

HB

215

ALASKA STATE LEGISLATURE

House of Representatives

COMMITTEE ASSIGNMENTS

RULES COMMITTEE, CHAIRMAN
LABOR & COMMERCE COMMITTEE, MEMBER
LEGISLATIVE COUNCIL, MEMBER
SPECIAL COMMITTEE ON OIL & GAS, MEMBER
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Representative Norman Rokeberg

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SPONSOR STATEMENT FOR HB 215 By: Representative Norman Rokeberg by Request

An Act relating to the investment responsibilities of the Alaska Permanent Fund Corporation; relating to regulations proposed and adopted by the Board of Trustees of the Alaska Permanent Fund Corporation and providing procedures for the adoptions of regulations by the board; and providing for an effective date.

The investments of the Alaska Permanent Fund are guided by a "legal list" contained in Alaska Statutes. The corporation's Board of Trustees recently engaged two consulting firms, Callan Associates and RV Kuhns, to review the impact of the legal list restrictions on the Fund's investment risk and returns.

What both firms found is that the Fund may be taking on greater risk without the promise of commensurate returns due to the investment restrictions in state statutes.

Modern investment theory focuses on the combined risk of a total portfolio, rather than the risk of each asset type. In our current environment, it is important to diversify a portfolio among assets that do not respond in the same way to similar market conditions, assets which aren't correlated in their performance. This better ensures a positive return for the Fund and lowers overall risk.

Under the current investment list, the Legislature must change the statutes to allow for new investment types. A small "basket clause" does allow up to 10% of the Fund to be invested in items not included in the legislative list, but with part of the basket already allocated, little room is available for new asset types or growth in existing assets beyond current limits.

Because the Constitution specifies that the Fund will be invested only in assets "specifically designated by law," the Legislature may not simply remove the legal list and direct the Trustees to invest under the Prudent Investor Rule alone. However, a recent Attorney General's opinion states that the Legislature is able to move the list to regulation, where the Trustees may make changes in a more timely fashion.

This legislation would make that change, granting the Board authority to establish and administer a legal investment list in regulation. Several important restrictions will be maintained in statute, including the requirement that all investments conform to the Prudent Investor Rule.

Giving the Board this flexibility will help ensure the continued health of the Fund and the ability to sustain distributions in perpetuity by allowing the Trustees to gain the full benefit of the investment professionals who work for the corporation, its managers and advisors.

For more information, please contact Laura Achee @ Alaska Permanent Fund Corporation, 465-2059.

FISCAL NOTE

STATE OF ALASKA
2005 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: HB 215
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue
 Title Perm Fund Corp. Investments/Regulations RDU AK Permanent Fund Corporation
 Component AK Permanent Fund Corporation
 Sponsor Representative Rokeberg
 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 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Personal Services						
Travel						
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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 (FY2005) cost: 0.0

Mark this box (X) if funding for this bill is included in the Governor's FY 2006 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

HB 215 would move the Permanent Fund's allowed investment list from statute to regulation. APFC does not anticipate significant changes in staff workload or management fees as a result of this legislation.

Prepared by: Michael Burns, Executive Director/CEO Phone 907-465-2047
 Division Alaska Permanent Fund Corporation Date/Time 04/08/05
 Approved by: _____ Date 4/8/2005
 Agency _____

MEMORANDUM

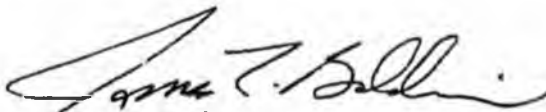
STATE OF ALASKA DEPARTMENT OF LAW

TO: Hon. Carl Brady, Chair
Board of Trustees
Alaska Permanent Fund Corporation

DATE: February 15, 2005

FILE NO: 663-05-0141

TEL. NO: 465-3600

FROM: 
James L. Baldwin
Senior Assistant Attorney General
Opinions, Appeals and Ethics

SUBJECT: Power of the Legislature to
authorize Board of Trustees of
Alaska Permanent Fund
Corporation to designate
investment subject only to the
Prudent Investor Rule

The Alaska Permanent Fund Corporation ("the Corporation") requested an opinion on whether the requirement in the Alaska Constitution that investments of the Alaska Permanent Fund ("the permanent fund") be "specifically designated by law" would allow the legislature to further delegate this power of designation to the board of trustees of the permanent fund. The board of trustees is investigating the legal consequences if they were to be given discretion over exercise of the power of designation subject only to the prudent investor rule.

Introduction.

Our advice on this question depends on the interpretation of a phrase in article IX, section 15 of the Alaska Constitution. Section 15 authorizes the establishment of the Alaska Permanent Fund. In pertinent part, the section requires that certain petroleum-related revenue be placed in a permanent fund, "the principal of which shall be used only for those income-producing investments specifically designated by law" as eligible for permanent fund investments. (Emphasis added). You desire to know whether the constitutional requirement that investments be "specifically designated by law" can be interpreted to permit the legislature to give to the board of trustees the power to make investments, not according to a list of investments established in AS 37.13.120 (hereinafter "the legal list"), but rather according to an exercise of discretion consistent with the prudent investor rule.

Short answer:

The legislature may delegate the power to designate investments to the board of trustees subject to the limitations explained in this memorandum.

Legislative History.

The legislative history of the constitutional provision we have been asked to construe provides some evidence that will assist in establishing a meaning. The permanent fund amendment was originally introduced by Governor Jay Hammond.¹ Even though the original approach gained passage in the House of Representatives during the First Session of the Ninth Alaska State Legislature, the governor offered a sponsor substitute the following year. The sponsor substitute proposed creation of a single dedicated fund to receive a stream of revenue from petroleum revenue sources.²

In his letter transmitting the sponsor substitute to presiding officers of each house of the legislature, Governor Hammond said:

The principal of the fund would be used only for investment in income-producing investments which the legislature would establish and change to meet current investment needs of the State.³

As introduced, the substitute resolution was silent concerning designation of permissible investments for the permanent fund. However, Governor Hammond's letter mentioned the legislature's role in setting the kinds of investments that would be appropriate for permanent fund principal. Apparently, he believed that this role was implied within the wording of the substitute version. During legislative hearings on the resolution, amendments were adopted in the House Finance and Judiciary Committees that expressly provided that investments will be designated by law.

The House Finance Committee reported out the resolution with amendments.⁴ As a part of these amendments, the Finance Committee provided that investments of

¹ HJR 39 (9th Alaska State Legislature, First Sess.).

² SSHJR 39 (9th Alaska State Legislature, Second Sess.).

³ 1976 House J. at 39 (January 15, 1976).

⁴ 1976 House J. at 541 (March 10, 1976).

principal "... shall be established by law".⁵ In the House Judiciary Committee, the finance amendments were accepted and incorporated in the Judiciary Committee Substitute with the word "established" deleted and the words "specifically designated" inserted in its place.⁶ This wording remained unchanged during subsequent hearings on the resolution and became the wording ratified by the people at the 1976 general election.

During discussion in the House Judiciary Committee, the stated intent of the provision requiring specific designation was to avoid having the permanent fund become a source of capitalization for existing state loan programs. At that time, revolving loan programs had provisions that enabled the sale or transfer of notes and other evidences of debt to the state treasury and public employee and teachers retirement funds. The proceeds of sale would then provide more money to make loans and thereby create constantly revolving loan enterprises.⁷

In a "Joint Chairman's Report" of the House Finance and Judiciary Committees, the intent of Governor Hammond was repeated that permanent fund money would be placed in "investments which the legislature would establish and change from time to time to meet the needs of the state."⁸ Based on the foregoing it does not appear that the legislature meant that individual investments must be specifically designated before the permanent fund can be invested. Rather, there must be an express authorization of the investment of permanent fund money in a particular manner. This distinction is important. The language of the resolution was not intended to require approval of individual investments but rather to prevent the possibility that authority to make an investment could be provided by or implied from a statute unrelated to the permanent fund. The authority to invest must be specific to the permanent fund and was not intended to include the investment of surplus state money in general.

The attorney general addressed the requirement to specify permanent fund investments in a 1977 opinion. This office concluded that the legislature's power to designate investments

is not plenary but rather is limited by the express terms of the amendment on the one hand and by implied trust concepts on the other. In other words,

⁵ *Id.*

⁶ 1976 House J. at 684 (March 24, 1976).

⁷ See e.g.; former AS 03.10.054 (Agricultural Revolving Loan Fund); AS 16.10.330 (Commercial Fishing Loans); AS 16.10.550 (Fishery Enhancement Loans); AS 44.33.370 (Residential Care Facility Loans).

⁸ 1976 House J. at 684.

the legislature may designate only income-producing investments and may not designate imprudent, income-producing investments or provide for imprudent administration of the fund principal. To the extent, if any that it did, the managers of the fund would nevertheless remain under a duty to make only prudent income-producing investments and to provide a prudent administration.⁹

When investment powers were first implemented for the corporation by the legislature in 1980, there was an express intent to "establish a trust held to a more restricted list of investments than most other fiduciary trusts including the Alaska State Pension Funds."¹⁰ In accomplishing that result, the legislature believed that it was establishing a legal list statute that had "a minimum of investment restrictions yet provides a very definite and certain framework."¹¹ Since 1980, the legislature has expanded the legal list of permitted investments a number of times.¹²

The Delegation Doctrine.

We believe that the courts would interpret the Alaska Constitution to permit the legislature to delegate its power to designate specific investments to the board of

⁹ 1976 Inf. Op Att'y Gen. at 2 (Sept. 16; J66-107-78).

¹⁰ 1980 Senate J. at 671.

¹¹ *Id.*

¹² The legal list set out in AS 37.13.120 originally authorized investment in direct obligations of the United States Treasury, federal agency securities, certificates of deposit, high-grade corporate bonds, quality short-term investments, and federally guaranteed loans. There was direction given to prefer Alaska investments as long as they met the standards of quality set out in law. Specifically, deposits could be made in Alaska banks, mutual savings banks, savings and loan associations, and credit unions. Residential real estate (owner-occupied single family dwellings, duplexes, and condominiums) could also be purchased if the mortgage was privately insured by a company doing business in Alaska. In 1982 the legal list was expanded to include investment equities. The legal list has since been expanded at least five more times by the legislature: in 1989 to include investments in non-U.S. securities; in 1992 to include A-rated corporate bonds; in 1994 to expand permissible real estate investments; in 1999 to make a variety of adjustments to the legal list, to authorize up to five percent of the fund to be invested in other prudent investments not specifically included in the list (the "basket clause"), and to increase the allocation limit placed on equity investments; and in 2004, the five percent limit on the basket clause was increased to ten percent.

trustees.¹³ The scope of a delegation permitted under the wording of the constitution is the question at hand. The legislature would have some latitude in constructing a workable framework for the investment authority of the board of trustees. However, the legislature must establish standards under which the board of trustees would exercise discretion in making its investment decisions. Based on past construction and legislative history, these standards must, at a minimum, be appropriate for a fiduciary relationship and tailored specifically for the permanent fund. Too broad of a grant of power without standards for the exercise of discretion would amount to an invalid delegation of the legislature's power to designate investments.¹⁴ In *Fairbanks North Star Borough*, the court outlined the method for evaluating the validity of a purported delegation of legislative power:

The essential inquiry is whether the specified guidance sufficiently marks the field within which the administrator is to act so that it may be known whether he has kept within it in compliance with the legislative will.¹⁵

The "field" is limited by attaching standards or conditions to the delegated powers under which the administrators are obliged to act in the performance of the powers. The court summed up its holdings on the delegation doctrine as follows.

Review of our decisions which have addressed delegation issues leads to the observation that whether one employs explicit or implicit standards, '[t]he basic purpose behind the nondelegation doctrine is sound:

¹³ See *Boehl v. Sabre Jet Room, Inc.*, 349 P.2d 585, 588 (Alaska 1960) (declaring that the delegation of state legislative powers is not unconstitutional; "a strict theory of separation of powers ignores [the] realities and the practical necessities of government. . . . The real question, then, is not whether there may be delegation. Rather, it is how far the legislature may go in delegating power to an agency . . ."); *Walker v. Alaska State Mortgage Ass'n*, 416 P.2d 245, 254 (Alaska 1966) (holding that creation of Alaska State Mortgage Association was not an unconstitutional delegation of legislative authority to provide for public health and welfare); *DeArmond v. Alaska State Dev. Corp.*, 376 P.2d 717, 722-23 (Alaska 1962) (finding that creation of the Alaska State Development Corporation which provided development loans to businesses was not an improper delegation of legislative authority).

¹⁴ See *State v. Fairbanks North Star Borough*, 736 P.2d 1140 (Alaska 1987) (governor's statutory power to reduce or withhold appropriations held invalid on two grounds: delegation without standards and violation of separation of powers).

¹⁵ 736 P.2d at 1143 (quoting *Synar v. United States*, 626 F. Supp. 1374, 1383-89 (D.D.C. 1986) (quoting *Yakus v. United States*, 321 U.S. 414, 426 (1944) (quotation marks omitted)).

Administrators should not have unguided and uncontrolled discretionary power to govern as they see fit.¹⁶

Based on the *Fairbanks North Slope Borough* case, the legislature should set limits on the amount of discretion that would be afforded to the board of trustees. However, in the absence of a court decision specifically on this question, it is not possible to give absolute certainty as to the validity of one set of standards over another. The Alaska Supreme Court approaches disputes involving delegated powers on a case-by-case basis by measuring the validity of standards according to a sliding scale.

... [t]he constitutionality of a delegation is determined on the basis of the scope of the power delegated and the specificity of the standards to govern its exercise. When the scope increases to immense proportions the standards must be correspondingly more precise.¹⁷

In *Fairbanks North Star Borough*, the court invalidated a statute that purported to convey a significant part of the legislature's power to the governor to amend appropriations. The delegation of power to the governor to impound or reduce enacted appropriations was characterized as a broad grant of power requiring precise standards limiting administrative discretion. The delegation failed because there was a total absence of a standard for performance of the delegated powers. Delegation of investment authority over a substantial amount of the state's wealth is significant but it arguably is not of "immense" proportions. The power to designate investments has been delegated to the Alaska State Pension Investment Board for a substantial amount of retirement funds without much in the way of detail other than recitation of the prudent investor rule set out in AS 37.10.071(c).¹⁸

In *Walker v. Alaska State Mortgage Ass'n*,¹⁹ the court explained that the complexity of the subject matter also affects the detail needed in standards governing the exercise of a delegated power. In *Walker*, the court found that standards for delegated power over a secondary marketing facility for housing mortgages need not be detailed in order to be found valid. The determination of appropriate investments in today's market is arguably a similarly complex subject that would allow a less precise set of standards

¹⁶ *Municipality of Anchorage v. Anchorage Police Department Employee Ass'n*, 839 P.2d 1080, 1086 (Alaska 1992)(quoting 1 K. Davis, *Administrative Law*, § 3:15, at 206).

¹⁷ *Fairbanks North Star Borough*, 736 P.2d at 1143.

¹⁸ See AS 14.25.180(c), and AS 39.35.080.

¹⁹ 416 P.2d 245, 254 (Alaska 1966)

for the exercise of discretion. Thus, it appears that court precedent would support a broadly stated delegation of investment authority to the board of trustees.

The Alaska Supreme Court uses a method of reviewing standards for the exercise of delegated power which does not focus on the precision of the standards but rather on whether they effectively prevent the arbitrary exercise of the delegated power. When it first employed this method, the court cited with approval the following advice on measuring the effect of limits on administrative discretion:

The focus should not be exclusively on standards; it should be on the totality of protections against arbitrariness, including both safeguards and standards. The key should no longer be statutory words; it should be the protections the administrators in fact provide, irrespective of what the statutes say or fail to say. The focus of judicial inquiries thus should shift from statutory standards to administrative safeguards and administrative standards. As soon as that shift is accomplished, the protections should grow beyond the nondelegation doctrine to a much broader requirement, judicially enforced, that as far as is practicable administrators must structure their discretionary power through appropriate safeguards and must confine and guide their discretionary power through standards, principles, and rules.²⁰

The foregoing instructs us that the validity of any legislation proposing a delegation of investment authority heavily depends on an evaluation of the safeguards applied by the legislature to prevent arbitrary administrative decision-making.

Municipality of Anchorage concerned the validity of the Anchorage Municipal Assembly's delegation of power to a private arbitrator to make final and binding determinations in certain labor contract disputes. The court characterized this as "a fairly narrow area, albeit an important one, . . ." ²¹ The court also acknowledged there were a panoply of implied standards that created "an elaborate and detailed structure which guides the arbitrator's decisions and guards against arbitrary action . . ." ²² Principally for these reasons the court held the delegation to be valid. In a subsequent case, the court

²⁰ *Municipality of Anchorage v. Anchorage Police Department Employee Ass'n*, 839 P.2d 1080, 1086 n.12 (Alaska 1992)(quoting 1 K. Davis, *Administrative Law*, §3:15, at 206-07).

²¹ *Id.* at 1086-89.

²² *Id.*

explained that *Municipality of Anchorage* suggests "the delegation doctrine should be animated more by due process concerns than by separation of powers principles."²³

We next consider whether the prudent investor rule would serve as an appropriate limit on the delegated investment power.

The Prudent Investor Rule as a Standard for Delegated Investment Power.

The prudent institutional investor rule provides a detailed structure to guide the decisions of the board of trustees and others with fiduciary investment responsibility.²⁴ The rule has been established since 1994 when it was codified in the Restatement of Trusts (Third).²⁵ The board of trustees have been subject to a form of the prudent investor rule since 1980 when AS 37.13.120(a) was enacted.²⁶ The rule applies to investment decisions made within the constraints of the legal list.²⁷ The prudent investor rule serves as a limitation on the actions of applicable fiduciaries. Under the Restatement, the prudence standard is one of conduct and not a test of the result of performance of a specific investment. The focus of inquiry by a court is how the fiduciary acted in his or her selection of the investment and not whether the investments succeeded or failed.²⁸ The prudent investor rule, not constrained by a legal list, would operate to determine whether the individual trustees, at the time they specified an

²³ *Usibelli Coal Mine, Inc., v. State*, 912 P.2d 1134, 1144, n.15.

²⁴ Restatement (Third) of Trusts, subsec. 277 *et. seq.*

²⁵ The rule was made applicable to the administration of private trusts in the state in May of 1998. It is set out in detail in AS 13.36.225 – 13.36.290.

²⁶ AS 37.13.120 provides:

(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.

²⁷ AS 37.13.120(g).

²⁸ See, *Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 317 (C.A. 5Tex. 1999)(ERISA implemented by regulations establishing the prudent investor rule).

investment for the permanent fund, used the appropriate methods to investigate the merits of the investment and to structure the investment to achieve the best result. In our opinion, adoption of the prudent investor rule, standing alone, by law would provide an extensive set of instructions to guide investment decisions of the board of trustees. The prudent investor rule is equivalent to the express and implied standards applicable to arbitrators found acceptable in *Municipality of Anchorage*. The prudent investor rule has withstood the test of time by requiring a process that guards against arbitrary exercise of power.

Any legislation to enact an effective standard must be in harmony with the wording of the Alaska Constitution requiring that investments be "specifically designated by law." In order to formalize the designation of prudent investments, we believe that the legislature should, by statute, provide that the designation of investments must be exercised by the adoption of administrative regulations by the board of trustees. The statute providing the specific authority to adopt regulations would be a delegation of authority from the legislature to the board of trustees to set policy and to act in the place of the legislature. Such regulations are reviewed by a court as if they have the effect of law.²⁹ By using this method to specify investments for the permanent fund, the delegation would be textually correct insofar as the Alaska Constitution's command that investments be "specifically designated by law." The asset classes of permitted investments could be set out in regulations.³⁰ In recognition of the need to respond to short term changes in markets, the legislature could establish an abbreviated adoption process for these regulations. This has been done for other financial enterprises of the state.³¹

Regulation adoption procedures have ingrained due process safeguards and protections against arbitrariness. By specifying investments by regulation, the board of trustees would follow an adoption procedure specified in law that requires adequate public notice and opportunity to comment.

Conclusion.

In our opinion, the legislature may delegate to the board of trustees the power to designate investments for the permanent fund. The statute making this delegation must incorporate adequate due process safeguards against arbitrary exercise of the delegated

²⁹ *Kelly v. Zamarello*, 486 P.2d 906, 911 (Alaska 1971).

³⁰ Under this approach, the legal list set out in AS 37.13.120 would be repealed and adopted in administrative regulations.

³¹ See, AS 44.88.085 (Alaska Industrial and Development Authority), and AS 18.56.088 (Alaska Housing Finance Corporation).

power and must contain adequate standards for the exercise of the delegated power. In order to satisfy the foregoing conditions, we recommend that the legislature consider authorizing the board of trustees to specify investments by the adoption of regulations. We further recommend that the legislature provide standards for the exercise of this regulatory power by requiring that the investment decisions formalized in the regulations comply with the prudent investor rule.

We hope the foregoing will assist the board of trustees in determining the validity and scope of legislation that would propose a delegation of investment power conditioned on exercise consistent with the prudent investor rule.

JLB:jn

This is written in a handout from the APFC:

POMV v Status quo in FY2004

POMV protects more of the Fund from overspending than is protected under the current structure.

They then go on to say that 6% realized earnings or \$1.6 billion plus 11% unrealized net gains of \$3.0 billion are either "unprotected or partially protected"

What does unprotected or partially protected mean?

Paul - Peter N. dropped this off
regarding the Perm Fund bill (215)^{SB}

* They are advertising that the PF
would be more "protected" if
legislature gave up their control of
the fund.

FISCAL NOTE

STATE OF ALASKA
2005 LEGISLATIVE SESSION

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CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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Estimate of any current year (FY2005) cost: 0.0
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Temporary						

ANALYSIS: (Attach a separate page if necessary)

HB 215 would move the Permanent Fund's allowed investment list from statute to regulation. APFC does not anticipate significant changes in staff workload or management fees as a result of this legislation.

Prepared by: Michael Burns, Executive Director/CEO Phone 907-465-2047
 Division Alaska Permanent Fund Corporation Date/Time 04/08/05
 Approved by: _____ Date 4/8/2005
 Agency _____



Alaska Permanent Fund Corporation

Reducing Risk, Increasing Return

Background

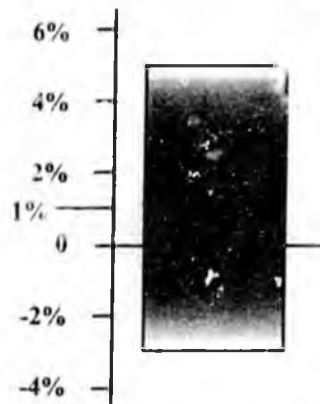
AS 37.13.120 contains a "legal list" of allowed investments for the Alaska Permanent Fund.

The Board of Trustees recently asked two consulting firms, Callan Associates and RV Kuhns, to determine the list's impact on the Fund's potential investment returns and risk. These firms found that the Fund may be taking on greater risk without the promise of commensurate returns under the restrictions in the legal list.

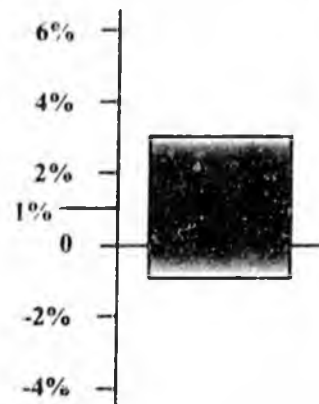
What is risk? Standard deviation? Volatility?

Risk is defined as the measurable possibility of losing value on an investment. It is expressed as the standard deviation above and below the return, the range of possible returns. In the example on the left, 4% is the standard deviation.

Expected return of 1% \pm 4%



Expected return of 1% \pm 2%

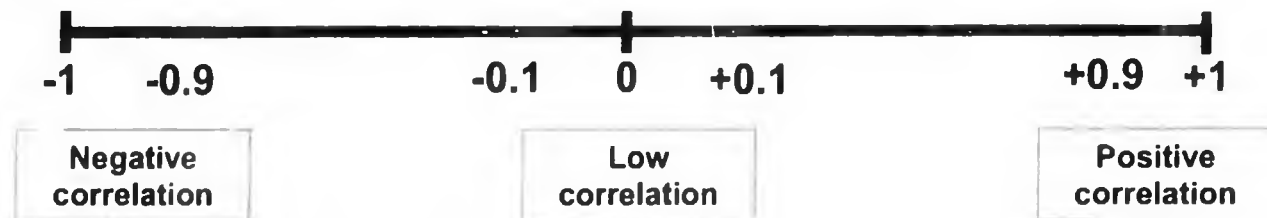


Volatility describes the level of risk for investments, from individual securities to investment strategies to a total portfolio. The returns on highly volatile investments can swing wildly, while the expected returns for less volatile investments will fall into a more narrow range. In the examples above, the figure on the left shows greater volatility and risk than the figure on the right.

What is correlation?

Correlation is a statistical measure of the relationship between two different assets, describing whether or not they move in tandem under various market conditions.

This relationship is expressed with a number between plus one (perfect positive correlation) and minus one (perfect negative correlation). Positively correlated investments usually rise and fall together, while negatively correlated investments move in opposite directions.



Investments with a low correlation (a correlation value close to zero) do not move in relationship to each other. The less correlated the assets, the less able we are to predict how these investments will perform in relation to each other.

Diversifying assets among negatively correlated investments can increase the likelihood of stable performance under various market conditions. Investing in assets with low correlation to each other can lower total portfolio risk even further.

Modern portfolio theory

In the past, institutional portfolios were managed by assessing the individual risk for each asset type. Investments that were considered too risky would not be included in the portfolio.

This is similar to how many individual investors approach their personal retirement portfolios. When the investor is young, they are open to more risk and can invest in more volatile assets. As they approach retirement age and the eventual payout of earnings, it becomes more important to protect the value of the portfolio and the investor shifts to less risky assets.

However, institutional funds have different characteristics than a retirement account. Institutional funds must be protected for the long term, while providing annual payouts. As markets have changed, this has created a modern portfolio theory that focuses more on spreading investments across non-correlated assets than focusing on the individual risk of each asset type. Managing investments in this manner can lower the overall risk of the portfolio, even while the fund is invested in assets that are considered risky.

How does this work?

The following hypothetical examples show how the correlation between assets can affect the overall risk for a portfolio.

<p>Portfolio A is invested in race horses and race tracks.</p> <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 20%;"></th> <th style="width: 30%; text-align: center;">Race horses</th> <th style="width: 30%; text-align: center;">Race tracks</th> </tr> </thead> <tbody> <tr> <td>Return</td> <td style="text-align: center;">10.0%</td> <td style="text-align: center;">7.0%</td> </tr> <tr> <td>Std. deviation (risk)</td> <td style="text-align: center;">12.0%</td> <td style="text-align: center;">8.0%</td> </tr> <tr> <td colspan="3">Correlation between assets: .90</td> </tr> </tbody> </table>		Race horses	Race tracks	Return	10.0%	7.0%	Std. deviation (risk)	12.0%	8.0%	Correlation between assets: .90			<p>Portfolio B is invested in Beanie Babies and fine art.</p> <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 20%;"></th> <th style="width: 30%; text-align: center;">Beanie Babies</th> <th style="width: 30%; text-align: center;">Fine art</th> </tr> </thead> <tbody> <tr> <td>Return</td> <td style="text-align: center;">10.0%</td> <td style="text-align: center;">7.0%</td> </tr> <tr> <td>Std. deviation (risk)</td> <td style="text-align: center;">13.2%</td> <td style="text-align: center;">8.8%</td> </tr> <tr> <td colspan="3">Correlation between assets: .10</td> </tr> </tbody> </table>		Beanie Babies	Fine art	Return	10.0%	7.0%	Std. deviation (risk)	13.2%	8.8%	Correlation between assets: .10		
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While the assets in each portfolio have corresponding returns, they have different risk levels and different correlations. When they are weighted the same, which portfolio has the greater total risk?

<p style="text-align: center;">Portfolio A</p> <p>Race horses = 56% of portfolio</p> <p>Race tracks = 44% of portfolio</p> <p>Expected return is 8.68%</p> <p>Standard deviation (risk) 10.00%</p>	<p style="text-align: center;">Portfolio B</p> <p>Beanie Babies = 56% of portfolio</p> <p>Fine art = 44% of portfolio</p> <p>Expected return is 8.69%</p> <p>Standard deviation (risk) 8.70%</p>
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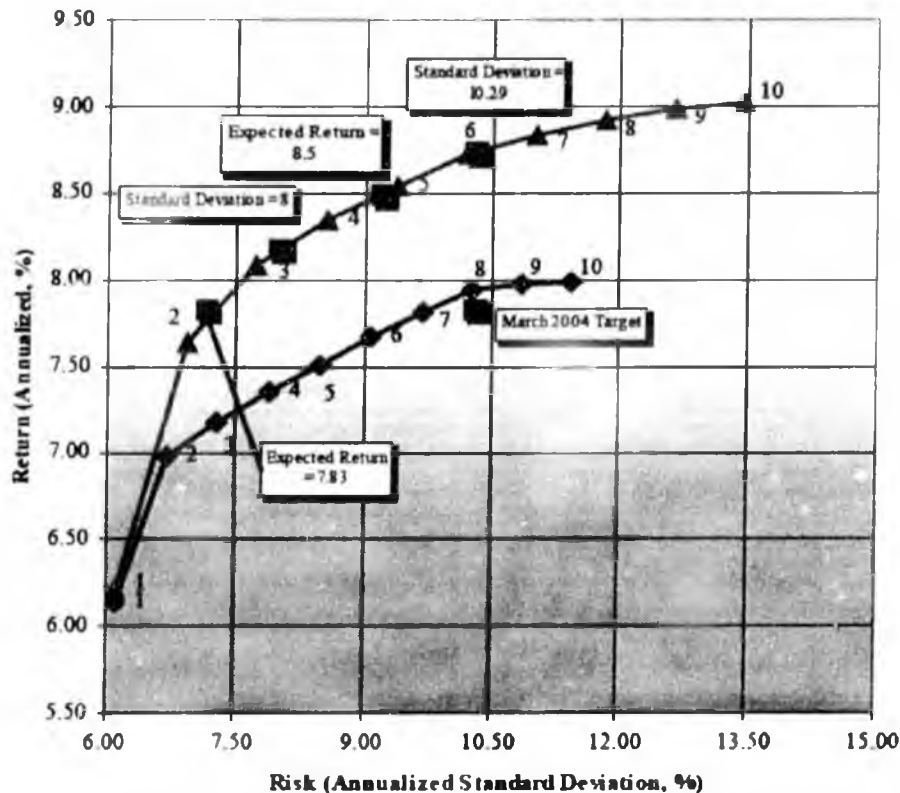
The portfolio using higher risk investments was able to achieve a lower overall risk for equal returns because it used investments that are less correlated.

Where is the Permanent Fund?

The following chart shows potential risk and return for various portfolios under the Fund's current investment restrictions (blue line), and under the Prudent Investor Rule alone (red line). The underlying asset allocations for the main points of this chart are shown on the next page.

The chart demonstrates that under the Prudent Investor Rule, the Fund could potentially earn the same return as the current portfolio (March 2004 target) with more than 3% less risk (Expected Return = 7.83). Or, for the same risk the Fund could earn almost 1% more return (Standard Deviation = 10.29).

Efficient Frontier



The Trustees understand the Legislature's need to balance risk and return for the Fund. While an aggressive rate of growth may be desired by some, others may find it more important to lower the Fund's risk while maintaining a reasonable rate of return.

Increasing the Fund's investment options would allow the Trustees greater flexibility in managing the Fund for the benefit of all Alaskans, whether it is for greater return, lower risk or both. This is especially important as the Legislature begins to contemplate the use of Fund earnings for more than just the dividend program.

How would the Trustees use that flexibility?

The statutory list prevents investments in newer high risk assets such as broad emerging market debt, high yield bonds and certain forms of real estate investments. These assets, while considered risky on their own, can lower the overall risk of a portfolio through low correlation with other asset types.

These asset types are fairly easy to describe, and with time could be added to the statutory list with Legislative approval. However, by the time they are added, the investment opportunity may have closed, leaving the Permanent Fund out in the cold.

As the investment world seeks new ways to improve returns in increasingly efficient markets, investors are creating new strategies that mix multiple investment options or asset types within a single investment mandate. Absolute return strategies, an alternative asset type that the Fund currently invests in under the 10% basket clause, are portfolios that invest for an absolute target return using the most promising investment opportunities available. These portfolios are defined by their return targets, not by the assets they hold.

Large Cap US Equity	30	20	20	20	20
Small/Mid Cap US Equity	7	5	5	5	5
International Equity	16	10	10	10	10
Emerging Markets	2	0	6	0	4
Fixed Income	28	20	20	20	20
Non-US Fixed Income	4	5	0	5	1
Real Estate	6	15	14	15	15
REITs	4	0	0	0	0
Private Equity	2	0	10	4	6
Absolute Return	1	10	5	10	9
Cash Equivalents	0	0	0	0	0
Commodities	0	5	5	5	5
Convertibles	0	0	0	0	6
High Yield	0	0	0	0	0
Real Return	0	1	0	1	0
Timber	0	5	5	5	5
TIPS	0	4	0	0	0
Total	100	100	100	100	100

This new wave of investment practice does not fit well within the rigid structure of a legal list. If the Fund's legal list were moved to regulation as suggested by a recent Attorney General's opinion, it would still require that these strategies have some form of definition. However, the less cumbersome regulatory process would allow Trustees to craft and modify regulatory definitions of alternative investment strategies.

The Prudent Investor Rule

STATE/TERRITORY ADOPTIONS*		
of the PRUDENT INVESTOR ACT		
Alaska (ASPIB)	Maryland **	Pennsylvania
Arizona	Michigan	Rhode Island
Arkansas	Minnesota	South Carolina
California	Missouri	South Dakota
Colorado	Montana	Tennessee
Connecticut	Nebraska	Texas
District of Columbia	Nevada	Utah
Hawaii	New Hampshire	U.S. Virgin Islands
Idaho	New Jersey	Vermont
Illinois	New Mexico	Virginia
Indiana	North Carolina	Washington
Iowa	North Dakota	West Virginia
Kansas	Ohio	Wisconsin
Maine	Oklahoma	Wyoming
Massachusetts	Oregon	
* Source is National Conference of Commissioners on Uniform State Laws		
** Substantially Similar		

The Prudent Investor Rule is a legal standard that requires the APFC Board of Trustees to act as a prudent institutional investor would when making investment decisions. Alaska statutes require that the Board follow the Prudent Investor Rule in addition to the other statutory investment restrictions.

The Permanent Fund's peers—state pension funds and large institutional endowment funds—have been moving away from legal investment lists. Instead, they are simply required to conform to the Prudent Investor Rule.

New York and New Mexico are both seeking legislative approval to expand the investment flexibility for their state pension funds.

What can we do?

The Constitution says that the Alaska Permanent Fund will be invested in assets "specifically designated by law." This prevents the Legislature from removing the legal list and simply requiring that all Fund investments conform to the Prudent Investor Rule. However, a recent Attorney General's opinion says the Legislature may delegate authority to the Board of Trustees to create a list of allowed investments in regulation. A regulatory list may be amended more quickly than statutes, allowing the Trustees the flexibility to respond to changes in the investment world.

Legislation drafted at the request of the Trustees would allow the list to be moved to regulation, while maintaining key restrictions in statute. The most important of these restrictions is the requirement that all Fund investments conform to the Prudent Investor Rule.

The Alaska Permanent Fund Corporation thanks Michael O'Leary of Callan Associates, and Russ Kuhns, Rebecca Gratsinger, and Jim Voytko of RV Kuhns, for their assistance in producing this handout.