

HB

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FILE

Supplemental Testimony

Thank you for considering the Board of Trustees' supplemental request for authority to pay Permanent Fund corporate receipts for increased manager fees so promptly this session. For the record, I am Jim Kelly, Director of Communications for the Alaska Permanent Fund Corporation and with me this morning is Peter A. Bushre, Chief Financial Officer.

The good news is that the Permanent Fund is performing better than expected so far this fiscal year.

Assets under management have grown from \$22.1 billion as of June 30 to \$23 billion as of December 31, and that growth is on top of the \$747 million dollars which the legislature appropriated and which the Fund paid out in dividends to all the residents of this state in October..

We don't yet have performance numbers for the Fund for the last quarter – although we are expecting them by the end of the week, but based on the performance of our capital market benchmarks, Fund total return has been flat to modestly positive the last three months.

However, for the first quarter of the fiscal year, which is where most of this year's growth was produced, the Fund earned a period return, not annualized, of 5.04%. The high performer during that period was the APFC's U.S. equities at 8.84%.

Annualized that is more than a 35% return, which is why we asked Legislative Budget Audit and Committee to introduce this supplemental for us 3 months ago when those were the returns we were looking at and, of course, manager fees are based on the value of assets under management so when the Fund goes up in value, the manager fees increase.

That is the general rule. There are some mitigating factors which the Board has put into place which have had the effect of reducing the growth of manager fees. One is the permanent movement of a greater percentage of equity assets into passive index accounts. Fees for passive management are just a fraction of active management fees.

The second is the temporary movement of literally billions of dollars of equity assets into a passive transition account during the Fund's restructuring. The restructuring was undertaken to accomplish the

Board-directed shift in asset allocation – more into passive management, more into international equities and more into emerging markets.

Most of this restructuring took place in the last quarter although a portion is still on-going.

The Fund has experienced a number of positive outcomes from the restructuring, but one which is surely good news for the people of Alaska is that significant capital gains have already been realized, so that net income for the Permanent Fund for the first half of the year is \$1.5 billion, and we are projecting net income for the year in excess of \$2.1 billion.

As good as this is, however, and this is excellent and unexpected news – a word of caution is in order. Expectations going forward do not support the kind of returns institutional and institutional investors have been earning these past few years.

You'll hear quite a bit more about it later this week in the Capital Markets Outlook we have arranged for the Finance Committees for later this week, on Thursday morning at 8:00 a.m. Suffice to say for now that the Fund is expecting single digit returns from all asset classes going forward, with the exception of small-cap U.S. stocks which our investment consultant, Callan Associates, is projecting at 10.1% on average for the next five years.

But, in addition to the lower returns, expectations are also for increased short-term volatility. Which brings me back to the supplemental and our request that you amend our original request, and reduce the amount to four million four hundred and ninety-four thousand dollars.

We think this will provide sufficient corporate receipts to pay our managers for the remainder of the year. Importantly, let me repeat what we told the LB&A committee: money budgeted for manager fees will be used solely for manager fees; if it turns out that we don't need this amount, unused corporate receipts will lapse.

Fees for the first six months total \$11,079,800. This supplemental will allow us to pay an additional \$14,106,200 for the last two quarters of the year. For perspective, that means that for every dollar of net income the Fund earns this year, manager fees cost 1.19 cents – that's nearly 99 cents profit per dollar of revenue. That's a positive ratio.

Peter and I would be happy to answer any questions.



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MEMORANDUM

DATE: January 23, 1998

TO: Byron I. Mallott
Executive Director

FROM: Peter A. Bushre *PAB*
Chief Financial Officer

SUBJECT: FY98 Supplemental Budget Request

At your direction, staff has reviewed the FY98 supplemental budget request for manager fees of \$8,145,000 to determine the current reasonableness of the amount. The request was prepared in September 1997 and the following subsequent events indicate the need for reanalysis:

- The Alaska Permanent Fund Corporation has incurred/expended external equity/fixed-income manager fee charges of \$11,079,800 through December 31, 1997 which represent 54% of the FY98 budget for manager fees.
- The rebalancing of Permanent Fund equity investments has/will reduce manager fees significantly.
- Equity investments have been reduced to the lower limit of the equity allocation range and proceeds have been reinvested in fixed income securities.

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- Actively managed equity investments have been converted to cash/index funds and is being gradually reinvested in actively managed portfolios until year end.
- The growth of the S&P 500 index, the benchmark for most APFC equity investments, for the first half of FY98 is approximately the same as the growth of the S&P 500 index for the first half of FY97.
- The majority of FY97 growth occurred in the last quarter of the fiscal year.

We have prepared the following analysis of estimated manager fees for the remaining two quarters of FY98 for comparison with the budget assuming that equity values continue to appreciate at a rate comparable to FY97.

FY98 Budget for Manager Fees	\$20,692,000
Actual Fees July 1, 1997-December 31, 1997	<u>11,079,800</u>
Balance of FY98 Manager Fee Budget Remaining	9,612,200
Estimated Fees January 1, 1998-June 30, 1998	<u>14,106,200</u>
Projected Shortfall in FY98 Manager Fees	<u>(\$4,494,000)</u>

RECOMMENDATION

Original FY98 Supplemental Budget Request	\$8,145,000
Recommended Reduction of FY98 Supplemental	<u>3,651,000</u>
Revised FY98 Budget Shortfall in Manager Fees	<u>\$4,494,000</u>