

ALASKA LEGISLATURE COMMITTEE BILL FILES - 1987 - 1988 8879

HB 547 cont. 400

Finally, item (6) (b) (3) significantly restricts the manager's ability to fully participate in above average performance in some of the smaller markets. In Appendix II I have highlighted some of the excellent returns achieved in countries like Italy, Switzerland, The Netherlands and Hong Kong. All of these markets are restricted to a 10% weighting. In the case of Germany the maximum permitted weighting in 1985 was 20% which in my opinion was too restrictive.

I hope this is useful for your discussion of guidelines later this month. I am looking forward to seeing you in Anchorage on October 29th

Best regards

Yours sincerely

*Paul Lambert*

Because our experience until recently has been equity investing, we have confined our remarks to the effect investment restrictions have on investing in the stock market. In brief, we believe that investment restrictions, by putting large segments of the market off-limits, tend to reduce investment results without necessarily lowering the risk involved.

The guideline restricting investments to the common stock of companies that have paid dividends in each of the three years immediately preceding the investment, we would argue, is an outmoded rule which provides little information about a company's financial condition or the appropriateness of a company's stock as an investment. A company with a solid dividend payment record could produce lower earnings in the future, thereby jeopardizing future dividend payments and lowering its stock price. Similarly, the fact that a company does not pay a dividend is not an indication of its financial position or the attractiveness of its stock as an investment vehicle.

A company's dividend policy is more a function of the company's stage in its life cycle. Often, dividend-paying companies are more mature, slower-growing companies whose net profits exceed the profitable investment opportunities their own businesses offer. Companies which pay no dividends are typically rapidly growing companies whose internal business ventures offer investment returns in excess of other investment vehicles. Profits are retained to foster future earnings growth through the construction of manufacturing facilities, the development of distribution networks and research and development.

The guideline restricting investments to stocks which are listed upon a stock exchange, in our view, again limits investment opportunities while not necessarily reducing risk. With the development of the National Association of Securities Dealers Automated Quotation (NASDAQ) System, the over-the-counter market has become a securities market with reliable statistics and adequate liquidity through the existence of multiple market makers. NASDAQ currently lists roughly 5,000 stocks versus 2,300 for the New York Stock Exchange and 800 for the American Stock Exchange. The companies on NASDAQ range from small, relatively new companies to larger, more established corporations such as MCI Communications, Apple Computer, Intel Corporation, Liz Claiborne, and Genentech. This segment of the stock market represents a dynamic, capital-creating sector since many of these companies generate economic growth through the creation of new jobs and the introduction of new products and services. While this segment of the market may not offer the best investment opportunities at all times, a guideline prohibiting investment in that market severely restricts an investment manager's ability to act on the best investment opportunities available.

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An extensive study by Roger G. Ibbotson and Rex A. Sinquefeld, compared nominal and real rates of return and levels of risk for portfolios of the Standard and Poor's Composite Stock Price Index, representing the common stocks of many large corporations, and small capitalization stocks, representing the fifth (smallest) quintile of the New York Stock Exchange, for the 60-year period December 31, 1925 to December 31, 1985. The standard deviation, a measure of variation in average results, indicates the degree of risk, with a higher standard deviation expressing a higher degree of risk. The table below shows that common stocks have a higher degree of risk than low-risk Treasury bills, but also had a significantly higher average annual rate of return. In turn, smaller capitalization stocks offer a higher rate of return.

	Average Annual Rate of Return (Nominal)	Average Annual Rate of Return (Real)	Standard Deviation
Common Stocks	12.0%	8.8%	21.2%
Small Capital- ization stocks	18.3	14.8	36.0
Treasury Bills	3.5	0.4	3.4

Source: Stocks, Bonds, Bills and Inflation: 1986 Yearbook.  
(Chicago: Ibbotson Associates, 1986)

We would cite two specific examples from our own recent experience to illustrate why investment restrictions do not reflect current market conditions and, hence, needlessly limit investment opportunities.

One of our largest holdings at year-end 1986 was Digital Equipment Corporation (DEC), the second largest computer manufacturer in the world, with \$7.6 billion in revenues and \$617 million in profits in fiscal 1986. It has been in business for almost 30 years. By most standards it is one of America's leading corporations. In 1986 it also was a good investment, closing the year at \$104.75 a share, for a gain of 58%. However, like many high-growth technology companies, DEC pays no dividends. Because of investment guideline restrictions, a few of our clients were not permitted to benefit from this investment opportunity.

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Genentech, the leading biotechnology company, is another company which pays no dividends and, furthermore, trades in the over-the-counter market. It, too, was one of our largest holdings in 1986. Its stock's performance has been extraordinary, with the per share price ending 1986 at \$85 a share, for a gain of \$50.13 a share or 144%. Again, this superlative investment opportunity was lost to those of our clients with investment restrictions.

In arguing against restrictions of any kind, we would advance one final illustration of how restrictions can impede performance results. Among our 25 largest holdings at year-end 1986 were five drug companies. Their inclusion in our portfolio reflected our view that exciting new products would produce a stream of high profits which would be further enhanced by the decline in the foreign exchange value of the dollar. As the table below shows, our analysis proved correct and this industry was among the top ten industry groups in 1986. However, one of our clients gained nothing from this investment strategy since its investment guidelines prohibit investing in drug companies.

	Percent Gain in 1986
Bristol-Myers	24.7%
Lilly	33.2
Merck	80.8
Schering-Plough	35.9
Upjohn	39.7

In conclusion, investment guidelines, by restricting the types of stocks suitable for investing, can result in a poorly diversified portfolio, so the return on the portfolio, given its level of risk, might well be lower than it would be with a better diversified portfolio. We have cited specific cases where current restrictions have prevented our clients from obtaining superior investment results. Since these restrictions can lower investment returns without reducing the risk to capital, they do not serve the best interests of the funds.

# INVESCO CAPITAL MANAGEMENT

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January 12, 1987

Mr. James R. Wilson  
State Investment Officer  
State of Alaska  
Department of Revenue  
Treasury Division - Pouch SB  
Juneau, Alaska 99811

Dear Jim:

This letter and the enclosed documents are in response to your request for INVESCO's views concerning the legislation being submitted in Alaska relative to your existing investment restrictions and the proposed "prudent institutional investor" rule. Rather than attempt to present a formal organized response, I hope you will permit me to present our thoughts in a random manner, first by making general observations and, secondly, by addressing specific restrictions.

## General Observations

1. First, you must understand that the typical money manager has an inherent bias against having any restrictions placed on his ability to make investment decisions on behalf of his clients. The attitude might best be characterized as "If you show enough confidence in us to pay us a large fee and give us full discretion, don't then inhibit our ability to make the best investment decisions on your behalf by imposing unnecessary restrictions on us."
2. There is a basic inconsistency in, on the one hand, hiring an outside manager and giving him full discretion on investment decisions and then imposing arbitrary restrictions limiting his ability to make those investment decisions. Hiring an outside discretionary manager implicitly acknowledges that 1) the investment expertise is unavailable in-house at a reasonable cost and 2) is a display of confidence in the investment expertise of the outside manager. The inconsistency lies in the fact that, having made the implicit acknowledgement that the investment decisions can best be made by someone else, to then, in effect, make investment decisions via the imposition of arbitrary restrictions on that outside manager is a contradiction-in-terms.
3. Many years ago, when most investment guidelines and restrictions were established, the money management industry was very small, largely unregulated, with widely varying levels of expertise, and rapid turnover. These characteristics cried out for the imposition of guidelines and restrictions in order to ensure some structure and order and a reasonable outcome. In the last ten to twenty years, however, the money management profession has become highly professional, highly disciplined, highly educated, highly motivated, and closely regulated. These characteristics are

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consistent with a relaxation or elimination of flexibility-reducing restrictions since they are simply unnecessary. To permit a doctor to practice his profession but limit the medical devices and medicines he is permitted to use would be an extreme, but apropro, analogy.

4. Most public plans with which we are aware include both a prudent man rule and some investment restrictions, although the inclusion of the prudent man rule frequently is done simultaneously with a reduction and/or elimination of many restrictions. But in a sense, the requirement that an outside money manager act under the prudent man rule (and, particularly, if he is required to act in the newer expanded versions of the prudent man rule, i.e., the "prudent expert" or "prudent institutional investor" rule) and then is also required to operate under an extensive list of restrictions and guidelines is redundant, at best, and inevitably leads to reduced returns or heightened risks, or both, at worse. Since the money manager never physically is permitted to touch securities of any kind (that function being performed by the custodian bank) and management contracts typically call for termination of the contract on 30 days notice, there is an overpowering built-in pressure on money managers to act prudently since this is the surest way of insuring a continuation of the investment management relationship and the resulting continuing flow of fee income.
5. The very nature of investing has changed dramatically in the last twenty years but in many cases plan sponsors, through their investment guidelines and restrictions, have changed little or not at all to conform to the new market realities. Twenty or so years ago the investment decision-making process was unstructured, haphazard, and often random, with only a few available investment vehicles largely limited to stocks and bonds, stock and bond prices were quite stable, and the necessity of making quick or frequent investment decisions simply did not exist. Today, all of this has changed. The investment process is highly disciplined, analytical and structured. The sheer number of alternative investment vehicles has exploded in recent years to the point that today there appears to be a new investment vehicle introduced almost daily. Whereas stability characterized the investment scene in days past, today it can be characterized as extremely volatile. A stock market that fluctuated by only 40 points or so in a month or even during a six month period of time in the past was not unusual. Today, the stock market can easily fluctuate by this amount in one day or even in one hour. On the bond side, there have been years when yields on long term bonds fluctuated by only 10 or 15 basis points. Today, bond yields can fluctuate by 50 or even 75 basis points in one day or even in one hour. In the past, investment decisions were few and far between and investment decisions could be made on a leisurely basis. Today, not only has the number of investment decisions required of the money manager exploded, but the frequency with which they must be made has increased requiring an endless series of decisions in order to maximize investment returns.

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In the new environment characterized by countless dozens of alternative investment vehicles, each of which is highly volatile in price, and which requires endless number of decisions, frequently made, the imposition of the extensive restrictions, investment guidelines, statutory lists of permissible investments, and maximum/minimum percentage investment allocations simply precludes the possibility of maximizing investment returns within permissible risks parameters. The best example of this can most dramatically be shown by looking at the enclosed Solomon Brothers reports of investment returns on a wide variety of investment vehicles over varying periods of time. A brief examination of these historical rates of return highlight a few relevant points. First, is the wide range of returns of the alternative investment vehicles over various periods of time. Second is the persistence of a change in investment results from one vehicle to another once a trend is established. The general point is that to limit one's investments to one or two or three particular asset classes is to doom a fund to inferior performance, assuming only that had the restrictions not existed that a correct investment decision was at least possible. The most dramatic example of this, of course, would be the common restriction that investments be limited to stocks and bonds. Had that decision been made in the early 1970's and maintained throughout the decade, the fund would have underperformed virtually any other combination of any other asset class, since bonds and stocks were the two worst performing assets for that decade. The information contained in these short Solomon Brothers reports for each of the last ten years represents documented evidence to us that any restrictions with respect to limiting or prohibiting specific asset classes, investment vehicles, or establishing minimum or maximum percentage commitments, by definition, inhibits the money manager's ability to perform the duty for which he was hired, i.e., to maximize returns within the acceptable risk parameters.

Since the money manager is required under the prudent man rule to properly diversify the portfolio anyway, why impose additional restrictions requiring him to limit his ability to function in the manner expected of him when he was hired?

We have argued above (hopefully persuasively) that with an expanded and comprehensive prudent man rule, superimposing a set of restrictions is redundant, at best, and inconsistent, at worst. It may be overkill to discuss the inapplicability of specific restrictions. However, there may be some value in commenting on specific restrictions and how they may adversely impact the performance of a fund. Let me simply list some of the major restrictions applicable to your fund and comment on each briefly.

1. A rated or better bonds - this excludes a very rapidly growing universe of lower-rated, higher-yielding bonds which periodically offers superior risk/return characteristics. Through proper diversification, the increased credit risk can largely be eliminated. Also, Baa and BBB rated bonds are considered investment grade by the rating services themselves, and, in any event, are frequently considered upgrade candidates to the A rating.

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2. Companies must have paid dividends for three consecutive years prior to purchase. This, obviously, excludes a large universe of non-dividend paying companies. While a portion of this universe is represented by companies who are unable, due to poor financial condition, to pay dividends, another large portion of this universe is represented by very high quality companies, with very rapid earnings growth rates and high rates of return, where earnings can be more profitably reinvested in the business than paid out to stockholders in the form of dividends.
3. Ten percent maximum investment in foreign securities - twenty and even ten years ago, this would have been considered a rather liberal policy since the absolute number of foreign securities available to domestic investors was quite limited in number, and further limited by chronic illiquidity. Today, all this has changed. The globalization of the securities markets is expanding geometrically and the returns available from foreign investments frequently exceed, to a dramatic degree, those returns available domestically.
4. A-1 and P-1 commercial paper only - since 85% of all commercial paper issued is rated either A-1 or P-1 or both, this is not much of a restriction and it is highly unlikely that a money manager would invest in anything other than this A-1/P-1 rated commercial paper, in any event.
5. 50% maximum investments in stocks and bonds - This, perhaps more than any other restriction, inhibits the fund's ability to maximize its return consistent with its perceived level of acceptable risk. With the explosion in the number and variety of alternative investment vehicles available today, and the enormous returns periodically available from those securities, it is important for any fund to maximize its potential exposure to as many of these vehicles as possible.
6. Five percent maximum in any one name - this falls under the category of a restriction that is unnecessary since it would be highly unusual for any money manager to concentrate a security holding to any degree greater than 5%. It would call into question the prudence of such a move and imply a lack of sufficient diversification.
7. Investments must be listed on a SEC registered exchange - this restriction amounts to limiting investments to securities listed on the New York or American Stock Exchange since NASDAQ (over-the-counter) is not technically registered as an exchange with the SEC. The NASDAQ over-the-counter market is an enormous and rapidly growing market and obviously is an attractive source of potential investment. Again, whereas perhaps 20 years ago over-the-counter securities were synonymous with small, risky investments, this is simply not true today. The nature of the market has shifted, but many funds have failed to adjust old restrictions to reflect the new realities of the market place.

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Jim, I hope the above observations and comments are useful to you in your effort to bring the law governing your fund more in line with the current market environment. I commend you for your effort and hope you are successful in your endeavor. If you have any additional questions or if I can provide you with any additional information, please do not hesitate to call me.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "D. Sallee".

Donald B. Sallee

Meeting of Retirement Boards  
for Public Employees and Teachers Retirement Systems  
on March 24, 1987

Presentation by James R. Wilson  
concerning recommended changes to  
statutes which affect investment  
management, with comments by  
Milton B. Barker, Deputy Commissioner,  
and various board members.

Jim: I might run back just a little bit in time. When I came up here in June of 1983, I asked to see the statute laws concerning investments. I went over those and I told Milt, "A lot of those laws shouldn't be there, they're wrong, but for the next couple of years they won't bother us." I would have preferred to see them change last year but we couldn't get on the legislature's calendar. I was hopeful we would definitely be on the calendar this year. But I said at that time it wouldn't hurt us for the first couple of years because we were so far behind from where we ought to be that the statutory restrictions wouldn't necessarily be a restraint in early years. But eventually they would be a restraint, and they are getting to be a restraint, and we do need some changes now.

Our equity percentages are up now, and we are getting more comparable to the other funds. Our rates-of-return have been buoyed-up for the last couple of years by three things we're not likely to see again. First, huge declines from very unprecedently high interest rates to the much more modest levels we have today. We're not going to see a repeat of that. They're not going to drop down to 1 percent now. So that great benefit and rate-of-return on our bond portfolio is behind us. Second, we've had a huge rise in the stock market since August of 1982, one of the great bull markets in our history. It's been running for almost four and one-half years at unbelievably large increases. Remember our graph this morning, how much it's gone up. That too is not going to continue. Don't look for that for the next couple of years. It has really out done itself. As far as I'm concerned it's a bubble at this point. A bubble that can burst at any time. How big the bubble gets before it bursts is open to question. You never know until the bubble bursts. So we're not going to see that again in the future. Third, in the international markets we've had the huge decline in the foreign exchange value of the dollar, and that has given us a tremendous increase in all of our foreign returns. Much of our high rate-of-return has been tied to these three single events. Events which are rare occurrences and which cannot be expected to occur again over the next few years. One of the most important things for us and for our managers over the next few years is that we are going to have to work a lot harder to get a good rate-of-return. We are not going to be swept along by a flood tide that will give us great returns in almost any investment sector. We are going to have to pick and choose our investments carefully. It becomes very important how good we are at it and what's even more important is how much freedom we will have to pick and choose. Unfortunately, we frequently find that the things we should do in order to increase the investment portfolio returns we cannot do because the statutory law doesn't allow us to do it. Now is the time when those statutory restrictions get very binding and they're going to be hurting our rate-of-return over the next few years. Our

external managers have repeatedly complained to us about the restrictions. We have measurements from some of them of how much our rate-of-return has been reduced by the statutory restrictions which apply to them and over which we have no discretion. Our concern over the rates-of-return of the retirement funds reflects a number of considerations. The pension beneficiaries under our retirement systems currently rely, under the law, on the employers' promise to pay the stated pension benefits when they are due and payable. The employers' obligation to pay is not conditioned on the adequacy of the monies available in the retirement funds. But if there is not enough money already set aside in the retirement funds, then the payment of the pension benefits begins to depend primarily upon the ability and the willingness of the employers to increase tax revenues enough to be able to pay the pension amounts. One would like to believe that promises made by governments will always be kept, but history exhibits too many exceptions. A promise to pay you is not as certain an event as having the cash in your hand. Consequently, the best security that pension beneficiaries have concerning the certainty of receiving their pension benefits is the adequacy of the monies already held in the retirement funds. The larger the funds are, in relation to the future payment liabilities, the more certain is the payment of the pensions.

The size of the pension funds are primarily dependent on investment returns. As we noted this morning, for the last few years 25 percent to 30 percent of the increases in the amount of the retirement funds has come from new contributions, whereas 70 percent to 75 percent has come from investment income and net investment gains. Our ability to achieve good investment returns in the difficult markets we foresee over the next couple of years is going to depend upon the amount of flexibility we have in selecting appropriate investments. The current statutory investment restrictions do not give us the flexibility we need in order to achieve the investment return objectives. We cannot be expected to successfully compete against other investors who can use any investment media when we are restricted to limited categories and structures.

In order to remove those handicaps, we drafted last year a set of necessary changes to the statute laws. (Some of them were necessary just to straighten out the statutes. Probably as a result of modifications over the years, the statutes now contain confusing and conflicting terminologies and ambiguities.) Unfortunately, we had to do it for six different funds, so it got rather lengthy because you have to repeat in each fund's statute what you had said in the other ones. So it became a large stack of pages, 40 some pages, which shouldn't be necessary, but that is the way we have to do things.

I thought I would review what some of those changes are. I

believe they are necessary for two reasons. First, to remove unnecessary restrictions that will impede future investment performance and, second, to strengthen the requirements in the statutes. I believe it is important that the statutes clearly state certain things. Who is responsible for what? What are the responsibilities? It's pretty wishy-washy in the existing statutes. One of the changes is to require reports by the commissioner of revenue to the retirement boards. There is nothing in the statutes that requires it. For the last few years we have been delivering to the boards fairly substantial reports concerning investment activity, status, and performance. I hope you find them useful. But there is nothing in the statutes that requires that it be done. And we would like to put that in there, that the commissioner must render these reports to the boards.

(Comments by board members concerning the lack of data previously furnished to them.)

And they could always go back to that. You could get another commissioner or someone who says, I don't want to bother with this any more. So, I'd rather have it be put in that statutes that it will be furnished to you. We also want to put in the statutes that the funds will be audited independently by an outside CPA firm. That is for your security, as well as the state's and everyone else concerned, that there should be an independent outside audit. It's not required currently. We happen to do it, but there is no law that requires that we do it so it could be abandoned at any time. There's a lot of money involved here. We have over \$3 billion just between the two boards sitting here today. I believe it should be audited by somebody other than in-house auditors.

The new statutes spell out what the current statutes do not, that the commissioner of revenue is a fiduciary and has a trust responsibility for the funds, that they are not to be confused with other types of state funds. It may not be necessary, because I think one could prove in a court of law, under common law, that they are fiduciary trusts. But why go through a battle in the courts when we can simply change the statutes to say that it is a fiduciary trust. The virtue of the change is, if it's a trust fund and the commissioner is a fiduciary, then you can't invade the trust fund for other purposes. The legislature or the administration can't decide that they need some money for this or that purpose and they are going to get it or borrow it from the pension funds because those funds have a lot of money. I hope that situation will never arise, but why take the chance? We've seen it arise in a few states (Oklahoma, Texas, and New York) and some other states are considering dipping into the big pool of assets held by their pension funds saying, well, we need the money and we'll give you a promissory note to give it back to you some other day. I

think we should try to avoid that risk by making it very clear this is a fiduciary trust and the commissioner is the fiduciary. That it's not his money, it's not the legislature's, and it's not the state's money. Once they've put it in the trust fund, they've lost control of it. It now belongs to the trust, it can't be removed, it can't be touched. And I think we should make that clear in the statutes.

Another change we want to make concerns the so-called prudent man rule. Of course, for us, it's a prudent institutional investor rule, which is what is in the statutes currently. There is a conflict here because the statutes also contain other things--you may do this, you may not do this--and some of those restrictions are contrary to the requirement that you be prudent. One requirement tells us that we must be prudent, wise, and do the best thing, and the other one tells us that we can't do it, or we must do something that is imprudent. Having two sets of conflicting standards in the statutes puts us in an impossible situation. If we abide by the one standard, then we violate the other, and conversely. There are two general types of changes we are seeking. One is to remove a lot of those self-defeating restrictions, and I'll review some of them later. And the other is to strengthen the prudent man standard, which is not strong enough and should be strengthened. What we want to include in the statutes is not a prudent institutional investor, but a prudent professional institutional investor. For example, you could have a bank running a million dollars in trust funds for 47, or 147, different clients, none of which have more than \$50,000, and the bank cannot afford professional staffing costs, so they have an amateur managing the funds for the clients. Technically, that meets the definition of an institutional investor, but that's not a high enough standard for our large funds. We want a professional standard, one which would apply to a professional large financial institutional investor, a so-called prudent expert rule. And that's why we want to include the word professional in there, to increase the standard of care and expertise that has to be met on these investments. We want trust in there in order to be very clear that this is a trust account, it's not to be comingled, mixed, or confused with other state monies. And we want the requirement in there that in making those prudent decisions one has to consider the purpose of the fund. There is nothing in the current statutes about purpose. One also has to consider the investment objectives. There's nothing in there currently about investment objectives. The whole area is just neglected, even though it is critically important in investment management.

(Question by a board member concerning who the professional requirement would apply to.)

Jim: To all the staff members of the portfolio management section. We actually moved to that requirement some time ago, and it's required now in our position qualification standards. We're all members of investment analysts societies. The only person who isn't is the new man, Steve. He's in the only position where you don't have to be a member upon joining the staff, but you must become one within two calendar years or you're fired. They only give exams once a year so he has only two chances to pass the exams and be accepted by a society as a member, or he'll be fired because you must make it within two calendar years--for that position. All the other positions have to be filled with people who are already bona fide members of the Financial Analysts Federation.

(Question by board member as to whether it would apply to the deputy commissioner of revenue.)

Jim: No. But it applies to everybody in portfolio management. So, we want the funds' purpose and the funds' objectives to be included in the statutory considerations. And we want an absolute requirement (there isn't any right now) on the commissioner of revenue in managing the fund as fiduciary that he must consider the status of the funds' investments and the system's liabilities. One has to look at the whole problem of the system, what the investment assets are, and what the liabilities of the system are. Both of those need to be considered not only on the basis of how they look today, but of how they are probably going to look in the future. Today everything may be all right. But one has to foresee the problems that are going to arise later on. We want to put that in, that it must be taken into consideration by the commissioner.

(Question by the actuary concerning the dilemma posed where the commissioner is the fiduciary and he not only has the official responsibilities but he must act in like fashion with other professionals who are knowledgeable in this area. Usually that goes hand in hand with the definition of fiduciary responsibilities. You have to act with the knowledge that other people are similarly endowed with that knowledge. Yet, on the other hand, he's politically appointed.)

Milt: Well, as long as he is able to delegate that responsibility to people who do have that expertise, I think that takes care of the problem.

(Question by a board member as to whether the commissioner would delegate the responsibilities.)

Milt: He certainly does. Otherwise the staff and the external managers would have no authority to manage the investments as they do. Those delegations are on file and are shown in the

General Investment Policies statement.

Jim: Another requested change is a requirement to determine the appropriate investment objectives to fit those circumstances. There is currently no requirement that there be any objectives, or that anybody should establish them, or anything. It's a major omission. An additional requirement would be to establish investment policies. The commissioner would have to establish investment policies aimed at achieving those objectives. We consider those three elements as being very important, what's the purpose of the fund, what are the objectives we're trying to achieve, and what is the investment policy that will serve that objective. It is the normal, ordinary course of development that you should have in any investment management. We currently do it, but there is no legal requirement for it to be done. Somebody else can come in and say, to heck with all that, we'll do what we feel like at the moment.

Another change we've put in the statutes is that the commissioner shall act only in the best financial interest of the beneficiaries. Nothing else should be taken into consideration, no pressure from other sources to do other things. The commissioner shall act only in the best financial interest of the beneficiaries.

(Comment by a board member: " I would like to see a governor who says okay to that.")

Jim: It is a very important requirement in a place where there is a crossroads between the state's administration and the management of these funds. It has to be very clear that the commissioner's actions regarding these funds is going to be based only on the best financial interest of the beneficiaries. Make it absolutely clear in the statutes.

(Comment by a board member: "That would take pressure off the ones doing it.")

Jim: It would, and we know how widespread the potential threats can be. Fortunately, for the last few years, there hasn't been that sort of pressure. But we all know about the financial condition the State is getting into, and somebody is going to look around some day and say, hey, there's \$3 billion over there in the pensions funds. Sooner or later they're going to come knocking on the door. If we can get it in the statutes, we would be in a much better position to defend the funds against potential raids.

(Comments by a board member: "When you think about it, you would get public support in closing the door.")

Jim: I think now I should review with you some of the particular statutory restrictions which we are seeking to remove. One of the more onerous of them is the asset allocation limit of no more than 50 percent in corporate issues (that includes both stocks and bonds). You may recall from this morning's presentation that we expect to be at 40 percent in common stocks (including domestic and international) and 9 percent in corporate bonds by the June 30 end of this fiscal year. We'll be within 1 percent of the limit, so from that point on we will be unable to increase those investments. You've already seen what the other public and corporate pension funds are doing, they have higher percentages in equities--especially the corporate funds--and if you include corporate bonds, their percentages are even higher. This has put, and will put, us at a disadvantage on comparative rates-of-return. There's no good reason for the 50 percent limitation. Considering how much our mortgages have shrunk, it means that we're going to have to keep 35 percent to 40 percent in government bonds at all times, and that's the lowest yielding sector in the market. Our three highest yielding investments for the past three years running now have been 1) international equities, 2) common stocks, and 3) corporate bonds, and all of these are classified as corporates. Our best performing assets are the ones on which we're approaching the 50 percent limit, so we can't go any further. We have to get rid of that restriction. There is no sense to it. We also have a 5 percent voting stock limitation. That reflects an old SEC standard, that if you have over 5 percent of a company's stock, then you're a major holder and you have to report every purchase and sale of the stock under the Securities and Exchange Commission laws. I can't even recall a case, after a long time in this business, where a prudent investor, an investment manager acting in a trust capacity, ever acquired anywhere near 5 percent of an issuer's public stock. It would normally be considered a little imprudent because you would have such a large piece that it would no longer be liquid. You would be at a significant risk, so they don't do it. They don't even come close to the 5 percent limit. But we would be restricted by that limitation, if we were involved in private venture capital deals or private placements. One could end up, particularly in venture capital deals, with more than 5 percent of the stock. The statutes say nothing about it being public stock, they just say you can not hold more than 5 percent of a stock. We would like that removed. It's not that we are going to go out and buy up control of corporations, but it serves no useful purpose. If we were going into a venture capital investment with a few partners where our portion of the equity was to be more than 5 percent, we would have to let the other partners take larger percentages in order to make up for our inability to exceed 5 percent. Since the equity portion of those types of financings usually constitute most of the profit on the investment, the other partners would end up making more

on the investment than we would. So one would like to see that limitation removed.

There is another outdated requirement that we can only invest in stocks that are listed on the stock exchange, that is the New York Stock Exchange and the American Stock Exchange. Those are the only stocks we can buy. There is only one exception, we can buy insurance or bank stocks, provided they have a certain minimum amount of capital. All of our stock managers, domestic and overseas, have complained about that. I have data from them showing how much additional return we gave up because they have to stay in stock exchange stocks. Twenty years ago the NASD over-the-counter market was a low volume and thinly traded market. You never knew if you could sell after you had bought, and you didn't know if the price was fair. But the NASDAQ now is as large in volume, actually larger frequently, than the New York Stock Exchange. It has some of the larger, better known companies in the nation on it, many of which don't intend to list on the exchanges. Today the NASDAQ is a large, well-developed market, but we can't hold any stocks that are on it. Alger, in particular, has complained. The three best performers they had in everybody's portfolio, except ours, last year were three that we couldn't hold because of these restrictions. Either it wasn't on the stock exchange, or it hadn't paid dividends for the previous three years.

That's the next restriction I want to discuss. We cannot purchase a stock if the company hasn't been paying dividends for the previous three years. That restriction is also a hold-over from olden days. The thought was, if it's a healthy company, it should be paying dividends, and if it hasn't been paying dividends for at least three years, it isn't a healthy company. Well, times changed dramatically after World War II, particularly after the '50s. Newer companies, or even older companies, who were encountering rapid growth and expansion and had a great need for capital, would either stop paying dividends or never start paying dividends. The rationale was, we need the money to finance the growth of the business, to build more plant. If you're in a very heavy growth phase with a strong demand for your goods, you need all the money you have. There was the additional rationale of, why pay it out to the stockholders when they are going to have to pay tax on it again, it's double taxed. We can invest it for them back into the business at higher rates-of-return than they can obtain in other investments. A company which has been paying dividends is not necessarily healthy, and a company which is not paying dividends is not necessarily unhealthy. But our statutes say that if they haven't been paying dividends for three years, you can't buy the stock. You may remember from our last meeting, the frustration of the international managers over the three year dividend rule. When England began privatizing, selling out companies which had been taken over by the government and

socialized within the last 20 years, they couldn't purchase the new issues because the companies didn't pay dividends while they were government owned. British Telephone just became a public company again, but we couldn't touch the stock. It's a virtual monopoly on all the telephones in England, Scotland, and Wales. But we couldn't touch it. The same situation was true for British Gas and British Airways. France, Italy, New Zealand, and other countries have been doing the same thing. But when they are coming out of socialism, even if they are very well established, even if they were only socialized within the last 10 or 20 years and have a long record going back before that, we can't touch the stocks until three years after they start paying dividends. There is no real sense to it. It's a silly rule and it has to go.

We have another statutory restriction that really drives our staff up the wall. It says we can't buy a corporate debt issue unless it has a rating of "A" or better on it. At first glance that might seem reasonable, but actually it's an irrational trap. Debt is much more secure on any company than is its equity, because the equity only gets the residue of what's left. Debt has a prior claim. We are now in the position where we can buy the stock of a company whose debt we cannot buy, because the debt is not "A" rated. In other words, we can take a riskier position on the investment but not a less risky position. When we were trying to invest the little endowment funds and we couldn't put them with our equity managers because of the cost of doing it for small amounts, we tried to get them into convertible bonds. But we were trapped by the "A" rated rule. There are not many "A" rated convertible bonds because convertible bonds are always lower rated than the straight debt of a corporation. Here again, we can buy the stocks of companies whose convertible bonds we can't buy, because of the "A" rating requirement. The whole thing is non-sensical. It has to go.

(Comment: "It's pretty much piece meal type of legislation.")

Jim: Yes. It was not well thought out. Nobody tried to put it together to see if the whole thing made sense. There are 25 sections of this in the statute--you may do this, you may not do that, you can do this only under this condition.

Another restriction says we can only invest in commercial paper if it has the highest rating. But as people have pointed out, over 85 percent of all the commercial paper sold in the U.S. has the highest rating. So, that's not really restrictive at all. What's the point of putting it in? There is none. Our own operating standards are so high that we only invest to the extent of 2 percent of the capital of the corporation issuing the paper. That's our cut-off limit, which is much more restrictive than anything they have in the statutes. We might

open it up to 3 percent or 4 percent if we feel it's necessary or desirable, but we're operating on a standard that's much higher than anything required by the statutes.

We have, as I mentioned earlier, the 10 percent foreign investment limitation. By June 30 we'll almost be at 10 percent and we won't be able to put any more money into the very profitable foreign area. In fact, if those markets continue rising, we'll have to start pulling the money back.

There is also permission in the statutes to invest in gold. And I'm requesting the removal of that. I should report to you (and I know there are some strong feelings on this subject) that no other pension fund in the U.S., except for one union fund, ever invested in gold. No endowment funds invested in gold. No foundation funds ever invested in gold. All of them are under the prudent man rule, and no prudent manager would dare to do it because of the difficulty of defending it as a prudent investment. So they didn't touch it. I'd be delighted to remove it. And if it hadn't been in the statutes, it might not have been purchased last time.

I haven't gone over every one of the 25 sections, but what I've said should give you some idea of the kind of limitations that are in the statutes and why we need to remove them.

(Question by board member: "When will you have this ready?")

Jim: It's ready now. It was ready four months ago.

(Comment by board member: "You've never distributed it.")

Jim: I have to get permission from above first.

(Question by board member: "To distribute it to us?")

Jim: Yes.

Milt: Again, I don't want to get ahead of Administration on this. They're the ones who have to introduce it. So, until we can convince them, there doesn't seem to be much use to have you people pouring over rather thick documents. That's why we are trying to outline for you what the substance of it is.

(Question by board member: "You're looking at...not this session?")

Milt: I suspect we're not looking at legislation this session. Because it is over half over, and this would be a major piece of legislation. I would like to get it introduced in this session, and that might be possible, but any action is very unlikely.

(Question by board member as to whether the new commissioner of revenue would support the changes.)

Milt: Well, I think so once we have a chance to go over with him the details of these things as Jim has outlined them for you. He is concerned that we could get a commissioner in here who might want to ride rough shod through the less restrictive statutes and play fast and loose with the funds, so that is the reason we've also been considering setting up a trust company with an independent board to be responsible for the trust and endowment type investments. That is also on the agenda for Jim to talk about. So I don't know if you want to cover some further aspects of the investment legislation, if not, we might go on and talk about that a little bit. That's the kind of concern we're going to have to answer for the commissioner and for the governor and the legislators.

(Comment by board member: "Just in listening to the overall tone of the proposed legislation, I guess I heard you saying removing limitations so there would be a lot less restriction. On the other hand, you did not speak in terms of minimums. I guess I understand having professionals manage the funds, basically, and then also having a strategy, but I guess my question is, it becomes a very big fluid thing. Are there some time limits?, or from a professional sense do you look at it as a five-year plan?, ten-year plan?, an investment plan that is constantly being revised?, or is it...I guess in my mind I see it as being very, very fluid now and it was really enacted as law as minimums.)

Jim: You have to be fluid, I'm afraid. It's just the unfortunate nature of the beast. It's the only way one can successfully manage investments. It would be nice if we were able to forecast the next five or ten years. I don't mind forecasting. I do it all the time, otherwise there wouldn't be any direction to what we do. But to make a forecast for five or ten years and really believe in it is virtually impossible. You'd have to know exactly where the markets were going to go, or at least have a very high order of probability, as to what the markets would do and wouldn't do, to be able to set down a rule for a four or five or ten year period. From my own personal experience and, I think, the experience of almost everybody else in the field, it never comes out that way. You've got to be flexible, fast on your feet, willing to change, and as the markets change, you shift your policy to try to continue to make money in the best media that you can find to make some money in. And it's not always the same. There will be a time when the foreign area is not going to be attractive and you're going to want to pull the money back. There will be a time where domestic equities will not be attractive, and they may not be for a year or two or more at a time, and we may want to cut that back and put the money

elsewhere. But you have to keep moving it and shifting it because the markets don't stay static on you and rates of return aren't locked in and what they'll do isn't locked in. You can't be rigid facing a fluid situation. You've got to be fluid as well to adjust to it.

(Comment by board member: "The intended legislation will do much of that.")

Jim: And I think we need it, or in the future we're not going to have very good rates of return, not as good as they could be. I really think the funds should have the best rates of returns they can get because it's in your best interest and the beneficiaries' best interest that they do so.

(Question by the actuary: "I have a saying that a lot of people might enjoy. If you have one watch, you know what time it is. If you have two watches, you have no idea what time it is because they are never going to be exactly the same. We're talking about putting identical wording in PERS and TRS Alaska Statutes?")

Jim: Yes, and also in Judicial, Military, and the Endowment funds.

(Comment by actuary: "Have you considered, perhaps, saying that each of these funds must adhere to the standards as such of the other statute?, and then in only one place do we put down the limitations, freedoms, and responsibilities of this investment authority, and therefore only have it in one place. It would cut down the size and it would be less likely to be whip-sawed by piecemeal legislation in the future that says we're going to take a little bit away from here, and then you're going to get into a greater nightmare.")

Jim: There is some of this really because I think you'll find, and this has been done frequently, for Public Schools it refers to the pension fund criteria. And for the Mental Health, which is now a dead issue, it also referred to the other criteria. For the Judicial and Military, it refers to the Public Employees and Teachers statutes. So there is a lot of that reflected already in there. I'm afraid the two were drawn up so Teachers and Public both list their criteria, but the others all reflect on those. So that is done already.

Milt: It might make sense though to consolidate or use one statement of investment authority and responsibility for the Teachers and Public Employees. We'll have to look at that see if there is any problem in doing that.

Jim: There is, because I remember during the drafting stage they didn't quite set up. You remember the law covers the

entire system, the Division of Benefits side of it too as well, and they didn't quite make parallel language and structure and even the form the statutes. So, it's a little hard to squeeze the one under the other and that's why they are written separately, although they're identical in substance. They are written separately because they have to fit into the statute differently in those two cases, which wasn't true with the other ones.

Milt: I think the substance of them is not different but we would have to rewrite the entire PERS and TRS system statutes to be able to use one set because the investment provisions of those systems are referenced or interwoven differently into the statutes. It's a little bit more than we care to bite off unless somebody said yes, let's go.

(Comment by board member: "I think there are a couple of things I would like to bring out here. I think a lot of restrictions were put on the original statutes in the early days of the funds when it was under a million dollars. The first venture into the stock markets was a disaster. They lost something like \$26 million dollars. The legislature got us to (inaudible) that they directed us and the governor to get out of the stock market completely. And that was a big bust. The second point is I think the State's purpose is still here because the return of the fund is a minimum 8 percent return...9 percent, so that might not be in so many words but it is certainly implied that that is what it's supposed to be. That's what it is all built on.")

Jim: The unfortunate aspect of that, by using a rate that was too low, and it was., is that they contributed a lot more in earlier years than they had to. Now, that may not look too bad at this point because Public Employees are 100 percent funded and Teachers are getting very close to it.

(Comment by board member: "I'm saying, when (inaudible) . . .")

Jim: Well, there's another aspect. When you go into equities or anything like that, you should have professionals doing it. I'm afraid you didn't have them at that time.

(Comment by board member: "I know that.")

Jim: That's part of the problem.

(Comment by board member: "We also had teachers who were suspicious of stocks.")

Milt: I think the whole world is extremely...I guess you could say the whole world has become, more financially sophisticated about investments. Most people these days have IRAs. And

people are becoming a lot more knowledgeable about risks and investments and strategies and that sort of thing. I think that we've come to the point where it's time to shed some of that baggage that was attached to earlier days when investing was a mysterious practice.

(Comment by board member: "I figured that, but I would say in the long term there should be some restrictions somewhere along the line just to be prudent. There's got to be some minimum because this crew here two years ago would be a different crew. Three years from now it could be another different crew.")

Milt: It is, and I think the balance that we're trying to get is to allow that flexibility and still retain the prudence, relying upon the strengthening of the prudent man rule as well as more elaboration of written investment policy, which would be disseminated and provided in the investment policy statement for you people. Hopefully, we would be able to move to a trust company or independent organization with an independent board to provide some further insulation from political interference or adventurism in the world of investments. I think given the greater knowledge that people have about investment activity these days, the answer lies in higher standards and greater public exposure of what is going on, and then you can deal responsibly with allowing your investment managers to have flexibility. I think for the reasons Jim pointed out we're going to have to move in that direction if the funds want to continue to experience this superior investment performance. We've come to a big watershed here and it's going to be tougher to do that in the future if we have particular portions of the playing field off limits.

Jim: We have fleshed out in great detail, it was drafted some months ago, the details of this legislation. We have addressed only part of the problem. We have also proposed, without going into full detail, the formation of a state trust company, only for government funds, not open to the public at all.

(Comment by board member: "Would the independence of this trust company be comparable to that of the Permanent Fund board?")

Jim: More so. From this standpoint, and this has not been fleshed out in full detail, but let me try to explain it. The trust company would be set up and then either by statute or by requirement of statute, the commissioner of revenue would delegate his authority for the investment of the trust funds, that means all the pension funds and all of the endowment funds--not the state's general funds, they're a horse of a different color--but these trust funds which we're running for the benefit of other parties. That those trust funds would be

delegated to the trust company. The board of the trust company which would include the commissioner of revenue and a few other entities, and would also have to have half of its members from outside of the state--professionals in the trust business who are accustomed to running a trust endeavor. This is to keep it balanced, so that you don't have a politically appointed board who can then use that board power to try to force the trust company to do things. You want to insulate it from that. The outside directors from outside the state should be capable and fully qualified in this area, not as investment people but as custodians, trustees, and should be familiar with all the law on that subject, accustomed to abiding by it and knowing what it entails. These outside trustees would also constitute the audit committee of the board to inspect the business constantly, to receive the reports of outside auditors to make sure everything is up and above board, that everything is accounted for, and there's no monkey business going on with the monies, custody of securities, or anything else, to make sure it's very honest and above board and it's outside the control of anybody in the state playing around with the numbers or the accounting or anything else--just to make sure it's all clean and very honest. And that the board, the purpose of the board, would be to make sure the place is running and serving the purpose it's supposed to. But that the board would hire the management under contract, and the management would be investment management under contract so they're not under threat of, if you don't do what I tell you, you're fired routine. They've got to have enough independence. The board would hire the top management, who would hire the staff, and get them under contract so they would have some insularity. I've also proposed even earlier as a possibility, some outside professional advisors. So that you're not trapped if you have a staff of only four or five professionals, you're not trapped with them because up in this locality a small staff working together tends to inbreed and they start to think and act alike, and you don't have the outside thoughts and opinions coming in that could say you're getting way off on a tangent. I did this in the bank back in Chicago when we brought in some outside advisors. It was unbelievable at that time that a bank trust department would bring in outsiders, not as advisors telling us what to do, but to make sure we weren't getting off on a limb somewhere. I would propose that within the management, not in the board, there be some outside advisors from outside of the state. Highly, highly qualified people who have run billions of dollars successfully for a long period of time in this very field. To have them on that advisory group, which might meet a couple of times a year to review the policy, why it's appropriate for the current events and going forward, and unless they thought it was way out of line, they would say it's reasonable on that basis and go along with it. I would propose that that be in there too. Then we could really insulate the investment management of the funds away from an

awful lot of potential political appointees, legislative pressure, or anything else being done to try to dip into the funds or force them to do things that are unwise. So that is part of what we're talking about. If we could also get the trust company--first the law changes to increase the flexibility, then the trust company, and move the funds in there so they would be insulated from the very things we're worried about. Those details haven't been drafted out. They need some work on them.

Milt: That's right. That needs to be fleshed out because that's an integral part of balancing the greater freedom that we do want to give to the investment managers. I don't see anything happening this session with the legislation because, even if we got it introduced, we're obviously talking about major overhauls in the state's investment operations, so it's going to take a lot explaining as to what we're proposing, and educating people on the reasons for doing that, and what the potential benefits are of providing more open investment activities.

Jim: Are there any reactions to all of this?

(Comments by board member: "I surely like the one emphasized that the operation should be for the benefit of the beneficiary. I can recall, there needs to be a reminder on it throughout the state, we're not here to help the economy in Anchorage or in the bush or anywhere else, because we have one thing--a trust for the beneficiary. I like many of the other items too. I think that is just a really important concept, it's kind of a summation of everything.")

Jim: I know this wasn't in exhaustive detail and one of the parts we really haven't fleshed out that much, but do I take it there is a sense you would be supportive in this direction, to try to get this sort of legislation, a set-up through a separate trust company?

(Comment by board member: "I'm all for the trust arrangement because I've always said that at the time it is transferred, at that point they, are no longer state funds, they are employee funds.")

Jim: I've been saying the same thing, but I don't know if anybody backs me up.

(Comment by board member: "At the point they are transferred, they are no longer state funds.")

(Comment by board member: "I would want some limitations on the latitude of the investments. I don't mean right now, but I do mean sometime.")

State of Alaska  
Department of Revenue

# General Investment Policies



Treasury Division  
January 1988

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State of Alaska  
Department of Revenue  
Treasury Division

Memorandum Concerning  
General Investment Policies

A review of the bases for  
the policies, including relevant  
objectives, factors, and standards,  
as well as responsibilities,  
authorizations, and limitations.

Prepared by  
Treasury Division  
January 1988

The purpose of this memorandum is to summarize and explain the bases for the Department of Revenue's investment policies, the standards utilized in implementing the policies, and the authorities under which the investment policies and investments are made.

## I. APPLICABILITY

This memorandum covers the following listed separately invested funds:

- State of Alaska General Investment Fund
- AHFC Pledged Fund
- International Airports Construction Fund
- International Airports Revenue Fund  
(including the Repair and Replacement Reserve Account)
- State Mortgage Insurance Fund
- Public Employees Retirement Fund
- Teachers Retirement Fund
- Judicial Retirement Fund
- Alaska National Guard and Alaska Naval Militia Retirement Fund
- Public School Fund
- University of Alaska Fund

Within the General Investment Fund are the General Fund, special revenue funds, debt service funds, capital projects funds, enterprise funds, intra-governmental service funds, and other funds which are commingled for investment purposes. The International Airports Funds are the only separately invested enterprise funds. All trust funds are separately invested.

For separately invested funds, the income accrues to the fund which earned it. The income of all funds in the General Investment Fund accrues to the General Fund. The only exceptions are the Student Loan Fund, Alaska Clean Water Fund, Fish and Game Fund, Power Development Revolving Loan Fund, and trust funds or accounts--the most significant of which is the Permanent Fund Dividend Trust Account--all of which receive their pro-rata share of monthly General Investment Fund income, pursuant to Attorney General's opinions dated September 10, 1984 and July 19, 1985. Appendix A contains a Memorandum of Understanding between the Departments of Revenue and Administration that provides for the crediting of General Investment Fund income to funds or accounts other than the General Fund.

## II. COMMISSIONER OF REVENUE'S AUTHORITY

The Commissioner of Revenue has the general authority to invest all State funds, under AS 44.25.010 and AS 44.25.-020(2), and has either the primary or secondary authority to invest all monies deposited or held in the applicable funds under the sources cited below. These authorities are partly limited by relevant laws.

### A. Sources of Authority

The source of the Commissioner's authority for each of the applicable funds is:

1. State of Alaska General Investment Fund, under AS 37.10.070;
2. AHFC Pledged Fund, under Section 508 of the General Housing Mortgage Bond Resolution of the Alaska Housing Finance Corporation;
3. International Airports Construction Fund, under Section 3.02 of Resolution No. 68-4 of the State Bond Committee of the State of Alaska and AS 37.15.420;
4. International Airports Revenue Fund, under Section 5.02 of Resolution No. 68-4 of the State Bond Committee of the State of Alaska (the requirement to separately invest the Repair and Replacement Account is specified in this Resolution) and AS 37.15.430;
5. State Mortgage Insurance Fund, under AS 18.56.095;
6. Public Employees Retirement Fund, under AS 39.35.110;
7. Teachers Retirement Fund, under AS 14.25.180;
8. Judicial Retirement Fund, under AS 22.25.048(c);
9. Alaska National Guard and Alaska Naval Militia Retirement Fund, under AS 26.05.228(c);
10. Public School Fund, under AS 37.14.170 and subsequent delegation by the Public School Fund Advisory Board (see Appendix B);
11. University of Alaska Fund, under AS 14.40.400 and subsequent delegation by the Governor (see Appendix C).

## B. Limitations of Authority

The Commissioner's authority is limited in the various funds to specific types of investment instruments, and in certain funds the maximum percentage which can be held in some classes of investments is also specified.

### 1. Permissible Investment Instruments

The instrument limitations are prescribed by Alaska Statutes for the various funds as follows:

- a. General Investment Fund, AS 37.10.070 (see Appendix D);
- b. AHFC Pledged Fund (see Appendix E);
- c. International Airports Funds, State Bond Committee Resolution No. 684 (see Appendix F);
- d. State Mortgage Insurance Fund, AS 18.56.-095(b) and AS 37.10.070(a), the General Fund (see Appendix G);
- e. Public Employees Retirement Fund, AS 39.35.110;  
Teachers Retirement Fund, AS 14.25.180;  
Judicial Retirement Fund, AS 22.25.048(c);  
Alaska National Guard and Alaska Naval Militia Retirement Fund, AS 26.05.228(c);  
Public School Fund, AS 37.14.170 (see Appendix H);
- f. University of Alaska Fund, AS 14.40.400 (see Appendix C).

Although not expressly stated in the statutes, the Attorney General has ruled in an opinion dated November 28, 1978 that the Commissioner has authority to enter into reverse repurchase agreements.

### 2. Percentage Allocations Within a Fund

Certain funds have maximum percentage allocations or dollar limitations for some investments as prescribed by Alaska Statutes or the Alaska Administrative Code. The funds are the Public Employees Retirement and the Teachers Retire-

ment. The Judicial Retirement Fund, Alaska National Guard and Alaska Naval Militia Retirement Fund, and Public School Fund are also subject to the maximums because Alaska Statutes place them under the same investment limitations as the retirement funds.

a. Statutes

- (1) corporate stock and debt securities may not exceed 50 percent of the fund (AS 14.25.180(c) and AS 39.35.110(c));
- (2) no more than 5 percent of the voting stock of a corporation may be owned (AS 14.25.180(c) and AS 39.35.110(c));
- (3) foreign securities may not exceed 10 percent of the fund (AS 14.25.180-(b)(23) and AS 39.35.110(a)(23)); and
- (4) foreign time deposits may not exceed 20 percent of the fund (AS 14.25.180-(b)(24) and AS 39.35.110(a)(24)).

b. Administrative Code

For real estate mortgage loan investments

- (1) a single loan may not exceed \$1,000,000 115 AAC 114.050(e) and 15 AAC 139.050(e)); and
- (2) loans may not exceed 20 percent of the portfolio measured at cost at the time of purchase of any loan (15 AAC 114.-050(f) and 15 AAC 139.050(f)).

III. COMMISSIONER OF REVENUE'S RESPONSIBILITY

The Commissioner is solely responsible for the realized investment results on the entirety of each of the funds, except to the extent that statutory law by prescribing or proscribing particular investments or allocations may effectively prevent the Commissioner from fully discharging that responsibility. The responsibility is amplified and limited by both laws and practical considerations.

A. Rule of Prudence

A rule of law concerning a trustee's degree of care in managing investments for a trustor or trust beneficiary has developed over a long period of years in

U.S. jurisprudence and it has commonly been referred to as the "prudent man rule." The rule held fiduciaries to a standard of care comparable to that which a person of ordinary prudence would use in managing his own investments. With regard to the Commissioner's responsibility for the investment of trust funds, the Alaska Statutes (previously cited) have held the Commissioner to the higher and more demanding standard of care required of an institutional investor managing large investments under a trust relationship. The standard presumes the institution is a sophisticated professional investor whose knowledge and ability to evaluate alternative investments is substantially greater than that expected of an ordinarily prudent layman. Conformance with the standard may be evidenced by comparison with funds managed under similar, if not identical, standards. The trust funds covered by the statutes are the Public Employees Retirement Fund, the Teachers Retirement Fund, the Judicial Retirement Fund, the Alaska National Guard and Alaska Naval Militia Retirement Fund, and the Public School Fund. The statutes do not apply the "prudent institutional investor" standard to the University of Alaska Fund, but the 1963 Opinion No. 13 of the Attorney General held that the "prudent man rule" is the proper rule for guiding the investment of that fund and the Governor's delegation to the Commissioner (see Appendix C) imposed the "prudent institutional investor" as the applicable standard. The statutes do not impose either the "prudent man rule" or the "prudent institutional investor" rule on the Commissioner in investing the monies of the International Airports Revenue Fund or the State Mortgage Insurance Fund. The General Investment Fund, which is not in itself a trust fund, although it may include some commingled trusts, is also required by AS 37.10.070(b) to be invested under the "prudent institutional investor" rule, even though that would not be required necessarily under prevalent trust law. There are no statutory standards for the AHFC Pledged Fund or the International Airports Construction Fund.

#### B. Fiduciary Law

The extant body of fiduciary laws in U.S. jurisprudence (one of which is the "prudent man rule") impose additional criteria on the actions of investment managers of funds held in trust. The primary focus of the laws is to require the trustee to act independently and only in the best objective interests

of the beneficiaries of the trust, ignoring all considerations relating to the interests of others or the trustee's own self-interest, and avoiding all self-dealing and all conflicts of interest between the trustee and either the trustor or the trust beneficiaries. Similar obligations have been imposed by numerous federal and state laws (Securities and Exchange Commission, Investment Advisors Act, banking trust laws, etc.) and by professional self-regulatory bodies (Financial Analysts Federation, National Association of Securities Dealers, and others). These requirements are directly applicable to all but four of the eleven funds covered by this memorandum. The Commissioner and the staff of the Revenue department involved in the process of investment policy or investment selection decisions, or implementing, recording, or administering those decisions, are held accountable for compliance with the substance of the relevant laws. There is a significant risk that the statutory limitations on investment instruments and on allocations may be in conflict from time to time with the Commissioner's duties under the "prudent institutional investor" rule and the other fiduciary standards, to the extent that the limitations prevent investments that would be considered prudent.

### C. Practical Considerations

The Commissioner's general responsibility is also partly constrained by a number of practical considerations.

#### 1. Nature of the Funds

The size of the funds and their purposes can act to exclude or include various investments as part of a particular fund's portfolio.

#### 2. Personnel

The number of qualified staff members affects the amount of time which can be expended in managing the investments of the funds.

#### 3. Data

The adequacy of the content and the timeliness of the financial information available, whether internal or external, can also act to limit or extend the investment opportunities.

4. Budgets

Budgetary constraints can limit both the personnel and data requirements available to the Commissioner.

5. Administration

Required administrative procedures can act to impede some investment activity, which may obviate some opportunities and limit the investment results.

D. Personnel Standards

The Commissioner depends on the staff of the Treasury Division of the Department of Revenue in fulfilling the investment responsibility. In order to assure their compliance with the appropriate standards of conduct, the following requirements have been established:

1. Treasury Staff

All employees of the Treasury Division are required, as a condition of employment, to acknowledge and abide by the rules of conduct contained in the statement attached hereto as Appendix I.

In addition, all Treasury staff are subject to AS 39.52, the Alaska Executive Branch Ethics Act.

2. Treasury Officers

a. All officers of the Treasury Division are additionally required to conform to the applicable substantive provisions of "The Code of Ethics and the Standards of Professional Conduct" of the Financial Analysts Federation, attached hereto as Appendix J, with the exception of Part VI (c) which is superseded by the more restrictive AS 39.52-170(a) which prohibits any outside employment or service that is incompatible or in conflict with official duties.

b. In order to better ensure professional levels of knowledge, ability, and experience investment officers involved in marketable securities are required to be

Fellows of the Financial Analysts Federation  
or Chartered Financial Analysts.

IV. THE INVESTMENT OBJECTIVE

The general objective of all financial investments is "to increase the amount of monies available for some purpose over some span of time." The specific objectives applicable to a certain fund depend primarily upon the nature of the fund. Derived from the general objective are a number of important considerations which are involved both in determining specific objectives and in developing specific investment policies.

A. The Amount of Monies

The amount of monies concerned in a particular fund's objective or policy may represent only the principal of the fund, or its income if it has not been distributed, or they may represent some combination of both principal and income--either separately or combined.

B. Increasing the Amount

1. Capital Preservation

Whether the concern is for the principal or the income, or some combination of them, increasing the amount of monies usually requires that at least the capital of the fund (principal contributions) will not be reduced. Funds whose capital is supposed to be consumed are, of course, an exception. This objective of preserving the capital relates to the following investment characteristics which are important in determining investment policy:

a. Credit Risk

Credit risk involves the investment issuer's willingness and ability to pay the income and principal of a fixed amount obligation as it becomes due and payable. Credit risks vary greatly from issuer to issuer and usually reflect the relative certainty of the issuer's ability to pay. Low credit risks imply a high degree of certainty that the obligations will be paid in full and on time. High credit risks for classes of investment or individual investment selections are accommodated in investment policy

by diversifying those investments among enough different issuers to reduce the fund's exposure to any single issuer's default, by holding marketable issues which can be sold if the issuer's credit risk rises substantially, and by continuing staff surveillance of the issuer's ability to pay.

b. Residual Risk

Equity investments are not fixed amount obligations. They are percentage ownerships of net income (after taxes) and the residue of assets remaining after retirement of all outstanding liabilities. The risk on equity investments is related to the future profitability of an enterprise and/or to its current or future liquidation value. Equities are usually diversified in order to reduce the fund's exposure.

c. Exchange Rate Risk

Exchange rate risk involves the fluctuations in the relative exchange rates between foreign currencies and the U.S. dollar and they are only involved when investments payable or valued in foreign currencies are held in a domestic portfolio. Exchange rates vary daily and reflect a number of factors. In the long run they are primarily determined by relative measures of economic productivity and prices, and trade and financial flows among countries. The risk to a fund is reduced by limiting the percentage exposure to the exchange rate, by diversifying the holdings among several foreign currencies, or by hedging the currency positions in the futures markets.

d. Market Risk

Market risk involves the market's valuation of an investment when it is voluntarily or involuntarily liquidated by the holder before its scheduled maturity date (in the case of fixed amount obligations) or at any time (in the case of equities). The valuation for a fixed amount obligation will reflect the market's perception of the credit risk (and exchange rate risk, if appropriate), the remaining time before

maturity of the issue, the fixed rate of pay on the issue, and the then current interest rate at which similar obligations are being purchased (sometimes referred to as the interest rate level risk). The valuation for an equity obligation will reflect the market's perception of the current and future profitability of the enterprise, the annual rate of income remittance (dividends), the liquidation value of the enterprise, the future expected price for the equity, the exchange rate risk when appropriate, and its probable return relative to alternative investments. Because market valuations change daily and only reflect the market's perceptions, they do not necessarily reflect the true relative value of alternative investments, nor do they reflect the historical returns for held investments, but they do reflect the probable price at which investments can be bought or sold at that time. Because investments are made to achieve realized returns rather than transitory perceived returns, the market valuation is not particularly relevant to held investments if they are not going to be imminently liquidated, but it is important in making new investments because it affects the probable returns that can be made on them in the future.

## 2. Returns on Investments

The return on an investment is not definite until the investment is terminated. The return is the difference in the amount of monies received from an investment as compared to the amount of monies invested in it. Returns may be divided into principal returns, or income returns, or some combination of income and principal returns, depending on the nature of the funds, the purpose of the investment, legal requirements, and accounting conventions. Investments are made based upon an expected level of return over a future time period. Calculating an imputed return based on the market valuation of a held investment which is not going to be imminently liquidated is not necessarily meaningful because it reflects neither the expected return basis on which the investment was made nor the return which will be realized when the investment is terminated.

The rate-of-return on investments is a comparative measure of annual returns among alternative investments. It is the percentage rate which mathematically represents the amount of annual increase or decrease in monies as compared to the amount invested. It is always stated as an annual rate regardless of whether the time period is a fraction of a year or a multiple number of years. Rates-of-return may reflect only income, or principal, or a combination of income and principal, and they may be expectational, imputed, or realized. They are used in investment management as a basis for reallocating the relative percentages of classes of investments in a fund and as a basis for selecting particular investments from among many alternatives. They are also used on an imputed or realized basis to compare the relative performances of various investments or classes of investments within a fund or among funds. The usual objective of portfolio management is to achieve a relatively high rate-of-return over a time period appropriate to the nature of the fund.

C. Availability

Availability is a restriction on the general objective. Increasing the amount of monies is useless if the monies are not available when they are needed for the purposes of the fund. The amount and timing of the need for monies depends mostly on the nature of the fund and varies greatly among funds. Known amounts at known times can be readily accommodated by either specific maturities or liquidations of unmatured or non-maturing issues. Unknown amounts or unexpected timing can only be accommodated by liquidations. Liquidating investments means selling them at the going market price to another investor. The ability to liquidate an investment will depend on its marketability. Securities in which ongoing secondary markets are maintained are readily marketable, and those rated as having either low credit or residual risks are highly marketable. Securities which do not have ongoing secondary markets and privately-placed non-security investments have either a very low degree of marketability or none at all. Marketability is also affected by the amount of the investment. Secondary markets presume certain ranges of amounts. Liquidating investments which are substantially larger or smaller than those ranges will

reduce both the marketability and the price. The ability of investment management to terminate some investments, procure others, realize returns, reallocate the fund's investments, and achieve high rates-of-return would be severely reduced if a fund was substantially invested in unmarketable investments.

D. For Some Purpose Over Some Span of Time

Both the purposes which are to be served and time over which they are to be served will vary greatly depending on the nature of the funds. Endowment type funds with a perpetual lifetime and no permissible withdrawals of principal are substantially different in purpose and time span than funds whose principal is committed to consumption within a near term period. The purpose and the time span are crucial factors in establishing the specific investment objectives and policies for a particular fund. They act to amplify or limit the classes of investments which can be considered and affect all of the characteristics previously mentioned, i.e., credit risk, residual risk, market risk, rates-of-return, and marketability.

V. THE NATURE OF INVESTMENT POLICIES

The strategic plan for achieving a particular fund's investment objectives is the fund's general investment policy. It is primarily concerned with the relative allocation of the classes of investments within the fund, but it can also be concerned with the structure or selections within a class of investments. Within the limits imposed by the nature of the fund, its investment objectives, and the constraints imposed by laws and practical considerations, the investment policy is designed to achieve a relatively high probable rate-of-return on the fund over some future time period. Although the imposed limits and constraints may be fairly static for long periods of time, the financial markets in which returns are realized are very dynamic. No matter how suitable and productive an investment policy may be at any point in time, subsequent changes in the financial markets can rapidly invalidate it. Consequently, investment policies have to be sufficiently flexible to quickly adapt to the dynamics of the marketplace if the desired rates-of-return are going to be achieved. The process of keeping the policies attuned to the probable future markets involves continuing reappraisals.

Investment policies are comprehensive derived strategies which represent evaluations of all of the significant factors utilized in selecting and managing investments. The most important of these factors is the probable rates-of-return which may be earned on particular investments between now and a future date. Those probabilities together with their relative degree of certainty and the risks associated with those investments are the essential considerations involved in determining the allocation of the fund among the potential classes of investments. The allocations are balanced within the policy with the intention of maximizing the fund's probable forward rate-of-return without permitting its probable risks to rise to an unacceptable level. Because investment policies are based on expected future events, their effectiveness in achieving the objectives can only be ascertained on an after-the-fact basis.

## VI. THE FUNDS AND THEIR INVESTMENT POLICIES

The application of the general investment objective to specific funds or types of funds results in the development of specific investment policies for each fund. A summary of the nature of each fund and its investment policy follows:

### A. The General Investment Fund

This does not include the unmarketable loans made under former State programs--all but one of which are no longer active.

#### 1. Nature

The General Investment Fund is a reservoir which holds State revenues until they are disbursed. It contains five broad categories of monies:

- a. revenues which will only temporarily be in the fund because they are subject to imminent disbursement in order to satisfy operating budget expenses;
- b. revenue receipts in excess of appropriations, which are usually in the fund for less than a year because they are subsequently appropriated and disbursed;
- c. revenues appropriated for capital budget projects, which may be in the fund for several years as monies are disbursed on an as needed basis;

- d. past revenues not appropriated for specific expenditures but held in reserve for emergency purposes, e.g. budget reserve fund;
- e. special revenue, reserve, operating, and trust funds which are commingled in the General Investment Fund but are separately accountable. These monies have mixed characteristics, are usually continuing in duration, and are a small percentage of the total fund.

The purpose of the fund is to combine these money flows into a pool where disparate inflows and outflows will frequently be offsetting and, consequently, the more stable pool will be more readily investible. The reduction through the use of a pool of the number of accounts which need to be invested also increases the size of the investments, reduces the number of investments, and minimizes the transaction and personnel costs. The fund is invested with the intent of earning income on the principal monies until the time of their disbursement. The income earnings constitute an additional source of revenues which are available for appropriation.

## 2. Policy

Because the principal of the fund has been appropriated and any realized losses would lead to curtailment of intended expenditures, preservation of principal is the most important determinant of investment policy. Because the expenditures are frequently large and their exact dates of disbursement are unknown, the policy has to allow for very high liquidity. Because the \$1 billion to \$2 billion size of the fund is very large, investments have to be limited to classes of investments which have secondary markets that can readily accommodate large holdings. Because the projected income from the investments is also appropriated before it is received, the projected income for any fiscal year should be relatively stable and certain. These characteristics denote an investment policy which avoids residual risks, has low credit and market risks, avoids substantial exchange risks, concentrates on large yet very marketable issues, and seeks to achieve a relatively high but non-volatile investment return within a fiscal year.

The current investment policy limits the investment selections to non-residual, fixed amount obligations. The vast majority of holdings consist of U.S. Treasury issues, which have the lowest credit risks, the highest marketability, and the best secondary markets for large holdings. The remaining holdings consist of short-term commercial or bank paper issues which have exceptionally low credit risks although they yield more income than U.S. Treasuries. The daily volatility in fund balances is handled through overnight repurchase agreements with the limited number of prime dealers with whom the Treasury Division has binding written agreements. The repurchase agreements have almost no risk because they are fully collateralized by delivered U.S. Treasury securities. The maturity structure of the fund is designed to provide cash through maturities at the probable dates it will be needed. The estimating of probable cash outflows is a continuing process and the maturity structure is constantly being altered to match the probable outflows. The particular investment selections and the maturity structure are also designed to maximize the income flow and, consequently, the current structure of interest rates and the future expected structure of those rates are important determinants of investment selections and maturity structure. In order to keep the income relatively certain, issues are usually held to their maturity date, unless the maturity schedule needs to be restructured. Currently, about 62 percent of the fund is scheduled to mature within the following 12 months and the remainder within three years.

B. AHFC Pledged Fund

1. Nature

The monies held in this fund are State funds which were required under the terms of an outstanding AHFC bond issue. The amount required depends upon standards and certifications stated in the bond indenture and any excess can be withdrawn on November 30 of each year. Excess amounts have been withdrawn each year so the monies currently held are less than \$10 million. The indenture restricts the investment maturities to six months or less and limits the choices to the instruments noted in Appendix D.

## 2. Policy

The stringent maturity and instrument limitations leave little room for discretionary policy. Preservation of principal is the most important characteristic and it is being served by keeping the fund invested in U.S. Treasury obligations. The maturity restriction avoids any market risk. The current investment policy is to purchase issues maturing on either the indenture's semi-annual interest pay dates of May 30 and November 30 or the nearest practical date preceding those days.

### C. International Airports Construction Fund

#### 1. Nature

The construction fund holds the proceeds of construction bonds as well as monies appropriated for the same purposes. The monies are withdrawn as needed to repay contractors for construction expenses. Consequently, it is a declining fund which eventually pays out all of its principal and income.

#### 2. Policy

The objective of the investment policy is to maximize the return on the monies while they are held in the fund without risking the principal or the presumed interest income. The investment restrictions (Appendix E) virtually eliminate credit risks, and market risks are minimized by attempting to match the schedule of maturities to the timing and amounts of anticipated withdrawals. The schedules of withdrawals are estimated by the architects or engineers involved in the projects. Section 3.03(c) of State Bond Committee Resolution No. 68-4 restricts maturities to no more than six months after the estimated dates on which the monies will be needed.

### D. International Airports Revenue Fund

#### 1. Nature

The Revenue Fund receives all of the revenues from the ongoing operations of the international airports. The monies are utilized to pay the continuing expenses of airport operations and

the principal and interest payments on outstanding airport revenue bonds. Although the bond payments are known amounts which are scheduled for the life of the issues, the revenue receipts and other expenditures are erratic in timing and highly variable in amount. Investment earnings are retained by the fund as an additional revenue.

## 2. Policy

The irregular, unforecasted cash flows out of the fund impose high liquidity and low risk requirements on its investments. These characteristics are met by investing solely in U.S. Treasury or money market issues due within no more than one year. The short maturities ensure minimal market risks, the issuers have very low credit risks, and the high marketability assures the availability of monies even if there are unexpected outflows. The separately invested Repair and Replacement Reserve Account, required under the terms of a bond indenture and subject to Section 5.04 of Resolution No. 68.4 of the State Bond Committee, is less subject to erratic flows and therefore may use maturities of up to five years duration. These stringent requirements effectively preclude maximizing the return on the investments. If reliable forecasts of probable cash flows were available, maturities might be lengthened and timed to take advantage of changing interest rate levels so a higher rate-of-return could be earned.

## E. State Mortgage Insurance (Trust) Fund

### 1. Nature

The monies in this fund constitute a State insurance reserve supporting holders of AHFC Insured Mortgage Bonds. The amounts required to be held in the fund are specified in AS 18.-56.095. Monies may be withdrawn from the funds as needed to effectuate the mortgage insurance programs, and the fund may receive monies from either special mortgage loan commitment fees or special mortgage loan defaults which were charged against the fund or appropriations by the legislature to meet the fund's size requirements. The fund has an unknown duration, it may vary in size perpetually, or it may decline to

zero at some future date when all Insured Mortgage Bonds are retired.

## 2. Policy

Fund investments have to have the characteristics of safety of principal from credit risks because the monies are an insuring guarantee and of high marketability because money may be withdrawn at any time. These characteristics are served under the Mortgage Insurance Agreement of December 6, 1975 between the State and AHFC which limited the investments to highly marketable and low credit risk U.S. Treasury or money market investments (see Appendix F). Subject to that restriction, the Commissioner of Revenue delegated investment management of the fund to the National Bank of Alaska under the terms of a Custody and Investment Agreement dated July 30, 1976.

## F. Retirement (Trust) Funds

This comprises the Public Employees Retirement Fund, the Teachers Retirement Fund, the Judicial Retirement Fund, and the Alaska National Guard and Alaska Naval Militia Retirement Fund, which are separately accounted and invested. Their natures are sufficiently similar to give them the same general investment policy. However, the two minor funds, the Judicial and the Alaska National Guard and Alaska Naval Militia, are too small to directly participate in equity and certain fixed amount investments. The Treasury Division has established a pooled account for domestic common stock investments of all the retirement and endowment funds to make participation by the minor funds practical. In the future, the Division may establish additional pools for other types of investments.

### 1. Nature

The retirement plans are defined benefit plans whose payment amounts for each enrolled employee are determined by their length of employment and their salary levels. They are joint contributory plans under which both the employee and the employer are required to make continuing contributions, with the exception of the Alaska National Guard and Alaska Naval Militia plan which is funded solely by employer contribu-

tions. According to law, the benefits payable under the retirement plans are contractual, deferred compensation arrangements which must be honored by the employers, who are Constitutionally prohibited from diminishing or impairing the accrued benefits. The employers are the effective guarantors of the benefits and they assume all of the financial risks concerning the adequacy of the contributions and the returns on the investments. Employees have a legal right to benefits immediately upon enrollment in the system, although their right to the employer's contributions is dependent on certain vesting requirements such as a minimum term of employment and the status of that employment (full-time, part-time, temporary, etc.). The plans are considered as being perpetual in nature because they apply to both current and future employees and the employers have the characteristics of perpetual existence.

The funds' invested assets are impounded monies dedicated to the payment of future benefits and are not subject to reversion to or use by the contributors, except when paid to beneficiaries under the terms of the plans. They are fiduciary trusts whose monies are held and invested only for the benefit of current and future retirees.

The investments represent the accumulated excess of contributions and realized income over benefits paid during the years since the plans' inceptions. The amount of additional monies contributed each year by the employees and employers are determined by consulting actuaries and are based on the expected future payments to current and future retirees, the amounts of the funds, and the expected future returns on investments. In order to determine the amounts of the funds, the actuaries annually value the funds' investments by utilizing a three year moving average of the ratios of total actuarial value to total book value, where total actuarial value is composed of market values for equities and book values for fixed amount obligations. This methodology decreases the annual volatility of both the valuations and the resultant levels of contributions. The actuarial method being utilized--projected unit credit method--requires contributions in the early years that exceed the accrual of benefits.

Cash inflows into the funds substantially exceed the current amounts of benefits payments and that condition is expected to continue for many years into the future. The net inflow is a typical situation for retirement plans who have a relatively low percentage of retired members. This is illustrated by the following statistics concerning the two major plans:

	<u>Public Employees Retirement System (1)</u>	<u>Teachers Retirement System (1)</u>	<u>Mean of U.S. Public Pension Funds (2)</u>
Average Age of Active Members	39.21	40.48	40.9
Average Years of Credited Service	5.96	9.81	11.6
% of Total Members Retired	14.4%	19.2%	29.3%
% of Active Members Vested	44.6%	48.0%	47.7%
Period in Years to Amortize Unfunded Accrued Benefits	25	25	30.1
% of Pension Obligation Funded	102.0%	93.2%	72.4%
Excess of Actuarial Interest Rate Assumption Over Salary Increase Assumption	2.8% (3) estimate	2.8% (3) estimate	1.8%

(1) "Actuarial Valuation as of June 30, 1986," William M. Mercer-Meidinger, Inc.

(2) "Public Pension Funds 1987," Greenwich Research Associates, Greenwich, Connecticut

(3) 2.5% for the first five years of an employee's service and 3.5% per year thereafter.

## 2. Policy

The most important characteristic of the funds for investment policy purposes is their perpetual nature and the long number of years before they will encounter any net outflows

(probably 15 to 20 years). The long time span accommodates investments which should enjoy higher returns over the long-run, although they may be slow to materialize, or be erratic in the short-run, and it allows greater use of investments which may have substantial market valuation risks. This characteristic expands the universe of investment possibilities and increases the potential for achieving higher returns on the investments.

The primary objective of the investment policy is to maximize the returns on the funds' total investments over a long time span without undertaking an unreasonable degree of risk of reducing the principal of the funds or of realizing the lower returns which would necessitate raising the contribution levels. Higher investment returns over the years mean a larger fund, and a larger fund size relative to a retirement system's liability for future benefit payments is the beneficiaries' best security that the pensions will be paid when they are due. Returns which average higher than the actuarially assumed returns (currently 9 percent for the two major retirement plans) can lead to either increases in pension benefits or decreases in the amounts of annual contributions. The time span over which the objective seeks to maximize returns is highly variable but usually falls in the range of between three to eight years. The time span cannot be precise because both the separate investment markets and the economy experience independent fluctuations in price and performance. Economic cycles usually range between three to six years, stock market cycles from two to four years, interest rate cycles from three to seven years, exchange rate cycles from four to eight years, and real estate cycles from four to ten years. Investment risks are related to the entire portfolio of a fund's investments rather than to the classes of investments which are components of the portfolio. All investments bear some degree of risk and the risks vary not only with the class of an investment and the stage of its related cycle but with the alternative investments within each class. Investments having higher expected future returns usually contain a greater risk of disappointment (lower returns) than those expected to have lower future

returns. The reasonableness of risk for a fund's investment portfolio is a judgment concerning the greater probability of achieving the expected higher future returns than the probability of realizing lower than average future returns.

Because investment markets are constantly fluctuating, the ratio of probable rewards (higher returns) to probable risks (lower returns) for an investment, or class of investments, or a fund is also constantly changing. In order to achieve the primary objective of the retirement funds, the funds' investments need to be continuously reallocated between classes of investments and among individual investments. The reallocating requires continuous reevaluations of the probable levels of future markets as compared to the levels of current markets. Consequently, the investment policy is the result of a dynamic and continuing evaluation process, rather than a static allocation of assets which ignores the changing markets and focuses on the past rather than the future.

The general investment policy of the two major retirement funds consists of ranges of allocations by investment classes. The ranges provide the flexibility needed to continually adapt the allocations to changing markets and expectations. The current range for equity investments runs from a low of 25 percent of the funds to a high of 50 percent, and the current level is about 40 percent. The longer term strategy of holding substantial percentages in equities reflects the probability that equities will continue to earn the highest relative returns on a long term basis, a condition which has been true for longer term periods in the past. Large public pension funds were recently holding about 44 percent in equities and corporate pension funds were holding about 60 percent in equities (the higher returns which corporate pension funds have historically earned have been basically due to their higher percentages of equities). Within the equity area, common stock investments may range from 21 percent to 46 percent of the funds (domestic commons at 17 percent to 42 percent and international commons at 4 percent to 10 percent). All common stock investments are being managed under discretionary contracts by external managers who were

competitively selected primarily on the basis of their investment performance. In order to limit the residual risk exposure of the retirement funds, the contracts require adequate diversification of holdings and prevent substantial investments in smaller, less seasoned business corporations. Real estate equities may range from 4 percent to 10 percent of the fund but the variance is less susceptible to short-term changes because of the long lead time needed to increase real estate equity investments and to realize the returns on those investments. Real estate equities are also managed by external managers. Although gold bullion investments are statutorily permissible, they are rarely, if ever, considered as reasonable investments by professional managers. The supply and demand factors which determine the price of gold are highly variable, essentially speculative, and are not usually susceptible to reasonable analysis or reliable forecasting. Consequently, the market risks are too great for gold to be considered as a component of the current policy.

The current range for fixed amount investments runs from a low of 50 percent of the funds to a high of 75 percent and is the complement of the equity investment range. The percent currently held in fixed amount investments is about 60 percent. The higher income yields available from fixed investments has given greater stability and certainty to the portfolios' annual returns and has helped avoid unnecessary volatility in the annual contribution rates. The current income yield of 10.10 percent on the fixed portion of the two major funds helps assure that even if the equity percentage is maximized the overall portfolio income yields will still meet the actuarial assumption for those funds of 9 percent per annum. The heavier reliance on fixed investments also reduces the overall return risks of the investment portfolios because the credit risks are substantially less than the residual risks of the equities. Within the fixed amount area, mortgage investments may range from a low of 2 percent of the funds to a high of 10 percent. Although the mortgage holdings usually are the highest income yielding segment of the fixed investments, they are essentially unmarketable and thereby limit the ability to reallocate the

portfolio holdings toward maximizing future returns. The current amount of 8 percent in mortgages is expected to decline toward the lower end of its range over the next several years. The remainder of the fixed amount area consists of fixed income securities which usually range from a low of 40 percent of the funds to a high of 73 percent. The securities include U.S. Treasury bonds, foreign government bonds, corporate bonds, and short-term money market issues. Bond investment management is aimed at maximizing income yields over interest rate cycles by lengthening maturities at high interest rate peaks and shortening them at low interest rate troughs. Because the corporate bonds and money market issues may entail significant credit risks, they are diversified to reduce the risk of default by any single issuer. The high marketability of the bonds facilitates limiting market risks by changing either the selections or the maturities. Alternatively, the market risks can be offset by hedging the holdings through the financial futures markets.

G. Public School (Endowment Trust) Fund

The Public School Fund is an endowment trust fund, separately accounted and invested.

1. Nature

The principal of endowment trust funds, including all subsequent principal contributions and principal gains, is retained in perpetuity in the funds, but the earned income is used for the purposes for which the trusts were established. The total retention of principal is a firmly established requirement of fiduciary law aimed at assuring perpetual income benefits by preventing diminution of the corpus of the trust. Additional principal contributions to the Public School Fund are made from State mineral revenues as compensation for land grant properties expropriated by the State. The total amount of compensation has not as yet been determined, but it will be a limited amount and at some future date additional contributions will cease. Income from the Public School Fund is used only for financing public education programs. Income earned on the principal of the fund is set aside in

income subaccounts and reinvested ending appropriation by the legislature and subsequent expenditure. In conformance with fiduciary principles, the distinction between principal and income is strictly maintained through accrual accounting with amortization of bond premiums and discounts on a constant yield-to-maturity basis in order to prevent unwarranted conversions of principal to income or income to principal.

## 2. Policy

The most important characteristic of the fund for investment policy purposes is its perpetual nature and the restriction that its principal can never be expended. As in the case of the retirement funds, this expands the universe of investment possibilities and increases the potential for achieving higher returns on the investments over the long run. The primary objective of investment policy should be to continuously increase the principal of the fund without severely reducing the current income flow available for the purposes of the trust. It is the typical objective of other endowment funds in the nation. The larger corpus over time leads to larger income flows, which in turn permit increased support of the activities for which the endowment was established. If the corpus were not to grow after the original contributions cease, the annual dollar income flows would be limited to the prevailing range of interest rates and would not be able to assist in financing any expansion of the activities or any increasing costs of the activities. The need for continuing growth of the principal of the fund in order to increase the available income is evident from the fact that the current income from the Public School Fund constitutes only about 1 percent of the total annual appropriations for public school programs.

Although the Public School Fund can invest as broadly as the retirement funds, until recent years it has been too small to effectively use the equity markets at reasonable transaction costs and the Commissioner of Revenue did not have the necessary discretionary authority. With the delegation of the authority from the Public School Fund Advisory board, required by

AS 37.14.170(a) and granted in September 1986 (see Appendix B), domestic common stock investments were initiated for the fund. Currently, the fund holds about 30 percent of its assets in common stocks and the remainder in straight corporate or federal government debt issues. The percentage held in equities will rise toward the retirement fund levels as opportunities develop in the equity markets. The corporate debt is diversified to reduce the exposure to credit risks and the debt maturities are structured to maximize interest income over interest rate cycles. Liquidity and market risks are not important elements of the policy, except to the extent necessary to preserve the ability to reallocate the investments within the funds. The fund's investment policy has been to maximize the realized return on the investments over a 10 to 20 year time span. Reduction of the perpetual life of the fund to a shorter time horizon is a practical necessity of the investment decision process.

Under the discretionary authority delegated to the Commissioner, the investment policy will shift to a predominant reliance upon equity issues. Educational endowment funds in the nation typically hold about two-thirds of their assets in equities. Because of the 50 percent statutory limitation on corporate obligations the policy range for equities is 30 percent to 50 percent. The equities currently are confined to domestic common stocks, through the consolidated investment pool which also includes the retirement funds' domestic common stock investments. When the fund grows larger, or when suitable pooled accounts are established by the Treasury Division, it may include real estate or international equities in its portfolio. This policy seeks to maximize the future income of the fund by increasing the principal of the trust. The greater potential exposure to residual risks is ameliorated through adequate diversification.

#### H. University of Alaska (Endowment Trust) Fund

This is a land grant endowment trust created by Acts of Congress dated January 21, 1929 and February 28, 1891 and amended by subsequent Acts dated September 19, 1966 and March 4, 1915 in which lands were

donated to the University of Alaska (as beneficiary) for the support of the Agricultural College and the School of Mines. The trust fund holds revenues from the use of the granted lands, proceeds from the sale of those lands, and any monetary gifts, bequests, or endowments made to the University of Alaska for the same purposes as the land grant.

#### 1. Nature

The trust is a typical university endowment fund and has the same perpetual preservation of principal nature as the Public School Fund. The principal contributions to the trust are erratic in timing and amount, and they do not flow from legislated appropriations. Income is used by the University for the Agricultural College and the School of Mines. As in the case of the other endowment trusts, the distinction between principal and income is strictly maintained through appropriate accounting procedures.

#### 2. Policy

The investment policy for this fund should be the same as the policy for the other endowment trust fund (IV.G.2) and for the same reasons. Unfortunately, such a policy would not be legal. Although the nature and purpose of the trust fund would most appropriately be served through equity investments, AS 14.40.400(b) restricts the fund's investments to interest-bearing securities. Opinion No. 13 (1963) of the Attorney General says "The prudent man rule is the proper rule for guiding the Commissioner of Revenue in the investment of the University's fund" and "In investing the endowment funds of the University of Alaska, the Commissioner of Revenue can obtain some guidance through observing the type of investments made throughout the United States by those responsible for the investment of university endowment funds." Since the time of that opinion, the prudent man rule has been upgraded to the prudent institutional investor rule through subsequent statutes affecting almost all funds. Because the nature or purpose of the trust, the prudent institutional investor rule, and the investment allocations of other university endowment funds are in conflict with the statutory limitation, it is strongly recommended that AS 14.40.400(b)

be repealed in favor of a new requirement limiting investments to the prudent institutional investor rule.

Within the constraints imposed by the interest-bearing statutory limitation, the fund's investment policy has been to maximize the income flow from the investments over one or more interest rate cycles. The fund now holds all of its assets in straight corporate or federal government debt issues.

If the interest-bearing limitation was removed, the new investment policy would move in the direction of heavier reliance on equity investments--as in the other endowment trust--in order to maximize the future income of the fund by increasing the principal of the trust.

## VII. ADMINISTRATION OF INVESTMENT POLICY

As noted under the nature of investment policies (V, preceding), the strategic policies are comprehensive derived evaluations of all of the significant factors which may affect investment prices and yields over some future time period. Many of the factors involved have been specified in the foregoing presentation. The development and execution of dynamic investment policies aimed at achieving the investment objectives in a constantly changing marketplace requires continuing re-evaluations by the professional investment analysts and managers who are investment officers in the Treasury Division.

### A. Development

Development of suitable investment policies for the various funds is primarily the ongoing responsibility of the professional staff of the Treasury Division. It requires review of large amounts of complex data concerning probable cash inflows and outflows from the funds, actuarial extensions, domestic and international economic developments and financial flows, industry and company financial studies, financial market pricings, and statutory, regulatory and tax law changes. The staff collects, organizes, analyzes, and evaluates the data in order to forecast the probable future movements of investment prices. The forecasts are revised as necessary and are the keystone underlying the formulation of investment policy for the retirement and endowment trust funds. They can also be a factor in the policies for the other shorter-term funds.

## B. Execution

The authority to invest the State Mortgage Insurance Fund was delegated to the National Bank of Alaska by a Custody and Investment Agreement dated July 30, 1976. The authority to invest all other funds has been delegated to the investment officers of the Treasury Division of the Department of Revenue by the written delegations contained in Appendices K and L. The exceptions to the general authorization to the Treasury Division are the delegations of authority by contract to independent investment management firms of specific amounts for investment in domestic and international common stocks. The current contracts were initiated in the 1984 fiscal year through the competitive procedures required for State professional service contracts.

### 1. Equities

The amounts placed with the common stock management firms and the timing of those placements are determined by the applicable investment policies which look to both the probable long- and short-term benefits to the funds. The amounts so placed with the management firms are invested at their discretion but within the limitations imposed by the contracts. The amounts invested in real estate equity pools and the timing of those investments are also determined by the applicable investment policies. The selection of the particular real estate equity pools is made by the Real Estate Management Section of the Treasury Division.

### 2. Fixed Amount Obligations (Non-Equities)

All fixed amount investments are selected, executed, and managed by the Treasury Division in conformance with the appropriate investment policies and under established operating standards and procedures. Real estate mortgages are the responsibility of the Real Estate Management Section and all securities are the responsibility of the Portfolio Management Section. The only exceptions to these responsibilities are:

- a. unexpected daily cash surpluses which may arise at the master custodian bank and which are invested by it for an overnight period under the terms of our contract with the bank;

- b. privately-placed and unmarketable Alaska securities previously acquired under former State loan programs which are being held in the General Investment Fund until they mature.

C. Operating Standards and Policies

The Treasury Division has established a number of policies and standards relating to the selection and execution of investment purchases and sales.

1. Pricing

Transaction methods are aimed at achieving the highest sale prices and lowest purchase prices, or the prevailing rates for non-priced securities.

- a. All U.S. Treasury and federal agency issue transactions are executed in the national markets using competitive auction procedures with large U.S. primary dealers.
- b. Corporate debt issue transactions are also executed in the national markets using competitive auction procedures with large, well-established broker-dealers, except when the procedure is impractical because the secondary market debt issue being purchased is only available from one dealer.
- c. Common stock transactions are executed in national stock exchange auction markets or over-the-counter markets by the external contracted managers. The trades may alternatively be executed at the discretion of the managers in the block trade market when size of the transaction, greater speed of execution, better prices, or lower commission costs are relevant factors.
- d. Other investments such as repurchase agreements, commercial paper, marketable bank paper, futures, foreign exchange, mortgages, and security lending arrangements are executed at prevalent national (or international) rates or prices through either limited auction or negotiation procedures.
- e. Foreign investments utilize a combination of the aforementioned procedures depending

upon the structure of the foreign market, the size of the transaction, and the limitation on trading because of time zone differences.

## 2. Deliveries

In order to prevent the risk in settling trades of releasing investments or cash without receiving the offsetting cash or investments, all investment transactions are limited to delivery against simultaneous payment. No payments are made nor investments delivered against "due bills" (I.O.U.'s).

## 3. Credit Standards

### a. Securities

The potential credit risks on all debt securities are determined by the Portfolio Management Section through financial analysis of the issuer. The standards of selection for acceptable credits are more demanding than those required by the relevant statutes and are primarily professional judgments concerning the probable ability of the issuer to avoid defaulting on the obligation. Regular financial reports are required of all issuers in whose obligations we invest. The credit standards are formulated, monitored, and revised as necessary by the analysts in the Portfolio Management Section.

### b. Mortgages

In addition to statutory and regulatory requirements, all real estate mortgage loans must meet the standards contained in Appendix M. These standards are developed and revised by the Real Estate Management Section.

## 4. Underlying Agreements

Certain transactions are limited to and by the terms of underlying and binding agreements entered into between the Treasury Division and other parties.

a. Repurchase Agreements

Repurchase Agreements (Repo's) are only transacted with non-bank primary dealers who have signed our repurchase agreement, which protects each party's right to the collateral in the event the other party defaults or goes bankrupt. The agreement limits acceptable collateral to U.S. Treasury obligations and requires a 102 percent ratio of the collateral's market value to the loan amount. The agreements are revised as necessary by the Portfolio Management Section.

b. Lending Agreements

Lending agreements similar in protective provisions to the repurchase agreements but covering the lending of owned debt securities against acceptable collateral and at the prevailing percentage rate and margin may be entered into with broker-dealers. The agreements are developed and revised by the Portfolio Management Section.

c. Master Demand Note Agreements

Lending agreements with major, prime-rated, non-bank, commercial paper issuers covering day-to-day loans of variable amounts of money to the corporate issuer and evidenced by annotation to master notes held by our custodian bank. Rates on the notes may vary daily in response to market rates. The agreements are developed and revised by the Portfolio Management Section.

d. Mortgages

Mortgage loan sales and servicing agreements are required of all sellers from whom the Treasury Division purchases mortgages. The agreements are revised as necessary by the Real Estate Management Section.

e. Real Estate Equities

All investments in real estate equity pools require underlying negotiated agreements between the Treasury Division and the seller or manager of the properties. These agree-

ments are developed by the Real Estate Management Section and reviewed by the Attorney General.

#### 5. Consolidated Investment Pools

The Treasury Division may establish pools for investment in particular types of assets by the various funds under management by the Division. The purpose of consolidated investment pools is to simplify administration, reduce costs, and provide a vehicle for diversified investment in these types of assets by smaller funds. Without such pools, small funds would be unable to invest in certain types of investments and would not be adequately diversified.

Currently, the Treasury Division maintains a domestic common stock consolidated investment pool. All domestic common stock holdings of the pension and endowment trust funds are represented by shares in this pool.

Each share is entitled to an equal portion of the pool's principal, realized gains or losses, and income. The pool shares, and therefore each fund's total holdings, are valued at the market value of the pool's principal at the end of each month. Contributions to, or withdrawals from, the pool (i.e., purchases or sales of pool shares) by a fund may be made at the end of each month at the pool shares' market value. Realized gains or losses are accounted for as a change in the book value of each fund's shares but are not distributed in cash. Income received is distributed in cash each month, first, to accrued income allocated to any withdrawal, and second, in proportion to each fund's remaining accrued income.

### VIII. ACCOUNTABILITY

#### A. Audits of Accounts

An annual financial audit is conducted each fiscal year by an independent Certified Public Accounting firm for the General and Segregated Funds, the Public Employees Retirement Fund, and the Teachers Retirement Fund. The scope of the audit includes a review of internal controls and of securities custody and safekeeping practices and procedures.

B. Safekeeping of Assets

Marketable securities are held by custodial banks under contracts with the Treasury Division. A small amount of securities or cash may be held from time to time at a futures broker under the requirements and supervision of the exchange on which the futures are traded. Cash held at clearing or custodial banks is kept at minimal operating levels. Non-marketable securities, mortgages, and unmarketable privately-placed loans are held in a vault in the Treasury Division.

C. Reporting

1. Investment Status and Activity

The Comptroller of the Treasury Division prepares separate monthly financial reports for the General Investment Fund, Public Employees Retirement Fund, Teachers Retirement Fund, Public School Fund, and University of Alaska Fund. The reports consist of asset statements, income statements on the accrual basis of accounting, and sources and uses statements.

2. Performance Reviews

Under contract with the Treasury Division independent organizations perform comparative investment performance reviews of the Public Employees Retirement Fund, the Teachers Retirement Fund, and the Public School Fund. The reviews currently cover the portions of each fund which are managed by outside firms under contracts with the Treasury Division and the portions of each fund which are managed by the Treasury Division, excepting mortgage holdings. The reviews compare the investment performance against market indices and funds of a similar nature or against other managers.

APPENDIX A

State of Alaska  
Memorandum of Understanding  
between  
Department of Revenue  
and  
Department of Administration

WHEREAS, Attorney General's opinions, file nos. 366-103-85 and 366-171-85, authorize the crediting of investment income to trust funds or accounts managed by the State, the fish and game fund, and the power development revolving loan fund (hereinafter, "Funds"); and

WHEREAS, these Funds are commingled for investment purposes with the State general fund and other funds in the General Investment Fund; and

WHEREAS, the Department of Revenue and the Department of Administration desire to formalize their agreement as to

- a. their respective responsibilities for crediting investment income of the General Investment Fund to these Funds; and
- b. the valuation of assets of these Funds in the event of their transfer from the General Investment Fund;

NOW, THEREFORE, BE IT RESOLVED BY the Department of Revenue and the Department of Administration that:

1. The Department of Revenue, Treasury Division will determine monthly the figures for:
  - (a) the book value at the end of the month of the marketable securities portfolio of the General Investment Fund; and
  - (b) the income during the month on the marketable securities portfolio of the General Investment Fund, including realized and accrued income, amortization of premiums, and accretion of discounts but excluding unrealized gains or losses attributable to changes in market values of securities.
2. The Department of Revenue, Treasury Division will calculate the amount of monthly investment income to be

credited to each Fund and the end of month balance for each Fund by:

- (a) calculating the pro rata share of each Fund by dividing
  - (i) the preliminary balance of the Fund at the end of the month by
  - (ii) the General Investment Fund balance for that month as reported under 1.(a) of this agreement less the income during the month on the General Investment Fund as reported under 1.(b) of this agreement;

the preliminary balance shall be the balance as of the end of the month as recorded on the State's automated accounting system (AKSAS) on the tenth business day following the end of the month, excluding the credit calculated in this agreement;

- (b) calculating the credit to each Fund for the month by multiplying each Fund's pro rata share as calculated in 2.(a) of this agreement by the General Investment Fund marketable securities portfolio income as reported under 1.(b) of this agreement; and
- (c) calculating the balance of each Fund at the end of each month by adding the credit calculated in 2.(b) of this agreement to the preliminary balance at end of the month.

The Department of Revenue, Treasury Division will provide documentation showing the amounts and calculations determined under 1 and 2 of this agreement to agencies desiring to verify the calculations as listed in Attachment A.

- 3. The Department of Administration, Division of Finance at the end of each fiscal year will record in the State's annual financial report, AKSAS, and any other books or accounts of record:
  - (a) the total investment income credited to each Fund (and debited to the general fund), which shall be the total of the credits calculated for each month during the fiscal year; and
  - (b) the balance of each Fund at the end of the fiscal year.

4. The Department of Administration, Division of Finance may delegate its responsibilities under this agreement to a State agency. The Division of Finance may record, or permit a delegated agency to record, credits, debits, and balances at a more frequent interval than annually.
5. In the event any assets of any Fund are transferred from the general fund to another State fund or in liquidation or partial liquidation of the Fund, the amount of cash transferred shall be the market value of the assets. The market value of the assets transferred shall be determined by multiplying the market value of the marketable securities portfolio of the General Investment Fund by the ratio of the Fund balance or portion of Fund balance being transferred, to the General Investment Fund balance as reported under 1.(a) of this agreement. Balances used in this calculation shall be as of the end of the month in which the transfer is made and shall include all credits to the Funds due under this agreement as of the date of transfer.
6. The funds listed on Attachment A are subject to this agreement. Other funds may become subject to this agreement upon the approval of the Attorney General. Funds which are clearly trust funds or clearly contain a statutory dedication of investment income will become subject to this agreement automatically.

This agreement takes effect July 1, 1986.

Department of Administration  
Eleanor L. Andrews, Commissioner

Department of Revenue  
Mary A. Nordale, Commissioner

          /s/ Eleanor Andrews            
(Signature)

          /s/ Mary A. Nordale            
(Signature)

          July 30, 1986            
(Date)

          August 8, 1986            
(Date)

## Attachment A

Funds and Accounts With Dedicated Earnings  
Revised as of January 29, 1988

<u>Fund or Account</u>	<u>Statutory Citation</u>	<u>Agency Verifying Credit Calculation</u>	<u>Frequency of Verification</u>	<u>Agency Responsible for AKSAS Entry</u>	<u>Frequency of Recordation</u>
Student Loan Fund	AS 14.42.210	Alaska Student Loan Corp.	Annually	Administration (Finance)	Annually
Alaska Clean Water Fund (exclusive of non-matching funds)(effective July 1, 1987)	AS 46.03.032	Administration (Finance)	Annually	Administration (Finance)	Annually
Fish and Game Fund	AS 16.05.110	Administration (Finance)	Annually	Administration (Finance)	Annually
Power Development Revolving Loan Fund	AS 44.33.600	Administration (Finance)	Annually	Administration (Finance)	Annually
Mental Health Trust Income Account	Ch. 132 SIA 1986 and AS 37.14.011(a)	Administration (Finance)	Annually	Administration (Finance)	Annually
Permanent Fund Dividend Trust Accounts	AS 43.23.105(e)	Revenue (Fiscal)	Quarterly	Administration (Finance)	Annually
Miscellaneous Trust Account (Department of Law)		Revenue (Fiscal)	Monthly	Administration (Finance)	Annually
Unlicensed Vessel Personnel Annuity Retirement Fund		Administration (Retirement & Benefits)	Semi-annually	Administration (Finance)	Annually
Warner Trust Fund		Community & Regional Affairs	Quarterly	Administration (Finance)	Annually
Exxon Trust Fund		Community & Regional Affairs	Quarterly	Administration (Finance)	Annually
Railbelt Energy Fund <sup>1/</sup>	AS 37.05.153	Administration (Finance)	Annually	Administration (Finance)	Annually
Budget Reserve Fund <sup>1/</sup>	AS 37.05.156(d)	Administration (Finance)	Annually	Administration (Finance)	Annually

<sup>1/</sup> Income is only to be calculated (step 2.(c) of the agreement is to be omitted) unless the legislature appropriates the income to the fund, in which case it will be credited. As a result interest will be compounded annually at best.

APPENDIX B

Public School Fund Advisory Board  
Resolution No. \_\_\_\_\_

Providing for the Authorization of the  
Commissioner of Revenue to Invest  
the Public School Fund in the Manner  
Specified in AS 39.35.110.

WHEREAS, AS 37.14.170 authorizes the Commissioner of Revenue, with the approval of the Public School Fund Advisory Board, to invest the principal of the Public School Fund in the manner specified in AS 39.35.110 for the Public Employees Retirement Fund;

WHEREAS, the Department of Revenue has provided to the Board of Education its General Investment Policies dated January 1986 which sets forth the authority, objectives, and investment policies for each fund which is invested by the Commissioner of Revenue;

NOW, THEREFORE, BE IT RESOLVED that the Public School Fund Advisory Board hereby concurs with the objectives and investment policies proposed for the Public School Fund by the Department of Revenue in its General Investment Policies; and

BE IT FURTHER RESOLVED that the Public School Fund Advisory Board hereby authorizes the Commissioner of Revenue to invest the Public School Fund in the manner specified in AS 39.35.110.

BY: /s/ Ernestine Griffin  
Chairman, Public School Fund  
Advisory Board  
DATE: September 26, 1986

ATTEST:

/s/ Marshall L. Lind  
Commissioner, Department of Education



APPENDIX D

The General Investment Fund  
Permissible Investment Instruments  
(AS 37.10.070)

Investments limited to:

1. obligations of, or obligations insured 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 issued by United States domestic banks which are members of the Federal Deposit Insurance Corporation for which a generally recognized secondary market exists or which are secured fully at all times as to the payment of principal and interest in accordance with Alaska law;
4. corporate debt securities with a minimum rating of "BAA" or the equivalent by a nationally recognized rating organization and the preferred and common stocks of companies which have paid dividends continuously for the last three years;
5. commercial paper bearing the highest rating of a nationally recognized rating organization;
6. securities of foreign governments, foreign governmental agencies, and foreign corporations the principal, interest, or dividends of which are payable in either United States dollars or foreign currencies;
7. bankers acceptances drawn on and accepted by banks with a combined capital and surplus aggregating at least \$200,000,000;
8. shares of federally chartered savings and loan associations in Alaska which are fully secured at all times as to the payment of principal and interest in accordance with Alaska law;
9. savings certificates issued by state-chartered savings and loan associations in Alaska which are fully secured at all times as to the payment of principal

and interest in accordance with Alaska law;

10. deposits with mutual savings banks in Alaska which are fully secured at all times as to the payment of principal and interest in accordance with Alaska law;
11. fixed-term certificates of indebtedness of federally insured credit unions in Alaska which are fully secured at all times to the payment of principal and interest in accordance with Alaska law;
12. foreign time deposits of both United States-owned and foreign-owned banks and trust companies denominated in either United States dollars or foreign currencies;
13. mortgages of the Alaska Rural Rehabilitation Corporation which secure agricultural loans, agricultural business loans, and agricultural processing loans;
14. futures contracts for the sale of investments only for the purpose of hedging an existing equivalent ownership position in investments of the types described above.

APPENDIX E

AHFC Pledged Fund  
Permissible Investment Instruments  
(Section 508 of AHFC General Housing  
Mortgage Bond Resolution)

Investments limited to:

1. direct obligations of or obligations guaranteed by the United States of America;
2. deposits in interest-bearing time deposits or certificates of deposit secured by obligations of, or unconditionally guaranteed by, the United States of America or by obligations described in 1 or 3 hereof;
3. bonds, debentures, notes, or participation certificates issued by any of the following Federal agencies: Bank for Cooperatives, Federal Intermediate Credit Banks, Federal Home Loan Banks System, Federal Land Banks, Export-Import Bank, Tennessee Valley Authority, Government National Mortgage Association, and Farmers Home Administration;
4. Public Housing Bonds issued by Public Housing Authorities and fully secured as to the payment of both principal and interest by a pledge or annual contributions under an annual contribution contract or contracts with the United States of America, or Temporary Notes issued by Public Housing Authorities or Preliminary Loan Notes issued by Local Public Agencies, in each case, fully secured as to the payment of both principal and interest by a requisition or payment agreement with the United States of America;
5. direct and general obligations of or obligations guaranteed by the State to the payment of the principal of and interest on which the full faith and credit of the State is pledged;
6. deposits in interest-bearing time deposit or certificates of deposit secured by obligations of or guaranteed by the State;
7. bankers acceptances drawn on and accepted by banks with a combined capital and surplus of at least \$200,000,000;

8. corporate obligations of prime or equivalent quality as rated by a nationally recognized rating agency; and
9. bank certificates of deposit which are secured as to payment of principal and interest in accordance with Alaska law.

## APPENDIX F

### International Airports Funds Permissible Investment Instruments (State Bond Committee Resolution No. 68-4)

Instruments for the Construction Fund, the Revenue Trust Fund, and the Repair and Replacement Reserve Account are limited to:

1. time or demand deposits in any bank or trust company authorized to accept deposits of public funds and secured at all times by such obligations as are required by law and to the fullest extent required by law;
2. direct obligations of the United States of America, obligations the principal of and interest on which are guaranteed by the United States of America;
3. obligations issued by federal land banks or federal intermediate credit banks established under the Federal Farm Loan Act, as amended;
4. bonds or debentures of the Federal Home Loan Bank Board or of any federal home loan bank established under the Federal Home Loan Bank Act;
5. obligations of the Federal National Mortgage Association established under the National Housing Act, as amended; and
6. debentures and consolidated debentures issued by the Central Bank for Cooperatives or banks for cooperatives established under the Farm Credit Act of 1933, as amended.

## APPENDIX G

### State Mortgage Insurance Fund Permissible Investment Instruments (AS 18.56.095(b) and AS 37.10.070(a))

Although the permissible instruments include all of those specified for the General Fund (Appendix E), the Mortgage Insurance Agreement dated December 6, 1975 between the State and AHFC has further limited investments to:

1. direct obligations of, or obligations insured or guaranteed by, the United States of America or agencies or instrumentalities of the United States;
2. bankers acceptances drawn on and accepted by banks and certificates of deposit of banks, with a combined capital and surplus aggregating at least \$200,000,000; or
3. interest bearing time deposits or certificates of deposit of a bank or trust company continuously secured and collateralized by obligations of the type described in paragraph 1 or by obligations of the State having a market value at least equal at all times to the amount of such deposit or certificate, to the extent such deposit or certificate is not insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation, or any successors thereto.

APPENDIX H

Public Employees Retirement Fund  
Teachers Retirement Fund  
Judicial Retirement Fund  
Alaska National Guard and Alaska Naval Militia Retirement Fund  
Public School Fund  
Permissible Investment Instruments  
(AS 39.35.110, AS 14.25.180, AS 37.14.170,  
AS 22.25.048(c), AS 26.05.228(c))

1. shares of federally chartered savings and loan associations in Alaska, to the extent that the investment is insured by the federal government or by an agency of the federal government;
2. deposits with mutual savings banks in Alaska, to the extent that the investment is insured by the federal government or an agency of the federal government;
3. deposits with state and national banks in Alaska to the extent that the investment is insured by the federal government or an agency of the federal government;
4. the guaranteed portion of Small Business Administration loans;
5. first lien real estate mortgages guaranteed by the federal Veterans Administration;
6. notes secured by mortgages of commercial or residential buildings if the mortgages are insured by a private mortgage insurance corporation which is authorized to do business in Alaska and has combined capital, surplus, and reserves aggregating at least \$20,000,000; however,
  - a. no mortgage insurance is necessary for commercial loans having loan-to-value ratios of less than 50 percent and the minimum coverage of other commercial loans shall be 10 percent for those having a loan-to-value ratio of 50-60 percent and 15 percent for those having a loan-to-value ratio greater than 60 percent but no more than 75 percent, and
  - b. no mortgage insurance is 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;

7. conventional residential mortgages if the originating financial institution retains at least 25 percent of the mortgage for a minimum of two years;
8. notes secured by mortgages of commercial buildings if the originating financial institution retains at least 25 percent of the mortgage until maturity;
9. FHA guaranteed portion of business and industrial loans made under the Rural Development Act of 1972;
10. bankers' acceptances which are eligible for discount at the Federal Reserve Bank and certificates of deposit issued by United States domestic banks which are members of the Federal Deposit Insurance Corporation if a generally recognized secondary market exists for the certificates of deposit;
11. obligations of, or obligations insured by or guaranteed by, the United States or agencies or instrumentalities of the United States;
12. 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;
13. corporate debt securities with a minimum rating of "A" or an equivalent rating by a nationally recognized rating organization;
14. preferred and common stock of companies which have paid dividends in each of the three years immediately preceding the investment; Stocks eligible for purchase are restricted to stocks which, except for bank stocks and insurance stocks, are listed upon an exchange registered with the Federal Securities and Exchange Commission;
15. commercial paper bearing the highest rating of a nationally recognized rating organization;
16. securities of foreign governments, foreign governmental agencies, and foreign corporations the principal, interest, or dividends on which are payable in either United States dollars or foreign currencies;

17. foreign time deposits of both United States-owned and foreign-owned banks and trust companies denominated in either United States dollars or foreign currencies;
18. gold bullion certified as to fineness of at least 99 1/2 percent;
19. futures contracts for the sale of investments only for the purpose of hedging an existing equivalent ownership position in investments of the types described above; and
20. a trust which is qualified under Sec. 401(a) of the Internal Revenue Code (26 U.S.C. Sec. 401(a)) and exempt from taxation under Sec. 501(a) of the Internal Revenue Code (26 U.S.C. Sec. 501(a)) and which is maintained as a medium for pooling a portion of the funds of pension and profit-sharing trusts for diversifying investments in real estate and interests in real estate.

APPENDIX I

State of Alaska  
Department of Revenue  
Treasury Division

Mandatory Agreement For All Treasury Personnel

The Treasury Division of the Department of Revenue is responsible for managing large amounts of investments and cash for either the State of Alaska or the beneficiaries of fiduciary trusts. The responsibility cannot be faithfully discharged if the integrity of the function is impaired through financial conflicts of interests or unnecessary dissemination of privileged information by the personnel of the Treasury Division. I voluntarily agree to adhere to the following behavioral standards as a condition of employment and with the understanding that any violations may constitute grounds both for dismissal and for any other penalties provided by law:

1. I will not engage in, nor recommend or suggest that others engage in, personal investment transactions which have an adverse effect upon the Treasury Division's investment transactions.
2. I may in the course of my employment obtain privileged information concerning recent, contemporaneous or impending Treasury Division investment transactions, or investment advice or counsel furnished to the Treasury Division, or tax payments, but I will not provide that information to others who do not have a functional need or a legal right to know it, nor will I utilize the information as a basis for making personal investments or for recommending or suggesting to other parties that they make investments whose returns are partly or wholly dependent upon similar or contrary investment transactions undertaken or to be undertaken by the Treasury Division. I understand that this restriction does not apply if the information has been disseminated to the public.
3. I will not accept from parties doing business with the Treasury Division any personal gifts or valuable considerations as a reward or inducement for any Treasury business done with them. The occasional unsolicited distribution by financial institutions of token gifts to their substantial customers, and meals or refreshments furnished while business is being transacted, may be accepted, subject to the reporting requirements of AS 39.52.130(b) if the gift or consideration exceeds \$50 and the recipient may take official action that affects the giver.

Acknowledged by:

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

## APPENDIX J

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### THE CODE OF ETHICS AND THE STANDARDS OF PROFESSIONAL CONDUCT

Adopted by The Federation of Financial Analysts and The Institute of Chartered Financial Analysts. Revised April 29, 1984.

#### THE FAF RESOLUTION

WHEREAS, the profession of financial analysis and investment management has evolved because of the increasing public need for competent, objective, and trustworthy advice with regard to investments and financial management; and

WHEREAS, those engaged in this profession have joined together in an organization known as The Financial Analysts Federation; and

WHEREAS, despite a wide diversity of interest among analysts employed by brokers and securities dealers, investment advisers, banks, insurance companies, investment companies and trusts, pension trusts, and other institutional investors and investment entities, there are nevertheless certain fundamental standards of conduct which should be common to all engaged in the profession of financial analysis and investment management and accepted and maintained by them; and

WHEREAS, the members of The Financial Analysts Federation adopted a Code of Ethics and Standards on May 20, 1962, which have been amended from time to time; and

WHEREAS, The Financial Analysts Federation provides for individual membership in it, requires that all of its member societies adopt its Code of Ethics and Standards of Professional Conduct, and requires that all individual members comply with them;

#### THE ICFA RESOLUTION

WHEREAS, the profession of financial analysis and investment management has evolved because of the increasing public need for competent, objective, and trustworthy advice with regard to investments and financial management; and

WHEREAS, The Institute of Chartered Financial Analysts was organized to establish educational standards in the field of financial analysis, to conduct examinations of financial analysts and to award the professional designation of Chartered Financial Analyst, among other objectives; and

WHEREAS, despite a wide diversity of interest among analysts employed by brokers and security dealers, investment advisers, banks, insurance companies, investment companies and trusts, pension trusts, and other institutional investors and investment entities, there are nevertheless certain fundamental standards of conduct which should be common to all engaged in the profession of financial analysis and investment management and accepted and maintained by them; and

WHEREAS, The Institute of Chartered Financial Analysts adopted a Code of Ethics and Standards on March 14, 1964, which have been amended from time to time;

NOW, THEREFORE, The Institute of Chartered Financial Analysis hereby adopts the following Code of Ethics and Standards of Professional Conduct:

NOW, THEREFORE, the following are the Code of Ethics and Standards of Professional Conduct of The Financial Analysts Federation:

*Members of The Financial Analysts Federation are obligated to conduct their professional activities in accordance with the following Code of Ethics and Standards of Professional Conduct. Disciplinary sanctions may be imposed for violations of the Code or Standards.*

*Members of The Institute of Chartered Financial Analysts are obligated to conduct their professional activities in accordance with the following Code of Ethics and Standards of Professional Conduct. Disciplinary sanctions may be imposed for violations of the Code or Standards.*

### THE CODE OF ETHICS

A financial analyst/Chartered Financial Analyst should conduct himself\* with integrity and dignity and act in an ethical manner in his dealings with the public, clients, customers, employers, employees, and fellow analysts.

A financial analyst/Chartered Financial Analyst should conduct himself and should encourage others to practice financial analysis in a professional and ethical manner that will reflect credit on himself and his profession.

A financial analyst/Chartered Financial Analyst should act with competence and should strive to maintain and improve his competence and that of others in the profession.

A financial analyst/Chartered Financial Analyst should use proper care and exercise independent professional judgment.

### THE STANDARDS OF PROFESSIONAL CONDUCT

#### I. Obligation to Inform Employer of Code and Standards.

The financial analyst/Chartered Financial Analyst shall inform his employer through his direct supervisor, that he is obligated to comply with the Code of Ethics and Standards of Professional Conduct, and is subject to disciplinary sanctions for violations thereof. He shall deliver a copy of the Code and Standards to his employer if the employer does not have a copy.

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\*Masculine pronouns, used throughout the Code and Standards, as well as throughout the Handbook, to simplify sentence structure, shall apply to all persons, regardless of sex.

**II. Compliance with Governing Laws and Regulations and the Code and Standards.**

**A. Required Knowledge and Compliance.**

The financial analyst/Chartered Financial Analyst shall maintain knowledge of and shall comply with all applicable laws, rules, and regulations of any government, governmental agency, and regulatory organization governing his professional, financial, or business activities, as well as with these Standards of Professional Conduct and the accompanying Code of Ethics.

**B. Prohibition Against Assisting Legal and Ethical Violations.**

The financial analyst/Chartered Financial Analyst shall not knowingly participate in, or assist, any acts in violation of any applicable law, rule, or regulation of any government, governmental agency, or regulatory organization governing his professional, financial, or business activities, nor any act which would violate any provision of these Standards of Professional Conduct or the accompanying Code of Ethics.

**C. Prohibition Against Use of Material Non-Public Information.**

The financial analyst/Chartered Financial Analyst shall comply with all laws and regulations relating to the use of material non-public information. (1) If the analyst acquires such information as a result of a special or confidential relationship with the issuer, he shall not communicate the information (other than within the relationship), or take investment action on the basis of such information, if it violates that relationship. (2) If the analyst is not in a special or confidential relationship with the issuer, he shall not communicate or act on material non-public information if he knows or should know that such information was disclosed to him in breach of a duty. If such a breach exists, the analyst shall make reasonable efforts to achieve public dissemination of such information.

**D. Responsibilities of Supervisors.**

A financial analyst/Chartered Financial Analyst with supervisory responsibility shall exercise reasonable supervision over those subordinate employees subject to his control, to prevent any violation by such persons of applicable statutes, regulations, or provisions of the Code of Ethics or Standards of Professional Conduct. In so doing the financial analyst/Chartered Financial Analyst is entitled to rely upon reasonable procedures established by his employer.