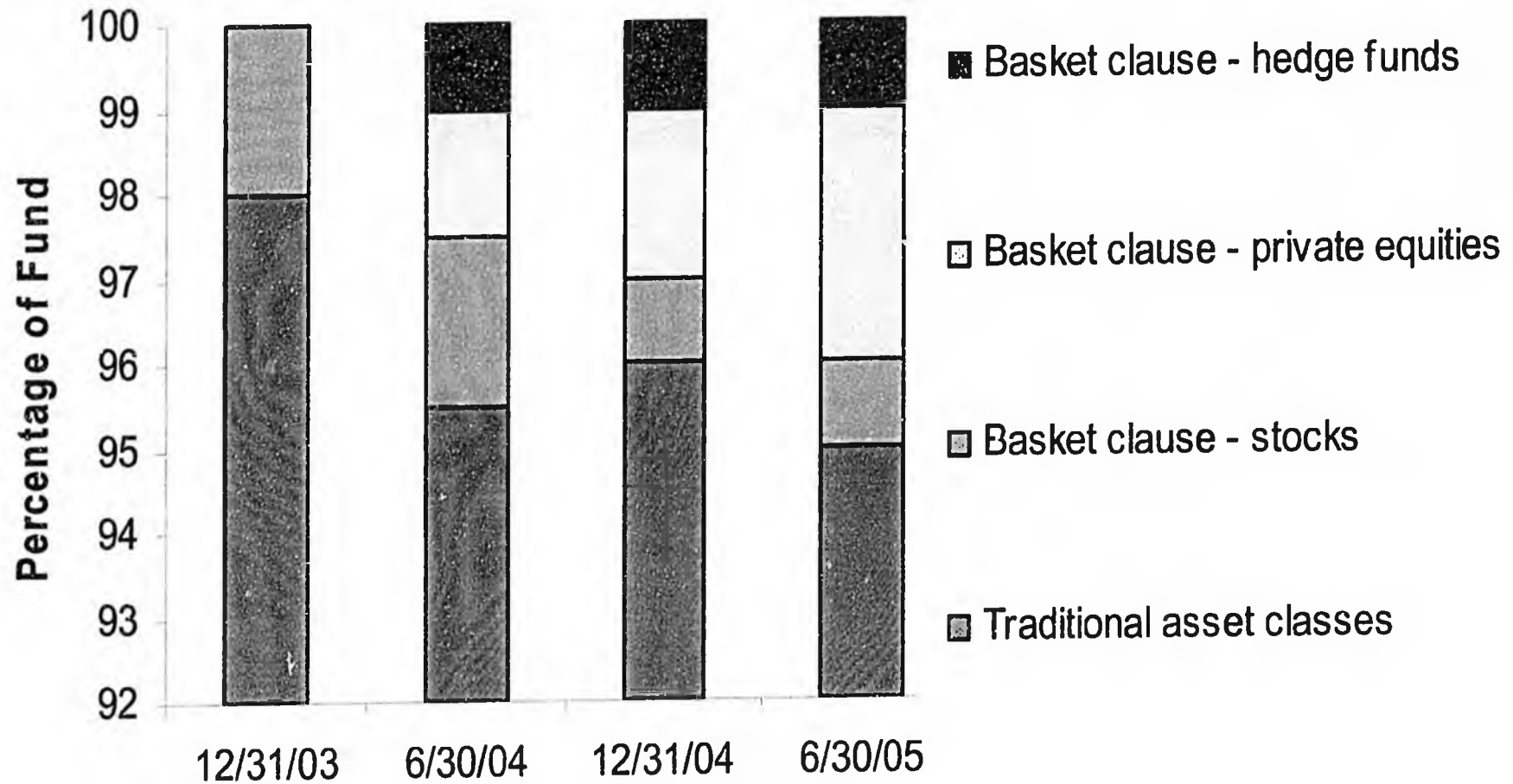


SB

326



Permanent Fund asset allocation



ACCOUNTABILITY

TO ALASKANS, FOR ALASKANS

SENATE COMMITTEE REPORT
First Committee of Referral

DATE: 2/13/04

FURTHER: Finance

Date of 5-Day Notice: 2/26/04
 (in accordance with Uniform Rule 23)

DATE TURNED IN TO OFFICE: 3/5/04

State Affairs Committee considered SENATE BILL NO. 326

SB 326 PERMANENT FUND INVESTMENTS

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

and recommends:

- be replaced with _____ CS SB 326 (STA)
- adopt previous _____ CS _____
- attached amendment(s)
- adopt Letter of Intent by _____ Committee
- further referral to _____ Committee

Senate Bill:	
<input checked="" type="checkbox"/>	Same Title
<input type="checkbox"/>	New Title
House Bill:	
<input type="checkbox"/>	Same Title
<input type="checkbox"/>	Technical Title Change
<input type="checkbox"/>	New Title w/ SCR # _____

NEW FISCAL NOTE(S):

Department	Date	Fiscal	Indet.	Zero	FN#
<u>DOR</u>	<u>2/24/04</u>			<input checked="" type="checkbox"/>	<u>1</u>

PREVIOUS FISCAL NOTE(S):

Department	Date	Fiscal	Indet.	Zero	FN#

APPROPRIATION - no fiscal note

SIGNATURES AND RECOMMENDATIONS:	DO PASS	DO NOT PASS	NO REC	AMEND
<u>John J. Caudrey</u>	<input checked="" type="checkbox"/>			
<u>Bert H. ...</u>			<input checked="" type="checkbox"/>	
CHAIR: <u>[Signature]</u>			<input checked="" type="checkbox"/>	

FISCAL NOTE

STATE OF ALASKA
2004 LEGISLATIVE SESSION

Fiscal Note Number: 1
 Bill Version: SB 326
 () Publish Date: _____

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 Senate 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 9:37 AM
 Approved by: Steve Porter, Deputy Commissioner Date 2/6/2004
 Agency Department of Revenue



Alaska Permanent Fund Corporation

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

(907) 465-2047

Sponsor statement for SB 326

Background

Alaska Statute 37.13.120 provides a list of investment guidelines for the Alaska Permanent Fund, and the Fund's Trustees make investment decisions within these guidelines. Sometimes it is necessary to update the Fund's statutes as investment practices evolve. Periodically the Trustees bring these proposed changes to the Legislature.

In 1999 the Legislature passed HB 156, a bill that made a number of necessary changes to the statutes. One change was the creation of a "basket clause" in AS 37.13.120(k). This clause allows the Trustees to invest up to 5% of the Fund in investments not included in the allowed statutory list, but that are appropriate under the prudent investor rule. The basket clause may also be used for allowed investments in which the Fund has reached its statutory limitation.

However the alternative investments allowed under the basket clause may conflict with the investments not allowed under the statutory list. AS 37.13.120(e) prevents the Fund from borrowing money against assets other than real estate to leverage an investment. AS 37.13.120(h) restricts the situations in which Fund assets may be invested in futures contracts. AS 37.13.120(j) bars investing in any debt instrument on which an interest payment has been defaulted in the preceding five years.

Many alternative investments, such as hedge funds, use one or more of the methods restricted in (e), (h) and (j) as part of their overall investment strategy. The Permanent Fund could not make these investments under current statutes, despite the fact that they might represent sound investment opportunities.

Senate Bill 326

SB 326 achieves two objectives. The first is to provide clean-up language for AS 37.13.120(e) and (k), in part by explicitly stating that the investments restricted under AS 37.13.120(h) and (j) are allowed under the basket clause. According to transcripts of committee hearings, the Legislature was aware when it created the basket clause, that it would be used for these types of alternative investments. The change in this bill would clean up the discrepancy in language between the sections while still maintaining the original legislative intent.

The second would expand the basket clause from 5% to 15%. This is necessary because the 5% limit is too small to allow the Trustees enough flexibility to keep up with changes in investment practices. For example, the Trustees are planning on placing up to 3% of the Fund in private equity investments. If these are successful investments, the value will grow to 4% or more of the Fund, leaving less than 2% of the basket clause for other investments.



Alaska Permanent Fund

Senate State Affairs Committee

Senate Bill 326

Investment Flexibility

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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

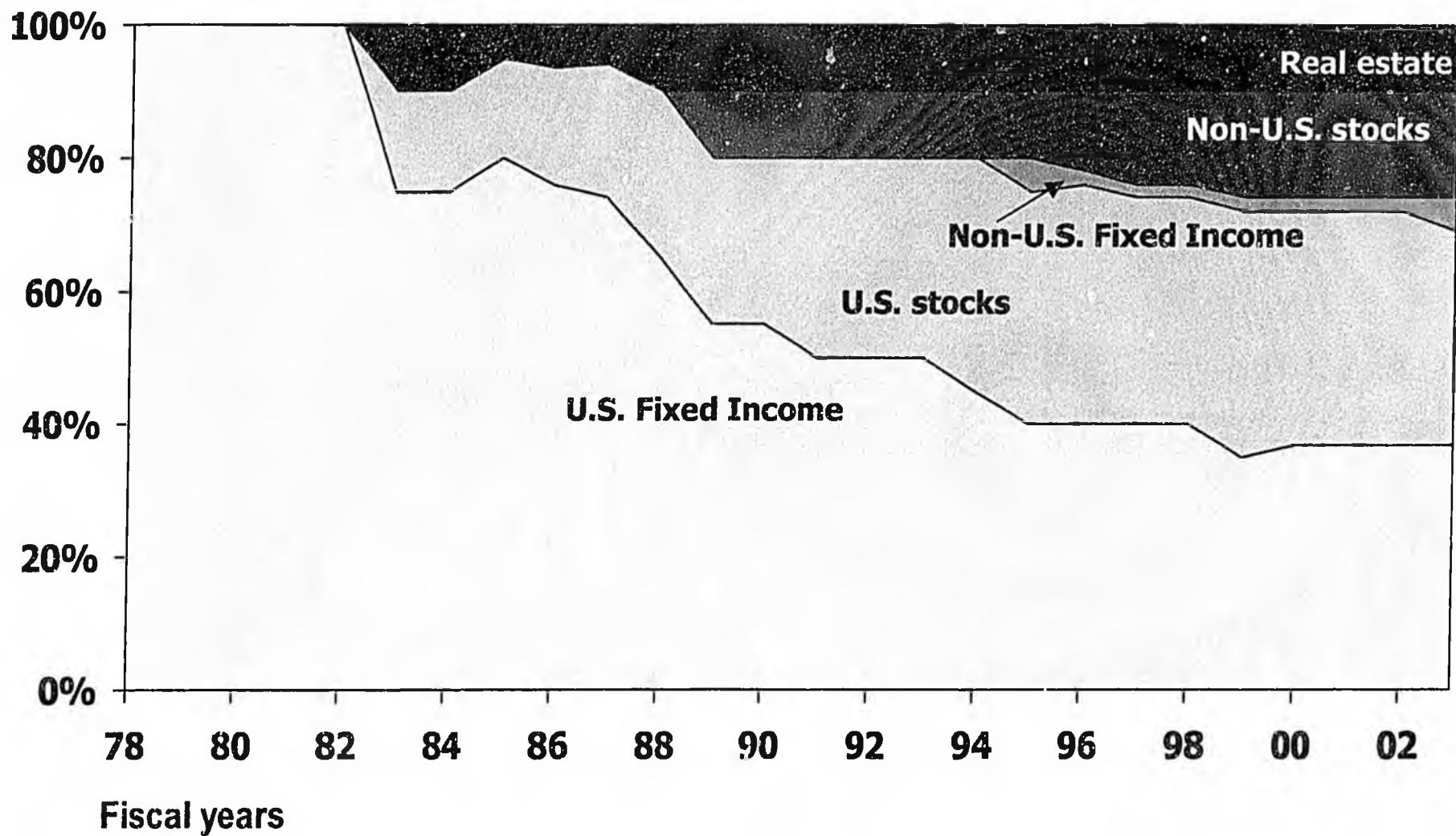
HB 525 gave the APFC authority to invest in corporate bonds rated BBB or higher.

1999 – SB 156, sponsored by the Senate Finance Committee

SB 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. SB 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.



Fund's historical asset allocation



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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%

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TO ALASKANS, FOR ALASKANS



Sec. 37.13.120. Investment responsibilities of the board.

(a) The prudent-investor rule shall be applied by the board in the management and investment of fund assets. The prudent-investor rule as applied to investments of the fund means that in making investments the board shall exercise the judgment and care under the circumstances then prevailing that an institutional investor of ordinary prudence, discretion, and intelligence exercises in the management of large investments entrusted to it not in regard to speculation but in regard to the permanent disposition of funds, considering probable safety of capital as well as probable income.

(b) The fund assets shall only be used for income-producing investments.

(c) The board shall maintain a reasonable diversification among investments unless under the circumstances it is clearly prudent not to do so.

(d) The board shall submit long-range and quarterly investment reports to the Legislative Budget and Audit Committee.

(e) The corporation may not borrow money or guarantee from principal of the fund the obligations of others except as provided in this subsection. With respect to real property investments of the fund, the corporation may, through an entity in which the investment is made, borrow money if the borrowing is without recourse to the corporation and the fund.

(f) The board may enter into and enforce all contracts necessary, convenient or desirable for purposes of the corporation.

(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

(1) obligations of, or obligations insured by or guaranteed by, the United States or agencies or instrumentalities of the United States;

(2) obligations secured by reserves paid in by the United States or agencies or instrumentalities of the United States or obligations of corporations in which the United States is a shareholder or member;

(3) certificates of deposit and term deposits of United States domestic banks that are members of the Federal Deposit Insurance Corporation and that may be readily sold in a secondary market at prices reflecting fair value or that are fully secured at all times as to payment of principal and interest as described in (m) of this section;

(4) certificates of deposit and term deposits of federally chartered savings and loan associations in Alaska that are fully secured at all times as to payments of principal and interest as described in (m) of this section;

(5) certificates of deposit and term deposits of mutual savings banks in Alaska that are fully secured at all times as to payments of principal and interest as described in (m) of this section;

(6) fixed-term certificates of indebtedness of federally insured credit unions in Alaska that are fully

secured at all times as to payments of principal and interest as described in (m) of this section;

(7) debt instruments that have been issued by domestic entities and that are rated investment grade, or debt instruments of comparable quality issued by nondomestic entities;

(8) short-term

(A) promissory notes that have been issued by domestic entities and that are rated investment grade;
or

(B) promissory notes of comparable quality issued by nondomestic entities, the interest on which may be payable in either United States dollars or nondomestic currencies;

(9) bankers' acceptances drawn on and accepted by United States banks each of which has a combined capital and surplus aggregating at least \$200,000,000;

(10) repurchase agreements, the securities underlying the agreements being any of the items in (1) - (6) of this subsection;

(11) the portions of business and industrial loans made under the Rural Development Act of 1972 that are guaranteed by the Farmers Home Administration;

(12) the guaranteed portion of Farmers Home Administration loans;

(13) notes secured by mortgages granting a first lien on residential real estate improved by completed buildings if the mortgages are insured by a private mortgage insurance corporation that is authorized to do business in this state and has combined capital and surplus aggregating at least \$20,000,000 and if loan-to-value ratios do not exceed 90 percent; however, mortgage insurance is not necessary for residential loans having a loan-to-value ratio of less than 70 percent and the minimum coverage of other residential loans shall be 10 percent for those having a loan-to-value ratio greater than 70 percent but less than 90 percent and 20 percent for those having a loan-to-value ratio of 90 percent;

(14) preferred and common stock and other equity interests in entities organized in the United States;

(15) certificates of deposit, term deposits, or bankers' acceptances, that are issued by a United States or nondomestic bank or trust company located outside of the United States and are denominated in United States or nondomestic currency if either (A) they may be readily sold in a secondary market at prices reflecting fair value, or (B) the issuing bank or trust company has capital, surplus, and retained earnings at the date of issue equaling at least \$500,000,000; investments made under this paragraph are not subject to the collateral requirements for domestic certificates under (m) of this section;

(16) equity interests in, and debt obligations secured by mortgages granting a first lien on, real estate if the real estate is located in the United States, is professionally managed, and is

(A) improved by completed and substantially rented buildings; or

(B) located within the market area of real property in which the fund holds an existing interest and is acquired

(i) for the purpose of creating or adding to a portfolio of similar properties; or

(ii) to retain or service the needs of existing tenants;

(17) securities of nondomestic governments and nondomestic government agencies, the principal of, or interest on, which is payable in either United States dollars or nondomestic currencies;

(18) securities of other nondomestic entities whose dividends, if any, may be payable in either United States dollars or nondomestic currencies;


(19) taxable municipal or state debt instruments that are rated investment grade;

(20) shares in a money market or short-term investment fund that has either collateral securities of a type authorized elsewhere in this section as acceptable collateral or securities of similar quality to those authorized elsewhere in this section as acceptable collateral;

(21) interests in a titleholding entity, real estate investment trust, real estate operating company, or other entity whose assets consist predominantly of

(A) equity interests in real property or debt obligations secured by mortgages granting a lien on real property, so long as the property is of a type in which the corporation is otherwise permitted to invest fund assets under this subsection; or

(B) interests in other entities in which the corporation is permitted to invest fund assets under this paragraph.

 (h) The board may enter into future contracts for the sale of investments purchased under (g) of this section, or for the sale of nondomestic currencies, only for the purpose of hedging an existing equivalent ownership position in these investments or as a means of implementing asset allocation strategies.

(i) The fund may at no time own more than five percent of the voting stock of a corporation unless the issuing corporation is an entity in which the Alaska Permanent Fund Corporation is permitted to invest fund assets under (g)(21) of this section. Domestic stocks, except for bank and insurance company stocks and stocks of corporations in which the Alaska Permanent Fund Corporation is permitted to invest fund assets under (g)(21) of this section, must be listed at the date of purchase on an exchange registered with the Securities and Exchange Commission. Except as otherwise permitted under (k) of this section, at the time of each investment, the aggregate investment of the fund in each stated category of investment may not exceed the following stated percentage of the total investments of the fund:

(1) mortgages under (g)(13) of this section - 15 percent;

(2) real estate investments under (g)(16) and (21) of this section - 15 percent;

(3) certificates of deposit, term deposit, or bankers' acceptances under (g)(15) of this section - 20 percent;

(4) interests in domestic and nondomestic entities under (g)(14) and (18) of this section - 55 percent.

★ (j) The assets of the fund may not be used for the purchase of debt instruments of a corporation or other entity upon which any regular interest payment has been defaulted within five years before purchase, except debt instruments never in default but which have been outstanding for less than five years.

(k) The board shall establish and from time to time as necessary modify guidelines for the investment of the assets of the fund. Before adoption of any guidelines, the guidelines shall be reported to the Legislative Budget and Audit Committee for review and comment. Notwithstanding (g) of this section or the percentage investment limitations under (i) of this section and so long as doing so satisfies the prudent-investor rule under (a) of this section, the board may invest up to five percent of the total assets of the fund in either or a combination of the following:

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

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

(l) The board shall invest the assets of the fund in in-state investments to the extent in-state investments are available if the in-state investments

(1) have a risk level and expected yield comparable to alternate investment opportunities; and

(2) are included in the list of permissible investments in (g) of this section.

(m) Certificates of deposit or the equivalent instruments that are not of a quality that may be readily sold in a secondary market at prices reflecting fair value must be secured by a pledge as collateral of

(1) investments authorized for the fund under (g)(1), (2), (4), or (8) - (10) of this section;

(2) obligations of the state or instrumentalities of the state that are rated at least "A" by a major bond rating service and have a demonstrated secondary market;

(3) the guaranteed portion of Federal Small Business Administration loans;

(4) the portion of first lien real estate mortgages guaranteed by the federal Department of Veterans Affairs; or

(5) notes secured by mortgages granting a first lien on commercial or residential real estate improved by completed buildings if the originating financial institution retains at least 25 percent of the mortgage until maturity.

(n) Investments or obligations pledged as collateral under (m) of this section must have value at least equal to the face value of the certificates of deposit being secured. The board may require substitution of collateral in order to ensure continued satisfaction of the requirements set out in (m) of this section.

(o) For purposes of (g) of this section, "investment grade" means a Standard & Poor's Corporation rating BBB or better, or Moody's Investors Service, Inc., rating of Baa or better, including a rating with a "+" or "-" designation or other variations that occur within these ratings, or a comparable rating by

another nationally recognized rating organization.

(p) For purposes of applying the percentage investment limitations established in (i) of this section, if the board determines that a particular form of investment authorized under (g) of this section may appropriately be classified in more than one category of investment, it may elect the category to which that form of investment is assigned.

Sec. 37.13.130. Gains and losses. [Repealed, Sec. 13 ch 81 SLA 1982].

Repealed or Renumbered

Sec. 37.13.140. Income.

Net income of the fund includes income of the earnings reserve account established under AS 37.13.145. Net income of the fund shall be computed annually as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding any unrealized gains or losses. Income available for distribution equals 21 percent of the net income of the fund for the last five fiscal years, including the fiscal year just ended, but may not exceed net income of the fund for the fiscal year just ended plus the balance in the earnings reserve account described in AS 37.13.145.

Sec. 37.13.145. Disposition of income.

(a) The earnings reserve account is established as a separate account in the fund. Income from the fund shall be deposited by the corporation into the account as soon as it is received. Money in the account shall be invested in investments authorized under AS 37.13.120.

(b) At the end of each fiscal year, the corporation shall transfer from the earnings reserve account to the dividend fund established under AS 43.23.045, 50 percent of the income available for distribution under AS 37.13.140.

(c) After the transfer under (b) of this section, the corporation shall transfer from the earnings reserve account to the principal of the fund an amount sufficient to offset the effect of inflation on principal of the fund during that fiscal year. The corporation shall calculate the amount to transfer to the principal under this subsection by

(1) computing the average of the monthly United States Consumer Price Index for all urban consumers for each of the two previous calendar years;

(2) computing the percentage change between the first and second calendar year average; and

(3) applying that rate to the value of the principal of the fund on the last day of the fiscal year just ended.

(d) Notwithstanding (b) of this section, income earned on money awarded in or received as a result of *State v. Amerada Hess, et al.*, 1JU-77-847 Civ. (Superior Court, First Judicial District), including settlement, summary judgment, or adjustment to a royalty-in-kind contract that is tied to the outcome of this case, or interest earned on the money, or on the earnings of the money shall be treated in the same manner as other income of the Alaska permanent fund, except that it is not available for distribution to the dividend fund, and shall be annually deposited into the principal of the Alaska permanent fund.