

HB

466

HFIN

FILE

FISCAL NOTE

STATE OF ALASKA
2004 LEGISLATIVE SESSION

Fiscal Note Number: 1
Bill Version: CSHB 466(STA)
(H) Publish Date: 3/9/04

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue
Title: Permanent Fund Investments RDU: AK Permanent Fund Corporation
Component: AK Permanent Fund Corporation
Sponsor: Rules by request of LBA
Requester: House State Affairs Committee Component No. 109

Expenditures/Revenues (Thousands of Dollars)

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

OPERATING EXPENDITURES	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2004) cost: 0.0
Mark this box (X) if funding for this bill is included in the Governor's FY 2005 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

The existing manager fee budget of \$40 million is sufficient to cover any changes in investments under this legislation.

Prepared by: Robert D. Storer, Executive Director Phone 465-2047
Division: Alaska Permanent Fund Corporation Date/Time 2/24/04 9:43 AM
Approved by: Steve Porter, Deputy Commissioner Date 2/6/2004
Agency: Department of Revenue

Adopted

WORK DRAFT

WORK DRAFT

WORK DRAFT

23-LS1699H
Cook/Craver
5/5/04

CS FOR HOUSE BILL NO. 466(FIN)
IN THE LEGISLATURE OF THE STATE OF ALASKA
TWENTY-THIRD LEGISLATURE - SECOND SESSION

BY THE HOUSE FINANCE COMMITTEE

Offered:
Referred:

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

A BILL
FOR AN ACT ENTITLED

1 "An Act relating to investments of Alaska permanent fund assets; and providing for an
2 effective date."

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

4 * Section 1. AS 37.13.120(e) is amended to read:

5 (e) The corporation may not borrow money or guarantee from principal of the
6 fund the obligations of others except as provided in this subsection. With respect to
7 [REAL PROPERTY] investments of the fund, the corporation may, through an entity
8 in which the investment is made, borrow money if the borrowing is without recourse
9 to the corporation and the fund.

10 * Sec. 2. AS 37.13.120(k) is amended to read:

11 (k) The board shall establish and from time to time as necessary modify
12 guidelines for the investment of the assets of the fund. Before adoption of any
13 guidelines, the guidelines shall be reported to the Legislative Budget and Audit
14 Committee for review and comment. No.withstanding (g), (h), and (j) of this section

1 or the percentage investment limitations under (i) of this section and so long as doing
2 so satisfies the prudent-investor rule under (a) of this section, the board may invest up
3 to 10 [FIVE] percent of the total assets of the fund in either or a combination of the
4 following:

5 (1) other types of investments not specifically listed in (g) of this
6 section;

7 (2) categories of investment subject to the percentage investment
8 limitations established in (i) of this section, even though investing additional assets in
9 a category will cause the aggregate investment in the category to exceed the applicable
10 percentage limitation.

11 * Sec. 3. This Act takes effect immediately under AS 01 10.070(c).



Alaska Permanent Fund

House State Affairs Committee

House Bill 466

Investment Flexibility

ACCOUNTABILITY

TO ALASKANS, FOR ALASKANS



Summary of Fund's statute changes

1980 – SB 161, Sponsored by Sen. Tim Kelly, Sen. George Hohman, Sen. Mike Colletta, and Sen. John Sacket

SB 161 created the Alaska Permanent Fund Corporation to manage the Permanent Fund and started the existing statutory list of allowed investments. This list extended beyond the Fund's initial investment limitation of Treasury bonds to include corporate bonds, certificate of deposits and bankers acceptances. The list initially allowed the Permanent Fund to invest in shares of savings and loan associations, but this provision has since been removed.

1982 – SB 684, sponsored by Gov. Jay Hammond

SB 684 allowed the Permanent Fund to invest in common stocks, partial ownership of real estate properties (not to exceed 40%), loans for commercial real estate and deposits of US dollars held overseas.

1989- HB 69, sponsored by Gov. Steve Cowper

HB 69 gave the APFC authority to invest in non-domestic (International) stocks and bonds.



Summary of statute changes (cont.)

1992 – SB 39, sponsored by the Senate Finance Committee

SB 39 gave the APFC authority to invest in A rated corporate bonds to a maximum of 5%. Prior to this change, the Fund could only be invested in bonds rated AA or higher.

1994 – HB 373, sponsored by Legislative Budget and Audit

HB 373 allowed the Fund to own up to 100% in real estate properties worth less than \$150 million, and up to 67% in properties worth greater than \$150 million.

1996 – HB 525, sponsored by the House Finance Committee

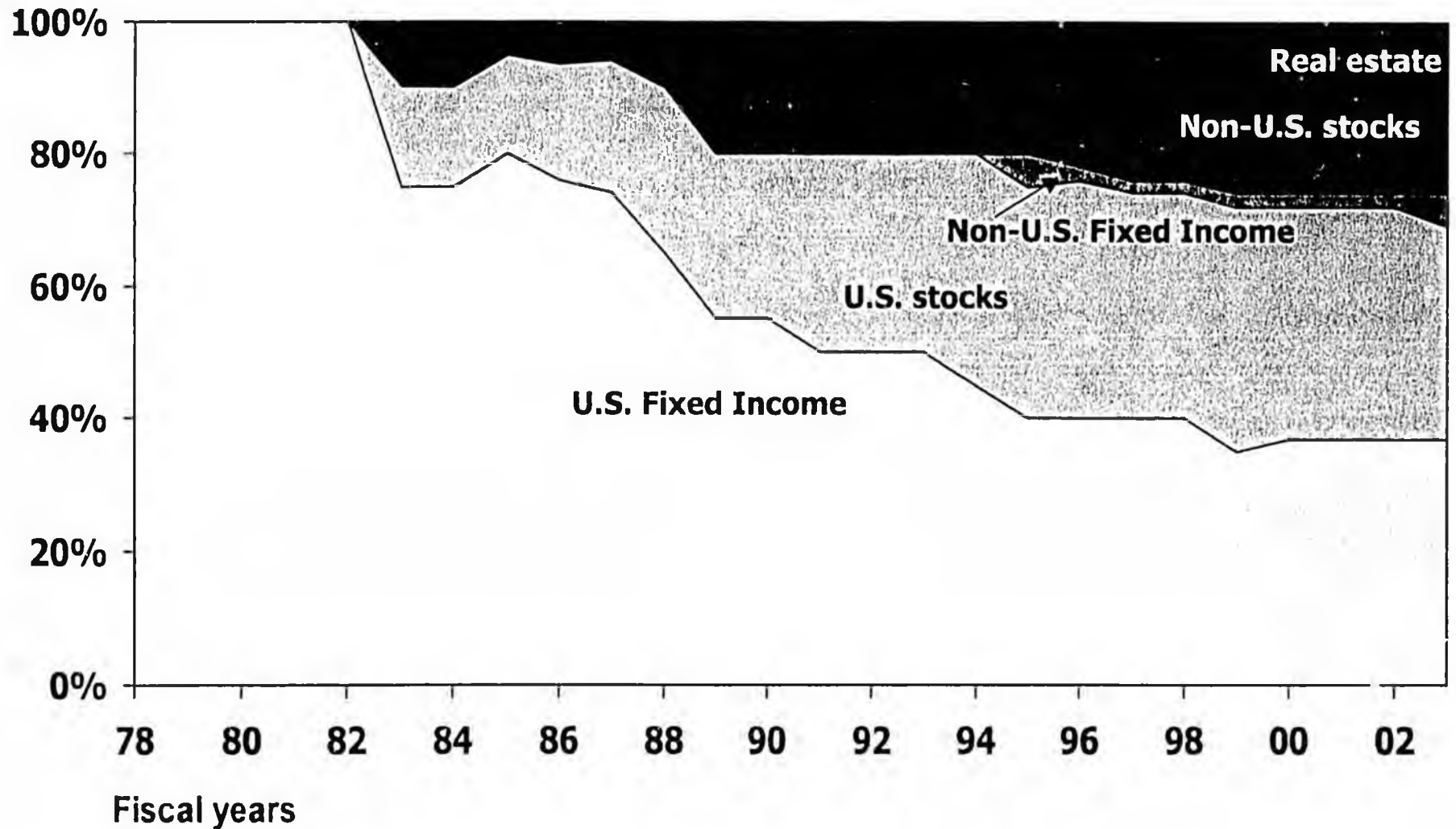
HB 525 gave the APFC authority to invest in corporate bonds rated BBB or higher.

1999 – HB 156, sponsored by the Senate Finance Committee

HB 156 allowed the Fund to leverage real estate investments and increased asset allocation limit for stocks to 55% of the total market value of the Fund. HB 156 also created the “basket clause” that allows up to 5% of the Fund to be invested in alternative investments or to be applied to existing asset allocations to expand their limits. In addition, HB 156 allowed the Permanent Fund to be the sole owner of any real estate property, regardless of value.



Fund's historical asset allocation





Benefits of proposed changes

- Investment flexibility
- Increased returns
- Increased diversification



Potential questions

- Too much risk?
- How will the Board of Trustees use this flexibility?
- Derivatives?



Fund's asset allocation and control bands

Domestic equities	37% +/- 7%
<u>International equities</u>	<u>16% +/- 5%</u>
Total equities	53% +/- 5%
Domestic bonds	32% +/- 7%
<u>Non-Dollar bonds</u>	<u>5% +/- 2%</u>
Total bonds	37% +/- 5%
Total real estate	10% +/- 2%

ACCOUNTABILITY

TO ALASKANS, FOR ALASKANS

23-LS1699VH
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10 percentage limitation.

11 * Sec. 3. This Act takes effect immediately under AS 01.10.070(c).

Alaska State Legislature

House of Representatives

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Representative Max Gruenberg

March 5, 2004

Robert Storer
Executive Director
Alaska Permanent Fund Corporation
P.O. Box 25500
Juneau, Alaska 99802-5500

Re: HB 466

Dear Mr. Storer:

Thank you for agreeing to take the time to answer questions regarding HB 466. The bill makes three major changes to Permanent Fund investment policy. Under current law, the fund's authority to borrow money is limited to investments in real property. This bill would remove that limitation. The bill would also increase from 5 to 15% the amount of the fund that may be invested under the "basket clause" which authorizes investments not specifically listed in AS 37.13.120(g). Finally, the bill would allow investments under the basket clause in futures contracts and in certain debt instruments with a history of default (commonly called "junk bonds").

These changes raise important policy issues and I have several questions relating to them. Since you have informed me that the Permanent Fund Corporation is no longer interested in pursuing proposed amendment No 1 this session, I will not direct questions to that issue but do have several general questions concerning the long-term goals of the fund.

Leverage or Borrowing by the Fund

1. The ability of the Fund to borrow through other entities needs to be explained and understood by the committee. Please describe how leverage or borrowing would be used in investments outside of real estate.
2. What would be the effect on fees paid by the Fund? Aren't they magnified by borrowing?
3. How does the use of leverage alter your expected return? Standard Deviation? Asset Allocation?
4. Why does a Fund that lends nearly 40% of its assets need to borrow money at higher rates than it can make on those assets?
5. You testified that the real estate portfolio is leveraged 15 percent and that this was a conservative level. Are you measuring this at the individual investment level, the manager level or at the total portfolio level? Which is the most important level of risk determination? What is industry standard on non-real estate financial leverage by public and private funds of the size of the fund?
6. What, if any, limits should the legislature place on the use of leverage? How does the prudent investor standard apply to this discretion?
7. Have you modeled various outcomes with leverage? If so, please provide the results.
8. Are you aware of situations in which a large public fund has refused to repay a non-recourse obligation? Did the failure to pay have any adverse consequences? Would you as the executive director recommend the same course of action under similar facts and circumstances?
9. Does the fund already have the authority under the basket clause to borrow for non-real property investments?
10. What controls are in place to assure that the borrowing will be ultimately positive for the fund and the State of Alaska? How can you be sure that your successor will employ the same types of controls?

Increased Percentage Allocated to Basket Clause

1. What types of asset classes would you add under this expanded authority?
2. What allocation to illiquid investments do you consider prudent under the current statute?

3. Do you need this expanded authority to achieve a 5 percent real return? Does the current statute provide sufficient latitude to achieve a 5 percent real return while maintaining prudent diversification?

4. Could you and would you go to a 70 percent investment level in stocks if you had this authority?

Futures and Junk Bonds

1. Junk bonds have historically been in and out of favor with investors. How would you describe their appeal as we close the first quarter of 2004? How does this compare to the late 80's and late 90's?

2. Is this the right time to make an allocation to junk bonds given the level of debt that exists in the market place?

3. If junk bonds are to be part of the portfolio, what allocation (\$ and %) is the right amount given the risk posture of the fund?

4. How much does it cost to manage junk bonds and how does this compare to managing investment grade bonds?

5. Could you achieve your objectives with respect to bonds by amending AS 37.13.120(g)(7) to authorize investments in bonds with lower quality ratings than the "investment grade" rating now required by statute?

6. Since the Fund can already use futures contracts for the purpose of hedging investments that it currently holds, what is the purpose of your proposed change?

7. Aren't futures contracts considered a very speculative investment? How would this be consistent with the requirement of AS 37.13.120 that all assets of the fund be invested in income-producing investments?

8. Isn't the risk of loss in futures trading potentially greater than the initial investment?

9. Under what circumstances would a prudent investor invest in futures contracts for anything other than hedging purposes?

Long-Term Goals of the Fund

1. Please provide a history of the targeted returns of the APFC for the total fund portfolio and a brief description of why changes were instituted.

2. At the Conference of Alaskans you stated that the ability to achieve a 5% distribution was based on a median case from the Fund's consultant's capital market

projections. Please provide us with the median case assumptions and outcomes as well as alternatives. Also, please clearly identify the Fund's current policy. If it is helpful to you; the format of the following chart would provide me the necessary information I'm looking for:

Alternative Asset Policies: Current Policy and Median Case Alternatives				
	Current Policy	A	B	C
U.S. Equity	___%	___%	___%	___%
Non-U.S. Equity	___%	___%	___%	___%
Fixed Income	___%	___%	___%	___%
Other (please show real estate, private equity, etc.)	___%	___%	___%	___%
	100%	100%	100%	100%
Expected Return	___%	___%	___%	___%
Expected Risk	___%	___%	___%	___%

3. The Department of Revenue and Permanent Fund web sites¹ provide the following information on returns for the State's three principal diversified funds – all of which are governed by the prudent investor standard. Only the Permanent Fund has additional constraints in the form of the percentage limitations on categories of investment. As of 9/30/03 the five, three and 12 month returns for the three funds are reported to be:

	5 year	3 year	1 year
APFC	4.71%	.68	16.59
TRS	4.48%	(-1.20)	17.20
PERS	4.44	(-1.18)	17.03

Please confirm that these figures are correct and provide the figures on the 10 year return for the three funds updated to year end if possible. Also, please provide the targets for these three funds for the fiscal year ending 2003 (actual and in basis points). Please be prepared to discuss the reasons for the difference in long term performance of each of these funds and how they performed compared to their target returns.

¹ <http://www.revenue.state.ak.us/treasury/ASPIB/results.htm>
<http://www.apfc.org/financials/index.cfm>
http://media.apfc.org/jccimages/financials/2003_9_Mgt.pdf

4. Please describe the asset allocation that produces the "least risky" portfolio designed to achieve a 5% real rate of return assuming a 3% inflation rate under both the current statutory limitations and under a prudent investor rule without those limitations. For purposes of the prudent investor analysis, it would be particularly useful to see a mix that is more aggressive than current policy, however. A suggested mix might include: U.S. equities 50%, non-U.S. equities 15%, fixed income (both investment grade and junk bonds) 20%, private equity 15%. This mix is just a suggestion, please use whatever mix you feel would be appropriate.

5. Please provide a chart describing projected assets of the Permanent Fund in one column and projected payouts over the next 20 years assuming that a five percent payout occurs as proposed by the Fund using both the current investment policy and the "least risky" scenario described above.

6. What is the probability that the fund will be able to make a 5% payout in the future without the necessity of invading the inflation adjusted corpus or "principal" of the fund?

7. Please describe the possibilities that exist under the two scenarios above that the Fund will lose "value" over the next twenty years. My definition of "lose value" is the likelihood in terms of percentages that the current fund would lose value after reasonable assumptions for inflation proofing. Please identify the source of all assumptions. I would appreciate your response in the following format:

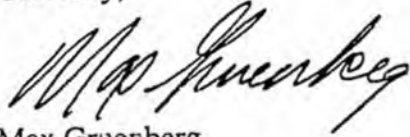
Probability of a Safe Future for Fund's Corpus		
Year	Current Statutory Policy	Prudent Investor Policy
2010	____%	____%
2020	____%	____%
2025	____%	____%

I think these questions raise important issues that relate not just to HB 466, but to all other proposals now being discussed with respect to the future of the Permanent Fund. I am sure that your answers would be of interest to other members of the legislature and many other Alaskans. For that reason, I am providing copies of this letter to other all members of the legislature and to the press. I would appreciate it if you would copy all other members with your response.

I understand you may not be able to provide written responses to all of these questions before the next hearing on HB 466 and I would appreciate it if you would supplement your response as you are able to.

Thank you for your assistance in this matter. I look forward to hearing from you.

Cordially,

A handwritten signature in cursive script, appearing to read "Max Gruenberg".

Max Gruenberg
State Representative

cc: Members of the Legislature