

HB

156

SFIN

FILE

5/14/99

SENATE FINANCE COMMITTEE REPORT

DATE: 5/10/99

FURTHER:

DATE TURNED IN TO OFFICE: 5/14/99

Finance Committee considered

CS FOR HOUSE BILL NO. 156(FIN)

"An Act relating to investments by the Alaska Permanent Fund Corporation; and providing for an effective date."

and recommends:

- be replaced with S CS HB 156 (FIN)
- adopt previous _____ CS _____ (_____)
- attached amendment(s)
- adopt Letter of Intent by _____ Committee
- further referral to the _____ Committee

- Senate Bill:**
- same title
 - new title
- House Bill:**
- same title
 - technical title
 - new: SCR# _____

| SIGNING DO PASS | DP | OTHER RECOMMENDATIONS | NR | DNP | AM |
|------------------------------|----|-----------------------|----|-----|----|
| <i>[Signature]</i> | ✓ | | | | |
| <i>[Signature]</i> | ✓ | | | | |
| <i>[Signature]</i> | ✓ | | | | |
| <i>[Signature]</i> | ✓ | | | | |
| <i>[Signature]</i> | ✓ | | | | |
| <i>[Signature]</i> | ✓ | | | | |
| Co-Chair: <i>[Signature]</i> | ✓ | Co-Chair: | | | |
| Co-Chair: <i>[Signature]</i> | | Co-Chair: | | | |

NEW FISCAL NOTE(S):

| Department | Date | Zero | Fiscal |
|------------|------|------|--------|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

PREVIOUS FISCAL NOTE(S):*

| Department | Date | Zero | Fiscal |
|--------------------|---------|------|-----------|
| Rev/Rev Operations | 4/28/99 | | 3,154,600 |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

APPROPRIATION -- no fiscal note

*include fiscal notes accompanying Governor's bill

5/14/99

No: 2

FISCAL NOTE

Bill Version: CSHB 156 (FIN)

(H) Publish Date: 5/3/99

STATE OF ALASKA 1999 LEGISLATIVE SESSION

Revision Date/Time (Note if correction) _____ Dept. Affecte Revenue _____
 Title An Act relating to investments by the Alaska BRU Revenue Operations
Permanent Fund Corporation Component Alaska Permanent Fund Corporation
 Sponsor House Rules Committee
 Requester House Finance Committee Component Serial No. _____

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

| OPERATING EXPENDITURES | FY 2000 | FY 2001 | FY 2002 | FY 2003 | FY 2004 | FY 2005 |
|------------------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Personal Services | | | | | | |
| Travel | | | | | | |
| Contractual | 3,154.6 | 6,175.7 | 6,434.5 | 6,731.4 | 7,055.0 | 7,390.4 |
| Supplies | | | | | | |
| Equipment | | | | | | |
| Land & Structures | | | | | | |
| Grants & Claims | | | | | | |
| Miscellaneous | | | | | | |
| TOTAL OPERATING | 3,154.6 | 6,175.7 | 6,434.5 | 6,731.4 | 7,055.0 | 7,390.4 |

| | | | | | | |
|-----------------------------|------------|------------|------------|------------|------------|------------|
| CAPITAL EXPENDITURES | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
|-----------------------------|------------|------------|------------|------------|------------|------------|

| | | | | | | |
|-------------------------------|-----------------|------------------|------------------|------------------|------------------|------------------|
| CHANGE IN REVENUES () | 98,135.0 | 102,033.8 | 106,308.8 | 111,214.6 | 116,561.2 | 122,101.6 |
|-------------------------------|-----------------|------------------|------------------|------------------|------------------|------------------|

FUND SOURCE (Thousands of Dollars)

| | | | | | | |
|--------------------------|----------------|----------------|----------------|----------------|----------------|----------------|
| 1002 Federal Receipts | | | | | | |
| 1003 GF Match | | | | | | |
| 1004 GF | | | | | | |
| 1005 GF/Program Receipts | | | | | | |
| 1037 GF/Mental Health | | | | | | |
| Other Corporate Receipts | 3,154.6 | 6,175.7 | 6,434.5 | 6,731.4 | 7,055.0 | 7,390.4 |
| TOTAL | 3,154.6 | 6,175.7 | 6,434.5 | 6,731.4 | 7,055.0 | 7,390.4 |

Estimate of current year (FY99) cost: 0.0

POSITIONS

| | | | | | | |
|-----------|--|--|--|--|--|--|
| Full-time | | | | | | |
| Part-time | | | | | | |
| Temporary | | | | | | |

ANALYSIS: *This fiscal note assumes an increase in costs and revenues associated with a 10% increase in public equity investments. It is likely over the 5 year period of this fiscal note that the APFC will use this increased investment flexibility in other asset types as well, e.g., real estate, fixed-income, and alternative investments such as private equity. The new investments would be entered into in order to add incremental value to a very large asset base. Investments with the potential to add significant value may require significant increased costs. All new investments will be reviewed by the Board of Trustees prior to implementation and presented to the APFC's oversight committee, the Legislative Budget & Audit Committee, for review and comment.*

Prepared by Peter A. Bushre *Peter A. Bushre* Phone 465-2301
 Division Alaska Permanent Fund Corporation Date/Time _____
 Approved by _____
 Commissioner Wilson L. Condon *Wilson L. Condon* Date 4/28/99
 Agency Department of Revenue

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SENATE FINANCE
COMMITTEE
Amendment Number: #1
Bill Number: CS HB 156(FIN)
Sponsor: Tomson Date: 5/14/99
Logged In By: Mindy

AMENDMENT

moved by Parrell
object Adcoms - Withdrawn
w/o obj. ADOPTED

OFFERED IN THE SENATE BY SENATOR TORGERSON
TO: CSHB 156(FIN)

- 1 Page 1, line 7 following "may,"
- 2 Delete "either directly or"

- 3 Page 4, following line 2
- 4 Insert "(C) and professionally managed"

A FAX

Alaska State Legislature

Date: 14 May 1999

To: Gail - Leg. Legal

Fax #: 2029 Phone #: 2450

From: Mindy - Senate Finance

Phone #: 4935

Re: HB 156 1-LS0500\H
plus the following amendment
final please - call w/ questions

*Thx
Mindy*

Following this page, please find 1 pages(s). If this does not reach you in full, please inform us ASAP.



THANK YOU

*faxed
5/14 4:15
4:40 Tam called
w/ questions - referred
to Darwin*

BB156



Alaska Permanent Fund Corporation

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

May 10, 1999

Senator John Torgerson
Co-Chair, Senate Finance Committee
Capitol Room 516
Juneau, Alaska 99811

Dear Senator Torgerson:

I am writing to request that you schedule House Bill 156 in the Senate Finance Committee at your earliest convenience.

This bill, which would provide increased flexibility investment for the Alaska Permanent Fund Corporation (APFC) Board of Trustees is an important piece of legislation which could help the state earn an additional \$300 million per year on average over the next 20 years.

We look forward to testifying in support of this bill at your earliest convenience. Thank you.

With warm regards,

A handwritten signature in black ink, appearing to read "Jim Kelly". The signature is stylized with a large, looping initial "J" and a cursive "Kelly".

Jim Kelly
Director of Communications

c: Byron I. Mallott
Board of Trustees

Alaska State Legislature

REPRESENTATIVE
GAIL PHILLIPS
Chair

SESSION ADDRESS
State Capitol
Juneau, Alaska 99801-1182
(907) 465-2689
Fax: (907) 465-3472

Legislative Budget and Audit Committee

SPONSOR STATEMENT / House Bill 156

“An Act relating to investments by the Alaska Permanent Fund Corporation; and providing for an effective date”.

The Legislative Budget and Audit Committee (LBAC) is charged with oversight of the Alaska Permanent Fund Corporation (APFC). Specific to this legislation, AS 24.20.151 (2) under purposes of the Committee reads “holding these agencies (lending or investment entities) accountable to statutory intent in their performance by recommending, where appropriate, changes in policy to the agencies or changes in legislation to the legislature”.

On March 4, the APFC submitted this legislation in draft to LBAC members for their review. On March 23, the APFC presented this legislation to the Committee and the members present agreed unanimously to introduce it, without revision, in both bodies.

House Bill 156 modernizes the operations of AS 37.13.120, the statutes that set out the “legal list” of permissible investments of APFC assets. The revisions requested in this legislation are aimed at providing increased investment flexibility, reduced risk, and hopefully increased returns for the Permanent Fund.

Specifically House Bill 156 allows the trustees to invest up to 5% of Fund assets to: (1) make or retain greater asset class commitments than currently allowed; and /or (2) invest in individual securities or instruments that are not expressly permitted. However, the legal list approach is maintained and current asset allocations, while modestly expanded, remain in place.

The first committee of referral, the House State Affairs Committee, made one amendment to HB 156. On page 6, line 20, the limit on owning domestic and nondomestic entities was raised from 50% to 55%. The House Finance Committee made one amendment to page 6, line 3, and that was leaving the word “own” in place and denying the requested change to “acquire”.

As you know, any revisions to APFC investment policy require careful consideration on our part, the legislature. On the behalf of the LBAC, I urge members to vote for this legislation.

INTERIM ADDRESS

345 W. Sterling Highway, Suite 102B, Homer, Alaska 99603 (907) 235-2921 Fax: (907) 235-4008



Alaska Permanent Fund Corporation

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

MEMORANDUM

DATE: April 2, 1999

TO: Representative Gail Phillips
Chair, Legislative Budget & Audit Committee

FROM: Jim Kelly *JK*
Director of Communications

SUBJECT: **Bill Analysis for HB 156/SB 115**

Attached below is a bill analysis prepared for HB 156/SB 115, "An Act relating to investments by the Alaska Permanent Fund Corporation; and providing for an effective date." Originally drafted March 4, 1999 by APFC legal counsel Ron Lorensen, it has been slightly revised to conform with the bill as approved for introduction by the Legislative Budget & Audit Committee.

At the Board of Trustees' request, I have prepared a draft of proposed legislation to make a number of technical and other changes to improve and modernize the operation of AS 37.13.120, the section that sets out the "legal list" of permissible investments of Fund assets. Working within the framework of the existing "legal list," the proposed changes are intended to provide more internal consistency and greater flexibility for Fund investments in light of the tremendous changes in financial markets and investment vehicles that have occurred since the list was enacted in the early '80's.

The draft has been prepared in regular legislative drafting style, with additions to existing text underlined and deletions shown in square brackets and in all capital letters. These changes are summarized, by investment category (fixed income, equity, or real estate), below. As appropriate to illustrate a particular change, further explanation and/or "real world examples" of the effect of a proposal are separately set out in italicized text.

1. Fixed Income.

(a) Amending paragraph (g)(8)(A) (at page 2, line 24) to delete the requirement that short-term domestic promissory notes be "of the highest ratings assigned by a nationally recognized rating service" and to require, instead, that these notes be "investment grade."

"Investment grade" is the quality level required of all other debt instruments under the statute, so this change will provide for consistency.

(b) Amending paragraphs (g)(7) (at page 2, line 19) and (g)(19) (at page 5, line 12) to change the existing reference to "debt securities" to "debt instruments."

For many purposes, the terms "debt securities" and "debt instruments" are used interchangeably. However, their formal definitions as set out in Barrons' Dictionary of Finance and Investment Terms are slightly different, with "debt instruments" having a somewhat broader scope than "debt securities." This change would avoid any issue that a particular instrument does not qualify as a "debt security" for investment of Fund assets. Since the quality of a particular investment would still have to be rated investment grade, this change would not affect applicable risk considerations.

(c) Amending subsection (j) (at page 6, line 23), which prohibits investment in bonds on which any regular interest payment has been defaulted within the last five years, to substitute "debt instruments" for "bonds."

This change would conform the terminology used in this provision to the change in terms from "debt securities" to "debt instruments" described above at (b). There is no apparent reason why the restriction in investing in debt that has defaulted on interest payments should be limited only to bonds.

2. Equities.

(a) Amending subsection (h) (at page 5, line 29), which limits the situations in which the Board may enter into futures contracts for the sale of assets held by it, to permit the use of futures contracts to implement asset allocation strategies in the Fund's equity portfolio.

APFC experience has shown that there are a number of situations in which the use of futures contracts in furtherance of its asset allocation strategies can improve performance in the Fund's equity portfolio. For example, when one of the APFC's managers is holding cash as part of its portfolio (either in anticipation of a planned purchase of new or additional equities or as the result of the liquidation of a part of its portfolio at the direction of the APFC), the manager can avoid the opportunity cost of not being fully invested in equities by purchasing S&P 500 Futures contracts, in effect "equitizing" the cash balance until it is needed, at which point the S&P 500 Futures would be sold. The same benefit from the use of S&P 500 Futures can also be seen on a larger scale when realignments in the Fund's investments are made either to implement changes in the Board's asset allocation plan or to bring the Fund's asset mix back within established allocation guidelines.

(b) Amending the first sentence in subsection (i) (at page 6, line 3), which establishes a five percent limitation on ownership of voting stock of a corporation, to change the word "own" to "acquire" for purposes of determining when the percentage limitation is to be applied.

As presently worded, the limitation on "ownership" might actually come into operation at some time after the stock is purchased (acquired) by the Fund, thus forcing the Fund to sell a portion of its holdings in the corporation, even though the Fund satisfied the five percent limit at the time the stock

was purchased. This could happen, for instance, if a corporation were to buy back and then retire a portion of its own voting stock, thereby reducing the total shares outstanding and--at the same time--effectively increasing the Fund's percentage ownership of those remaining shares.

3. Real Estate.

(a) Amending subsection (e) (at page 1, line 5), which prohibits the Alaska Permanent Fund Corporation (APFC) from borrowing money, to explicitly permit borrowings against real estate assets so long as the obligation to repay those borrowings is secured and can not be enforced directly against the APFC or the Fund.

In connection with real estate, properly managed leveraging may improve the rate of return on the Fund's real estate investments or reduce risk by reducing the cash investment in an asset. In addition, several title-holding general partnerships through which the Fund currently invests in real estate have borrowed money in the past, and there is some question whether, given the Fund's status as a general partner in those partnerships, those borrowings might constitute either borrowings by the Fund or a guaranty of the obligations of another. The change would address this uncertainty by specifically authorizing debt financing for a particular real estate investment without subjecting any other investment of the Fund to the risks of the borrowing.

A real world example is the Fiesta Mall in Mesa, Arizona. A tenant of the mall requested that the mall be expanded to accommodate its square footage needs. Although the APFC considered the additional investment to be appropriate, one of the APFC's partners in the property was either unable or unwilling to invest more cash in the property. The only way to retain the tenant was to finance the expansion of the property through debt which was

incurred in the name of the partnership and which was without recourse to the APFC.

(b) Substantially revising paragraph (g)(16) (beginning at pages 3, line 27), which deals with limitations on investments in real estate. Presently, that provision includes a set of investment limitations that apply only to real estate investments in which the Fund has invested more than \$150 million, one of which is the requirement that the Fund not own more than 67% of an investment exceeding the \$150 million threshold. The existing provision also effectively precludes the Fund from acquiring undeveloped real estate, even though that real estate offers the opportunity to enhance the value of an existing Fund-owned property through expansion.

The proposed amendment eliminates the 67% ownership limitation for real estate investments that exceed \$150 million. This current restriction limits the APFC's ability to negotiate on large transactions, since competitors are aware that the Fund is limited to 67% ownership. A real world example of this problem is where the contract of a partnership or limited liability company contains a "buy-sell" provision in which one of the partners can either take full control of an asset or exit the asset by picking a price and forcing the remaining partners to decide whether to buy or sell at that price. The Fund currently owns three assets with total values exceeding \$150 million. If a partner in one of those properties were to exercise a buy-sell option, the price it offered might be artificially affected because it knows that the APFC could not legally elect to be a buyer of more than 67% of that asset.

The amendment also allows the APFC the ability to acquire undeveloped real estate tied to an existing property in order to enhance that property and/or to retain tenants. A real world example of the problem this amendment addresses is where a tenant whose business is growing decides that it needs more space. The tenant might request that the property owner(s) expand the building that it is currently

renting. Sometimes this expansion can only occur by purchasing a neighboring vacant lot and constructing a build-to-suit project in close proximity to the property. Under the statute as it presently reads, the Fund could not acquire the vacant lot for that purpose and might lose the tenant as a result.

(c) Adding a new paragraph (21) to subsection (g) (at page 5, line 19) to authorize the Fund to make real estate investments through title holding corporations and "securitization" structures or other investment vehicles, so long as the assets owned by the entity in which the Fund invests consist predominantly of real estate equity and debt investments of a type in which the Fund would otherwise be permitted to invest.

This change would address two lingering legal questions regarding the permissible contours of the Fund's real estate investment portfolio. First, it would make clear that the Fund may hold real estate assets indirectly through separate title-holding entities or other investment vehicles (such as real estate investment trusts--REITs--and commercial mortgage-backed securities programs) by explicitly authorizing those alternate investment forms. Second, it would allow the Fund's real estate portfolio to include pools of real estate assets that might contain some foreign properties, so long as a particular pool of assets is predominantly made up of U.S. real estate. Currently, because the statute limits the Fund to investments in real estate located in the United States, the APFC's REIT manager has been advised that it may not purchase shares of a REIT which contains even one foreign property. This restriction has precluded investment in several REITs from which the investment manager believes the Fund could obtain solid returns, even though the foreign property holdings of those REITs are quite limited.

(d) Amending subsection (i) (at page 6, line 3), which establishes a five percent limitation on ownership of voting stock of a

corporation, to make the five percent limitation inapplicable to interests in real estate title-holding corporations, REITs, and other real estate co-investment vehicles.

On its face, the current language prohibits the Fund from investing in more than five percent of the voting stock of any corporation. A literal application of this limitation would have the effect -- presumably not intended by the original drafters -- of precluding the Fund from engaging in the typical institutional practice of setting up separate title-holding corporations to insulate itself from liabilities arising from ownership of real estate. A real world example of this concern is a limited liability company in which the APFC is a majority co-owner. It may at some point be advantageous to convert the ownership to common stock, yet the APFC would not be able to do this because of the five percent limitation since the Fund would then own more voting stock than legally allowed.

4. General/Non-specific Changes:

(a) Revising paragraphs (g)(7), (g)(8) (beginning at page 2, line 19), (g)(14) (at page 3, line 17), and (g)(18) (at page 5, line 9), paragraph (i)(4) (at page 6, line 19), and subsection (j) (at page 6, line 23) to explicitly authorize investments in debt instruments and equity interests issued by entities other than just those legally organized as corporations.

At present, these provisions expressly refer to "corporate" securities, but for purposes of sound investment policy, there seems to be no good reason to distinguish between securities issued by corporations and those issued by limited partnerships, trusts, limited liability companies, or other entities.

Examples of the effect of this change in the fixed income area are securities such as Equipment Trust Certificates (ETC's) and Asset Backed Securities

(ABS's) which would become eligible for purchase, since they are issued out of a trust, rather than by a corporation. These securities are generally of higher quality because of structured collateral backing the investment, thereby providing relative value alternatives that may offer greater safety, return, or a combination of the two.

(b) Adding language to subsection (k) (beginning at page 6, line 29) to authorize the Board to invest up to five percent of the Fund's assets either (or both) in (i) types of investments other than those specifically set out in subsection (g)'s "legal list;" or (ii) in additional investments in a category of investment authorized under subsection (g), but for which the investment percentage "caps" established under subsection (i) (e.g., the 50 percent limitation on equities) has been reached. Under this new language, these investments would still have to satisfy the prudent-investor rule.

Examples of other types of investments for which this limited authority could be used include private debt, venture capital, timber, gas, and agriculture/farmland.

(c) Adding a new subsection (p) (at page 7, line 13) to authorize the Board to decide what category a particular form of investment belongs to if that investment could be included in more than one category for purposes of applying the asset allocation caps established under subsection (i) (beginning at page 6, line 3).

This change would permit the Board to refine asset allocation targets and would help clarify for the purpose of asset allocation decisions how a particular asset should be categorized. A relevant example is a REIT, where the underlying asset is real estate, but it trades like a stock and may even be included in the S&P 500 index.

cc: Board of Trustees, APFC
Byron I. Mallott, Executive Director, APFC
Terry Brown, CIO, APFC
Peter Bushre, CFO, APFC

MAR 03 1999

ALASKA PERMANENT
FUND CORPORATION

March 1, 1999

MICHAEL J. O'LEARY, JR., CFA
EXECUTIVE VICE PRESIDENT

Mr. Jim Kelly
Director of Communications
Alaska Permanent Fund Corporation
801 West 10th Street, Suite 302
Juneau, AK 99801



SAN FRANCISCO

NEW YORK

CHICAGO

ATLANTA

DENVER

Re: Proposed "Basket" Clause Flexibility

Dear Jim:

As promised, I want to give you my thoughts on the proposed language that would enable the APFC to invest in a very limited way beyond the specific securities identified in current statute.

Specifically, the proposed change would allow the APFC to invest 5% of fund assets beyond otherwise permitted investments. This latitude could be used to:

- 1) make or retain greater asset class commitments than otherwise specifically allowed; and/or;
- 2) invest in individual securities or instruments that are not expressly permitted.

Clearly, the use of such flexibility would have to be prudent and appropriate for the fund. I should at this point add the requisite disclaimer that neither Callan Associates Inc. nor I are attorneys so my comments are offered from an investment professional's perspective not from a legal perspective.

Over the years, many public funds that operated under a "legal" list type of standard have sought and obtained authority to invest beyond the detailed list. In recent years many public entities have moved toward a "prudent" person standard and away from a legal list. Typically, under a pure prudent person standard there are no statutory limits with regard to either asset class restrictions or individual securities. In other cases, public funds may have asset class limitations but no individual security limitations and obviously there are still some that have both asset class and security limitations. In Alaska, the State Pension Investment Board operates under a prudent person standard without asset class or security limitations while the APFC obviously is governed by both asset class and security limitations.

As you know, the Institute for Fiduciary Education (IFE) maintains a web site that includes information on a number of public funds. The information is provided by the funds and, of course, may not be current and may be misinterpreted by IFE. Nonetheless, we have found that it is a useful source of data regarding general trends and practices. By searching that site, we found 24 U.S. based public funds that reported having a "basket" clause in their investment language. Of this total, 13 were domiciled in either Michigan or New York.

While both Michigan and New York have comparatively permissive investment statutes, the "basket" clause provides authority for subject public funds to invest either in securities or asset categories beyond the statutory limitations. For example, New York has a 70% maximum equity constraint and a 15% basket limitation. A fund subject to the statute could invest a total of 85% in equity like assets (including real estate and alternative investments). In practice, the authority has been used by one of our clients to invest a greater than statutory limit in foreign equities and in alternative investments.

The Michigan basket clause provides that retirement systems with assets of less than \$250 million may invest up to 5% of their assets in investments not otherwise qualified under statute. It provides up to 10% flexibility for larger funds. In Michigan's case, the basket liberalization does not apply to asset class limitations. So for example, a large fund could not use the basket provision to invest up to 75% in equities (the equity limit was 65%).

There appear to be two common themes behind trends toward liberalization of investment provisions. The first is that investment professionals recognize that risk should be considered primarily at the total fund level. An individually "risky" investment may well serve to reduce overall risk by offsetting some of the risk associated with another investment. The best illustration of this acceptance may be the Department of Labor's statement that in considering fiduciary conduct under ERISA the Department will utilize a "total portfolio" standard. The second motivating factor is that investment practices and commonly used instruments are changing rapidly. A good illustration is the evolution of fixed income securities. For example, asset backed securities are commonly utilized in high quality bond portfolios today. They are included in common bond market indices such as the Lehman Aggregate Bond Index. They are not currently permitted under APFC's governing statute. While other proposed changes in the draft statute would address this specific issue, we and others expect to see continued evolution of new fixed income instruments.

In my opinion, APFC might use the basket primarily at the asset class level. As you know, the current statutory limit for equity investments is 50%. In practice, the APFC must actually target a slightly lower level (currently 48%). This lower level is utilized to minimize the frequency and magnitude of portfolio rebalancings. If the basket clause were approved, the board could consider actually establishing a 50% target. Should the

Mr. Jim Kelly
Alaska Permanent Fund Corporation
Page 3 of 3

equity market subsequently advance such that the equity exposure increased to 52 or 53% there would be no need to mechanically reduce equity exposure and incur the resultant transaction costs. The other potential application is at the individual security level. While other changes included in the proposed statute address many of the obvious limitations of the current list (e.g. asset backed securities), the change would provide the board with flexibility to deal with other instruments that may evolve. Similarly, the basket clause might be utilized to opportunistically purchase securities such as BB rated bonds should spread differences more than offset the potential credit risk.

I hope that you find this letter helpful and I look forward to discussing it with you later this week.

Sincerely,



Michael J. O'Leary, Jr., CFA
Executive Vice President

cc: Terry Brown - APFC

The Case for Increased Investment Flexibility: HB 156



**APFC Presentation to House Finance
April 28, 1999**

Need for HB 156

- **Modernizes statutes, responsive to current market opportunities and challenges**
- **Requested change is conservative and maintains the legal list approach**
- **Allows your Fund managers to add incremental value**
- **Improves total portfolio risk management**



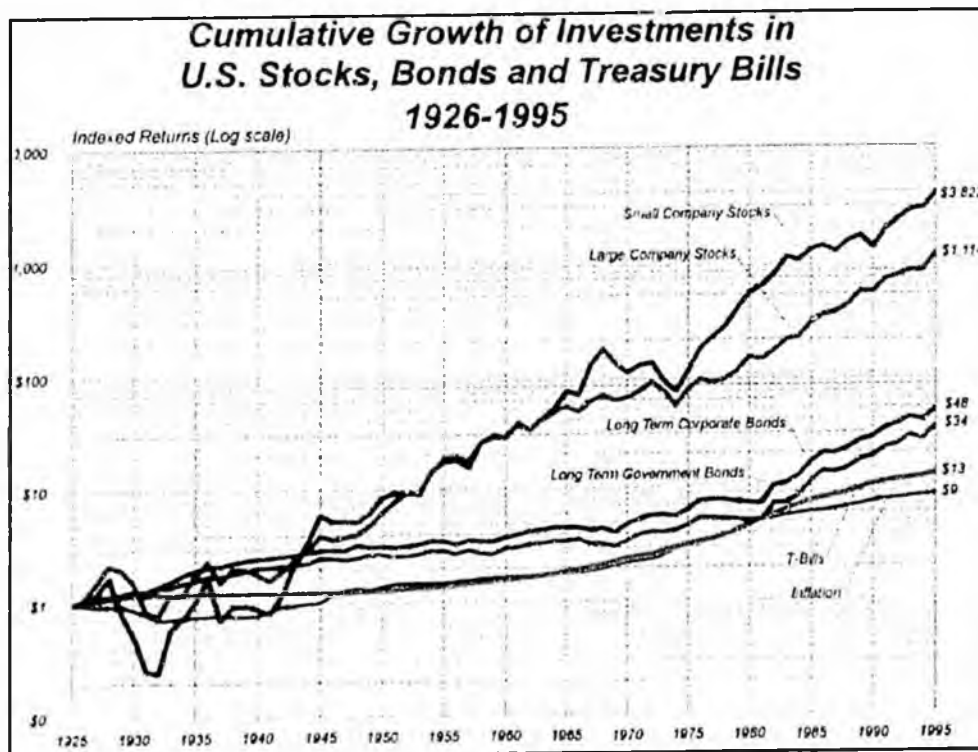
Long-term perspective

Asset class performance

Consider the growth of \$1.00 invested in various U.S. asset classes from Dec. 31, 1925 to Dec. 31, 1995:

| | | |
|------------------------|----|-------|
| ◆ Inflation | \$ | 9 |
| ◆ Treasury bills | | 13 |
| ◆ Treasury bonds | | 34 |
| ◆ Large company stocks | | 1,114 |
| ◆ Small company stocks | | 3,822 |

3

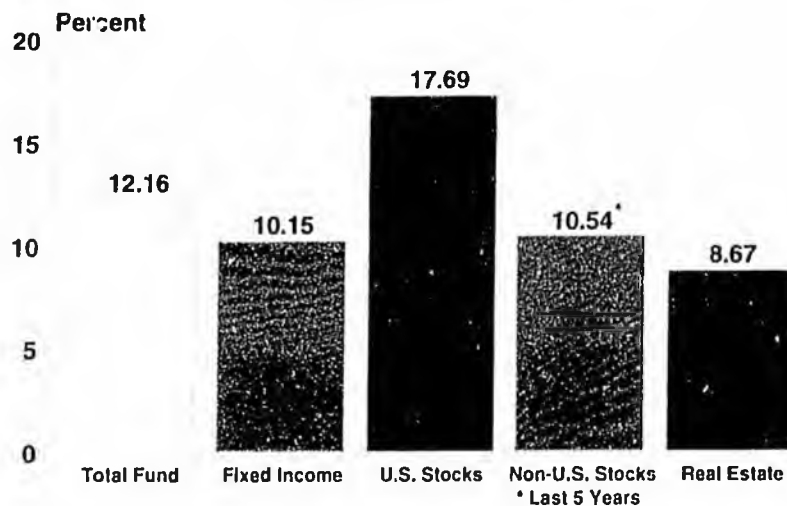


APFC performance



Long-term total returns

15 years ended December 31, 1998



Opportunity Cost: 1997-1998

APFC Actual Rates of Return

| | <u>Fixed Income</u> | <u>U.S. Stocks</u> | <u>Difference</u> |
|------|---------------------|--------------------|-----------------------------|
| 1997 | 9.52% | 31.00% | 21.48% |
| 1998 | 9.90 | 23.62 | 13.72 |
| | <u>10% of Fund</u> | <u>Returns</u> | <u>Increased Income</u> |
| 1997 | \$2.07 billion | 21.48% | \$324 million |
| 1998 | \$2.36 billion | 13.72% | \$444 million |
| | | <u>Total:</u> | <u>\$770 million</u> |



Key assumptions

Increased volatility in capital markets

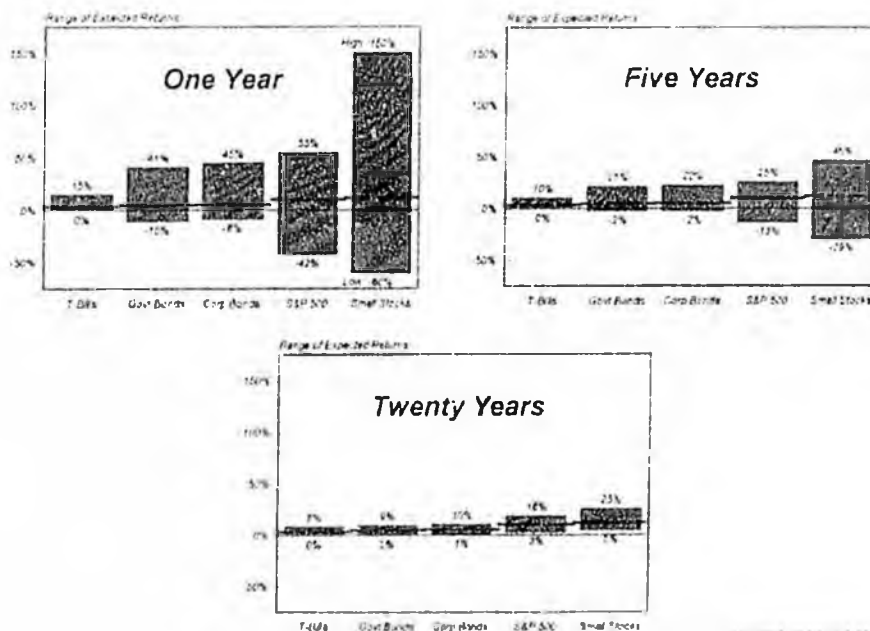
| Asset Class | Index | Expected Return | | | Expected Risk | | |
|---------------------|---------------|-----------------|-------|--------|---------------|-------|--------|
| | | 1998 | 1999 | Change | 1998 | 1999 | Change |
| Equities | | | | | | | |
| Large Cap | S&P 500 | 9.10 | 9.00 | -0.10 | 13.30 | 15.00 | 1.70 |
| Small Cap | CAI Small | 10.10 | 11.20 | 1.10 | 19.10 | 25.30 | 6.20 |
| International | MSCI EAFE | 9.60 | 10.00 | 0.40 | 18.50 | 21.50 | 3.00 |
| Fixed Income | | | | | | | |
| Domestic | LB Agg | 6.60 | 5.60 | -1.00 | 5.50 | 5.30 | -0.20 |
| International | SB Non-US | 6.55 | 5.60 | -0.95 | 11.20 | 11.00 | -0.20 |
| Other | | | | | | | |
| Real Estate | CRES | 8.25 | 8.00 | -0.25 | 14.50 | 16.50 | 2.00 |
| Alternatives | Veco 100 | 12.30 | 12.30 | 0.00 | 35.00 | 36.00 | 1.00 |
| Cash Equiv. | 90-day T-bill | 4.80 | 4.40 | -0.40 | 1.00 | 0.70 | -0.30 |
| Inflation | CPI-U | 3.40 | 3.00 | -0.40 | 0.95 | 1.75 | 0.80 |

LOWER RETURNS

HIGHER RISK

ALASKA'S
PRIMARILY
FUND
ALASKA'S
FUTURE

Risk Diminishes Over Time



Percent Of Market Value distribution of income

Another way to manage risk is a POMV distribution of income:

- **Provides more predictability and stability in annual distributions**
- **Disconnects investment decisions from short-term spending considerations**
- **Spending provision becomes part of long-term investment strategy rather than tactical response to market cycles**



Key assumptions

At the heart of APFC investment planning for the future will be the attempt to mediate among these conflicting objectives:

1. Maximize long-term total return.
2. Maximize annual spending distributions.
3. Preserve the *real* (i.e., inflation-adjusted) value of the Fund and the distributions.
4. Maximize the stability and predictability of spending distributions.



Key assumptions

- Q. How much can be distributed while still preserving the real (i.e., inflation-adjusted) value of the fund?**
- A. If you want to preserve the real value of the Fund, you must not spend more than the real rate of return on your investments over the long term.**

11



Key assumptions

And the real rate of return on your investments will be determined by:

- 1. Capital market returns**
- 2. Your asset allocation**

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Key assumptions - status quo



Projected PF Realized and Total Rates of Return Based on the the Fund's 1999 Asset Allocation and 1999 Callan Capital Market Assumptions

| ASSET CLASS | CAPITAL MARKET ASSUMPTIONS | | | PERMANENT FUND | | |
|--------------------------------|----------------------------|-----------------|--------------|------------------|---------------------------|------------------------|
| | INCOME RETURN | EXPECTED GROWTH | TOTAL RETURN | ASSET ALLOCATION | PROJECTED REALIZED RETURN | PROJECTED TOTAL RETURN |
| Domestic Equities: | | | | | | |
| Passively Managed | 1.80% | 7.60% | 9.40% | 14.62% | 0.82% | 1.37% |
| Actively Managed | 1.80% | 7.60% | 9.40% | 19.38% | 1.82% | 1.82% |
| Sub-Total | | | | 34.00% | 2.64% | 3.20% |
| International Equities: | | | | | | |
| Passively Managed | 1.50% | 8.50% | 10.00% | 4.90% | 0.28% | 0.49% |
| Actively Managed | 1.50% | 8.50% | 10.00% | 9.10% | 0.91% | 0.91% |
| Sub-Total | | | | 14.00% | 1.15% | 1.40% |
| Bonds: | | | | | | |
| Domestic | 5.60% | 0.00% | 5.60% | 40.00% | 2.24% | 2.24% |
| International | 5.60% | 0.00% | 5.60% | 2.00% | 0.11% | 0.11% |
| Sub-Total | | | | 42.00% | 2.35% | 2.35% |
| Real Estate: | | | | | | |
| | 6.50% | 1.50% | 8.00% | 10.00% | 0.73% | 0.80% |
| | | | | | 6.87% | 7.75% |
| | | | | | 3.87% | 4.75% |

Note: Permanent Fund projected realized returns assume that, over a five year period, active managers will make 100% of the income return and 100% of the expected growth capital gain (and that passive managers and real estate will make 100% of the income return and 50% of the expected growth). Permanent Fund total returns assume all managers will make 100% of the income return and 100% of the expected growth. Capital market assumptions are provided by Callan Associates, Inc.

Minus 3.00% Inflation = Real Rates of Return

Key assumptions - HB 156



Projected PF Realized and Total Rates of Return Based on the the Fund's 1999 Asset Allocation and 1999 Callan Capital Market Assumptions

| ASSET CLASS | CAPITAL MARKET ASSUMPTIONS | | | PERMANENT FUND | | |
|--------------------------------|----------------------------|-----------------|--------------|------------------|---------------------------|------------------------|
| | INCOME RETURN | EXPECTED GROWTH | TOTAL RETURN | ASSET ALLOCATION | PROJECTED REALIZED RETURN | PROJECTED TOTAL RETURN |
| Domestic Equities: | | | | | | |
| Passively Managed | 1.80% | 7.60% | 9.40% | 16.77% | 0.94% | 1.58% |
| Actively Managed | 1.80% | 7.60% | 9.40% | 22.23% | 2.09% | 2.09% |
| Sub-Total | | | | 39.00% | 3.03% | 3.67% |
| International Equities: | | | | | | |
| Passively Managed | 1.50% | 8.50% | 10.00% | 4.90% | 0.20% | 0.49% |
| Actively Managed | 1.50% | 8.50% | 10.00% | 9.10% | 0.91% | 0.91% |
| Sub-Total | | | | 14.00% | 1.15% | 1.40% |
| Bonds: | | | | | | |
| Domestic | 5.60% | 0.00% | 5.60% | 35.00% | 1.96% | 1.96% |
| International | 5.60% | 0.00% | 5.60% | 2.00% | 0.11% | 0.11% |
| Sub-Total | | | | 37.00% | 2.07% | 2.07% |
| Real Estate: | | | | | | |
| | 6.50% | 1.50% | 8.00% | 10.00% | 0.73% | 0.80% |
| | | | | | 6.90% | 7.94% |
| | | | | | 3.98% | 4.94% |

Note: Permanent Fund projected realized returns assume that, over a five year period, active managers will make 100% of the income return and 100% of the expected growth capital gain (and that passive managers and real estate will make 100% of the income return and 50% of the expected growth). Permanent Fund total returns assume all managers will make 100% of the income return and 100% of the expected growth. Capital market assumptions are provided by Callan Associates, Inc.

Minus 3.00% Inflation = Real Rates of Return

Key assumptions - CS HB 156 (State Affairs)



Projected PF Realized and Total Rates of Return Based on the the Fund's 1999 Asset Allocation and 1999 Callan Capital Market Assumptions

| ASSET CLASS | CAPITAL MARKET ASSUMPTIONS | | | PERMANENT FUND | | |
|--------------------------------|----------------------------|-----------------|--------------|------------------|---------------------------|------------------------|
| | INCOME RETURN | EXPECTED GROWTH | TOTAL RETURN | ASSET ALLOCATION | PROJECTED REALIZED RETURN | PROJECTED TOTAL RETURN |
| Domestic Equities: | | | | | | |
| Passively Managed | 1.80% | 7.60% | 9.40% | 18.92% | 1.06% | 1.78% |
| Actively Managed | 1.80% | 7.60% | 9.40% | 25.08% | 2.36% | 2.36% |
| Sub-Total | | | | 44.00% | 3.42% | 4.14% |
| International Equities: | | | | | | |
| Passively Managed | 1.50% | 8.50% | 10.00% | 4.90% | 0.28% | 0.49% |
| Actively Managed | 1.50% | 8.50% | 10.00% | 9.10% | 0.91% | 0.91% |
| Sub-Total | | | | 14.00% | 1.15% | 1.40% |
| Bonds: | | | | | | |
| Domestic | 5.60% | 0.00% | 5.60% | 30.00% | 1.60% | 1.68% |
| International | 5.60% | 0.00% | 5.60% | 2.00% | 0.11% | 0.11% |
| Sub-Total | | | | 32.00% | 1.79% | 1.79% |
| Real Estate: | 6.50% | 1.50% | 8.00% | 10.00% | 0.73% | 0.80% |
| | | | | | 7.08% | 8.13% |
| | | | | | 4.08% | 5.13% |

NOTE: Permanent Fund projected realized returns assume that over the year period, active managers will make 100% of the passive return and 100% of the expected growth, capital gains and total passive manager and real estate will make 100% of the passive return and 50% of the expected growth. Permanent Fund total returns assume all managers will make 100% of the passive return and 100% of the expected growth. Capital market assumptions are provided by Callan Associates, Inc.

Minus 3.00% Inflation = Real Rates of Return

Key assumptions



GASB Income

Fund Value

67,337 | 5,957 | 28,999 | 40,955.60 | 18,248 | 11,710 | 13,099 | 7,274 | 11,245 | 65,355

GASB net income is statutory net income plus the net change in unrealized gains and settlement earnings.
Per Department of Revenue's Spring 1999 Revenue Forecast.
Earnings reserve appropriated to principal.

STATUS QUO WITH 7.75% TOTAL RETURN

70,126 | 61,887 | 29,827 | 42,106.04 | 18,257 | 12,803 | 14,192 | 8,101 | 12,072 | 67,316

GASB net income is statutory net income plus the net change in unrealized gains and settlement earnings.
Per Department of Revenue's Spring 1999 Revenue Forecast.
Earnings reserve appropriated to principal.

STATUS QUO WITH 7.94% TOTAL RETURN

73,028 | 67,812 | 30,850 | 43,247.05 | 18,264 | 13,898 | 15,287 | 9,047 | 13,018 | 69,395

GASB net income is statutory net income plus the net change in unrealized gains and settlement earnings.
Per Department of Revenue's Spring 1999 Revenue Forecast.
Earnings reserve appropriated to principal.

STATUS QUO WITH 8.13% TOTAL RETURN



Key assumptions



Daily Unaudited Position
as of April 26, 1999

| | | |
|--------------------|-------------------------|-------------|
| Fixed Income | \$11,009,700,000 | 42% |
| U.S. Equities | \$9,545,000,000 | 36% |
| Non-U.S. Equities | \$3,543,200,000 | 13% |
| Real Estate | \$2,055,000,000 | 8% |
| <u>Alaskan CDs</u> | <u>\$140,000,000</u> | <u>1%</u> |
| TOTAL | \$26,292,900,000 | 100% |



Source: www.apfc.org

Key assumptions

“Crossing of the lines in 1998”

Billions of \$

