	9,852,187
11 Hunt's View Apartments	19.6%	6	1,972,448	10,053,252
12 Plaza Port West	13.4%	5	1,370,297	10,241,381
13 Goldbelt Building	40.0%	2	4,161,831	10,404,576
14 Zia Vista Apartments	40.0%	2	4,165,180	10,412,950
15 Conservatory Apartments	19.6%	6	2,366,938	12,063,902
16 Tree Tops Apartments	40.0%	2	4,955,649	12,389,122
17 Tri-County Corp. Center	33.3%	3	4,130,595	12,391,786
18 Eastridge Apartments	40.0%	2	4,985,158	12,462,895
19 Royal Farms Apartments	40.0%	2	5,432,099	13,580,247
20 Bridgewater Apartments	33.3%	3	4,965,889	14,897,666
21 Overlook Apartments	40.0%	2	5,973,706	14,934,266
22 Skyler Ridge Apartments	40.0%	2	6,126,795	15,316,988
23 Innesbrook Apartments	40.0%	2	6,349,682	15,874,204
24 Villages of Forest Ridge	33.3%	2	5,467,086	16,401,257
25 MNTX Business Center	40.0%	2	7,130,326	17,825,816
26 Club at Tanasbourne	40.0%	2	7,210,300	18,025,750
27 Waterford Place Apts.	40.0%	2	7,401,600	18,504,000
28 Bank of California Center	40.0%	2	8,014,113	20,035,281
29 Amador Oaks Apartments	39.7%	3	8,105,813	20,417,665
30 Siesta Key & Cedar Key	16.7%	2	3,455,269	20,733,686
31 Bristol Place Apartments	40.0%	2	8,535,550	21,338,875
32 Riverbend Apartments	40.0%	2	9,505,718	23,764,295
33 Mill Pond & Conifer Creek	40.0%	2	9,662,512	24,156,280
34 Paragon Building	25.0%	2	6,513,231	26,052,926
35 Crystal Creek Apartments	40.0%	2	10,779,871	26,949,678
36 Lakefront Apartments	40.0%	2	11,024,930	27,562,325
37 Arboretum Lakes	40.0%	2	11,255,740	28,139,349
38 37 West 57th Street	40.0%	2	11,441,158	28,602,896
39 Island Club Apartments	40.0%	4	13,491,470	33,728,676
40 Blue Ash Business Park	23.7%	5	8,155,945	34,485,734
41 Club Apartments	33.3%	2	12,363,540	37,090,620
42 Alameda Industrial Prop.	40.0%	2	15,098,981	37,747,453
43 Dallas Industrial Port.	40.0%	4	15,393,732	38,484,330
44 Frontier Building	19.0%	8	8,171,630	42,963,352
45 Westwood Place	31.8%	2	14,141,683	44,442,748
46 One Corporate Plaza	40.0%	3	17,934,596	44,836,490
47 Danada Centers	40.0%	3	18,400,000	46,000,000
48 MIW-OPUS Properties	33.1%	4	17,940,559	54,213,859

Property	Permanent Fund Ownership	Number of Partners	Permanent Fund Investment	Cost of 100% of Investment
49 Oakwood Mall	16.7%	3	9,964,000	59,784,000
50 ARA Reading Center	31.4%	3	18,785,746	59,851,424
51 Ontario Place	40.0%	4	23,960,000	59,900,000
52 Beaverton/Redmond Tech.	40.0%	2	25,259,853	63,149,632
53 Walnut Building	38.2%	3	24,933,348	65,235,707
54 Fiesta Mall	40.0%	4	26,232,300	65,580,750
55 919 North Michigan	40.0%	3	28,554,686	71,386,714
56 Harman International	40.0%	2	32,014,143	80,035,357
57 South Park Tower	40.0%	2	32,045,962	80,114,906
58 University Square Mall	21.0%	6	19,509,524	93,011,894
59 One O'Hare Center	40.0%	6	38,551,026	96,377,564
60 Owings Mills	25.3%	4	25,491,300	100,955,644
61 IBM's SWMD Headquarters	40.0%	2	41,416,084	103,540,209
62 St. Louis Center	16.6%	5	18,494,089	111,449,115
63 McKinley Mall	10.6%	4	15,037,838	141,363,617
64 Monroeville Mall	17.1%	3	26,009,927	152,058,063
65 1818 Market Street	16.1%	7	25,724,266	159,829,672
66 155 East 57th Street	22.7%	3	37,573,374	165,322,851
67 Westside Pavilion	12.3%	7	29,796,506	242,186,977
68 Tysons Corner Center	38.0%	6	145,049,462	381,709,112

8-LS1492E  
Cook  
2/1/94

CS FOR SENATE BILL NO. 245(STA)  
IN THE LEGISLATURE OF THE STATE OF ALASKA  
EIGHTEENTH LEGISLATURE - SECOND SESSION

BY THE SENATE STATE AFFAIRS COMMITTEE

Offered:  
Referred:

Sponsor(s): SENATE RULES COMMITTEE BY REQUEST OF THE LEGISLATIVE BUDGET AND  
AUDIT COMMITTEE

A BILL

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# FISCAL NOTE

**STATE OF ALASKA**  
**1994 LEGISLATIVE SESSION**

**BILL NO.** Senate Bill No. 245

Revision Date: \_\_\_\_\_

Dept. Affected: Department of Revenue

Title: "An Act relating to investments of the permanent fund involving equity interests in and debt obligations secured by mortgages on real estate; and providing for an effective date."

BRU: APFC

Component: APFC

Sponsor: Senate Rules Committee by Request of the LB&A Committee

Requestor: Senate State Affairs

COMPONENT SERIAL NO. 109

**Expenditures/Revenues:**

(Thousands of Dollars)

OPERATING	FY95	FY96	FY97	FY98	FY99	FY00
PERSONAL SERVICES	-0-	-0-	-0-	-0-	-0-	-0-
TRAVEL	-0-	-0-	-0-	-0-	-0-	-0-
CONTRACTUAL	-0-	-0-	-0-	-0-	-0-	-0-
SUPPLIES	-0-	-0-	-0-	-0-	-0-	-0-
EQUIPMENT	-0-	-0-	-0-	-0-	-0-	-0-
LAND & STRUCTURES	-0-	-0-	-0-	-0-	-0-	-0-
GRANTS, CLAIMS	-0-	-0-	-0-	-0-	-0-	-0-
MISCELLANEOUS	-0-	-0-	-0-	-0-	-0-	-0-
<b>TOTAL OPERATING</b>	-0-	-0-	-0-	-0-	-0-	-0-

<b>CAPITAL:</b>	-0-	-0-	-0-	-0-	-0-	-0-
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<b>REVENUE FUND SOURCE:</b>	-0-	-0-	-0-	-0-	-0-	-0-
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**FUNDING:**

(Thousands of Dollars)

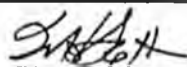
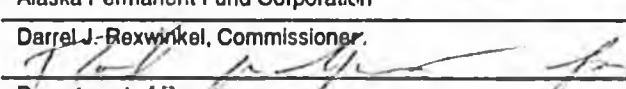
1002 Federal Receipts	-0-	-0-	-0-	-0-	-0-	-0-
1003 GF Match	-0-	-0-	-0-	-0-	-0-	-0-
1004 GF	-0-	-0-	-0-	-0-	-0-	-0-
1005 GF/Program Receipts	-0-	-0-	-0-	-0-	-0-	-0-
1006 GF/MHTIA	-0-	-0-	-0-	-0-	-0-	-0-
Other	-0-	-0-	-0-	-0-	-0-	-0-
<b>TOTAL</b>	-0-	-0-	-0-	-0-	-0-	-0-

**POSITIONS:**

FULL-TIME	-0-	-0-	-0-	-0-	-0-	-0-
PART-TIME	-0-	-0-	-0-	-0-	-0-	-0-
TEMPORARY	-0-	-0-	-0-	-0-	-0-	-0-

Estimate of current year (FY94) impact: \$ -0-

**ANALYSIS:** (Attach a separate page if necessary)

Prepared by: William H. Scott, Executive Director   
 Division: Alaska Permanent Fund Corporation  
 Approved by: Darrel J. Rexwinkel, Commissioner  
 Commissioner:   
 Agency: Department of Revenue

Phone: 465-2047  
 Date: January 31, 1994  
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SB245

Rail Scott

40% limitation - PF-how can that control

Board accepts restrictive resolution

PF will still invest on larger transactions

invest flexibility for investing 100% in smaller projects

rate of return in real estate - carbon-cash = 7.7%

plus appreciation

< 7% in real estate now

Rail gear 10%

State says 15%

Jim Kelly

① 50% or 51% -

instead of 100%?

② 100% of asset < say 15 million

(smaller holdings)

30 million

PB -

PLS. CALL MI Spokane

SB244/245

Re: V&S history

# 277-7277

OK  
on  
changes

10 million

2/4/94 9:05a STA

SB 245

Pete Jeans - PFC

started w/ real estate pools

rows 1- top 10 in holding in US

no control