

**ALASKA LEGISLATURE**

**1879**

**HOUSE and SENATE FINANCE COMMITTEE FILES, 1999 - 2000**

30

# Payment Adjustments

## Original Participating Manufacturer Payments

### Initial Payment Adjustments

- ✦ Volume Adjustment
- ✦ Non-Settling States Reduction
- ✦ Offset for Miscalculated or Disputed Payments

### Annual Payment Adjustments

- ✦ Inflation Adjustment
- ✦ Volume Adjustment
- ✦ Previously-Settled States Reduction
- ✦ Non-Settling States Reduction
- ✦ NPM Adjustment
- ✦ Offset for Miscalculated or Disputed Payments
- ✦ Federal Tobacco Legislation Offset
- ✦ Litigating Releasing Parties Offset

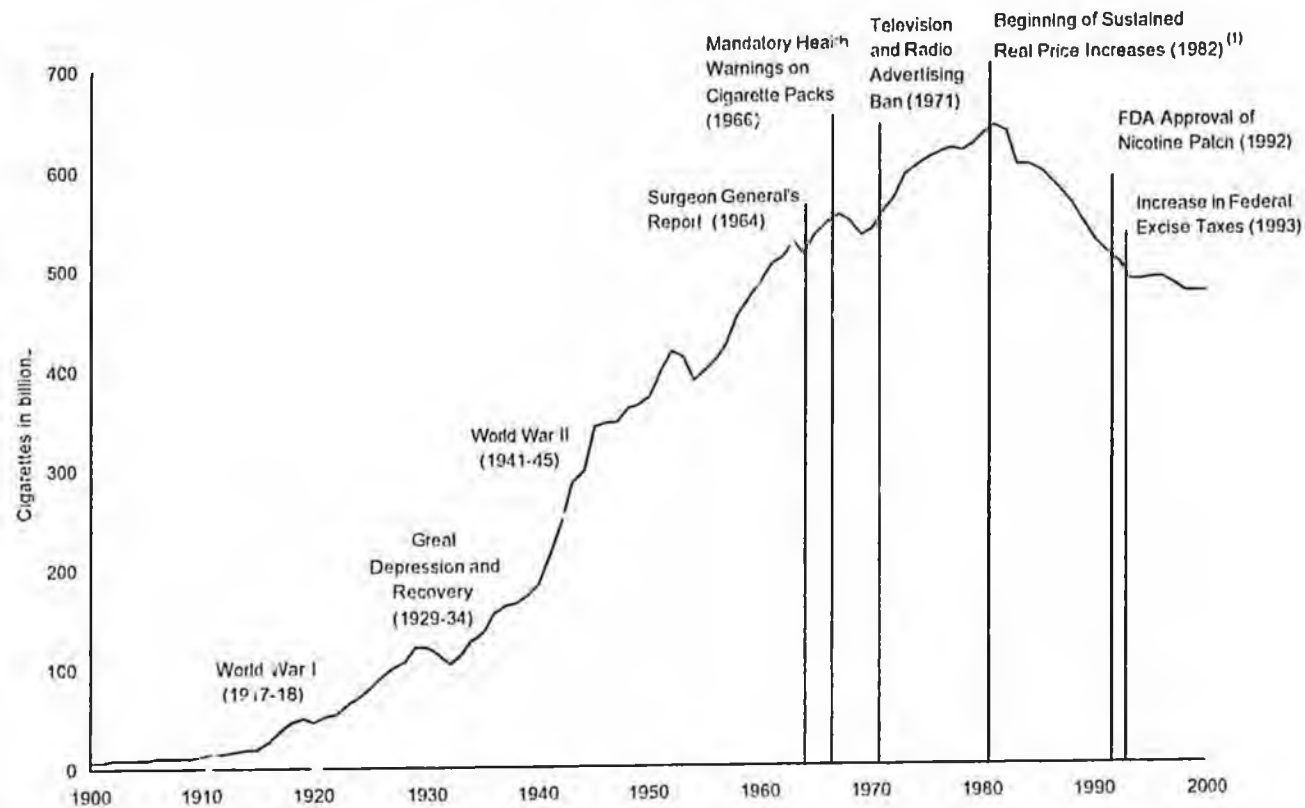
## Subsequent Participating Manufacturer Payments

### Annual Payment Adjustments

- ✦ Inflation Adjustment
- ✦ Volume Adjustment
- ✦ Non-Settling States Reduction
- ✦ NPM Adjustment
- ✦ Offset for Miscalculated or Disputed Payments
- ✦ Federal Tobacco Legislation Offset
- ✦ Litigating Releasing Parties Offset

# U.S. Cigarette Consumption Trends

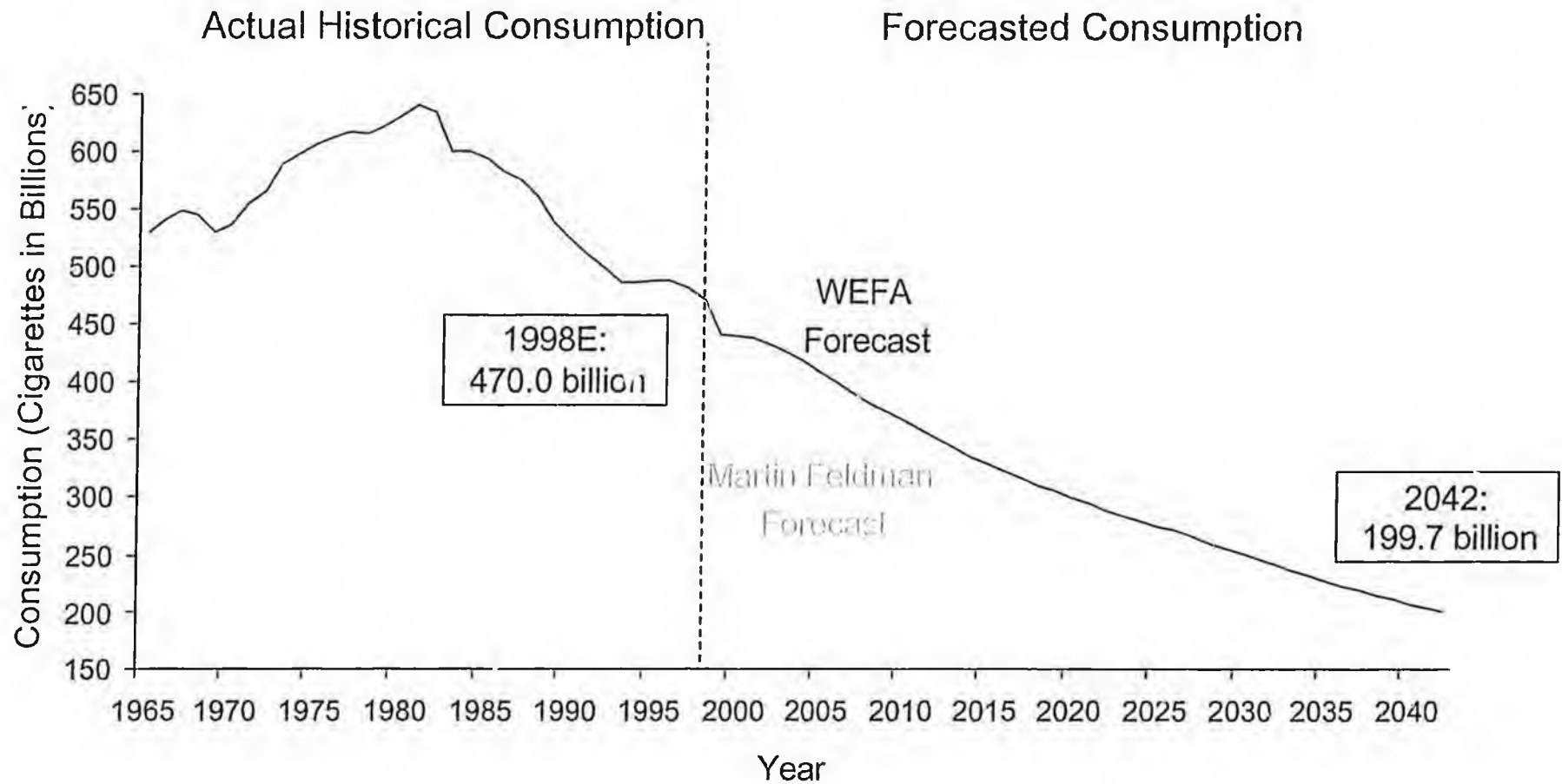
*Cigarette Consumption, 1900-1998*



Source: U.S. Department of Agriculture

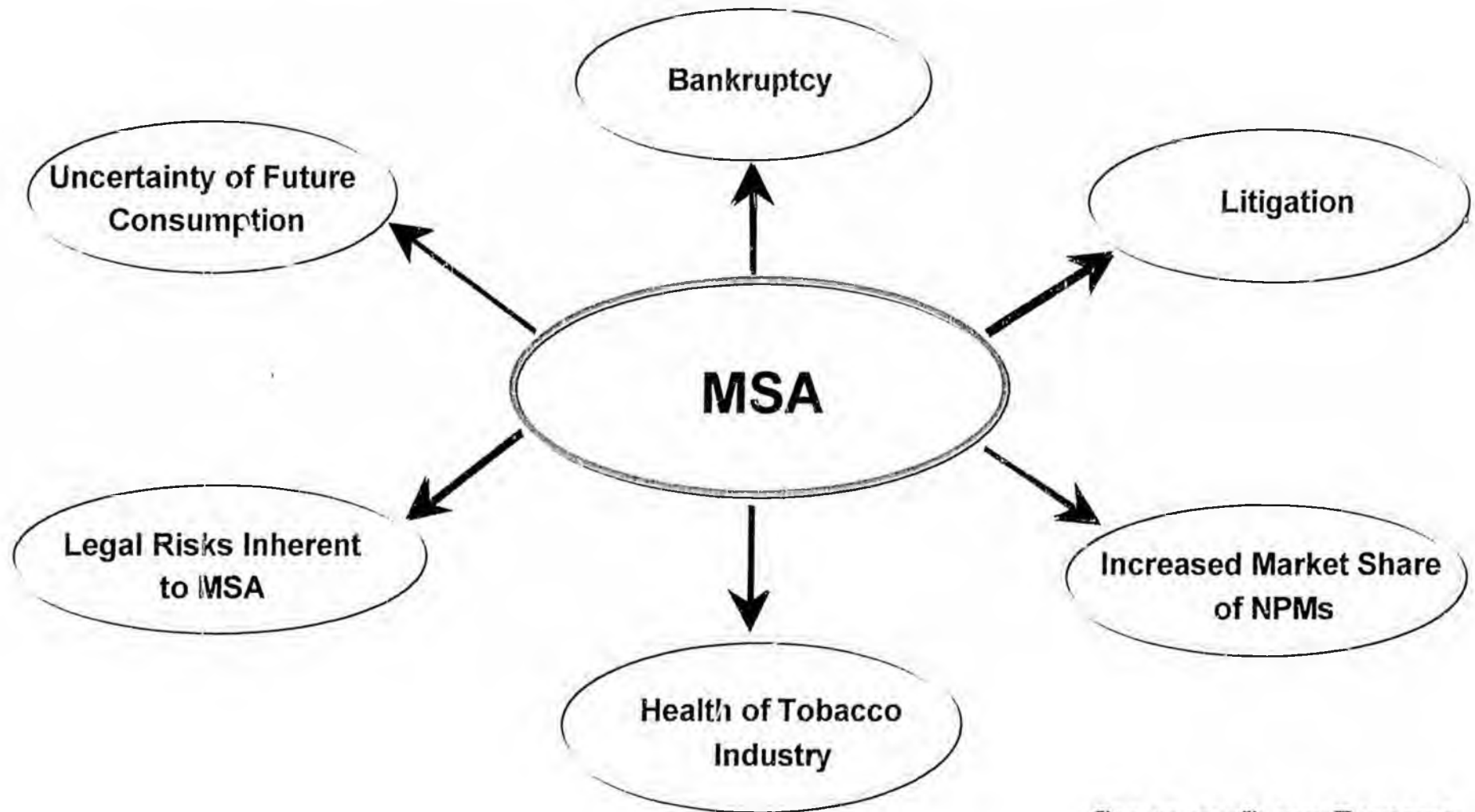
(1) Jeffrey E. Harris, "A Working Model for Predicting Consumption and Revenue Impacts of Large Increases in the U.S. Federal Cigarette Excise Tax" 1994

# WEFA Forecasts a 58% Decline in Total U.S. Consumption of Cigarettes Over the Next 43 Years



# Credit Concerns Regarding Payments under the MSA

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# Credit Concerns Regarding Payments Under the MSA

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## Credit Concerns

Uncertainty of future cigarette consumption

Bankruptcy of a PM

Increased NPM market share

Legal risks inherent to the MSA

## Mitigating Factors

- Utilize an independent consultant
- Provide potential investors objective and accurate forecasts
- Strategic bankruptcy is unlikely due to benefits of MSA
- Credit bankruptcy is unlikely due to the strength of the tobacco industry
- The widespread enactment of the model statute and the strong incentives of MSA
- Viewed as an executory contract, reducing risk of nonpayment in bankruptcy

# Credit Concerns Regarding Payments Under the MSA

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## Credit Concerns

Litigation

Health of Industry

## Mitigating Factors

- Third party provider suits largely unsuccessful
- Florida Supreme Court is reviewing class-wide punitive damages issue in Engle
- Aggregate individual awards unlikely to pose financial threat
- 36 states require more than 50% comparative fault for recovery
  
- PMs are enormously profitable (Phillip Morris EBIT >40%; RJR >20%)
- Credit quality greater than rating
- Liquidity and interest coverage in AA category

# Should Alaska Leverage Its Funds?

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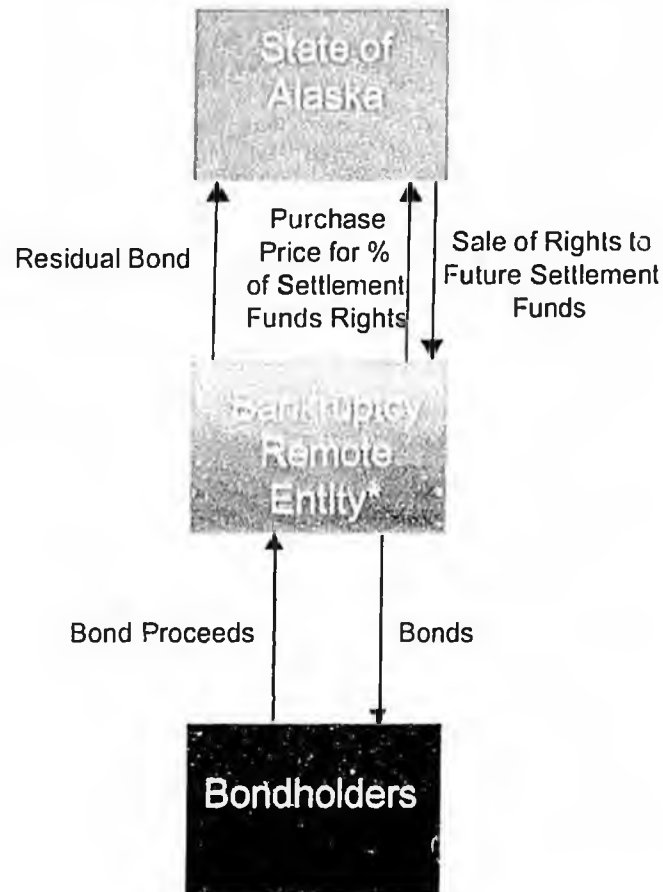
- ✦ Future receipt of tobacco settlement revenues uncertain
- ✦ Tobacco settlement revenues are not a diversified source of income for the state
- ✦ Alaska can receive residual tobacco settlement revenues after debt service payments
- ✦ Alaska can choose whether to issue the funds for capital spending or invest them
- ✦ Alaska may employ an endowment strategy to diversify revenue from tobacco settlement payments

## Securitization Benefits

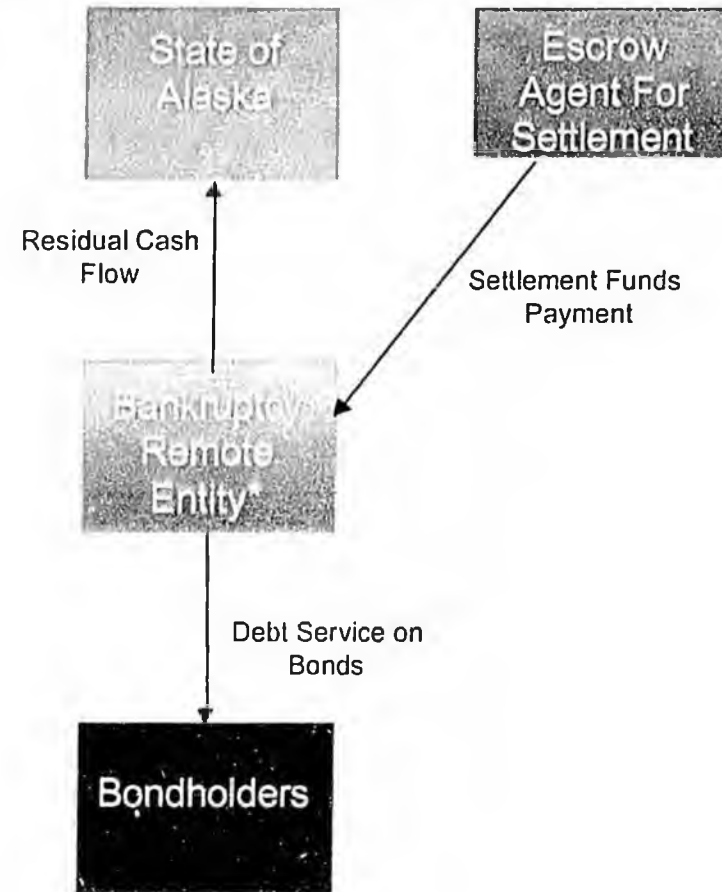
- Keep upside of residuals
- Eliminate downside risks of Tobacco Settlement Revenues

# Structured Credit or Securitization

## STRUCTURE AT ISSUANCE



## ONGOING DEBT SERVICE



\* Could be an existing State authority/issuer or a newly created not-for-profit corporation

# Why Securitize?

## State of Alaska Results

	<b>GROSS VALUE</b>	<b>PRESENT VALUE*</b>	<b>RISK</b>
<b>Tobacco Settlement Revenues over 30 years</b>	<b>\$1,009,029,562</b>	<b>\$405,932,133</b>	<b>Uncertain</b>
<b>Net Proceeds from Securitization</b>	<b>307,570,730</b>	<b>307,570,730</b>	<b>Certain</b>
<b>Residual after Debt Service</b>	<b>240,238,958</b>	<b>93,733,330</b>	<b>Uncertain</b>

\* Based upon 7% discount rate.

# Legislative Considerations

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- ✦ Must direct payments to a bankruptcy-remote or separate state entity
  - Occurs through a “sale” or non-recourse transfer of Settlement Funds
  - Should clarify that the State no longer “owns” the Settlement Funds
- ✦ Legislation should include non-impairment covenants
  - Alaska will enforce MSA
  - State will not impair the Settlement Funds, the financing structure or the rights of bondholders
  - State will not allow the Authority (or the entity issuing bonds) to file for bankruptcy
- ✦ Declare the Authority or issuing entity does not have authority - today or in the future - to file for bankruptcy
- ✦ Authorize Authority or issuing entity to create a non-profit entity to serve purely as a financing vehicle
  - This will enable future transfers of Settlement Funds
  - Non-impairment covenants would be necessary again

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Alternative State Transportation  
Financing Techniques

January 26, 2000

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## Highway Revenue Bonds

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- ◆ Supported by dedicated revenue stream rather than unlimited full faith and general obligation pledge
- ◆ Typically secured by State highway user tax receipts and/or excise taxes
  - Motor fuel taxes
  - Motor vehicle registration fees
  - Motor vehicle license fees
  - Penalties and fines
- ◆ Rating criteria
  - Diversity and stability of the pledged revenue stream
  - Governmental support
  - Program management, quality of planning, construction management, maintenance and inspection
  - Coverage of debt service (both historic and projected)
  - Legal and practical restrictions to additional debt issuance

# Highway Revenue Bonds - State Comparisons

Issuer	Issuer's Rating	State's Rating	Pledged Revenues	Rate Covenant	Additional Bonds Test	Debt Service Reserve	Debt Service Coverage
Alabama Highway Authority	A1/AA-	Aa/AA	Motor vehicle tag taxes, Gasoline & motor fuel taxes, Petroleum inspection fees, Vehicle identification marker fees, Liquefied petroleum gas permit fees	2.0xM.A.D.S.	Statutorily determined.	A.A.D.S.	2.39x
Arizona Transportation Board (Regional Area Road Fund)	AAA-	NA/NA	1/2 cent general sales tax in Maricopa County only	N/A	2.0xM.A.D.S.	N/A	3.00x
Arizona Transportation Board (Highway User Revenue Fund)	Aa1/AAA	NA/NA	Miscellaneous user fees, Fuel tax, Motor vehicle fees	N/A	3.0xM.A.D.S. \$800 Million issuance cap	N/A	6.73x Senior 4.68x Junior
State of Connecticut Department of Transportation	A1NA	Aa3/AA-	Motor fuels tax, Motor vehicle receipts, I.P.F. revenue, FTA grants	2.0xM.A.D.S.	2.0xM.A.D.S. (based on adjusted revenues)	M.A.D.S.	2.6x
Delaware Transportation Authority	A1/AA	Aa1/AA+	Motor fuels tax, Vehicle document/registration fees, Miscellaneous transportation revenue, Delaware Turnpike revenue	N/A	1.75xM.A.D.S. Senior 3.0xM.A.D.S. Junior on pledged revenues net senior debt service	0.5xM.A.D.S. unless revenues are less than 2.00x M.A.D.S. during last 12 months (then 1.00x M.A.D.S.)	N/A
State of Florida Department of Transportation (Full Faith and Credit Bonds)	Aa2/AA+	Aa2/AA+	Gasoline tax, Supplemental G.O. Pledge	N/A	New A.D.S. can not exceed 90% of Pledged Revenues 1.11xM.A.D.S. minimum coverage	N/A	12.96x
State of Hawaii Department of Transportation	Aa3/A+	Aa3/A+	Highway fuel license taxes, Vehicle registration fees, Vehicle weight taxes, Rental motor vehicle and tour vehicle surcharge taxes	N/A	2.0xM.A.D.S. Senior 1.30xM.A.D.S. Junior	0.5xM.A.D.S.	22.7x-24.31x Historical 14.0x Actual 10.9x-7.01x Projected

# Highway Revenue Bonds - State Comparisons (cont'd)

Issuer	Issuer's Rating	State's Rating	Pledged Revenues	Rate Covenant	Additional Bonds Test	Debt Service Reserve	Debt Service Coverage
State of Kansas Department of Transportation	Aa2/AA	NA/NA	State Highway Fund (Motor fuel tax, driver's lic. & vehicle registration tax, and a portion of state sales and use tax)	3.0xM.A.D.S	3.0xM.A.D.S.	Required to be funded only if can not maintain rate covenant.	6.88x
State of Maryland Department of Transportation	Aa/AA	Aaa/AAA	Corporate income tax, Motor vehicle fuels tax, Motor vehicle titling tax, Plus others if needed	N/A	2.0xM.A.D.S. \$1.2 billion maximum allowable debt outstanding	N/A	3.55x
Commonwealth of Massachusetts (Special Obligations Revenue Bonds)	Aa3/AA	A1/AA-	Gasoline tax	N/A	Existing lien is closed	0.50xM.A.D.S.	Actual-3.29x
State of Michigan State Trunk Line Fund	A1/AA-	Aa2/AA+	Motor fuels taxes Motor vehicle registration fees Title fees License plate fees	N/A	2.0xM.A.D.S.	N/A	6.7x-8.2x Historical 8.4x Actual
State of Mississippi Department of Highways	A1/AA	Aa3/AA	Gasoline Tax Privileged tax on earmarked revenues, Fuel identification	N/A	2.0xM.A.D.S.	M.A.D.S.	9.12x
State of Montana Department of Highways	A1/AA-	Aa3/AA-	Diesel License tax Gasoline license tax Diesel fuel tax Gasoline fuel tax Gross vehicle weight tax Coal severance tax	N/A	3.0xM.A.D.S. \$150 million maximum allowable debt outstanding	M.A.D.S. only if coverage drops below 3.0x	6.10x
State of Nevada Department of Transportation	Aa/AA	Aa2/AA	Motor vehicle fuels tax Special fuels tax Federal aid	N/A	2.0xM.A.D.S. only if specifically authorized by legislature	M.A.D.S.	6.51x
New Jersey Transportation Trust Fund Authority	Aa3/A+	Aa1/AA+	Transportation Trust Fund (State appropriation)	N/A	N/A	N/A	N/A

## Highway Revenue Bonds - State Comparisons (cont'd)

Issuer	Issuer's Rating	State's Rating	Pledged Revenues	Rate Covenant	Additional Bonds Test	Debt Service Reserve	Debt Service Coverage
State of New Mexico (Senior State Highway Debentures) (Senior Subordinate Lien Rev.)	Aa/AAA A/NR	Aa1/AA+	Gasoline excise taxes Motor vehicle registration fees Federal Highway Funds	Revenue amount constitutionally protected.	5.0x Senior 2.5x Sr. Sub. 1.75x Subordinate	Required only if coverage falls below 2.0x A.D.S.	9.8x
New York State Thruway Authority	A/A-	A/A-	Petroleum business tax Motor vehicle registration fee Highway use tax Motor fuel gasoline tax	N/A	2.0x A.A.D.S.	0.5x M.A.D.S. or 10% of Par	5.5x
State of Ohio (Highway Obligation Bonds)	Aa/AAA	Aa/AA+	Motor vehicle license tax Driver's license fee Highway use fee Gasoline tax Motor transportation companies tax Private motor carriers tax Motor vehicle fuel tax	N/A	N/A	N/A	N/A
Oklahoma Capital Improvement Authority (State Hwy Capital Improvement Rev. Bonds)	A/A+	Aa/AA	Appropriation lease	N/A	Statutorily determined.	0.5x A.A.D.S.	N/A
State of Oregon Department of Transportation	Aa/AA	Aa2/AA-	Motor vehicle fuels tax Motor carrier tax Fuel use tax	N/A	3.0x A.A.D.S.	N/A	28.0x
Puerto Rico Highway Authority	Baa/AA	Baa/AA	Fuels tax Motor vehicle license fees Tolls Oil tax (subordinate to GO but has never happened)	N/A	1.5x M.A.D.S.	M.A.D.S., but can use L.O.C. or surety	N/A

## Highway Revenue Bonds - State Comparisons (cont'd)

Issuer	Issuer's Rating	State's Rating	Pledged Revenues	Rate Covenant	Additional Bonds Test	Debt Service Reserve	Debt Service Coverage
State of Utah (General Obligation Highway Bonds)	Aaa/AAA	Aaa/AAA	Annual tax on all real and personal property within the State subject to taxation	N/A	N/A	N/A	N/A
Commonwealth of Virginia Transportation Board	Aa2/AA	Aaa/AAA	Transportation Trust Fund (State appropriation)	N/A	N/A	N/A	N/A
State of Wisconsin Department of Transportation	A/AA-	Aa2/AA	Vehicle registration	1.0x debt service	1.75xM.A.D.S.	Requirement established for each individual series.	3.8x

# Grant Anticipation Revenue Vehicles (“GARVEEs”)

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## *Two Types of GARVEEs*

- ◆ Direct and Indirect
- ◆ Direct: Only Federal Aid Highway Projects are eligible; state must abide by federal statutes and regulations
- ◆ Indirect: Both federal and state projects are eligible; state subject to its own statutes and regulations

# Grant Anticipation Revenue Vehicles (“GARVEEs”)

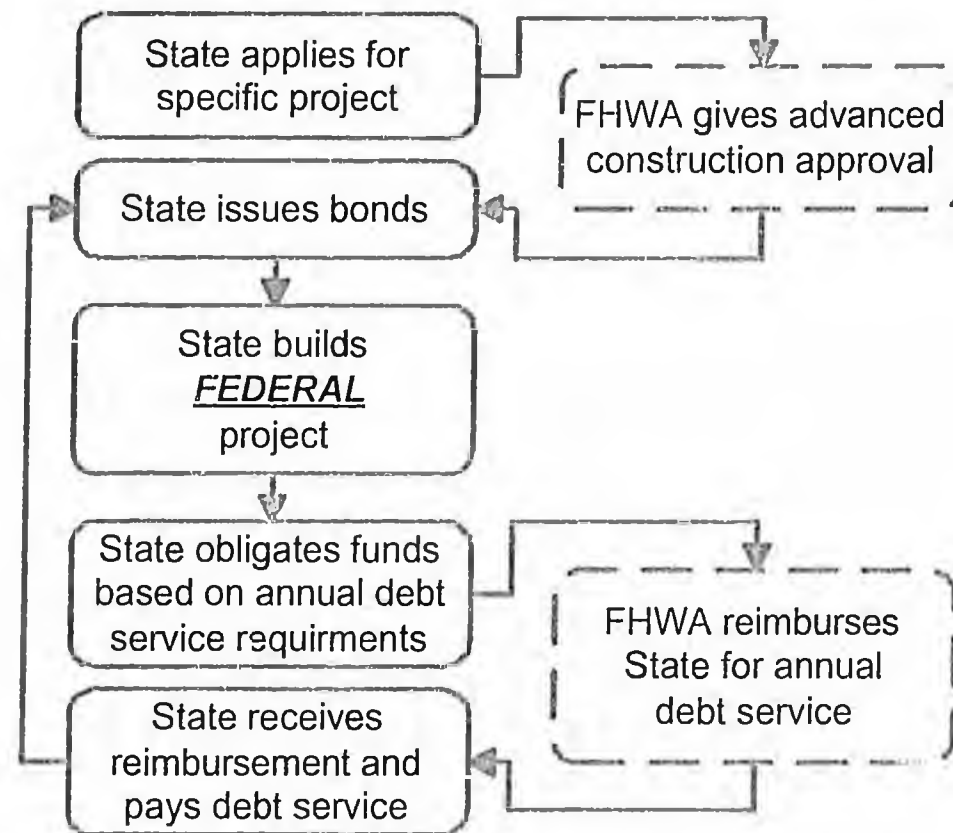
## *Direct GARVEEs*

- ◆ Program FHWA funds for debt service payments
- ◆ Only Federal Aid Highway Projects are eligible
- ◆ Principal and interest payments are reimbursed by the FHWA
- ◆ Secured only by FHWA funds

# Grant Anticipation Revenue Vehicles (“GARVEEs”)

## *Direct GARVEEs*

- ◆ Used to finance a specific project or projects
- ◆ DOT submits the debt service schedule for approval (this is called “programming”)
- ◆ All proceeds need to be spent on the specific project or projects that were approved leaving no spending discretion or flexibility
- ◆ DOT submits for reimbursement three days before each principal/interest payment and DOT receives a reimbursement before the payment is actually made



# Grant Anticipation Revenue Vehicles (“GARVEEs”)

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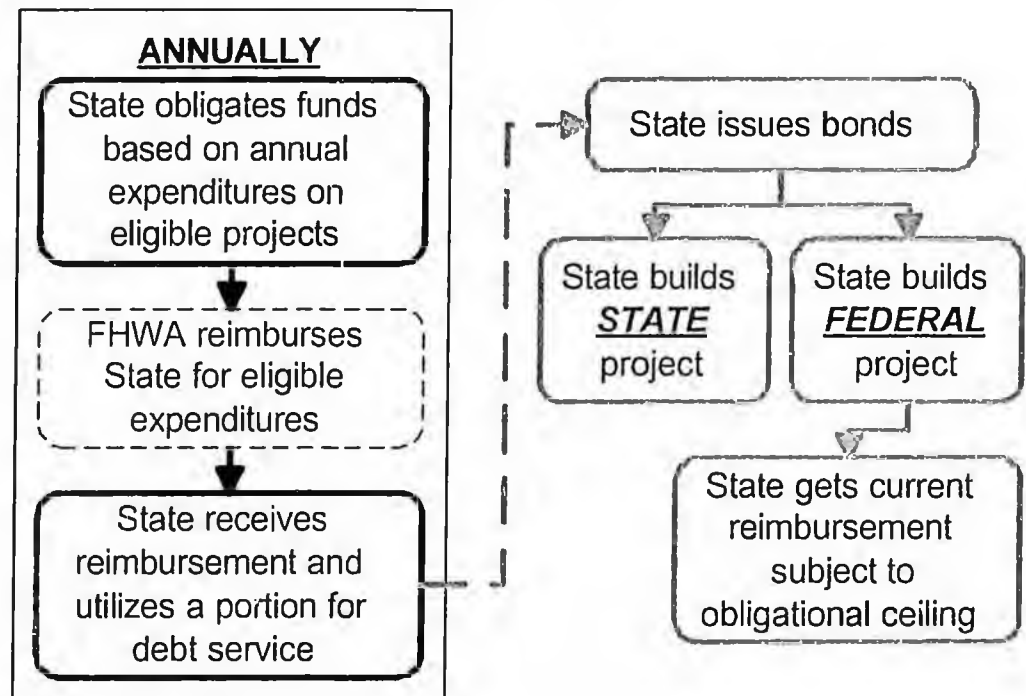
## *Indirect GARVEEs*

- ◆ After receiving FHWA reimbursements, State DOT repledges those funds to pay principal and interest on a new series of GARVEEs
- ◆ Federal interest in FHWA reimbursements has been extinguished
  - Both state and federal projects are eligible
  - State labor wage rates, environmental law and regulations, construction standards and WBE/MBE goals are used - not federal
- ◆ GARVEEs can be secured only with FHWA funds
- ◆ State DOT management of projects is critical since a timely flow of reimbursements is necessary

# Grant Anticipation Revenue Vehicles (“GARVEEs”)

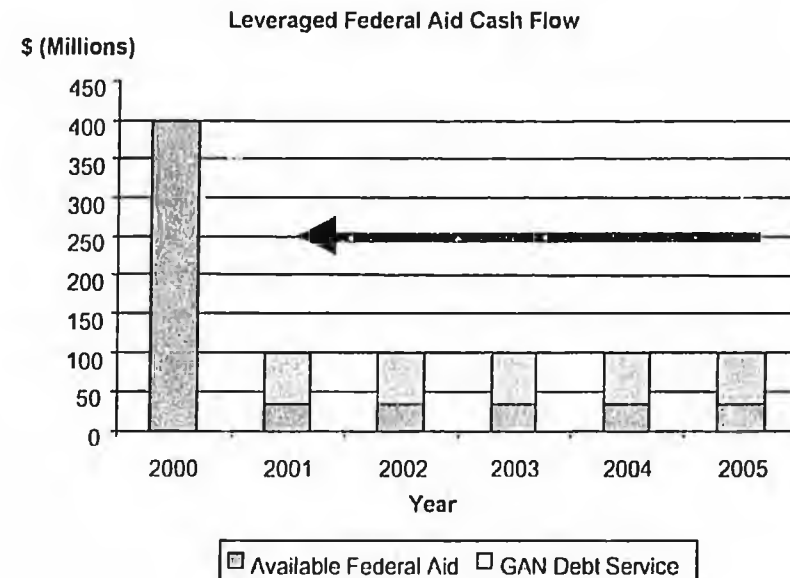
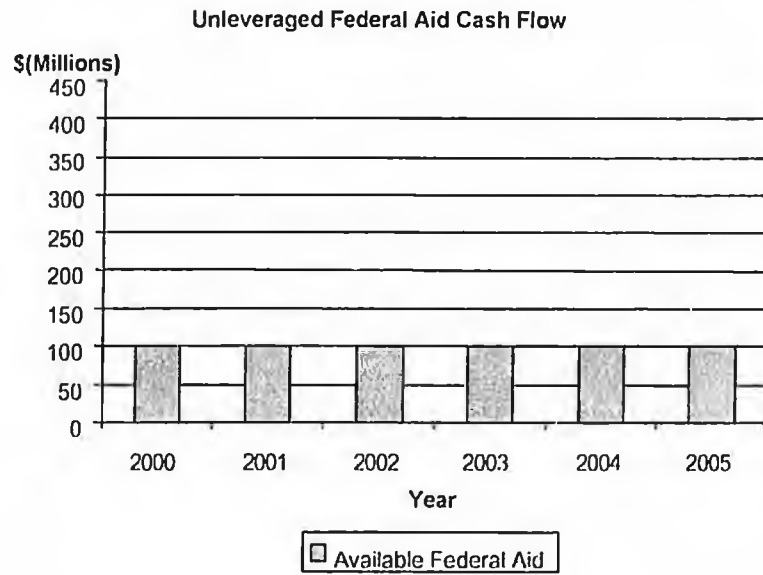
## *Indirect GARVEEs*

- ✦ No restrictions on the usage of bond proceeds - treated as any other State funds - can spend on either Federal or State projects
- ✦ Issued without FHWA approval
- ✦ Backed by future federal reimbursements for future federally eligible expenditures
- ✦ DOT continues its federal aid program, seeking annual reimbursements for eligible expenses
- ✦ Reimbursements used to amortize the GARVEE bonds



# Example of Leveraging Federal Funds

*Utilizing GARVEEs can allow a state to bring forward approximately \$300 million of additional Federally Funded Projects into 2000 from FY 2001-2005 for every \$100 million to be received annually*



Note: These cash flows are exemplary of leveraging of Federal highway funds and do not reflect either specific project related leveraging or specified cash flow leveraging

## Credit and Ratings Issues

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- ◆ Federal Aid Highway Program
  - Multi-year program authorization and support
  - Annual review and obligation levels
  - Congressional authorization/appropriation
  - Structural change in program
  
- ◆ Structural Issues
  - Single project versus program
  - State's ability to match
  - Reimbursement cash flow and lien
  - Coverage stress tests for future potential FHWA \$ reductions

## Credit and Ratings Solutions

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- ◆ Conservative approach aimed toward high credit quality
  - Authorizes low cost revenue debt financing of the State's transportation projects for short-term or long-term borrowing
  - Project-specific or programmatic
- ◆ Structured around the FHWA and federal budget principle of contract authority (creditworthy funding commitment)
  - Passage of Federal Transportation Equity Authorization Act for the 21st Century (TEA-21) creates Federal commitment for the apportioned amounts for the current authorization period of five years plus two additional years
- ◆ Distinctions made between bonds maturing within the current authorization period and those maturing beyond the current authorization period
- ◆ Capital markets acceptance:
  - Standard & Poor's, Moody's and Fitch will provide investment grade ratings within and beyond the current reauthorization period in the A level
  - MBIA and AMBAC will insure debt issuance within and beyond the current reauthorization period



# RECORDS CERTIFICATION



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Signature of Camera Operator

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Fund...

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**FILE**

# **Alaska Permanent Fund Corporation 1999 Capital Market Projections**

**Callan Associates, Inc.**  
Michael J. O'Leary CFA  
Executive Vice President

**January 1999**



# APFC Manager Survey

- Asked managers to provide detailed 1 & 5 year projections
- Outline areas for under & over allocation
- Problem
  - ✓ Most were not able to provide input on all areas
- Information was very interesting & provided some unique insights

# Inflation Expectations

- Almost all expect inflation to remain low but -
- Most expect slight acceleration over the next five years from recent levels
- High inflation forecast was 4%
- Most common fell in 2-3% range
- Low inflation forecast was 1.5%

# S&P 500 One Year Return Projections

- Five managers anticipate negative returns
  - ✓ Clay Finlay (-15%); Julius Baer; Ark; Invesco; Brinson
- Six managers expect returns of 0-10%
  - ✓ DRCM; Bankers Trust; Rogge; Society; Schroder & Capital Guardian
- Three managers envision slightly more than 10%
  - ✓ Alaska Permanent Capital; Lazard (12%) & Putnam

## 5 Year S&P 500 Projections Slightly More Optimistic

- Four managers expect returns of less than 5%
  - ✓ Julius Baer (-2%); Clay Finlay; Ark & Brinson
- Seven expect returns of between 5 and 10%
  - ✓ Invesco; Rogge; Schroder; Society; Lazard, DRCM & Capital
- Three anticipate returns of more than 10%
  - ✓ Bankers Trust (12%); Putnam & Alaska Permanent Capital

# Small Cap Return Forecasts

- Nine managers provided projections for small and/or mid cap stock indices
- Eight of the nine expected small cap stocks to do better than their projections for the S&P 500
- The spread in estimated returns varied widely from a high of 8.5% for Clay Finlay
- Most, however, expected a 1 to 2% premium using the managers 5 year estimates

## Managers are more optimistic for international stocks

- Twelve managers provided EAFE return estimates
- In all cases, they expect equal or greater than S&P 500 returns for international stocks in 1999
- Range in 5 year return estimates
  - ✓ between 5 and 10% - Invesco; Clay Finlay; Julius Baer; DRCM: Rogge; Capital Guardian; Society & Schroder
  - ✓ more than 10% - Brinson; Bankers Trust; Lazard and Putnam

# Bond Market Return Expectations

- Most expect 5 year bond returns to fall in a range of 5-6.5%
  - ✓ Bankers; Invesco; Ark; Brinson; Capital; Society; Schroder; Putnam; Lazard
- Two firms have slightly more optimistic forecasts
  - ✓ Alaska Permanent Capital; & Rogge
- One firm, Invesco, projected a negative 1999 return for bonds
  - ✓ another, DRCM has a 4.7% 5 year return projection

# Real Estate Outlook

- Close consensus of estimates
- One year projections cluster around 11.5% for NCREIF
- Five year estimates fall in 10-12% range
- Differences in opinion regarding REIT outlook
  - ✓ La Salle; AEW and RREEF expect better returns from REITS near term
  - ✓ Richard Ellis & Sentinel expect lower than direct property returns from REITS

# The Economic Environment for the Next Five Years

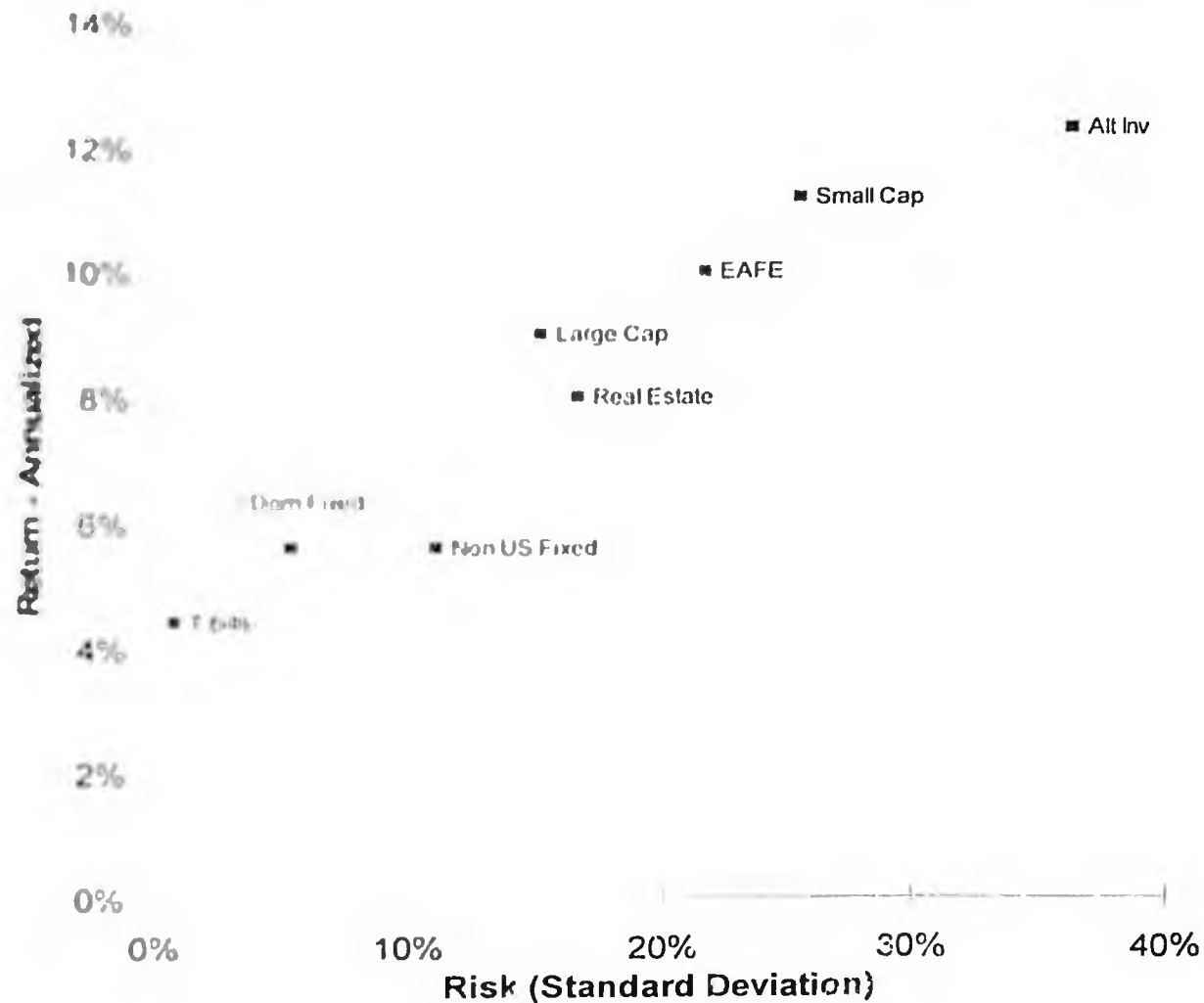
- U.S. economy coming off third straight year of GDP growth  $>3\%$ , and is eight years into the current expansion...
- Despite troubles in Asia and Russia, and the potential for problems spreading to Latin America
- Inflation remains low, despite lowest unemployment in 28 years
- Real incomes are rising
- Risk of recession is real, but receding

## Callan's 1999 Capital Market Projections

Asset Class	Index	Expected Return			Expected Risk		
		1998	1999	Change	1998	1999	Change
<b>Equities</b>							
Large Cap	S&P 500	9.10	<b>9.00</b>	-0.10	13.30	<b>15.00</b>	1.70
Small Cap	CAI Small	10.10	<b>11.20</b>	1.10	19.10	<b>25.30</b>	6.20
International	MSCI EAFE	9.60	<b>10.00</b>	0.40	18.50	<b>21.50</b>	3.00
<b>Fixed Income</b>							
Domestic	LB Agg	6.60	<b>5.60</b>	-1.00	5.50	<b>5.30</b>	-0.20
International	SB Non-US	6.55	<b>5.60</b>	-0.95	11.20	<b>11.00</b>	-0.20
<b>Other</b>							
Real Estate	CRES	8.25	<b>8.00</b>	-0.25	14.50	<b>16.50</b>	2.00
Alternatives	Veco 100	12.30	<b>12.30</b>	0.00	35.00	<b>36.00</b>	1.00
Cash Equiv.	90-day T-bill	4.80	<b>4.40</b>	-0.40	1.00	<b>0.70</b>	-0.30
Inflation	CPI-U	3.40	<b>3.00</b>	-0.40	0.95	<b>1.75</b>	0.80

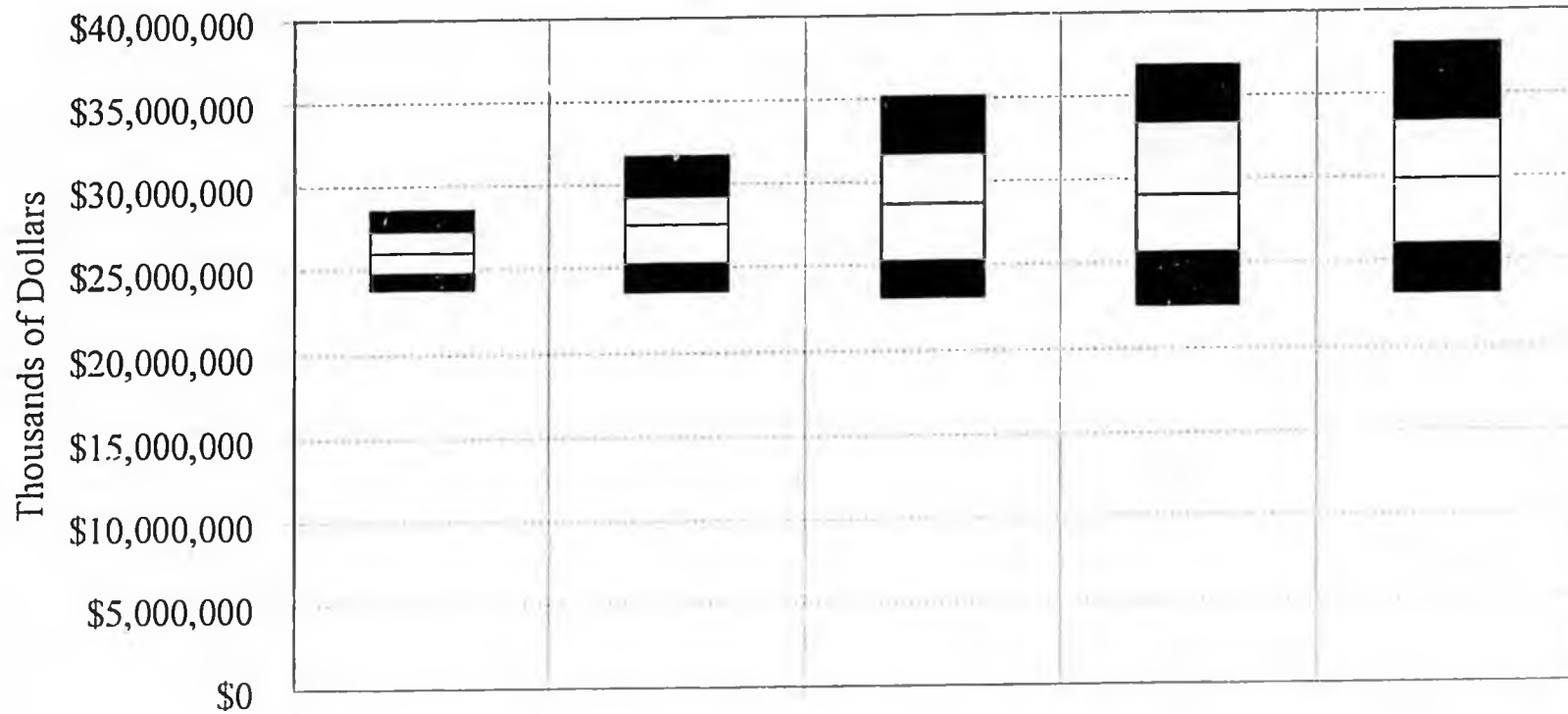
# Five-Year Capital Market Projections

*Higher Returns at the Price of Higher Risk*



# Range of Ending Market Value 5 Year Projection - Base Case

Ending Market Value



	1999	2000	2001	2002	2003
10th	\$28,549,894	\$31,775,090	\$35,135,230	\$36,829,372	\$38,008,381
25th	\$27,402,520	\$29,332,885	\$31,680,662	\$33,384,642	\$33,449,238
50th	\$26,016,612	\$27,561,997	\$28,673,109	\$29,003,072	\$29,925,348
75th	\$24,781,306	\$25,324,984	\$25,270,020	\$25,709,501	\$25,983,819
90th	\$23,865,713	\$23,624,007	\$23,052,876	\$22,465,553	\$23,126,773

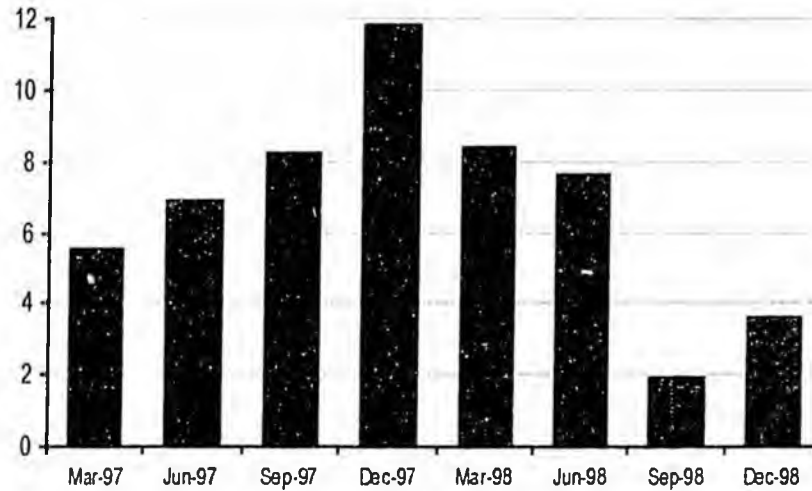
# REAL ESTATE OUTLOOK

JANUARY 1999



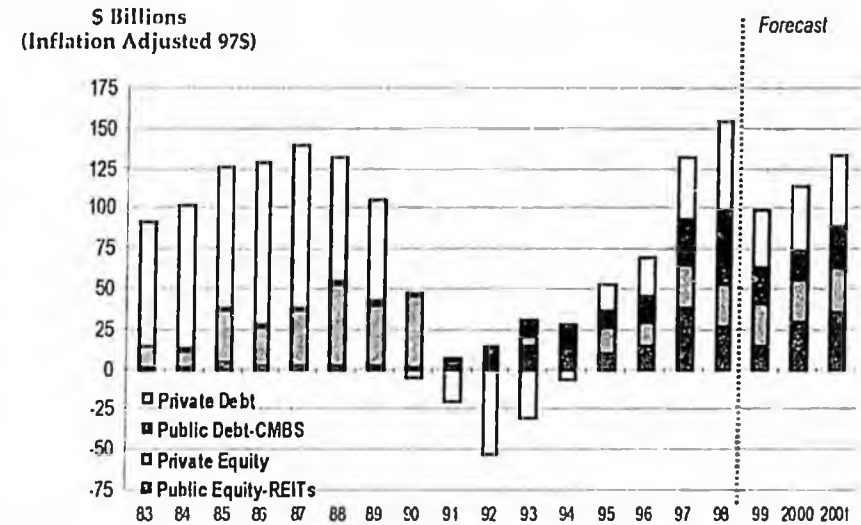
# TURBULENT U.S. CAPITAL MARKETS

**Equity Raising by REITs Has Peaked**  
(Quarterly Equity Raised by All REITs)



Source: NAREIT, LaSalle Advisors Investment Research

**Capital Flows To Real Estate**  
(Adjusted for Inflation)

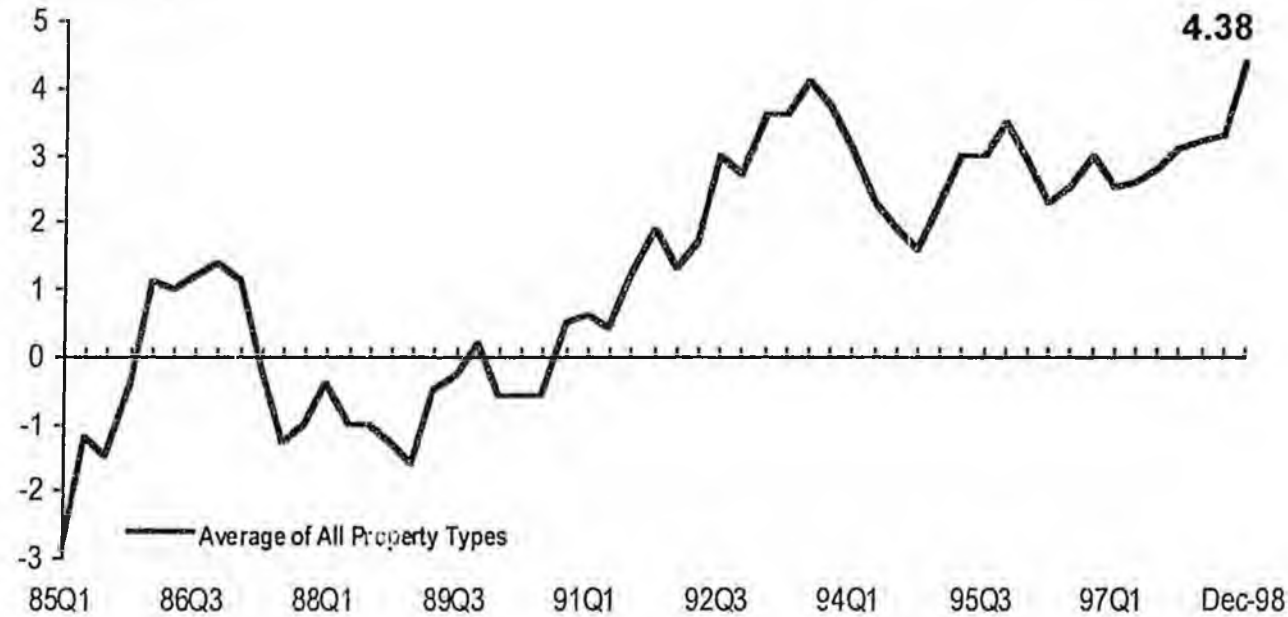


- Risk has been repriced for all real estate
- Fed has cut rates to ward off recession: low interest rates to prevail
- Real estate capital market discipline: flows will fall in 1999
  - Substantial increase in cost of high leverage debt
  - REITs access to equity capital shut off
  - Private lenders more cautious



# POSITIVE U.S. REAL ESTATE FUNDAMENTALS

% Cap Rate Spread Over  
10-Yr. Treasuries



- Real estate demand is slowing yet still positive
- New development plans halted when risk capital pulled back mid-1998
- Real estate yields at historic highs vis a vis treasuries
- Revenue growth forecast for at least 2 to 3 years
- Real estate prices have declined 10 to 15% from peak as REITs and leveraged buyers pull back



Source: RERC, Federal Reserve

# U.S. NATIONAL MARKET CYCLE

1st Quarter 1999

## Stagnant Market

- Opportunistic pricing
- Uncertain recovery timing

## Rising Market

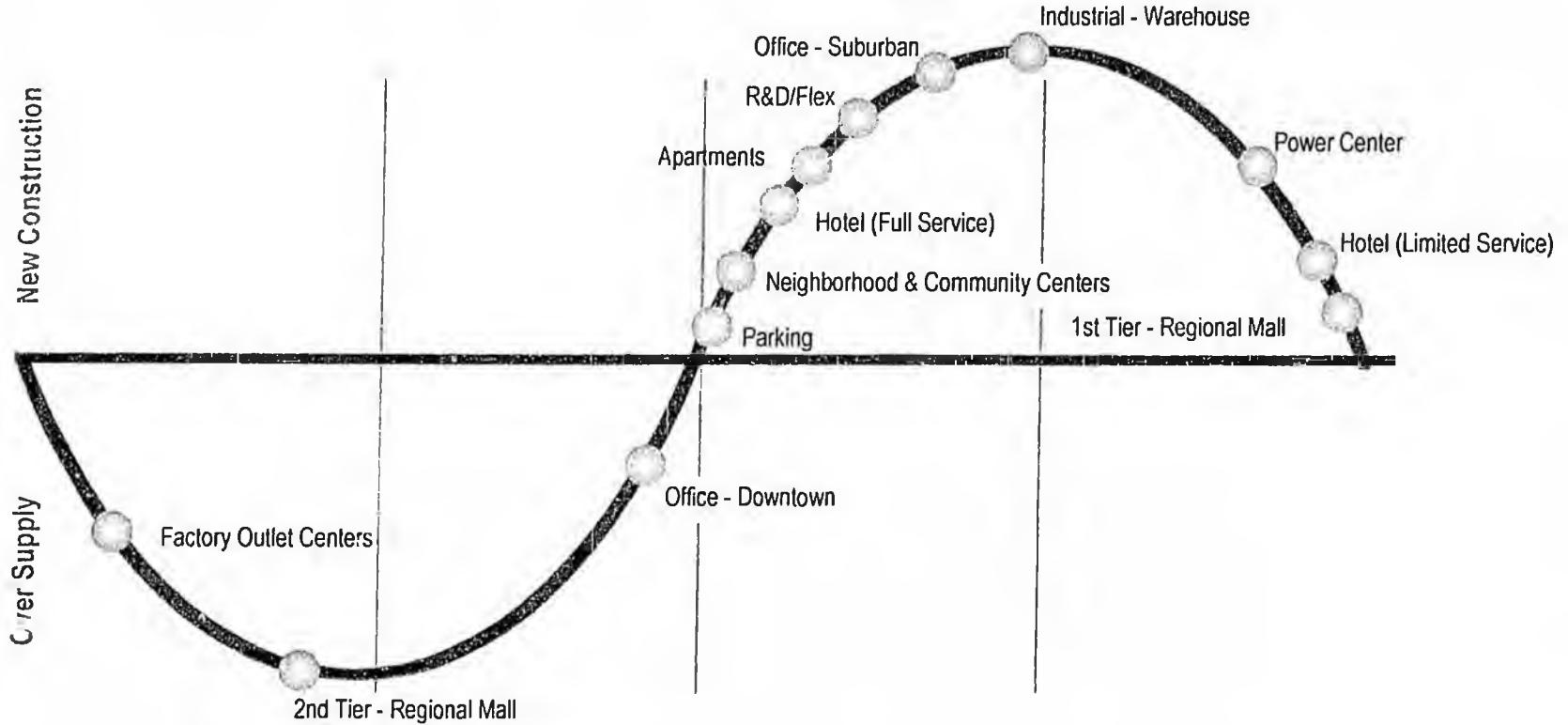
- Value-added/recovery strategy
- Discounted pricing
- Rising occupancy

## Supply Response

- New development
- Tight occupancy
- Rental growth slowing

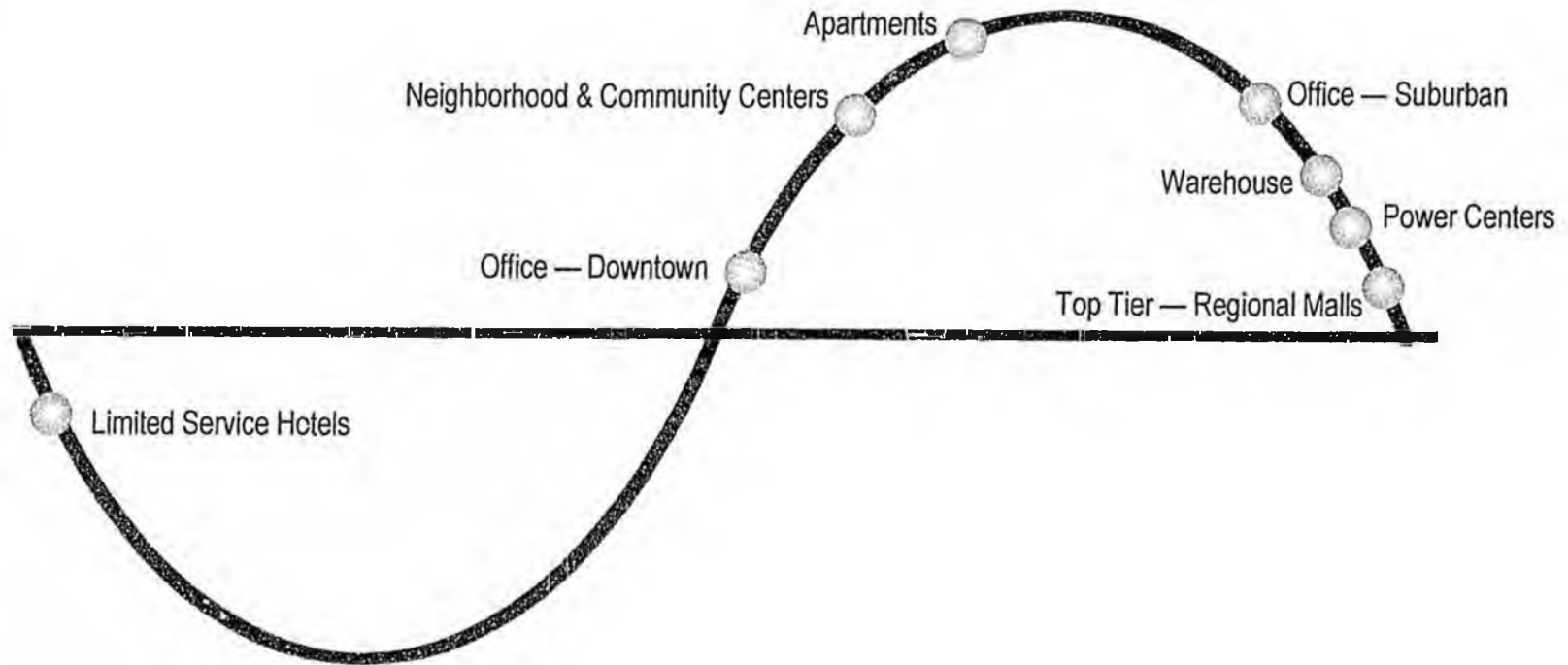
## Falling Market

- Supply ahead of demand
- Rent growth flat-declining



Source: LaSalle Advisors Investment Research

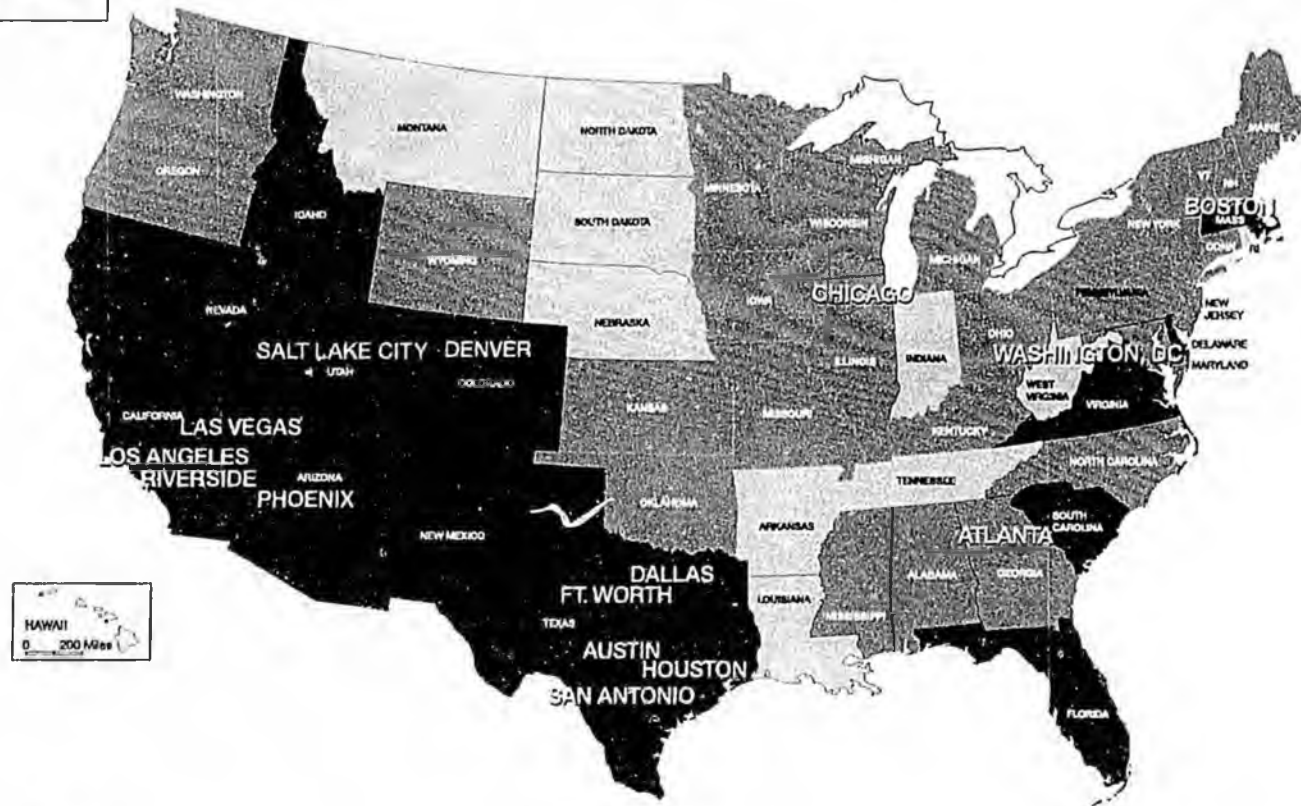
# CYCLE POSITION: FORECAST FOR FIRST QUARTER 2000



Source: LaSalle Advisors Investment Research

# 1999 EMPLOYMENT FORECAST

## Top 15 REGI Cities

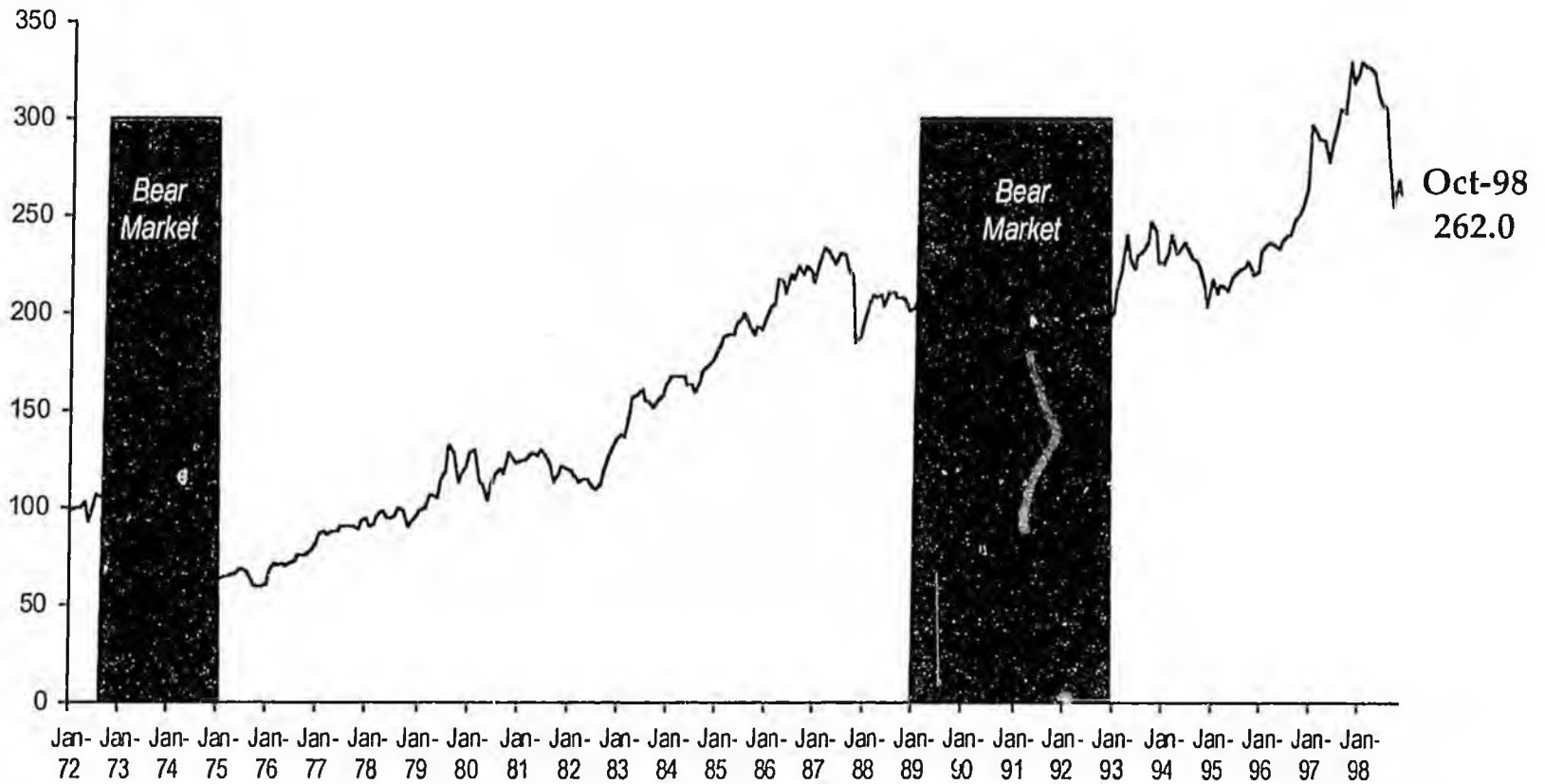


Above Average Job Growth
  Average Job Growth
  Below Average Job Growth



# PUBLIC REAL ESTATE: PRICE HISTORY

Index at NAREIT  
Equity Price Returns



## PUBLIC REAL ESTATE: WHY HAVE REITS UNDERPERFORMED IN 1998?

- Concerns about maturity of real estate cycle
- Uncertainty caused by proposed tax legislation
- Selling pressure from non-real estate REIT buyers
- High level of equity issues
- Overhang of acquired company shares



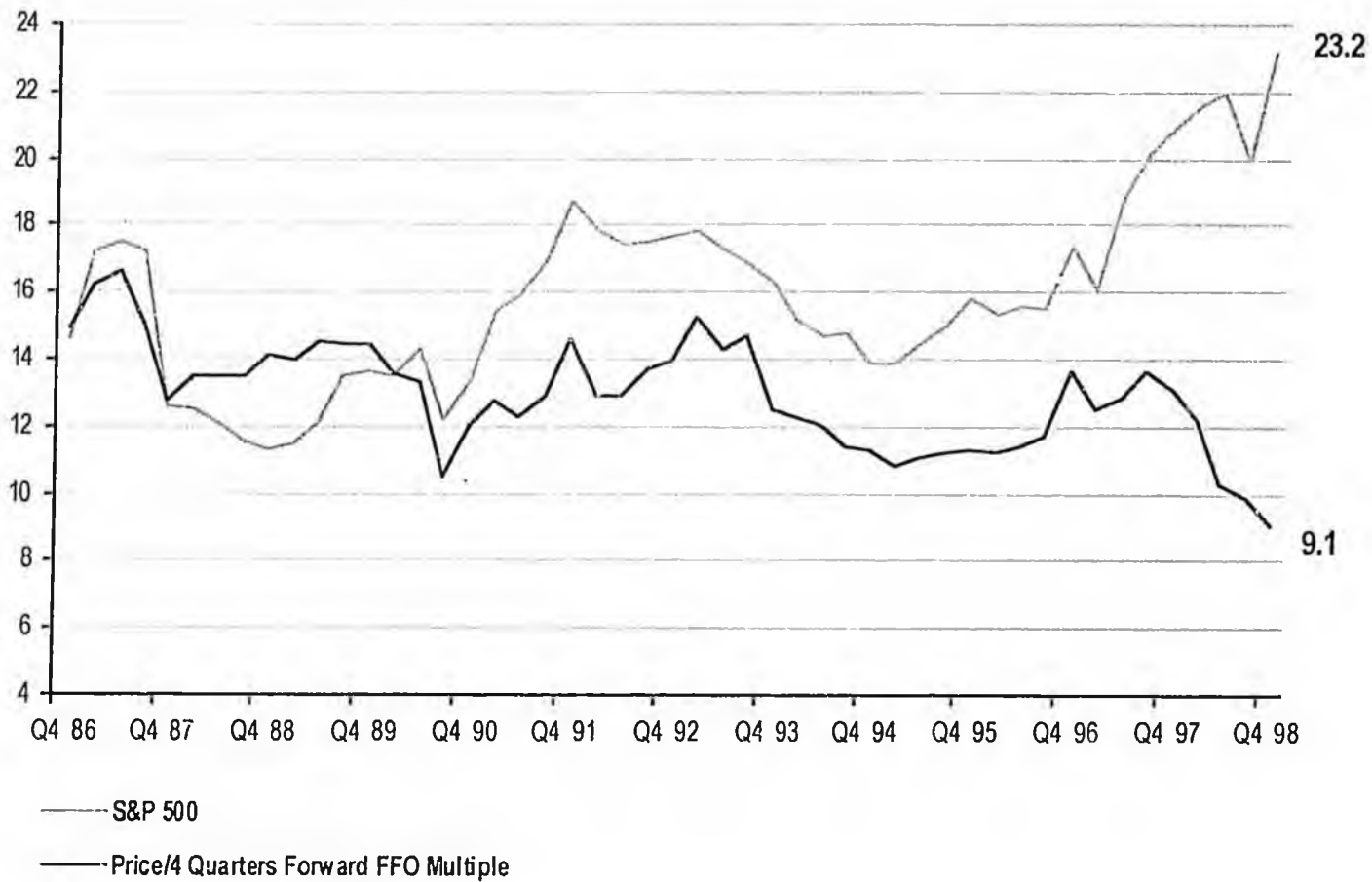
## PUBLIC REAL ESTATE: POSITIVE OUTLOOK FOR REITS THROUGH 1999

- Favorable real estate fundamentals
  - Most markets are at equilibrium
- Earnings growth is projected to be strong
  - Positive internal growth for most companies
  - Still a few acquisition opportunities
  - Some development opportunities
- Industry consolidation and securitization are continuing
- Valuation levels are compelling



# PUBLIC REAL ESTATE: MARKET OUTLOOK THROUGH 11/30/98

## REIT FFO Multiples



Source: Goldman Sachs

LaSalle Advisors

## FAVORABLE REAL ESTATE OUTLOOK

- Sound fundamentals in all domestic sectors
- High-yield spreads relative to government bonds
- Attractive current valuations relative to historic ranges and replacement cost
- Property pricing produces attractive forecast returns
- REIT pricing at discount to NAV and low FFO multiples



© 2000

STS

	One Year	Five Year
te NCREIF	11.5%	11.0%
e REIT	15.0%	12-14%



## **Capital Markets Outlook: January 21, 1999**

### **Profiles of Guest Speakers**

**Michael O'Leary, Jr., CFA**                      **Callan Associates, Inc.**  
Mr. O'Leary serves as Executive Vice President, National Director of Plan Sponsor Consulting Service, and Manager of Callan's Denver consulting office. Michael is a member of Callan's Client Policy Review and Management Committees and chairs Callan's Manager Search Committee. Michael rejoined Callan in 1990 after spending two years as practice leader in William M. Mercer Asset Planning's Denver office. While at Mercer, he also served on the firm's three-person National Practice Committee. Prior to Mercer, Michael spent five years in Callan's Chicago Office where he provide a full range of investment consulting services to foundations and public and private pension plans. Michael's prior experience includes positions as research analyst, director of research, director of portfolio management and defined contribution plan product management for major trust companies in Chicago and Hartford. Michael received his bachelor's degree from Fordham University and is a Chartered Financial Analyst.

**Bill Price**    **Dresdner RCM Global Investors**  
Bill Price joined RCM in 1977 and has been a principal since January 1979. After graduation from Dartmouth College, he spent several years as an interpreter and cultural affairs officer for the U.S. Department of State. In 1964 he became a Graduate Fellow and instructor of Political Science at the City University in New York. In late 1970 he joined Donaldson, Lufkin and Jenrette as an analyst and portfolio manager in its newly formed subsidiary Alliance Capital Management. He moved to Alliance Capital's San Francisco office in 1973 where he managed several large state retirement system portfolios, as well as corporate pension and endowment funds. In early 1977 he became manager of the \$700 million office. He joined RCM in December, 1977 as a member of the Equity Portfolio management team and coordinator of equity investment strategy and research. He now serves as the firm's Chief Investment Officer as well as Chair of the Board and Executive Committee.

**Lynn C. Thurber**                      **LaSalle Advisors Capital Management**  
Ms Thurber manages publicly traded real estate companies and international real estate investments, and serves as co-chair of LaSalle's Investment Committee. She was previously the Chief Executive Officer of Alex, Brown, Kleinwort Benson Realty Advisors, and their Investment Group's Chief Operating Officer. She was a principal at Morgan Stanley & Co., and a Director and member of the Investment Committee at the Morgan Stanley Real Estate Fund. Lynn Thurber earned her BA from Wellesley College, and her MBA from Harvard Business School. She is currently Co-President of LaSalle Advisors Capital Management, Inc.

**David Fisher**                              **Capital Guardian Trust Company**  
David Fisher is Chairman of the Board of Capital Group International, Inc. and Capital Guardian Trust Company, as well as an officer and director of numerous affiliated companies. He is a portfolio manager for U.S., non-U.S., global and emerging market assets and has been responsible for Capital's international investing activities since 1982. He joined the organization in 1969 as a financial analyst and was Director of Research for 10 years. Prior to joining Capital, David was a second vice president and financial analyst for Smith Barney and Co. and a marketing executive with General Electric Company in New York. He received a bachelor's degree from the University of California at Berkeley and an MBA from the University of Missouri Graduate School of Business Administration. David is a member of the Los Angeles Society of Financial Analysts and a founding member of the International Society of Security Analysts. He is a trustee of the J. Paul Getty Trust, the Lowe Institute, Alternative Living for the Aging, Claremont McKenna College and Harvard-Westlake School.

January 11, 1999

Ms. Joyce Andrews  
Alaska Permanent Fund Corporation  
P.O. Box 25500  
Juneau, AK 99802

Dear Ms. Andrews:

I have attached Capital Guardian's responses to Terry Brown's request for capital market assumptions and asset allocation positions. Note that the capital market assumptions are based upon research conducted by one of our macro economists and are not necessarily reflective of an overall "Capital Group view."

Our global balanced allocation target (60% stocks, 40% bonds) does not include real estate. The International Subcommittee (ISC), a subcommittee of CGTC's overall Investment Committee, meets formally twice each month to discuss asset allocation issues. This self-monitoring body, comprised of seven Capital global portfolio managers, provides individual asset allocation recommendations. Once each month the members of the subcommittee are given an opinion poll which allows them to verbalize where they would invest among global stocks and bonds. The results of the poll are discussed at the bi-monthly meetings to focus on key issues and variables in the individual responses from the group. The members' recommendations are then aggregated in order to arrive at an overall asset allocation decision.

Please do not hesitate to contact either Bob Spare or me if you have any questions or need additional information.

Sincerely,

Mike Casagrande

cc: Michael O'Leary

*Capital Market Assumptions*

	<u>One Year</u>	<u>Five Years</u>
<b>Domestic Stocks</b>		
S&P 500	6.0%	7.5%
S&P Midcap 400	--	--
S&P 600 Small Cap	--	--
Russell 2000	10.0%	9.0%
<b>International Stocks</b>		
MSCI-EAFE	12.0%	9.0%
MSCI Global Emerging Markets Free	18.0%	11.5%
<b>Real Estate</b>		
NCREIF Classic	--	--
NCREIF All Properties	--	--
Morgan Stanley REIT	--	--
<b>Fixed Income</b>		
Lehman Aggregate	4.5%	6.5%
Lehman Government Corporate	--	--
Lehman Corporate Rated A	--	--
Salomon Non Dollar World Government Bond Index	--	--
Hedged	5.0%	7.5%
Unhedged	7.0%	6.5%
Merrill Lynch High Yield Master	11.0%	9.0%
<b>Short Term</b>		
90 day T-bill	4.4%	5.0%
<b>Consumer Price Index</b>	1.9%	2.3%

WLP

## FINANCE AND ECONOMICS

Economic growth

## Profits of doom

SHARE prices in much of the world ended 1998 higher than they started it. Oddly, at the same time, the profitability of companies is shrinking, even in the world's leading economies. This begs the question of whether equity prices in rich countries now make any sense at all—but it also gives ominous warning of disappointing economic growth to come in 1999.

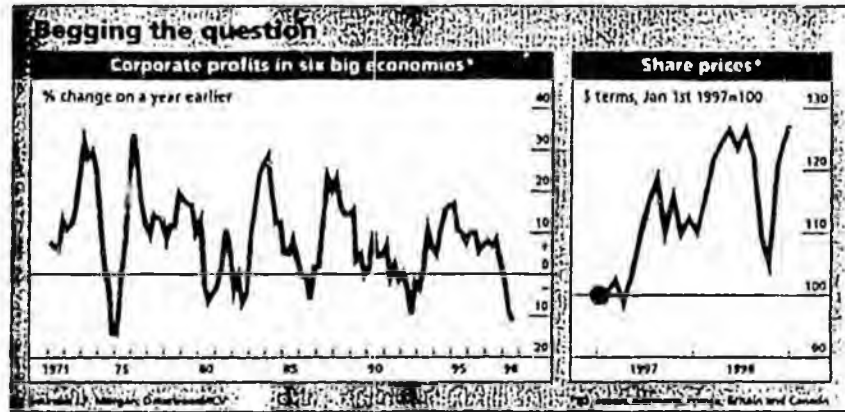
Share prices rose, on average, by more than 15% in 1998 in six of the rich world's biggest economies. But in the third quarter, the latest period for which there is data, company profits were 12% lower than a year earlier in those economies (see chart). Much of this is due to the continued sufferings of Japanese firms. But corporate profitability has fallen compared with the previous year in the other big economies as well.

Continued economic strife in Asia is one cause of slimmer profit margins elsewhere. The devaluation of Asian currencies, and a huge amount of excess productive capacity, have intensified global price competition, especially in homogeneous, tradable goods such as textiles, chemicals and commodities. But in America and Britain, several years of decent economic growth have driven down unemployment to such an extent that labour costs are starting to rise—although the impact of this has been cushioned by higher productivity.

These factors are unlikely to go away in 1999. And in continental Europe, the launch of the euro may increase price competition by making differences in pricing between countries in the euro-zone more transparent to consumers.

In the case of corporate profits, the main uncertainty is how fast, if at all, the world's big economies will grow. The frenzied cutting of short-term interest rates by central bankers since the autumn's brief financial-market crisis seems to have averted the worst for now. But yields on corporate bonds, especially American ones, are typically higher now than six months ago, because investors are more worried about the riskiness of these securities.

Worse, the recent decline in corporate profitability may itself point to slower growth ahead. In the past, changing profitability has been a useful lead indicator of economic trends. One reason is that, when firms earn lower profits, they generally become less optimistic about their future profitability, and vice versa—and so cut (or boost) their investment spending accordingly. Capital spending by companies is an important contributor to economic growth. If there is less of it, growth suffers. In continental Europe, most of the economic growth during the 1990s was due to



higher spending by companies.

America's economy is now especially vulnerable to a sharp reduction in investment by firms. Much attention has been lavished on American consumers' alarming recent habit of spending more than they earn. But American companies also have a "negative savings ratio", points out David Mackie, an economist at J.P. Morgan, because they have been borrowing so much to invest. British and continental European companies, in contrast, have not paid for capital spending in the 1990s by getting deeper into debt.

Running up debts to finance investment may make sense in conditions of

rapid economic growth. But, when growth slows and profitability tumbles, heavy indebtedness will force companies to make ferocious cuts in capital spending. Mr Mackie thinks this could be severe enough to push the American economy into deep recession. A similar thing happened in Japan, that other "miracle economy", in the early 1990s. Companies had been borrowing and investing as though the economy would grow for ever. Its economy is still paying the price. Japan's problems have mired Asia in recession; if America's economy went down the plughole, the rest of the world would probably follow suit.

## Hold your tongue

BEAUTY is in the eye of the beholder. This applies as much to economic figures as to the human kind. Whether an economic development is "good news" or "bad news" may depend on circumstances, or on who you are—something most scribblers tend to ignore. In the second article in our occasional series, we consider some of the emotive words that are misleadingly used to describe economic numbers.

Headlines that include the word "gloom" are more likely to make the front page, so writers are tempted to give their stories a grim spin. Thus, a fall in oil prices might trigger the headline: "Oil-price gloom". Lower prices are indeed bad news for producers—but they are good news for consumers. Or consider interest rates. Fundists always pronounce a rise in interest rates as "bad". Yet for every borrower there is a saver, who gains from higher rates. It is true that higher interest rates may force firms to cut investment and jobs. But in many countries the personal sector has more assets than debts at variable interest rates, so it is a



net winner when rates rise.

Trade balances are a rich source of over-emotional language used by economic writers. When a country's trade deficit shrinks it is always said to "improve"; if a surplus disappears it has "deteriorated". The presumption is: surplus good, deficit bad. But a country's trade balance is a poor gauge of economic strength. Since Japan's widening trade surplus reflects the depressed state of its economy, it is hardly good news.

Likewise, the recent shift in Asia's emerging economies from deficit to surplus: if these surpluses shrink next year as demand picks up, that will be good news, not bad. Commentators should note that trade deficits may increase or decrease—they can never "improve".

Finally, here is a reader's nomination for the best "financial babble"—the previous subject in this series. This gem comes from the *Independent*, a British newspaper: "Concerns that the economic outlook might not be as gloomy as feared hit interest rate hopes and sent financial markets lower yesterday..."

DRCM Capital Market Assumptions and Asset Allocation

	1 Year Rtn	5 Year Rtn	1 Year Wt
<b>Domestic Stocks</b>			
S&P 500	6.5%	7.0%	20%
S&P Midcap 400	7.0%	8.5%	10%
Russell 2000	8.0%	9.5%	15%
<b>International Stocks</b>			
MSCI-EAFE	8%	9%	5%
MSCI Global Emerging Markets Free	5%	11%	0%
Total EQUITY			50%
<b>Real Estate</b>			
NAREIT (All)	7%	7%	10%
Total REAL ESTATE			10%
<b>Fixed Income</b>			
Lehman Aggregate	6.15%	4.7%	10%
Lehman Government Corporate	5.85%	4.1%	10%
Lehman Corporate	6.50%	5.2%	10%
Salomon Non-Dollar World Government Bond Index			
Hedged	5.15%	3.1%	5%
Unhedged	5.15%	4.9%	0%
ML High Yield Master	8.50%	7.00%	5%
<b>Short Term</b>			
90 Day T-Bill	4.40%	4.85%	0%
Total BONDS			40%
Consumer Price Index	2%	3.5%	
Total PORTFOLIO			100%



# Capital International

## Emerging Markets Strategy Statement

December 31, 1998

Nineteen ninety-eight was an amazing year. At one point, several individual markets were down 70 to 90% in U.S. dollar terms, and the Morgan Stanley Capital International Emerging Markets Free Index was down more than 40% on a year-to-date basis, and more than 50% year-over-year. This carried over to the developed markets, and at times it felt as if the whole world was going to implode.

But volatility in emerging markets goes both ways, and we've had a snapback in the Index of over 25% from its September low. That's why it's so important to stay invested. If you look at the record of emerging markets over the past 12 years, much of their performance has come in very short spurts. In spite of what happened during the year, our original emerging markets fund, net of fees, has a return of nearly 20% per annum. But in three of those years the return was over 60%. It would be a shame

not to be there for that kind of return, because if you exclude those three years, returns would look fairly pedestrian.

### Riding Out the Storm

The most important thing we did all year was to heed our own advice and not panic—and it would have been easy to panic. We kept about our business of attempting to buy good companies at attractive prices. In spite of mass redemptions in most retail mutual funds, our institutional and individual investors took the long-term view and remained invested.

We are confident of higher absolute returns looking forward because the reasons we believe in emerging markets as an asset class are still valid. Despite growth assumptions being lowered for many countries, we still expect to see more than 70% of the world's growth coming from the developing world over the next 20 years. But equity prices in emerging markets currently reflect much grimmer assumptions. That's why I passionately believe that in a few years we will look back on this point in time as an extraordinary buying opportunity. And I am not alone in that belief, as informed corporate buyers have continued to purchase operating assets on the cheap, often paying a substantial premium to what the market says those assets are worth.

### Taking a Closer Look

One of the things we wondered about during this time was, did it feel as bad inside these countries as it looked from the outside? I think it depends on where you look. People in Russia and Indonesia noticed a big difference. But in Thailand, the Philippines, Taiwan, or Latin America in general, it probably didn't feel as though the market had gone down 50%, 60%, or 70%, nor did it affect most people's lifestyles. In many places, the violent reaction of the financial market didn't accurately reflect what was really going on inside the country.

We asked three of our analysts to shed some light on this. In each case, the analyst was born and raised in the country he or she covers, and can provide some perspective as to what life was like on the inside during the financial crisis in the emerging markets.

#### Patricia Artigas: Argentina

Life for the average Argentine runs on different rails than the equity or debt markets. Since the hyperinflation of 1989-90, people don't keep their savings in stocks or in bonds. The stock market is extremely small compared to GDP (only about 15%, compared to 100% for the Chilean market), and while the economy was booming from the second half of 1996 until the third quarter of

### Index Returns As of December 31, 1998

MSCI Emerging Markets Indices	% of Index*	% Change in US\$	
		3 Months	12 Months
Indonesia Free	1.8	125.6	-31.5
Korea	10.7	114.4	141.0
Russia	1.3	68.4	-83.0
Philippines Free	2.1	58.8	13.5
Thailand Free	2.8	54.4	11.5
Hungary	1.6	38.6	-8.2
Colombia	0.8	33.1	-42.2
Greece	7.3	28.2	78.1
Venezuela	1.0	20.8	-49.2
Czech Republic	1.1	14.5	0.5
Chile	4.5	13.3	-28.5
Mexico Free	11.3	10.5	-33.5
Poland	1.4	10.1	-6.7
Argentina	4.6	7.3	-24.3
Taiwan	9.9	7.2	-20.6
Jordan	0.2	7.0	-11.0
Turkey	2.0	5.3	-52.5
South Africa	10.3	4.8	-27.6
Israel	3.3	4.6	-5.1
China	0.7	4.1	-42.4
Brazil	11.9	0.6	-39.6
Peru	1.0	-1.1	-40.2
India	7.9	-1.6	-21.3
Pakistan	0.4	-12.5	-56.0
EMF†	100.0	18.0	-25.3
EMF Far East	21.3	47.7	-6.2
EMF Asia	15.1	33.8	-11.0
EM Europe & Middle East	28.5	21.0	-26.0
EMF Latin America	35.1	7.1	-35.1

\* Morgan Stanley Capital International Emerging Markets Free Index.

† The MSCI EMF Index measures the performance of markets where a substantial portion of shares are available to non-domestic investors.

Note: All figures computed with gross dividends reinvested.

All indices are unmanaged.



1998, the number of local brokers and small and mid-sized financial institutions has been shrinking at a fast rate.

Unfortunately, the crisis in the emerging world and the deeper instability of our neighbor Brazil have made people begin to feel the indirect effect of the stock market collapse. The higher level of risk in the region has already had an impact on the capital inflows to Argentina, despite its solid fundamentals. Small and mid-sized companies are suffering the most from the effects of the reduced availability of financing and the higher unemployment rate. Unemployment is today's major economic concern, as it has been increasing from the already high rate of 13%. Despite that, most people continue to think things are better now than in the recent past, when inflation was 4,000% and the local currency had no value at all.

*Claire C. Cui: China*

China is a very special case. Typical middle-class persons cannot freely exchange currency to dollars or other hard currencies; it's illegal. And this closed system has shielded the country to a very large extent from the external financial crisis. It's really the domestic economy that affects the daily living standard of most people, not the stock market.

The stock market in China is also unique. There is an "A-share" market for domestic investors and two "B-share" markets for foreigners. The A-share market, which is much larger, has not yet experienced a crash. So the stock market turmoil that we saw in the emerging markets has not affected China that much.

However, the domestic economy is weakening. External demand from China's neighbors has slowed, and that has had an impact on the domestic economy. So the daily living standard has decreased a little bit since 1996, and with the economic outlook not improving, people are more careful about spending. But when the markets crashed it had little effect on the living standard.

*Osman Y. Akiman: Turkey*

In spite of last year's decline in share prices, life for the average Turk goes on as usual. (Of course, the 110% performance in 1997 helped soften that blow.) In Turkey, there are very few retail investors in the stock market (0.5% of market capitalization), and domestic institutional investors are basically non-existent. While this is a negative in terms of the development of the local market, there was no negative wealth effect from this year's drop in stock prices.

Of course there will probably be a reduction in discretionary spending for both corporations and individuals. For example, people will travel less. If they had been taking three trips a year now they'll take two trips a year. But purchasing power should stay the same. The economy, which is expected to have grown around 4.5% in

1998, is expected to slow to 1.5–2% next year, which is more or less equal to the population growth rate.

One point worth noting is that, unlike many other countries during this period, there has been virtually no local capital flight from Turkey. I think that reflects the deep sense of nationalism Turkish people have—they really believe in their country. And that thinking by the person on the street is reinforced by the government's commitment to market reforms and maintaining an open economy, even during this difficult environment.

Turkish history dates back seven centuries, and during that time, the Turks have built empires and have seen them destroyed. In that process, there have been many political and economic ups and downs, and Turks have learned how to deal with difficulty. I don't think there's any complacency about what's going on, but I think the Turkish people have confidence they can see through this difficult period as they have done in the past.

**The Real World Versus Pieces of Paper**

We are investors. And what we have tried to do over the years is draw a distinction between investing and trading pieces of paper back and forth. That's what led us to ask the question: what is really going on? Country by country and company by company, we realized the world was not coming to an end, even though the stock market was telling us it was. By understanding that outside the financial markets things were reasonably normal, we were able to stay reasonably calm and do what we always do, which is to invest in quality companies at fair valuations.

We thought it was appropriate that in September the Nobel Prize for economics was awarded to Professor Amartya Sen for his work on the economics of famine. That was in stark contrast to the previous year's award, which went to Robert Merton and Myron Scholes from Long-Term Capital Management for their option pricing model. There was an appropriate irony in that. And it illustrates the importance of understanding the real world versus explaining the price action of pieces of paper.

Looking back on 1998, the world was perilously close to a financial disaster. I believe when the Long-Term Capital story was breaking, the reason the regulators chose the route they did, knowing they would be accused of hypocrisy, was because they were scared of the alternative—that \$125 billion in debt could bring down major financial institutions. All this came out of leverage and computer models and thinking of things as nothing more than pieces of paper to be traded back and forth. And I believe that we would do well to remind ourselves that there's more to life than that!

— David I. Fisher  
*Capital International*

COMPLIMENTS OF LASALLE ADVISORS

## *Heard on the Beach*

December 31, 1998

We're certainly glad 1998 is over. It is difficult to overstate just how bad a year it was for REITs. The total return of -17% turned in by the Morgan Stanley REIT Index compares with +29% and -2% for the S&P 500 and the Russell 2000 indices, respectively. REITs underperformed the S&P by 45%! Numbers like these just weren't supposed to happen.

Numerous explanations have been provided for the poor performance by REITs in 1998 including fears of overbuilding, deflation, overpricing of acquisitions, etc. As we opined in our last edition of this piece, we are generally unsatisfied that these reasons provide a rational explanation for the severity of the underperformance. Alternatively, one could point out that REITs were due for a correction, since they generated total returns averaging 28% during each of the prior two years. After all, REITs have now generated total returns averaging about 11% over the last three years, a very "normal" result. In a vacuum this is fair, but in a market where virtually every other investment vehicle has dramatically outpaced these results (the S&P figure for the last three years is +30%/yr), the REIT performance is disappointing and perplexing. We continue to feel that much of the beating taken by REITs this year has been an overreaction to problems that are perceived to be more severe than is the case.

While REITs as a group may have been punished too severely, the actions of some REITs continue to add fuel to the argument that many of these new-to-the-public-market companies will make more than their fair share of missteps. Perhaps the prime example of this was the inability by some management teams to recognize that the market did not want their company out growing for the sake of growth. While the high profile deals that took place early in the year (e.g. Simon/CPI, Rouse & Westfield/Hahn, Boston Properties/Embarcadero & Pru Center) are easy targets, we believe that, by and large, they do not reflect poorly on management. As we opined at the time, some of these deals were richly priced, and the jury will remain out as to whether they were well-advised, but at least they took place at a time when very few people's crystal balls warned of the fallout that was to transpire in the latter half of '98.

Instead, we have found ourselves scratching our heads at the fact that a number of REITs have continued to adhere to their acquisitive ways long after the market had sent a strong signal that the vast majority of REITs should abstain, for the time being, from purchasing properties. Recent sizable purchases by Summit (Ewing), United Dominion (American Apartment Communities), Reckson (Tower), Prologis (Meridian), Highwoods (Nichols), and Cornerstone (Wilson) strike us as deals done by REITs that buy into the myth that REITs must grow or die. Perhaps some of these deals may eventually pan out, but most of them have done significant harm to the acquiror's balance sheet with little evidence that pricing was anything better than fair (e.g. SMT, UDR, RA, HIW). In other cases where the balance sheet is emerging unscathed, we have had difficulty buying into the grand strategy (CPP) or have felt the deal was pricey (PLD).

These are times when good management teams are distinguishing themselves, and the best way to do so is to focus attention on value creation through development/redevelopment or on the mundane, but important, tasks of improving property management, squeezing more juice out of the existing portfolio or safeguarding the balance sheet. Those REITs that continue to acquire properties just to meet FFO growth expectations will, no doubt, languish in today's unfriendly environment.

\*\*\*\*\*

Regional recessions, or, at least, regional slowdowns, may be back in the cards after a roughly two-year hiatus during which the economies of virtually all regions hummed along at a healthy pace. In addition to our long-standing fears about the future of Las Vegas, several other major cities now serve as cause for serious concern.

Houston will almost certainly be adversely impacted by the collapse in oil prices. Yes, Houston has managed to grow at a healthy clip through the oil price decline of recent years, and there are few signs that the growth rate has slowed substantially. However, most of the drop in oil prices that has taken place this year has occurred during the last three months, as prices have dropped from \$16.00/barrel at the beginning of October to an average price during December of just over \$11.00/barrel. The 30+% drop that has occurred in the last three months will almost certainly result in cutbacks by major employers in these markets, and it may be that the recent layoff announcements, while admittedly small in number, are merely the tip of the iceberg. Despite proclamations that the city has diversified greatly its employment base, it is impossible for us to buy into the premise that Houston is not still very reliant on the health of the domestic oil industry, which in turn is heavily impacted by the price of oil.

Equally troubling is the news out of Seattle. As is the case in Houston with its reliance on oil, progress has been made in Seattle toward making Boeing less of a 500-pound gorilla. Nevertheless, the airplane maker is still one very large monkey. So far this year Boeing has announced layoffs totaling 48,000 jobs, slightly over half of which will be concentrated in the Seattle-area. A layoff of this size could well result in a total job loss of over 75,000 people in this city after factoring in a multiplier effect. If things get this bad, the job loss will equate to over 5% of the city's total employment base; enough to negate the positive effects of any other employment growth the city may experience during the next couple of years. Microsoft is often cited by the city's boosters as a major engine for growth, but it is revealing to note that Microsoft currently employs fewer people than Boeing is laying off! The havoc being wreaked on Seattle by the Asian flu may also affect Portland, where the city will almost certainly see a cooling from the robust employment growth pace of recent years. The "Silicon Forest" has been the focus of much of the city's growth of late, as computer hardware manufacturers and suppliers have established massive plants in the area. This business has languished in '98 as a result of slack demand, and with the now-lower production costs in Asia, will likely continue to suffer as pricing pressure increases.

Finally, while it is difficult to single out any particular cities other than these that have undue exposure to the troubles caused by Asian turmoil, it seems fair to conclude that most cities/regions that have large manufacturing bases will experience below-average growth. The entire rust-belt will likely experience even less exciting growth than the relatively unimpressive rates of recent years. REIT investors who have, in recent years, grown accustomed to relatively consistent performance across various geographic regions should expect to see larger disparities develop during 1999.

Mike Kirby

January 11, 1999

Ms. Joyce Andrews  
Alaska Permanent Fund Corporation  
P.O. Box 25500  
Juneau, AK 99802

Dear Ms. Andrews:

I have attached Capital Guardian's responses to Terry Brown's request for capital market assumptions and asset allocation positions. Note that the capital market assumptions are based upon research conducted by one of our macro economists and are not necessarily reflective of an overall "Capital Group view."

Our global balanced allocation target (60% stocks, 40% bonds) does not include real estate. The International Subcommittee (ISC), a subcommittee of CGTC's overall Investment Committee, meets formally twice each month to discuss asset allocation issues. This self-monitoring body, comprised of seven Capital global portfolio managers, provides individual asset allocation recommendations. Once each month the members of the subcommittee are given an opinion poll which allows them to verbalize where they would invest among global stocks and bonds. The results of the poll are discussed at the bi-monthly meetings to focus on key issues and variables in the individual responses from the group. The members' recommendations are then aggregated in order to arrive at an overall asset allocation decision.

Please do not hesitate to contact either Bob Spare or me if you have any questions or need additional information.

Sincerely,

Mike Casagrande

cc: Michael O'Leary

*Capital Market Assumptions*

	<u>One Year</u>	<u>Five Years</u>
<b>Domestic Stocks</b>		
S&P 500	6.0%	7.5%
S&P Midcap 400	--	--
S&P 600 Small Cap	--	--
Russell 2000	10.0%	9.0%
<b>International Stocks</b>		
MSCI-EAFE	12.0%	9.0%
MSCI Global Emerging Markets Free	18.0%	11.5%
<b>Real Estate</b>		
NCREIF Classic	--	--
NCREIF All Properties	--	--
Morgan Stanley REIT	--	--
<b>Fixed Income</b>		
Lehman Aggregate	4.5%	6.5%
Lehman Government Corporate	--	--
Lehman Corporate Rated A	--	--
Salomon Non Dollar World Government Bond Index	--	--
Hedged	5.0%	7.5%
Unhedged	7.0%	6.5%
Merrill Lynch High Yield Master	11.0%	9.0%
<b>Short Term</b>		
90 day T-bill	4.4%	5.0%
<b>Consumer Price Index</b>	1.9%	2.3%

WLP

## FINANCE AND ECONOMICS

## Economic growth

## Profits of doom

SHARE prices in much of the world ended 1998 higher than they started it. Oddly, at the same time, the profitability of companies is shrinking, even in the world's leading economies. This begs the question of whether equity prices in rich countries now make any sense at all—but it also gives ominous warning of disappointing economic growth to come in 1999.

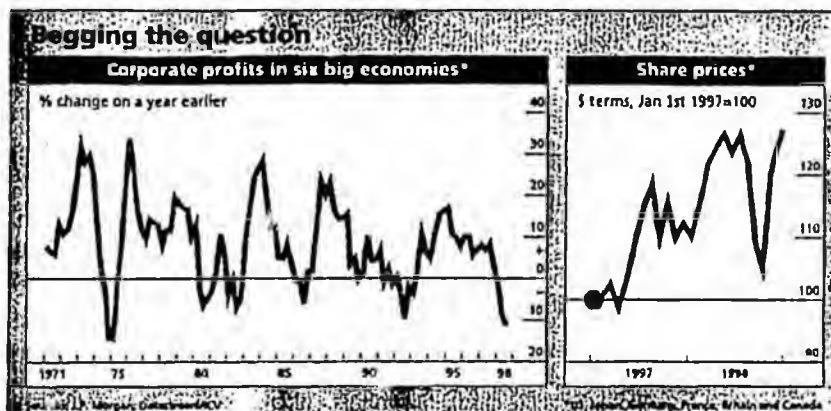
Share prices rose, on average, by more than 15% in 1998 in six of the rich world's biggest economies. But in the third quarter, the latest period for which there is data, company profits were 12% lower than a year earlier in those economies (see chart). Much of this is due to the continued sufferings of Japanese firms. But corporate profitability has fallen compared with the previous year in the other big economies as well.

Continued economic strife in Asia is one cause of slimmer profit margins elsewhere. The devaluation of Asian currencies, and a huge amount of excess productive capacity, have intensified global price competition, especially in homogeneous, tradable goods such as textiles, chemicals and commodities. But in America and Britain, several years of decent economic growth have driven down unemployment to such an extent that labour costs are starting to rise—although the impact of this has been cushioned by higher productivity.

These factors are unlikely to go away in 1999. And in continental Europe, the launch of the euro may increase price competition by making differences in pricing between countries in the euro-zone more transparent to consumers.

In the case of corporate profits, the main uncertainty is how fast, if at all, the world's big economies will grow. The frenzied cutting of short-term interest rates by central bankers since the autumn's brief financial-market crisis seems to have averted the worst for now. But yields on corporate bonds, especially American ones, are typically higher now than six months ago, because investors are more worried about the riskiness of these securities.

Worse, the recent decline in corporate profitability may itself point to slower growth ahead. In the past, changing profitability has been a useful lead indicator of economic trends. One reason is that, when firms earn lower profits, they generally become less optimistic about their future profitability, and vice versa—and so cut (or boost) their investment spending accordingly. Capital spending by companies is an important contributor to economic growth. If there is less of it, growth suffers. In continental Europe, most of the economic growth during the 1990s was due to



higher spending by companies.

America's economy is now especially vulnerable to a sharp reduction in investment by firms. Much attention has been lavished on American consumers' alarming recent habit of spending more than they earn. But American companies also have a "negative savings ratio", points out David Mackie, an economist at J.P. Morgan, because they have been borrowing so much to invest. British and continental European companies, in contrast, have not paid for capital spending in the 1990s by getting deeper into debt.

Running up debts to finance investment may make sense in conditions of

rapid economic growth. But, when growth slows and profitability tumbles, heavy indebtedness will force companies to make ferocious cuts in capital spending. Mr Mackie thinks this could be severe enough to push the American economy into deep recession. A similar thing happened in Japan, that other "miracle economy", in the early 1990s. Companies had been borrowing and investing as though the economy would grow for ever. Its economy is still paying the price. Japan's problems have mired Asia in recession; if America's economy went down the plughole, the rest of the world would probably follow suit.

## Hold your tongue

BEAUTY is in the eye of the beholder. This applies as much to economic figures as to the human kind. Whether an economic development is "good news" or "bad news" may depend on circumstances, or on who you are—something most scribblers tend to ignore. In the second article in our occasional series, we consider some of the emotive words that are misleadingly used to describe economic numbers.

Headlines that include the word "gloom" are more likely to make the front page, so writers are tempted to give their stories a grim spin. Thus, a fall in oil prices might trigger the headline: "Oil-price gloom". Lower prices are indeed bad news for producers—but they are good news for consumers. Or consider interest rates. Pundits always pronounce a rise in interest rates as "bad". Yet for every borrower there is a saver, who gains from higher rates. It is true that higher interest rates may force firms to cut investment and jobs. But in many countries the personal sector has more assets than debts at variable interest rates, so it is a

net winner when rates rise.

Trade balances are a rich source of over-emotional language used by economic writers. When a country's trade deficit shrinks it is always said to "improve"; if a surplus disappears it has "deteriorated". The presumption is: surplus good, deficit bad. But a country's trade balance is a poor gauge of economic strength. Since Japan's widening trade surplus reflects the depressed state of its economy, it is hardly good news.

Likewise, the recent shift in Asia's emerging economies from deficit to surplus: if these surpluses shrink next year as demand picks up, that will be good news, not bad. Commentators should note that trade deficits may increase—decrease—they can never "improve".

Finally, here is a reader's nomination for the best "financial babble"—the previous subject in this series. This gem comes from the *Independent*, a British newspaper: "Concerns that the economic outlook might not be as gloomy as feared hit interest rate hopes and sent financial markets lower yesterday..."



DRCM Capital Market Assumptions and Asset Allocation

	1 Year Rtn	5 Year Rtn	1 Year Wt
<b>Domestic Stocks</b>			
S&P 500	6.5%	7.0%	20%
S&P Midcap 400	7.0%	8.5%	10%
Russell 2000	8.0%	9.5%	15%
<b>International Stocks</b>			
MSCI-EAFE	8%	9%	5%
MSCI Global Emerging Markets Free	5%	11%	0%
Total EQUITY			50%
<b>Real Estate</b>			
NAREIT (All)	7%	7%	10%
Total REAL ESTATE			10%
<b>Fixed Income</b>			
Lehman Aggregate	6.15%	4.7%	10%
Lehman Government Corporate	5.85%	4.1%	10%
Lehman Corporate	6.50%	5.2%	10%
Salomon Non-Dollar World Government Bond Index			
Hedged	5.15%	3.1%	5%
Unhedged	5.15%	4.9%	0%
ML High Yield Master	8.50%	7.00%	5%
<b>Short Term</b>			
90 Day T-Bill	4.40%	4.85%	0%
Total BONDS			40%
Consumer Price Index	2%	3.5%	
Total PORTFOLIO			100%



# Capital International

## Emerging Markets Strategy Statement

December 31, 1998

Nineteen ninety-eight was an amazing year. At one point, several individual markets were down 70 to 90% in U.S. dollar terms, and the Morgan Stanley Capital International Emerging Markets Free Index was down more than 40% on a year-to-date basis, and more than 50% year-over-year. This carried over to the developed markets, and at times it felt as if the whole world was going to implode.

But volatility in emerging markets goes both ways, and we've had a snapback in the Index of over 25% from its September low. That's why it's so important to stay invested. If you look at the record of emerging markets over the past 12 years, much of their performance has come in very short spurts. In spite of what happened during the year, our original emerging markets fund, net of fees, has a return of nearly 20% per annum. But in three of those years the return was over 60%. It would be a shame

not to be there for that kind of return, because if you exclude those three years, returns would look fairly pedestrian.

### Riding Out the Storm

The most important thing we did all year was to heed our own advice and not panic—and it would have been easy to panic. We kept about our business of attempting to buy good companies at attractive prices. In spite of mass redemptions in most retail mutual funds, our institutional and individual investors took the long-term view and remained invested.

We are confident of higher absolute returns looking forward because the reasons we believe in emerging markets as an asset class are still valid. Despite growth assumptions being lowered for many countries, we still expect to see more than 70% of the world's growth coming from the developing world over the next 20 years. But equity prices in emerging markets currently reflect much grimmer assumptions. That's why I passionately believe that in a few years we will look back on this point in time as an extraordinary buying opportunity. And I am not alone in that belief, as informed corporate buyers have continued to purchase operating assets on the cheap, often paying a substantial premium to what the market says those assets are worth.

### Taking a Closer Look

One of the things we wondered about during this time was, did it feel as bad inside these countries as it looked from the outside? I think it depends on where you look. People in Russia and Indonesia noticed a big difference. But in Thailand, the Philippines, Taiwan, or Latin America in general, it probably didn't feel as though the market had gone down 50%, 60%, or 70%, nor did it affect most people's lifestyles. In many places, the violent reaction of the financial market didn't accurately reflect what was really going on inside the country.

We asked three of our analysts to shed some light on this. In each case, the analyst was born and raised in the country he or she covers, and can provide some perspective as to what life was like on the inside during the financial crisis in the emerging markets.

#### *Patricia Artigas: Argentina*

Life for the average Argentine runs on different rails than the equity or debt markets. Since the hyperinflation of 1989-90, people don't keep their savings in stocks or in bonds. The stock market is extremely small compared to GDP (only about 15%, compared to 100% for the Chilean market), and while the economy was booming from the second half of 1996 until the third quarter of

### Index Returns As of December 31, 1998

MSCI Emerging Markets Indices	% of Index*	% Change in US\$	
		3 Months	12 Months
Indonesia Free	1.8	125.6	-31.5
Korea	10.7	114.4	141.0
Russia	1.3	68.4	-83.0
Philippines Free	2.1	58.8	13.5
Thailand Free	2.8	54.4	11.5
Hungary	1.6	38.6	-8.2
Colombia	0.8	33.1	-42.2
Greece	7.3	28.2	78.1
Venezuela	1.0	20.8	-49.2
Czech Republic	1.1	14.5	0.5
Chile	4.5	13.3	-28.5
Mexico Free	11.3	10.5	-33.5
Poland	1.4	10.1	-6.7
Argentina	4.6	7.3	-24.3
Taiwan	9.9	7.2	-20.6
Jordan	0.2	7.0	-11.0
Turkey	2.0	5.3	-52.5
South Africa	10.3	4.8	-27.6
Israel	3.3	4.6	-5.1
China	0.7	4.1	-42.4
Brazil	11.9	0.6	-39.6
Peru	1.0	-1.1	-40.2
India	7.9	-1.6	-21.3
Pakistan	0.4	-12.5	-56.6
EMF†	100.0	18.0	-25.3
EMF Far East	21.3	17.7	-6.2
EMF Asia	15.1	33.8	-11.0
EM Europe & Middle East	28.5	21.0	-26.0
EMF Latin America	35.1	7.1	-35.1

\* Morgan Stanley Capital International Emerging Markets Free Index.

† The MSCI EMF Index measures the performance of markets where a substantial portion of shares are available to non-domestic investors.

Note: All figures computed with gross dividends reinvested. All indices are unmanaged.



1998, the number of local brokers and small and midsized financial institutions has been shrinking at a fast rate.

Unfortunately, the crisis in the emerging world and the deeper instability of our neighbor Brazil have made people begin to feel the indirect effect of the stock market collapse. The higher level of risk in the region has already had an impact on the capital inflows to Argentina, despite its solid fundamentals. Small and midsized companies are suffering the most from the effects of the reduced availability of financing and the higher unemployment rate. Unemployment is today's major economic concern, as it has been increasing from the already high rate of 13%. Despite that, most people continue to think things are better now than in the recent past, when inflation was 4,000% and the local currency had no value at all.

*Claire C. Cul: China*

China is a very special case. Typical middle-class persons cannot freely exchange currency to dollars or other hard currencies; it's illegal. And this closed system has shielded the country to a very large extent from the external financial crisis. It's really the domestic economy that affects the daily living standard of most people, not the stock market.

The stock market in China is also unique. There is an "A-share" market for domestic investors and two "B-share" markets for foreigners. The A-share market, which is much larger, has not yet experienced a crash. So the stock market turmoil that we saw in the emerging markets has not affected China that much.

However, the domestic economy is weakening. External demand from China's neighbors has slowed, and that has had an impact on the domestic economy. So the daily living standard has decreased a little bit since 1996, and with the economic outlook not improving, people are more careful about spending. But when the markets crashed it had little effect on the living standard.

*Osman Y. Akman: Turkey*

In spite of last year's decline in share prices, life for the average Turk goes on as usual. (Of course, the 110% performance in 1997 helped soften that blow.) In Turkey, there are very few retail investors in the stock market (0.5% of market capitalization), and domestic institutional investors are basically non-existent. While this is a negative in terms of the development of the local market, there was no negative wealth effect from this year's drop in stock prices.

Of course there will probably be a reduction in discretionary spending for both corporations and individuals. For example, people will travel less. If they had been taking three trips a year now they'll take two trips a year. But purchasing power should stay the same. The economy, which is expected to have grown around 4.5% in

1998, is expected to slow to 1.5-2% next year, which is more or less equal to the population growth rate.

One point worth noting is that, unlike many other countries during this period, there has been virtually no local capital flight from Turkey. I think that reflects the deep sense of nationalism Turkish people have—they really believe in their country. And that thinking by the person on the street is reinforced by the government's commitment to market reforms and maintaining an open economy, even during this difficult environment.

Turkish history dates back seven centuries, and during that time, the Turks have built empires and have seen them destroyed. In that process, there have been many political and economic ups and downs, and Turks have learned how to deal with difficulty. I don't think there's any complacency about what's going on, but I think the Turkish people have confidence they can see through this difficult period as they have done in the past.

**The Real World Versus Pieces of Paper**

We are investors. And what we have tried to do over the years is draw a distinction between investing and trading pieces of paper back and forth. That's what led us to ask the question: what is really going on? Country by country and company by company, we realized the world was not coming to an end, even though the stock market was telling us it was. By understanding that outside the financial markets things were reasonably normal, we were able to stay reasonably calm and do what we always do, which is to invest in quality companies at fair valuations.

We thought it was appropriate that in September the Nobel Prize for economics was awarded to Professor Amartya Sen for his work on the economics of famine. That was in stark contrast to the previous year's award, which went to Robert Merton and Myron Scholes from Long-Term Capital Management for their option pricing model. There was an appropriate irony in that. And it illustrates the importance of understanding the real world versus explaining the price action of pieces of paper.

Looking back on 1998, the world was perilously close to a financial disaster. I believe when the Long-Term Capital story was breaking, the reason the regulators chose the route they did, knowing they would be accused of hypocrisy, was because they were scared of the alternative—that \$125 billion in debt could bring down major financial institutions. All this came out of leverage and computer models and thinking of things as nothing more than pieces of paper to be traded back and forth. And I believe that we would do well to remind ourselves that there's more to life than that!

— David I. Fisher  
*Capital International*