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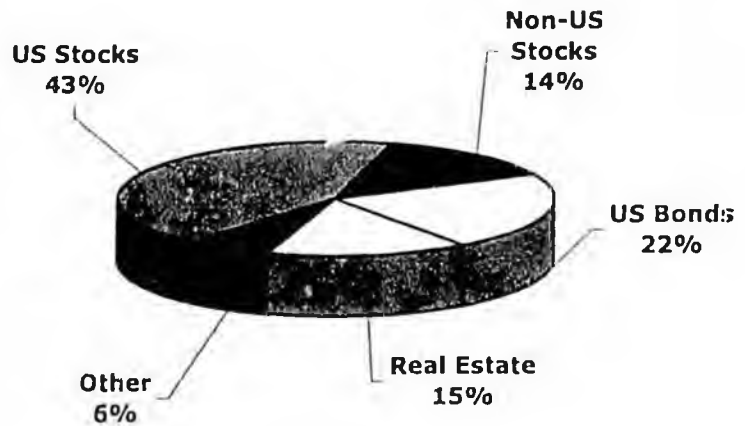
ADVISORS

**SFIN**

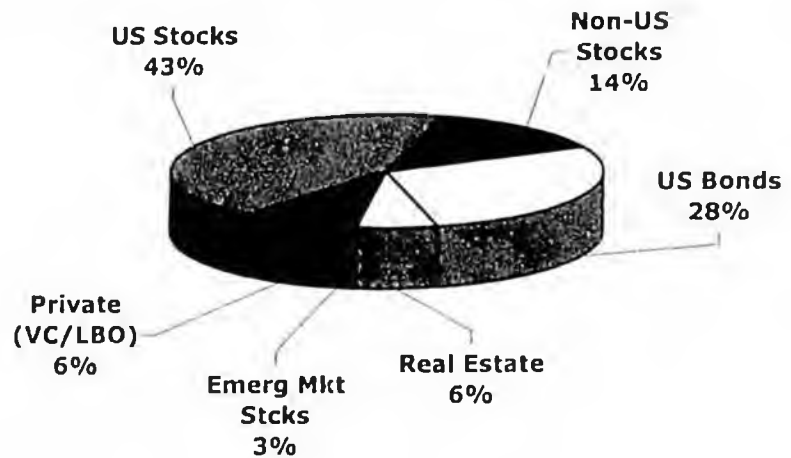
**FILE**

# Asset allocation of the Massachusetts Pension Reserves Investment Trust Fund

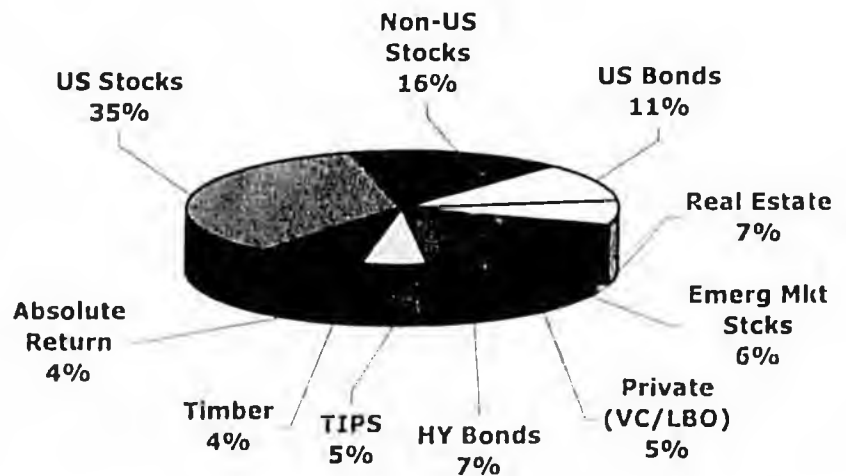
**1990**  
Five asset classes



**2000**  
Six asset classes



**2004**  
Ten asset classes



## **What has the PRIT Fund done?**

- 1. Increased asset classes from 5 to 10.**
- 2. Increased sub-asset classes to 15.**
- 3. Increased less liquid investments.**
- 4. Increased non-correlation of asset classes.**
- 5. Est. return 8.3%, est. risk 11.5%**

## **Goals**

- 1. Meet 8 ¼ % actuarial return target.**
- 2. Reduce risk by increasing non-correlation.**
- 3. Continue to diversify.**
- 4. Benefit from less liquid, higher return asset classes.**
- 5. Use indexing in public markets where appropriate.**



# Alaska Permanent Fund Corporation

## 2005 Capital Market Outlook

Michael J. O'Leary CFA  
Executive Vice President  
February 2005



## After a Slow Start, Capital Markets Enjoy Second Straight Year in the Black

	1999	2000	2001	2002	2003	2004	Avg Ann Return Five Years 2000-04
Russell 2000	20.90	-7.46	-11.46	-21.54	31.06	11.95	1.16
Russell 1000	20.91	-7.79	-12.45	-21.65	29.83	11.40	1.76
S&P 500	21.04	-9.10	-11.88	-22.10	28.83	10.88	-2.30
Russell 2000	21.26	3.02	2.49	-20.48	47.25	18.33	6.61
EAFE (\$US)	26.96	-14.17	-21.44	-15.94	38.59	20.25	-1.14
ED Aggregate	-0.82	11.63	8.13	10.26	4.10	4.33	7.71
S&P Non-US Bonds	-5.07	-2.63	-3.54	21.99	18.52	12.14	8.70
90-day T-bill	4.85	6.18	4.42	1.76	1.15	1.33	2.95
CPI-U	2.68	3.39	1.55	2.08	1.88	3.26	2.39

## The Current Economic Environment



### *Steady Growth But Unsteady Sentiment*

- U.S. economy all of the sudden looked hot in 2004, but the expansion has been underway for several years, and growth has actually continued at an orderly, if unspectacular pace.
- Jobs data finally turned around, and unemployment finally fell below 6%.
- Business spending was weak until recently, as many industries are still plagued with overcapacity.
- Inflation remains a low level threat, despite what we read in the headlines. Absent oil price pressures, core rate is around 2%.
- Interest rates are still extraordinarily low:
  - Treasury bonds yields are not that far from their 40-year lows.
  - Fed policy still seems to work, at least on consumers...
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## Leadership Passes From Consumers to Businesses



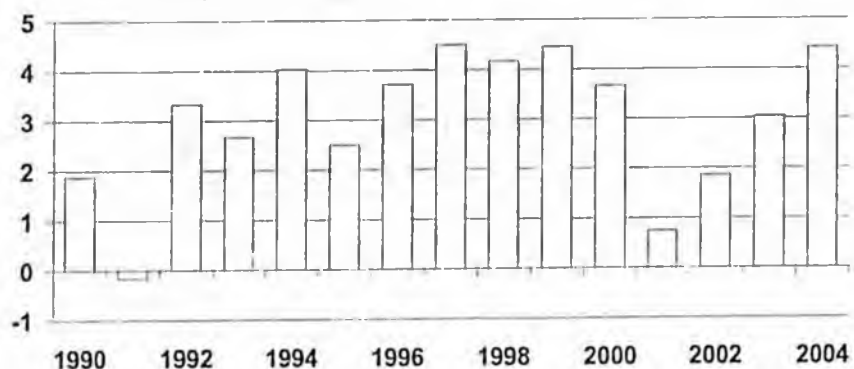
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- Housing markets have peaked but remain strong.
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- Nonresidential construction is beginning a slow recovery, restrained by excess capacity.
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- Exports are rebounding in response to the dollar's depreciation and renewed growth in foreign markets.
- Outlook for 2005 is "good but not great".

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*2004 Saw Best Growth Since the Late 1990s*



(Real GDP, annual percent change)



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## U.S. Economic Growth by Sector



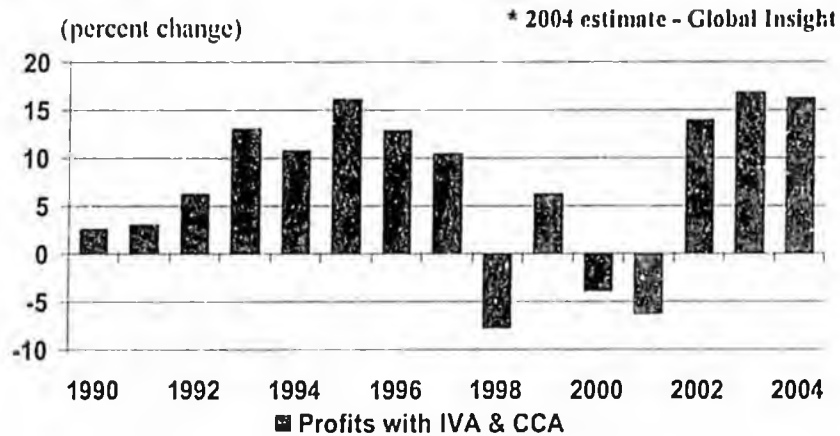
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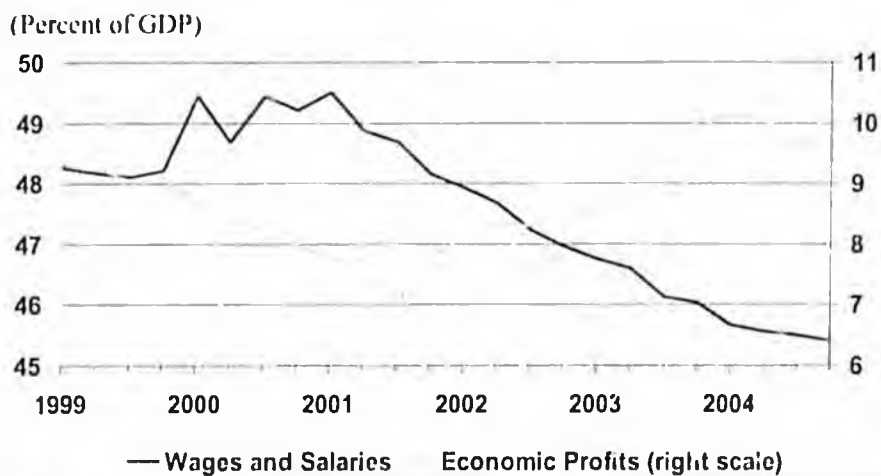


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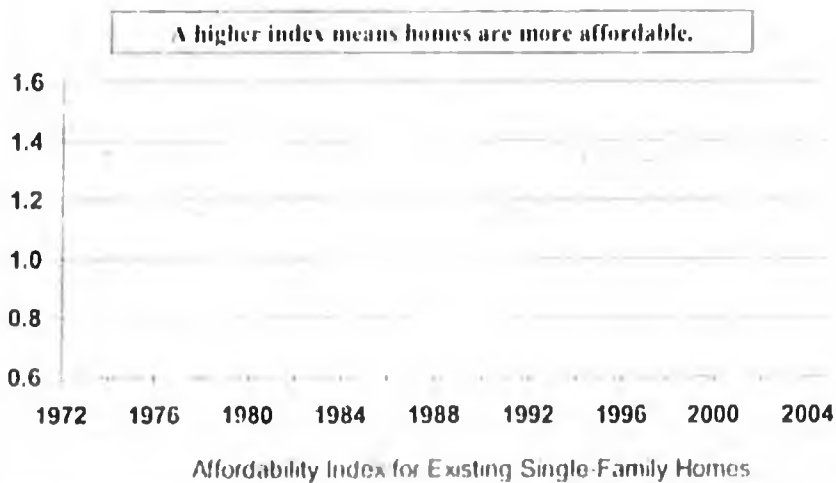
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- Federal tax cuts have boosted disposable income growth for three years. Now tax burdens are likely to rise.
- Debt service burdens and the household financial obligations ratio peaked in late 2001. But rising interest rates will forestall further improvement.
- Net result will be a slowdown, but not a retreat.
- Rising employment and income will drive the next phase of the expansion in consumer spending.
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## Inflation's (Temporary) Resurgence



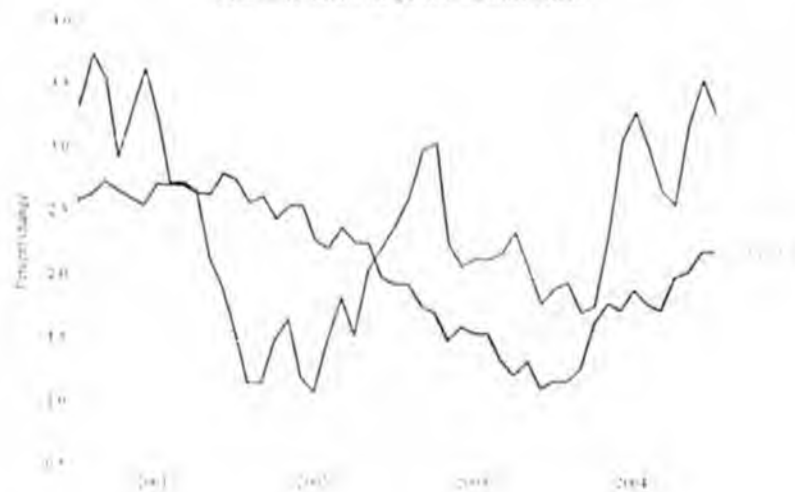
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- Despite the headlines, this recent burst of inflation is temporary.
- Slack labor markets and rising productivity will keep unit labor cost increases in the 2% range.
- Oil prices in the \$40s (or the \$50s) don't mean the same now as in the early 1980s.
- Supply responses will eventually bring down energy prices.
- Bottom line: core inflation will settle in the 2.0-2.5% range after 2004.

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## Inflation Has Ticked Up...



Year-Over-Year Change in Consumer Prices



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## ... But Headline Fears Are Overblown



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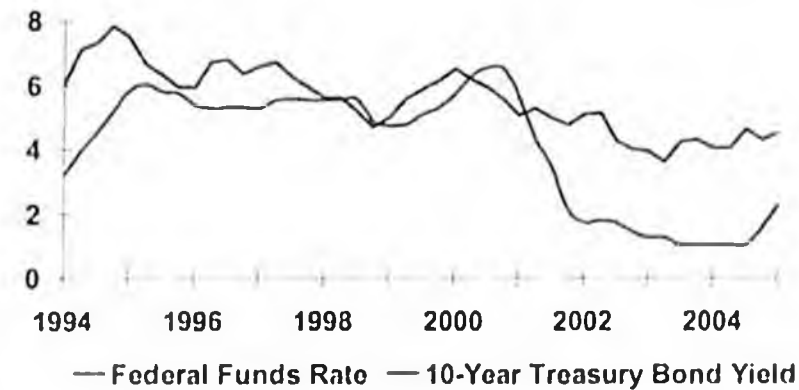
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## The Fed is Moving Toward Neutral

*Interest Rate Increases Should Stay Gradual*

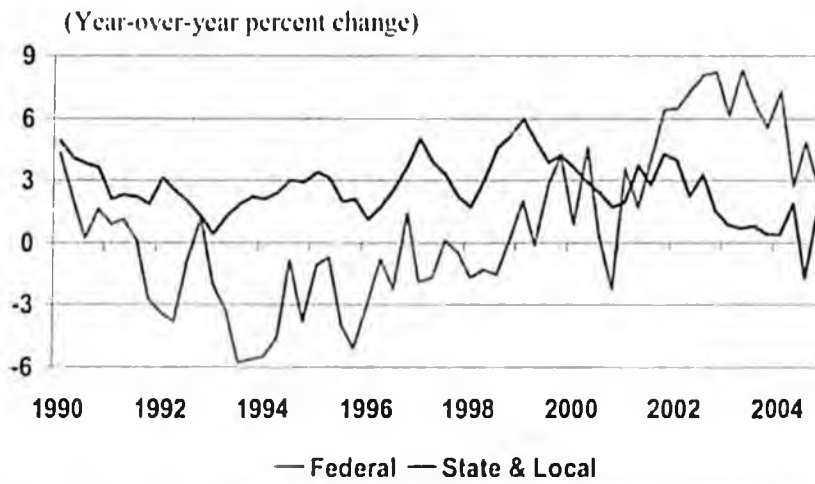


(Percent)



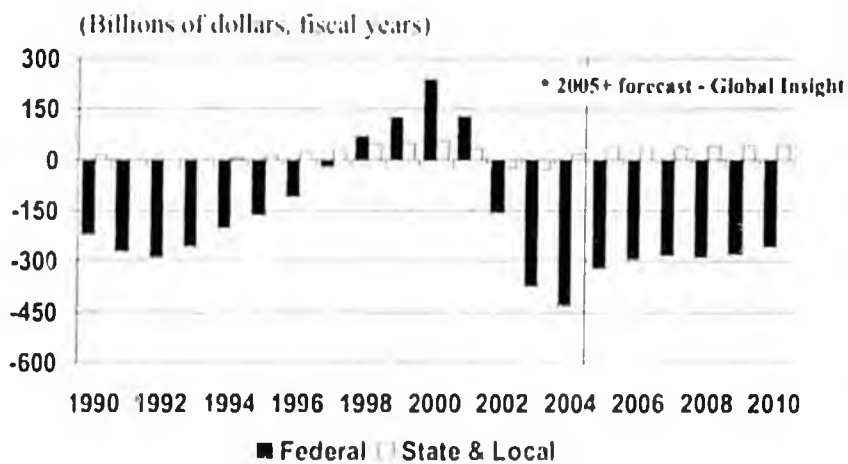
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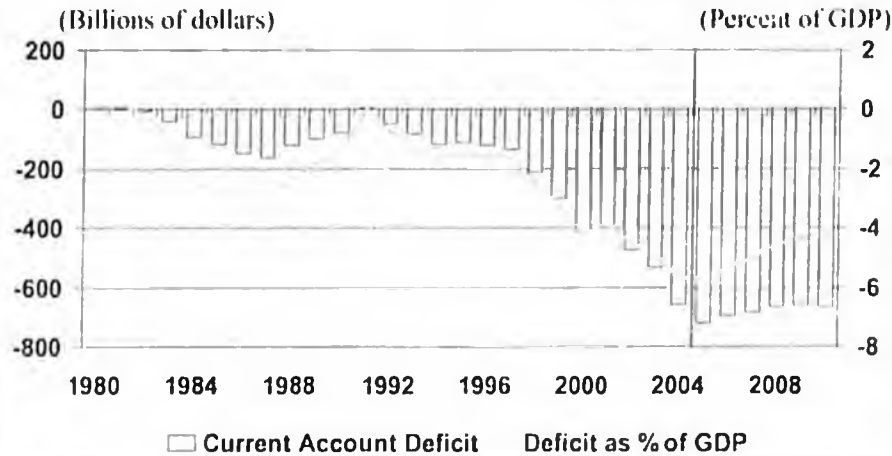


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\* 2005+ forecast - Global Insight



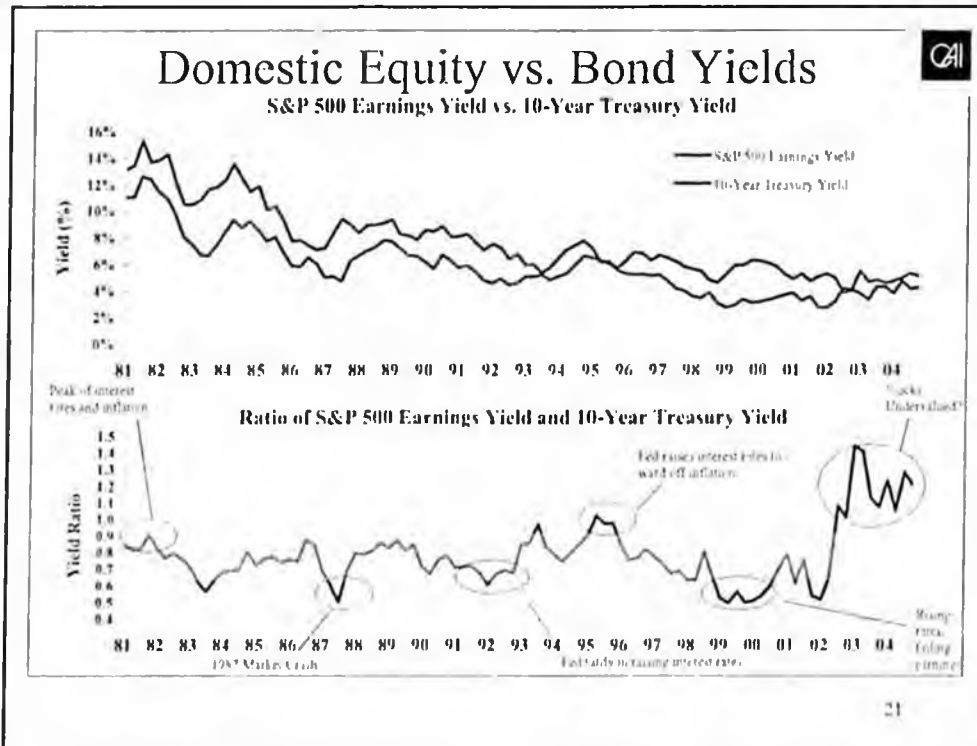
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- The economic recovery will continue, but growth will remain modest. Capital spending will ultimately follow GDP.
- Fed has already shifted to tightening monetary policy.
- The stock market recovery will be slow. Profits cannot outpace GDP, share prices cannot outpace earnings.
- Callan's outlook in a nutshell: expect a low inflation, low interest rate, low return environment.
- Low return expectations mean 8% nominal return assumptions may be difficult to achieve. Callan's 2005 assumptions won't likely generate an expected return for a 60% stock/40% bond allocation greater than 7.4% over the next five years. To the extent possible, investors may need to shift their focus to real return expectations.

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### Bond Market Faces a Challenging Environment

- With inflation in check, investors poured money into bonds following the bursting of the stock market bubble, driving prices up and yields to 40-year lows.
- Corporate (and particularly high yield) spreads widened through 2002, then staged a remarkable comeback in 2003 and 2004.
- Long-term secular decline in inflation since early 80s fueled bond market returns that may not be seen again for a long time.
- Looking forward, current yields and expectations for inflation and interest rates drive expected future returns. With low current yields and the potential for rising interest rates as the economy expands, prospects for future bond market gains may have faded. The best case for bonds is a faltering economy.

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## Domestic Fixed Income



Lehman Aggregate Index - Daily Yield to Worst from 1/1/01 to 12/31/04



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## 2005 Capital Market Projections



- Essentially no changes from last year's projections!
- Inflation is held at 2.6%, depicting inflation rising from current low levels.
- Cash returns reflect rising short-term yields, but still low real return of 0.4%.
- Bond returns held at 4.75% :
  - reflects current yield-to-worst, plus small adjustment
  - build in moderate increase in short rates, relatively stable long rates, higher realized yields on mortgages and shorter term debt is rolled
- Equity returns built from fundamentals: 3-4% real GDP growth which means 5.5%-6.5% nominal earnings growth, 2% dividend yield, 0.5%-1% "buyback" yield.
- Real estate return held at 7.6%, reflecting income expectations as high as 7% but acknowledging potential valuation limits.
- Private equity return held at 12%, a 3% premium over public markets.
- Premiums of international equity over domestic and small cap over large cap have been narrowed, reflecting recent performance and relative valuations.

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## 2005 Capital Market Projections

Summary of 5-Year Capital Market Projections (2005-2009)

Asset Class	Index	Projected	Projected Standard	Projected Yield	2004 Projections	
		Annual Return	Deviation (Risk)			
<b>Equities</b>						
Broad Domestic Equity	Russell 3000	9.00%	16.50	2.10	9.00%	16.50
Large Cap	S&P 500	8.85%	16.40	2.20	8.80%	16.20
Small Mid Cap	Russell 2000	9.85%	22.50	1.20	10.10%	21.50
International Equity	MSCI EAFE	9.25%	20.10	2.20	9.30%	20.30
Emerging Markets Equity	MSCI EM	9.80%	31.00	0.00	9.80%	31.00
<b>Fixed Income</b>						
Domestic Fixed	IB Aggregate	4.35%	4.50	4.75	4.35%	4.50
Defensive	IB Gov 1-5 Year	4.00%	3.15	4.00	4.00%	3.15
HIPS	IB HIPS	4.40%	6.00	4.40	4.40%	6.00
High Yield	CSI High Yield	6.75%	12.10	6.75	6.75%	12.10
Non-US Fixed	CSI Non-US Govt	4.65%	9.60	4.65	4.65%	9.60
<b>Other</b>						
Real Estate	Callan Real Estate	7.60%	16.50	7.00	7.60%	16.50
Private Equity	VI Post Venture Cap	12.00%	13.00	0.00	12.00%	13.00
Absolute Return	*	6.50%	10.50	0.00	6.50%	10.50
Cash Equivalents	90 Day T-Bill	3.00%	0.00	3.00	2.50%	0.50
Inflation	CPI	2.60%	1.40		2.60%	1.40



## Major Asset Classes Only

Asset Mix Alternatives  
Optimization Set 2003

Asset Class	Mix 1	Mix 2	Mix 3	Mix 4	Mix 5	Mix 6	Mix 7	Mix 8	Mix 9	Mix 10	Mix 11
Broad Domestic Equity	15%	20%	30%	40%	50%	60%	70%	80%	90%	100%	110%
International Equity	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
Domestic Fixed	100%	80%	60%	40%	20%	10%	5%	3%	2%	1%	0%
Non-US Fixed	0%	5%	10%	15%	20%	25%	30%	35%	40%	45%	50%
Real Estate	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Private Equity	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Absolute Return	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Cash Equivalents	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Inflation	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%

2/17  
Joint w/ those Fin.  
FK Perm Fund

Hawker  
Stoltz  
Holmes  
Meier  
Chenault  
Croft  
Wey

Crawford  
Olson

Wagner



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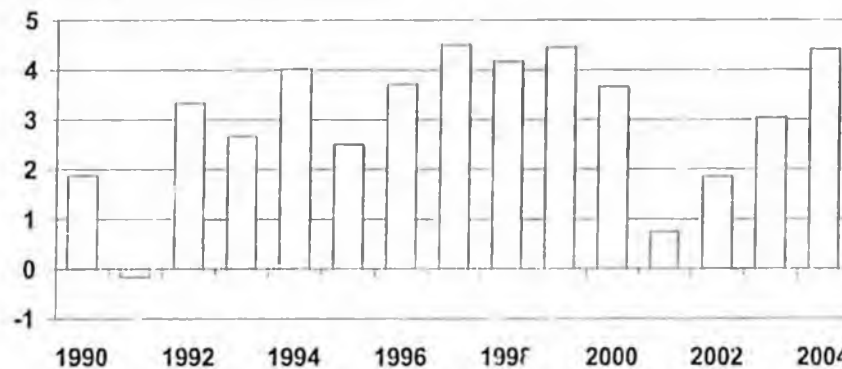
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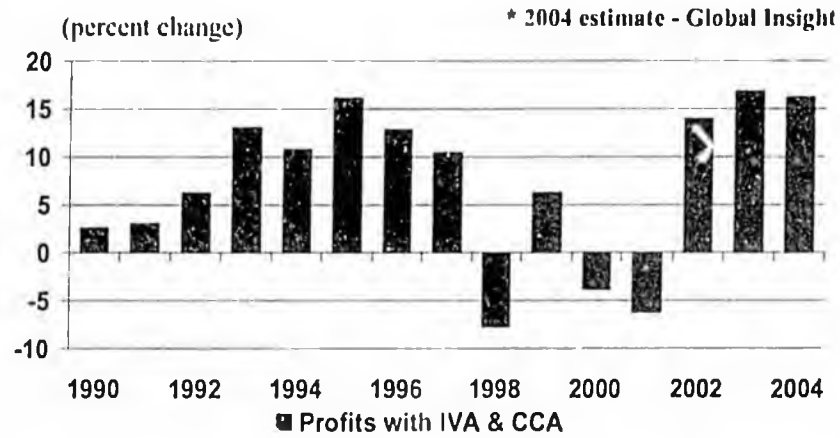
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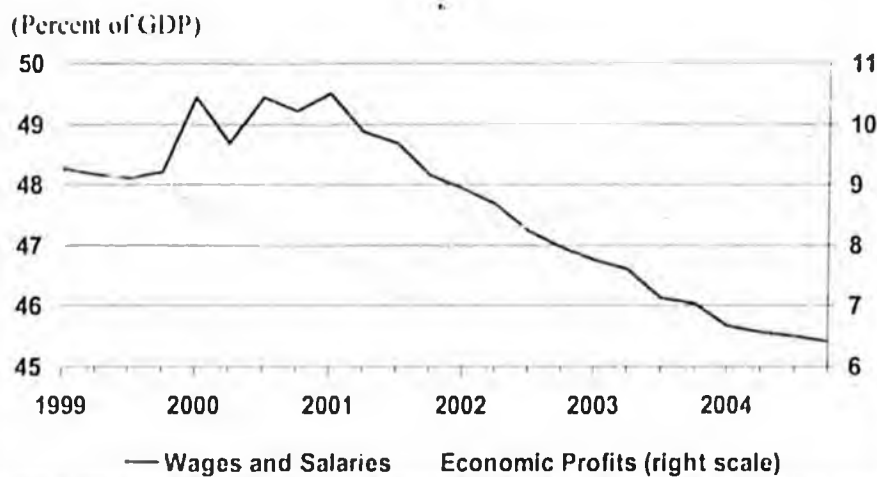


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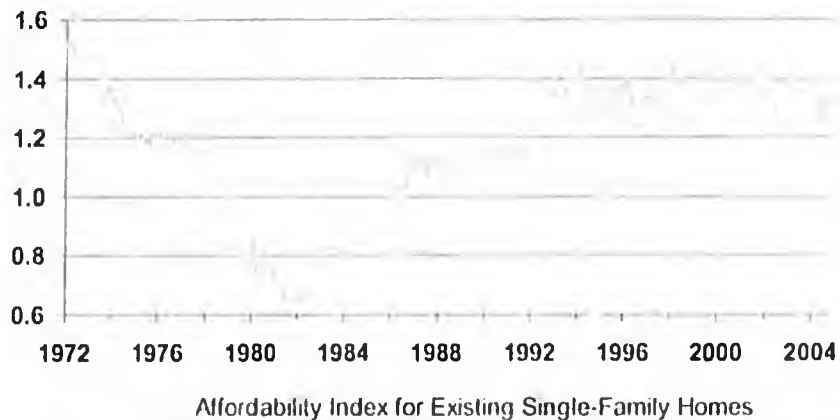
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A higher index means homes are more affordable.



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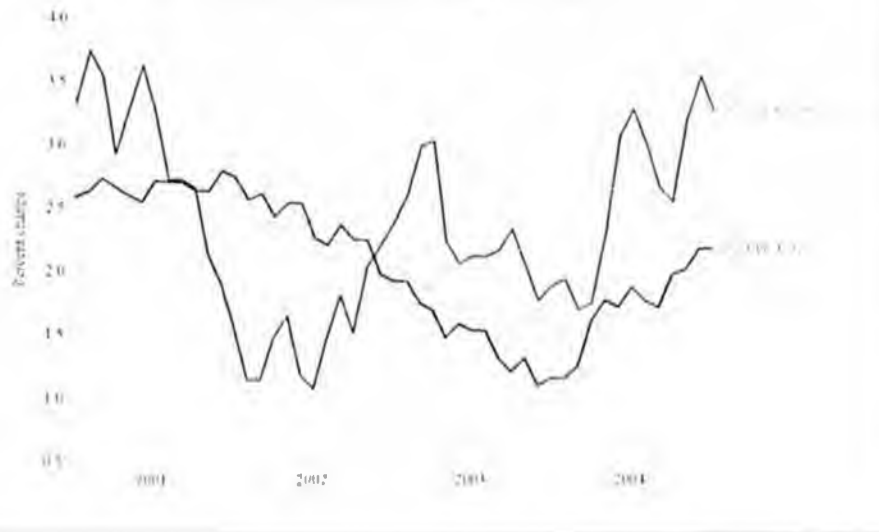
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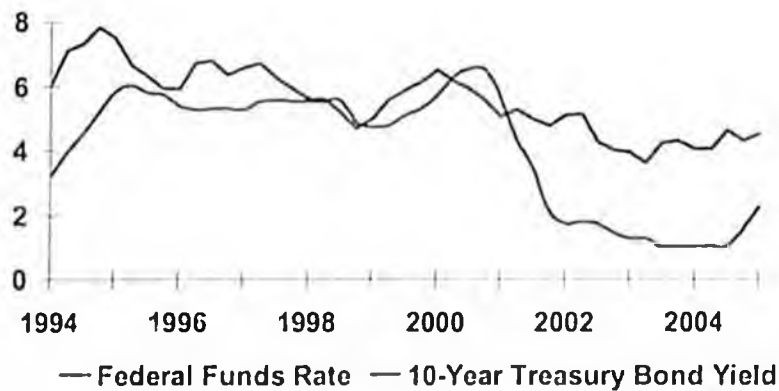


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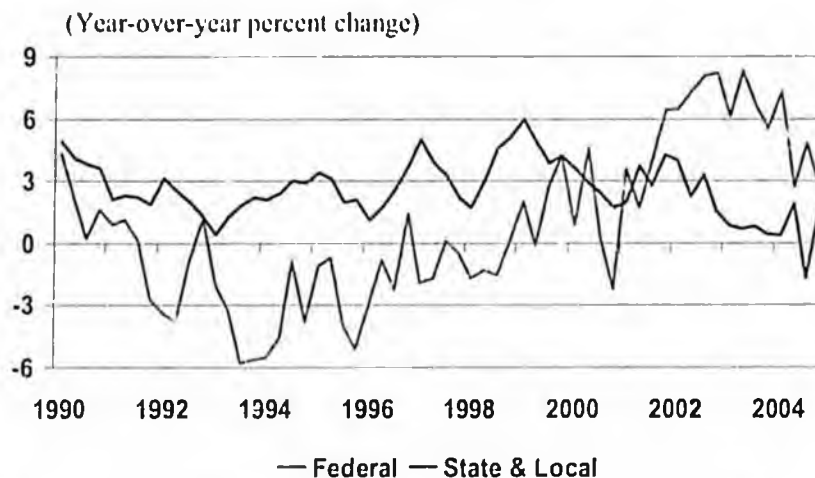


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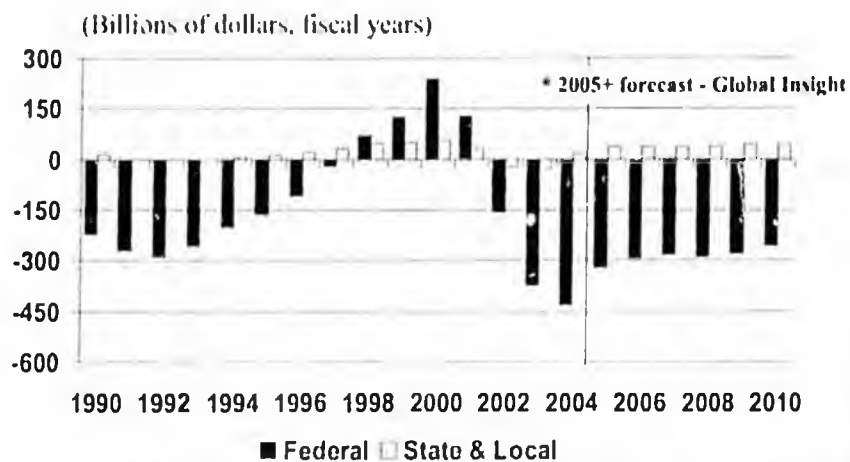
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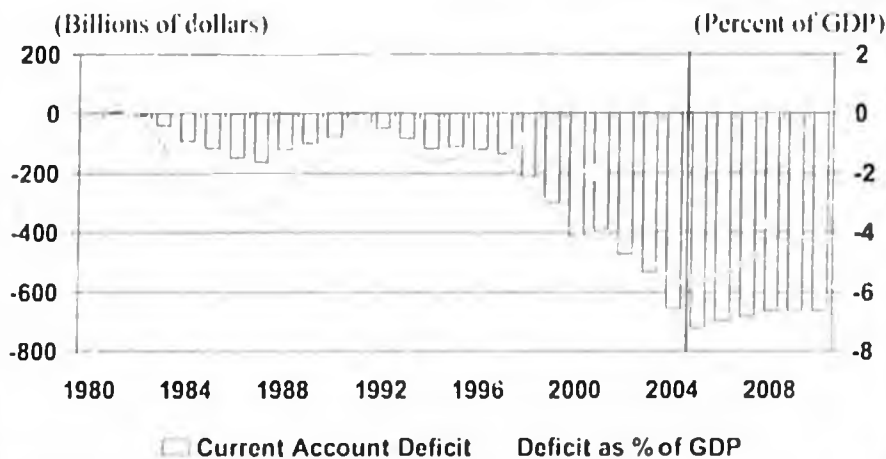


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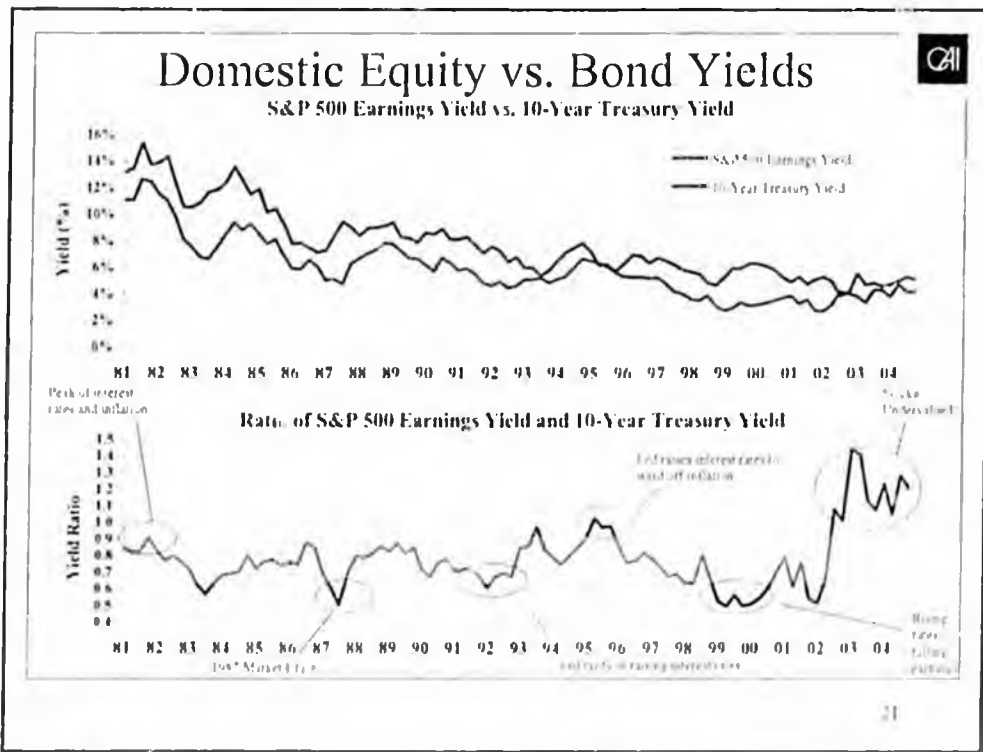
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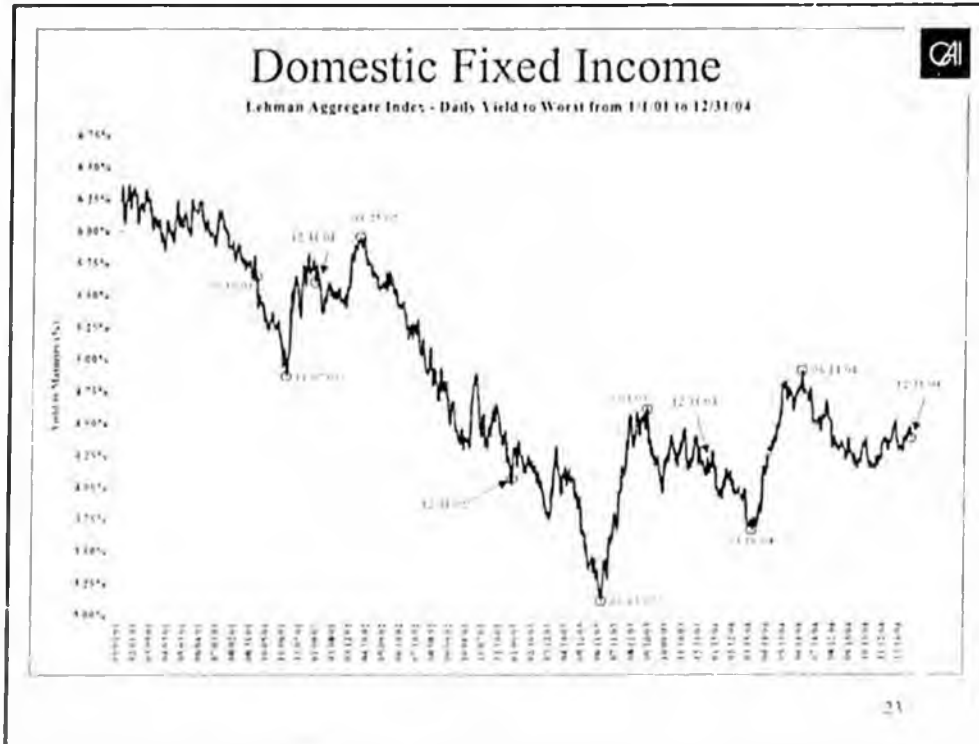
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Summary of 5-Year Capital Market Projections (2005-2009)

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<b>Equities</b>					
Broad Domestic Equity	Russell 3000	9.00%	16.00	2.10	9.00% 16.00
Large Cap	S&P 500	9.45%	16.40	2.20	9.45% 16.20
Small Mid Cap	Russell 2500	9.65%	22.50	1.20	10.10% 23.50
International Equity	MSCI EAFE	9.25%	20.10	2.20	9.10% 20.50
Emerging Markets Equity	MSCI EM	9.60%	31.00	0.00	9.60% 31.00
<b>Fixed Income</b>					
Domestic Fixed	ED Aggregate	4.15%	4.50	4.15	4.15% 4.50
Defensive	ED Govt 1-5 Year	4.00%	3.15	4.00	4.00% 3.15
TIPS	ED TIPS	4.80%	6.00	4.40	4.40% 6.00
High Yield	CSHY High Yield	6.75%	12.10	6.25	6.25% 12.30
Non-USA Fixed	ED Non-USA Govt	4.65%	9.00	4.65	4.65% 9.00
<b>Other</b>					
Real Estate	Global Real Estate	7.00%	16.50	7.00	7.00% 16.50
Private Equity	VI Post-Venture Cap	12.00%	34.00	0.00	12.00% 34.00
Absolute Return	*	6.50%	10.50	0.00	6.50% 10.50
Cash Equivalents	90-Day T-Bill	3.00%	0.00	3.00	2.70% 0.70
<b>Inflation</b>	CPI-U	2.00%	1.40		2.00% 1.40



## Major Asset Classes Only

Asset Mix Alternatives  
Optimization Set - 2005

	Mix 1	Mix 2	Mix 3	Mix 4	Mix 5	Mix 6	Mix 7	Mix 8	Mix 9	Mix 10	Mix 11
Equities	40%	45%	50%	55%	60%	65%	70%	75%	80%	85%	90%
Fixed Income	50%	45%	40%	35%	30%	25%	20%	15%	10%	5%	0%
Real Estate	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
Private Equity	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Absolute Return	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Cash	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Inflation	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Expected Return	10.5%	11.5%	12.5%	13.5%	14.5%	15.5%	16.5%	17.5%	18.5%	19.5%	20.5%
Standard Deviation	16.0%	17.0%	18.0%	19.0%	20.0%	21.0%	22.0%	23.0%	24.0%	25.0%	26.0%
Sharpe Ratio	0.65	0.67	0.69	0.71	0.73	0.75	0.77	0.79	0.81	0.83	0.85



Official Business

# Alaska State Senate

## Senate Finance Committee

Mail Stop 3100  
State Capitol  
Juneau, Alaska 99801-1182

### AGENDA

February 17, 2005

10:00 a.m.

Presentation by the Alaska Permanent Fund Board &  
Advisors

Joint Meeting with House Finance Committee

# Senate Bill 88

*A Bridge to Development*



*A Policy on General Fund  
Revenue Shortfall*

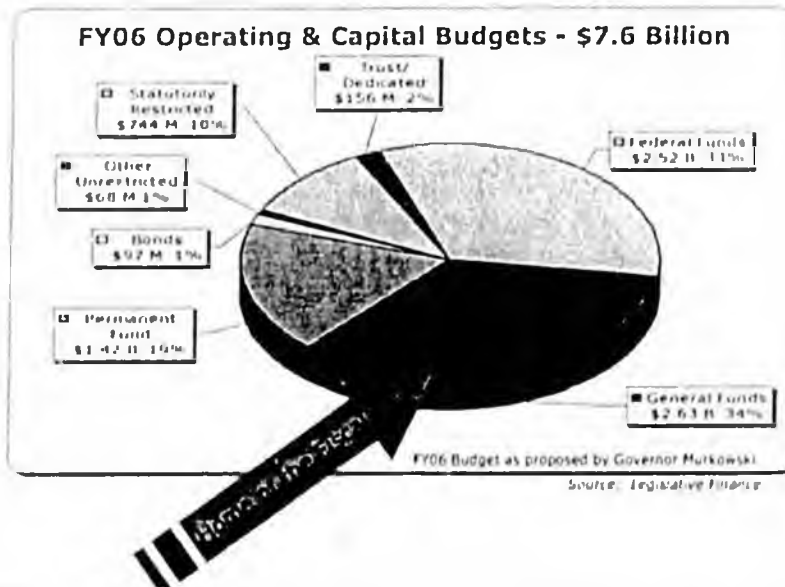
*February 15, 2005*

"It is the policy of the State of Alaska that the amounts necessary to cover a projected shortfall in general fund revenue during a fiscal year be appropriated equally from the Constitutional Budget Reserve fund and the Earnings Reserve Account."

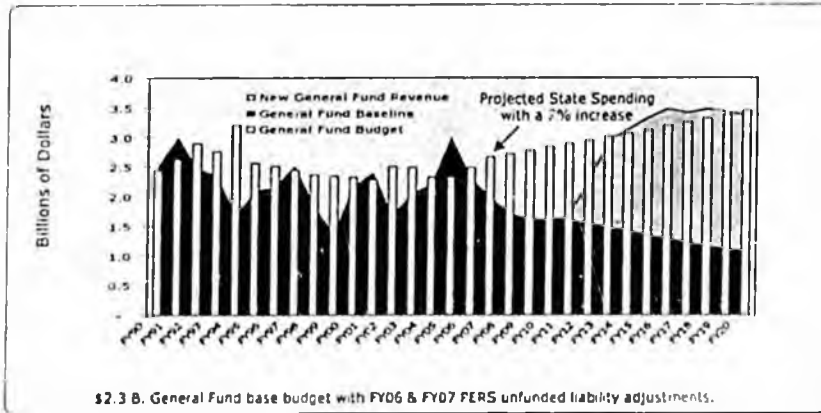
AS 37.07.010 Executive Budget Act

SB 88  
says

Why? Where's the problem?



# ... What's the problem?



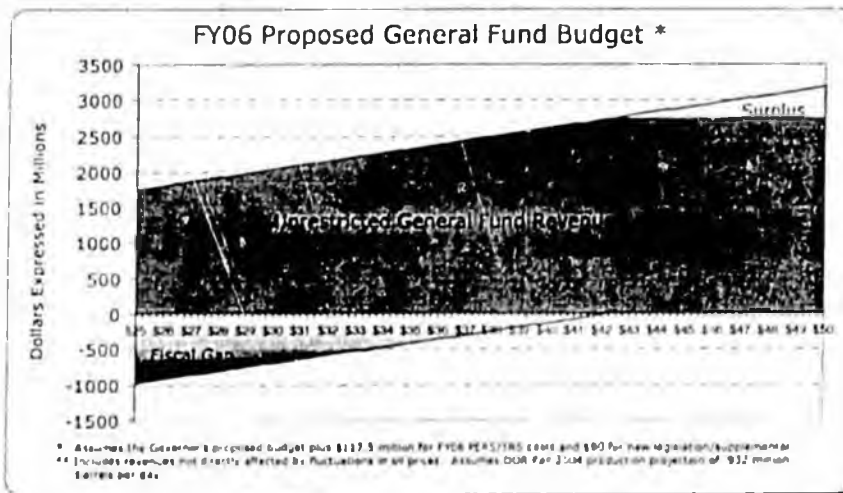
Source: Legislative Finance

General Fund revenue can be less than General Fund expenditures.

4

# ... and things can change quickly

*"For the Good or for the Bad"*



Source: Legislative Finance

... and they have

**ALASKA CONSTITUTION  
ARTICLE IX**

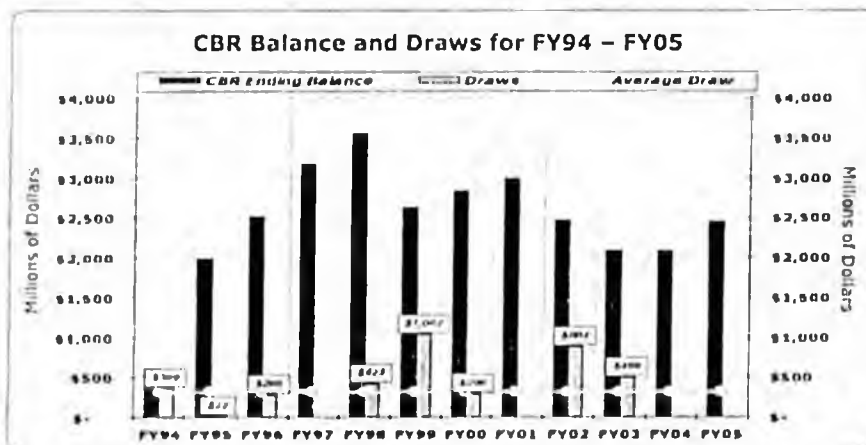
**Section 17. Budget Reserve Fund (a)**  
There is established as a separate fund in the State treasury the budget reserve fund. Except for money deposited into the permanent fund under Section 15 of this article, all money received by the state after July 1, 1990, as a result of the termination, through settlement or otherwise, of an administrative proceeding or of litigation in a State or federal court involving mineral lease bonuses, rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments of bonuses, or involving taxes imposed on mineral income, production, or property, shall be deposited in the budget reserve fund. Money may be appropriated from the fund only as authorized under (b) or (c) of this section.

Voters approved amendment in 1990.

- The CBR has been used to fill the fiscal gap 8 out of 12 years.
- Approximately \$5.5 billion has been withdrawn.
- The state has deposited into the CBR \$5.6 billion and earned \$1.6 billion in interest.

6

... for example



Source: Legislative Finance

- Draw 8 out of 12 years
- Average draw \$318 M
- Current balance \$2.1 B

7

## ... Alaska is a resource state

"Alaska has about 22 percent of the nation's 'known' oil reserves and 19 percent of the country's known natural gas."  
 Governor Murkowski, 12/14/2003

"TransCanada submits application to state, says 2012 start-up possible"  
 Petroleum News, 6/6/04

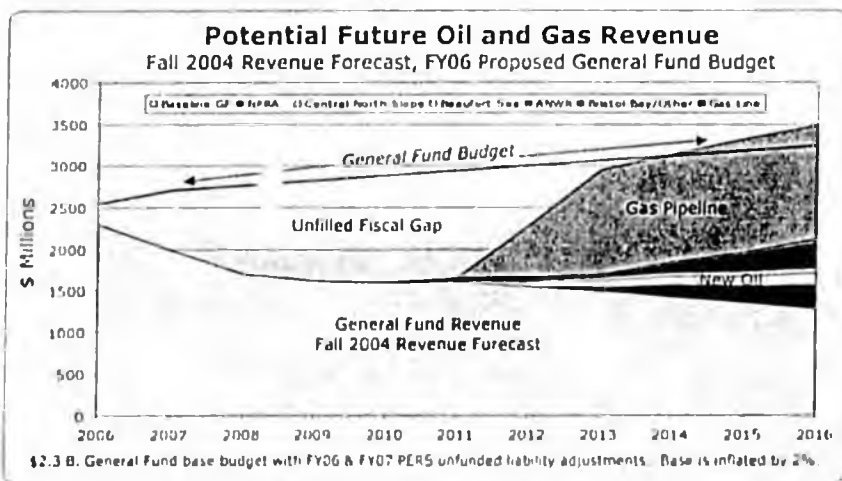
"Alaska officials consult bankers on gas pipeline"  
 Bond News, May 27, 2004

"\$53.9 million in NPR-A bids offered"  
 Fairbanks Daily News-Miner, 6/3/04

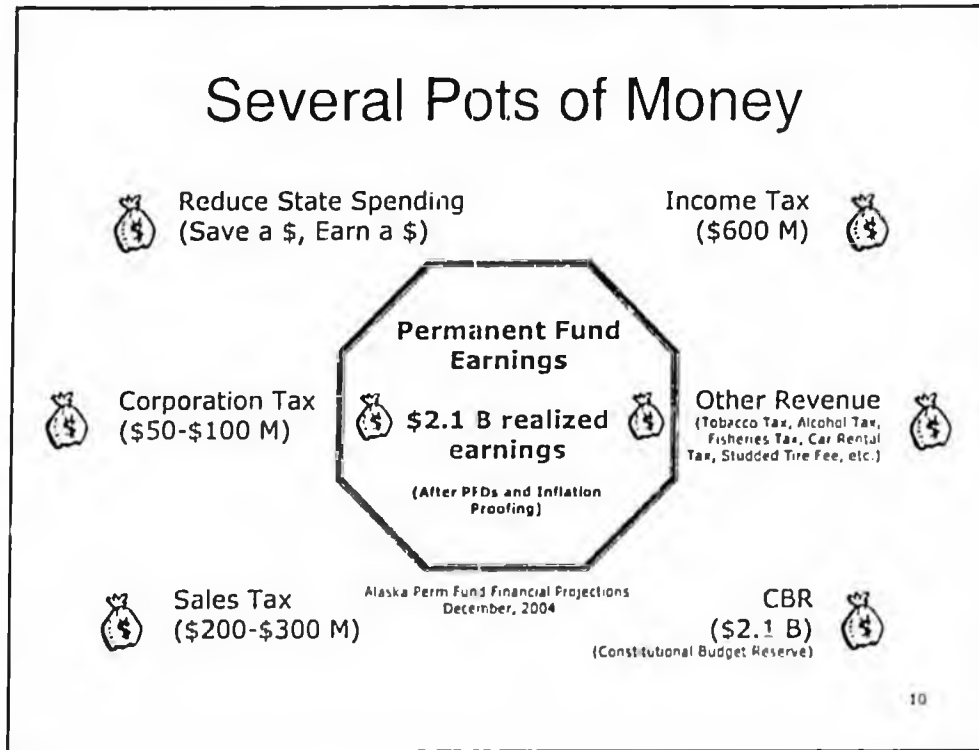
Federal land managers proposed giving oil drillers access to a forbidden chunk of the North Slope national Petroleum reserve."  
 Anchorage Daily News, 6/10/04

## ... a bridge is needed

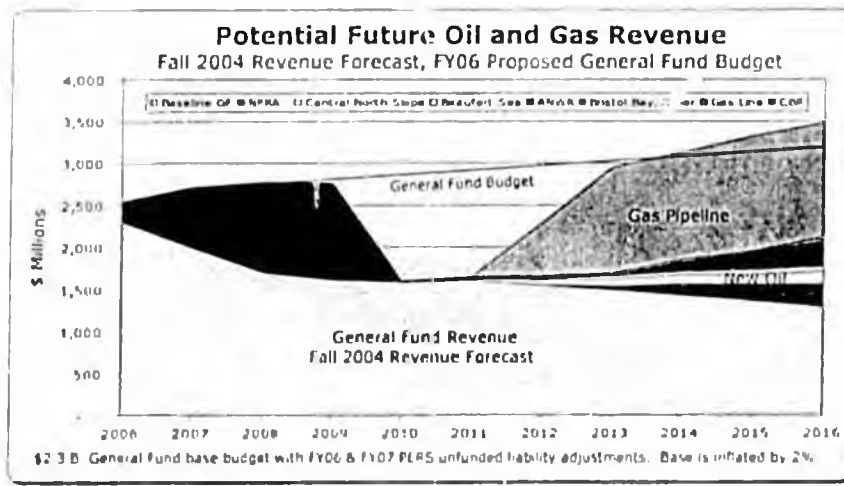
From Today to Development



# Several Pots of Money



... why not just the CBR?

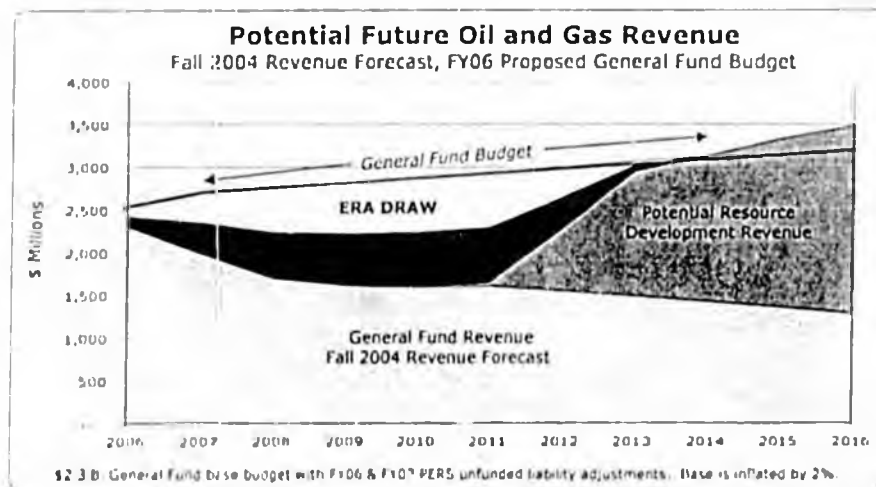


... so what if . . .

The Legislature splits the future fiscal gaps with equal contributions from the Constitutional Budget Reserve and the Earnings Reserve Account?  
(SB 88)

12

... and we build a bridge



13

... but can we?

**An Alaskan's  
Guide to the Permanent Fund**

The Fund would help create an investment base to continually generate future income. When oil ran out, Alaska would still have a major source of state revenues. Alaskans could use these revenues to pay the costs of basic government services, or for whatever purposes future generations of Alaskans decided.

Each year, the Fund would channel a significant portion of the oil revenues away from the legislature. Less state income reduces the opportunity for excessive state spending.

The Fund would transform non-renewable oil wealth into a renewable source of wealth for future generations of Alaskans.

Alaska Permanent Fund Corporation  
9th Edition, 1998, Pages 1 & 2

Yes, We Can!!!!

The Earnings Reserve Account, a result of wise investment of our Permanent Fund, has been and still is available to the legislature by a simple majority vote of 21-11.

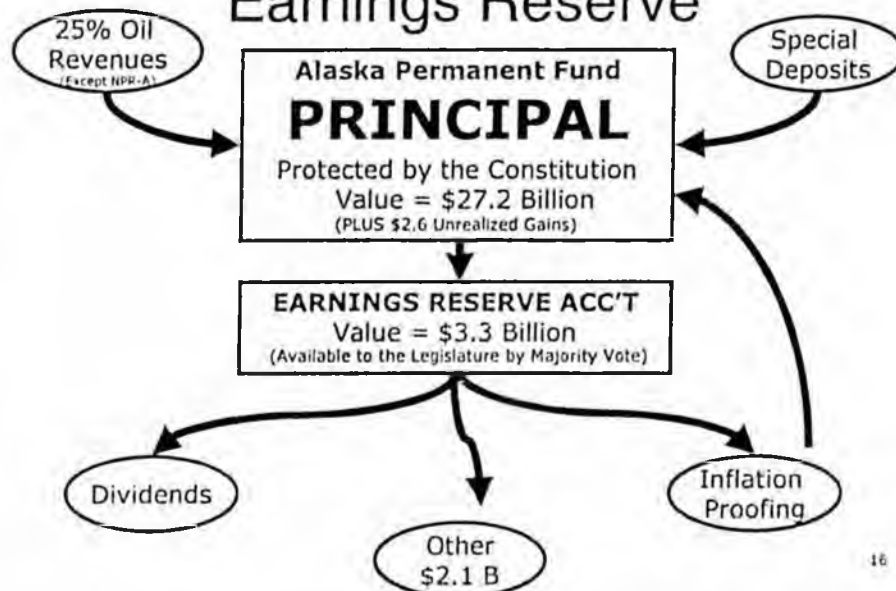
PF financial projections say ...

**ALASKA PERMANENT FUND  
PFND FINANCIAL HISTORY & PROJECTIONS**  
As of December 31, 2004

Historical Fund Balance - Projection				Historical Fund Balance - Projection				Historical Fund Balance - Projection			
Year	Oil	Gas	Total	Year	Oil	Gas	Total	Year	Oil	Gas	Total
1982	100	0	100	1992	100	0	100	2002	100	0	100
1983	100	0	100	1993	100	0	100	2003	100	0	100
1984	100	0	100	1994	100	0	100	2004	100	0	100
1985	100	0	100	1995	100	0	100	2005	100	0	100
1986	100	0	100	1996	100	0	100	2006	100	0	100
1987	100	0	100	1997	100	0	100	2007	100	0	100
1988	100	0	100	1998	100	0	100	2008	100	0	100
1989	100	0	100	1999	100	0	100	2009	100	0	100
1990	100	0	100	2000	100	0	100	2010	100	0	100
1991	100	0	100	2001	100	0	100	2011	100	0	100
1992	100	0	100	2002	100	0	100	2012	100	0	100
1993	100	0	100	2003	100	0	100	2013	100	0	100
1994	100	0	100	2004	100	0	100	2014	100	0	100
1995	100	0	100	2005	100	0	100	2015	100	0	100
1996	100	0	100	2006	100	0	100	2016	100	0	100
1997	100	0	100	2007	100	0	100	2017	100	0	100
1998	100	0	100	2008	100	0	100	2018	100	0	100
1999	100	0	100	2009	100	0	100	2019	100	0	100
2000	100	0	100	2010	100	0	100	2020	100	0	100
2001	100	0	100	2011	100	0	100	2021	100	0	100
2002	100	0	100	2012	100	0	100	2022	100	0	100
2003	100	0	100	2013	100	0	100	2023	100	0	100
2004	100	0	100	2014	100	0	100	2024	100	0	100
2005	100	0	100	2015	100	0	100	2025	100	0	100
2006	100	0	100	2016	100	0	100	2026	100	0	100
2007	100	0	100	2017	100	0	100	2027	100	0	100
2008	100	0	100	2018	100	0	100	2028	100	0	100
2009	100	0	100	2019	100	0	100	2029	100	0	100
2010	100	0	100	2020	100	0	100	2030	100	0	100
2011	100	0	100	2021	100	0	100	2031	100	0	100
2012	100	0	100	2022	100	0	100	2032	100	0	100
2013	100	0	100	2023	100	0	100	2033	100	0	100
2014	100	0	100	2024	100	0	100	2034	100	0	100
2015	100	0	100	2025	100	0	100	2035	100	0	100
2016	100	0	100	2026	100	0	100	2036	100	0	100
2017	100	0	100	2027	100	0	100	2037	100	0	100
2018	100	0	100	2028	100	0	100	2038	100	0	100
2019	100	0	100	2029	100	0	100	2039	100	0	100
2020	100	0	100	2030	100	0	100	2040	100	0	100
2021	100	0	100	2031	100	0	100	2041	100	0	100
2022	100	0	100	2032	100	0	100	2042	100	0	100
2023	100	0	100	2033	100	0	100	2043	100	0	100
2024	100	0	100	2034	100	0	100	2044	100	0	100
2025	100	0	100	2035	100	0	100	2045	100	0	100
2026	100	0	100	2036	100	0	100	2046	100	0	100
2027	100	0	100	2037	100	0	100	2047	100	0	100
2028	100	0	100	2038	100	0	100	2048	100	0	100
2029	100	0	100	2039	100	0	100	2049	100	0	100
2030	100	0	100	2040	100	0	100	2050	100	0	100

December 31, 2004

## Our Permanent Fund and our Earnings Reserve



## Alaska's Crown Jewels

... The Constitutional Budget Reserve fund and the Earnings Reserve Account ...



- Only legislature in America deciding how to manage \$31 billion for 650,000 people
- Every minute, every hour, every day, the world helps build Alaska by
  - Investing in corporate America
  - Investing in America's society
  - Investing in America's future
- The CBR and the ERA form the abutment to our Bridge to Development

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## ... but what about my check

How much less is my PFD if the Legislature draws \$250 M from the ERA each year?

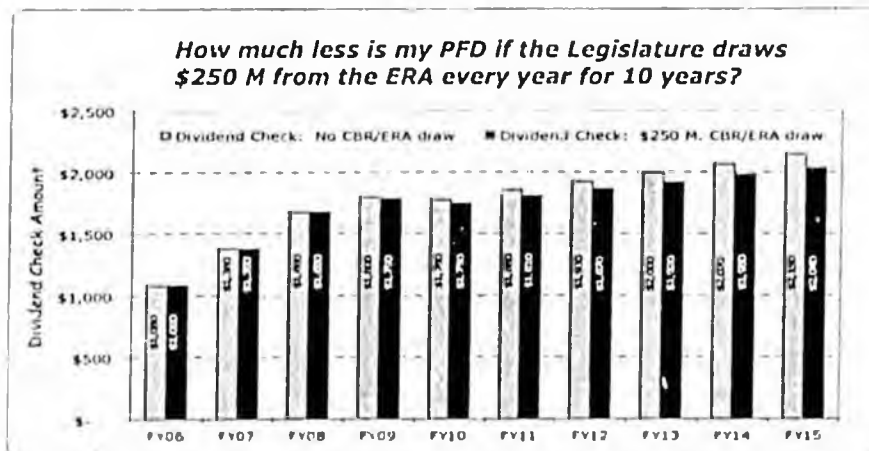
Fiscal Gap (millions)	ERA Draw (millions)	Fiscal Years Ahead									
		1	2	3	4	5	6	7	8	9	10
200	100	\$0	\$2	\$4	\$7	\$12	\$18	\$25	\$31	\$38	\$44
300	150	\$0	\$2	\$5	\$11	\$18	\$27	\$37	\$47	\$56	\$66
400	200	\$0	\$3	\$7	\$14	\$24	\$36	\$49	\$62	\$75	\$88
500	250	\$0	\$3	\$9	\$18	\$30	\$45	\$61	\$77	\$93	\$110
600	300	\$0	\$4	\$11	\$21	\$36	\$54	\$73	\$93	\$112	\$132
700	350	\$0	\$4	\$12	\$25	\$42	\$63	\$85	\$108	\$131	\$154
800	400	\$0	\$5	\$14	\$28	\$48	\$72	\$98	\$123	\$149	\$176
900	450	\$0	\$6	\$16	\$32	\$54	\$81	\$110	\$139	\$168	\$199
1,000	500	\$0	\$6	\$18	\$35	\$60	\$90	\$122	\$154	\$187	\$221

Source: Legislative Finance (Based on 7.6% rate of return, Perm Fund Financial Projections, Dec. 31, 2004)

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## ... how does this compare to status quo?


How much less is my PFD if the Legislature draws \$250 M from the ERA every year for 10 years?





Source: Legislative Finance

Answer: In five years, it's 30 less. In ten years, it's \$110 less. 19

## ... let's compare alternative revenue sources.

  
**Income Tax**  
 Raise \$250 Million  
 Cost \$1,000  
 (\$57,000 Adj. Gross Income)  
 Source: Department of Revenue

  
**Sales Tax**  
 Raise \$250 Million  
 Cost \$950  
 (\$57,000 Adj. Gross Income)  
 Source: Department of Revenue (2.75% Sales Tax)

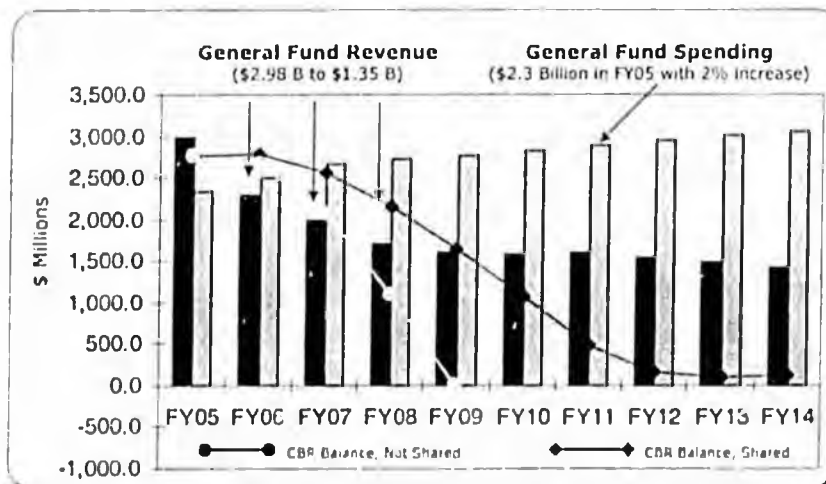
  
**Earnings Reserve**  
 Raise \$250 Million  
 Cost \$12  
 (Slide 18)  
 Source: Legislative Finance

Under the Bridge to Development Plan (SB 88), all Alaskans share in the Power of Earnings.

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Information is based on the second year of implementation

## ... but does this help the CBR?



Source: Legislative Finance - expected CBR return @ 4.7% plus expected settlements

21

. . . let's use only when needed

Senate Bill 88 demands spending accountability because . . .

- (1) the Earnings Reserve Account is the people's money and
- (2) each legislator must answer to the public on how much was spent from the Earnings Reserve to fund state services.

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. . . and to summarize

*The Bridge to Development Plan*



Bridges the State of Alaska revenue needs until development can occur



Recognizes Alaska's natural resource potential and opportunity for jobs



Recognizes the power of the Earnings Reserve - *the crown jewel of a fiscal plan*



Establishes accountability by forming a investment partnership with all voters

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. . . and . . .



When needed, minimizes the financial impact on Alaska families



Doubles the life of the CBR



Strengthens the Alaska's bond rating and saves millions of dollars



Provides Alaska with a stable and dependable long term fiscal plan

**Thank You!**

Gary Wilken, Prime Sponsor  
Senate Bill 88

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