

ALASKA LEGISLATIVE COUNCIL

279 SCOM 9: HOUSE SPEC. COMM. ON PERMANENT FUND 1977-78

Figure 8 - POSITION OF STATE ASSUMING 25% INCREASE
IN PETROLEUM REVENUES

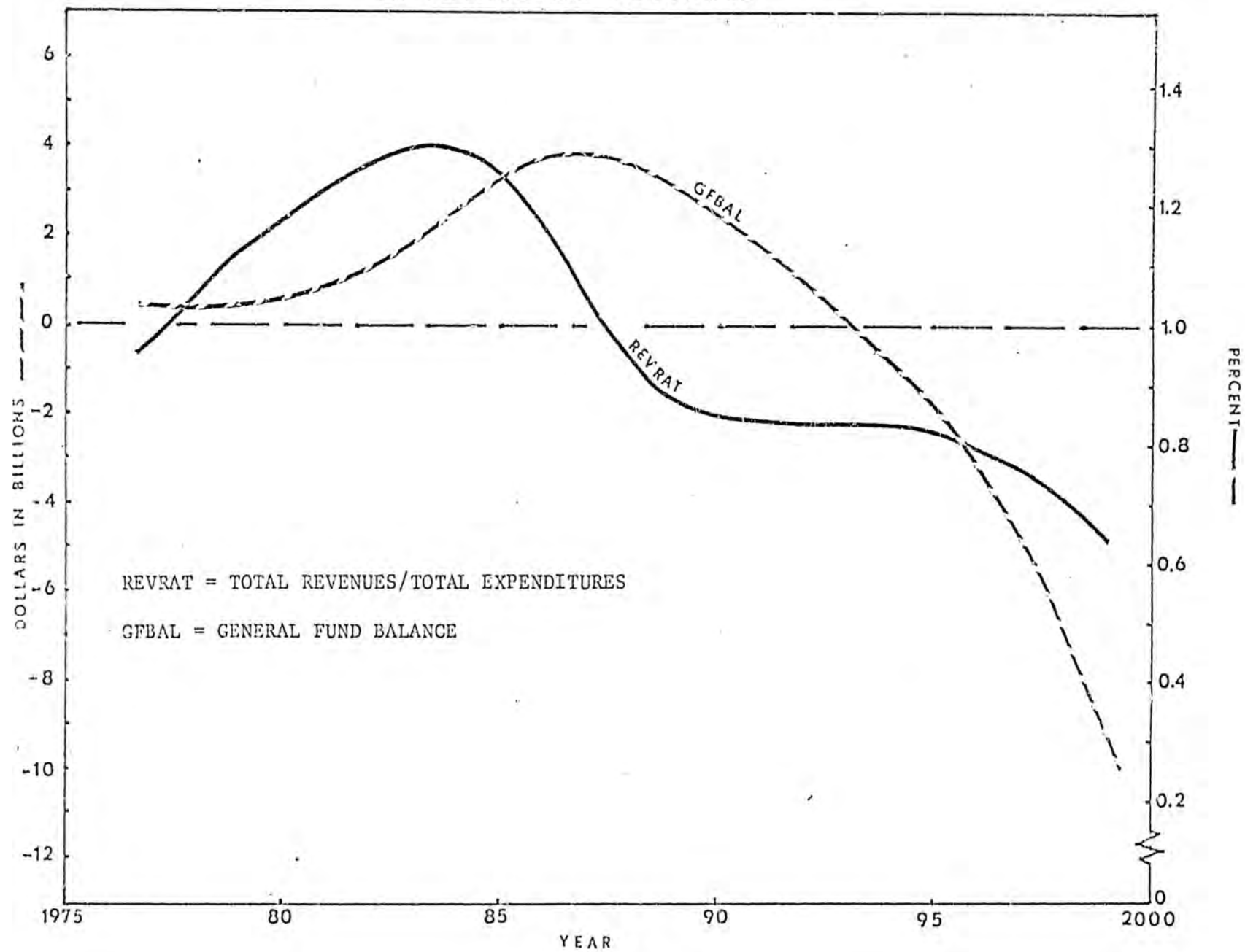


Figure 9 - FISCAL POSITION OF STATE ASSUMING 100%
CONTRIBUTION RATE PERMANENT FUND

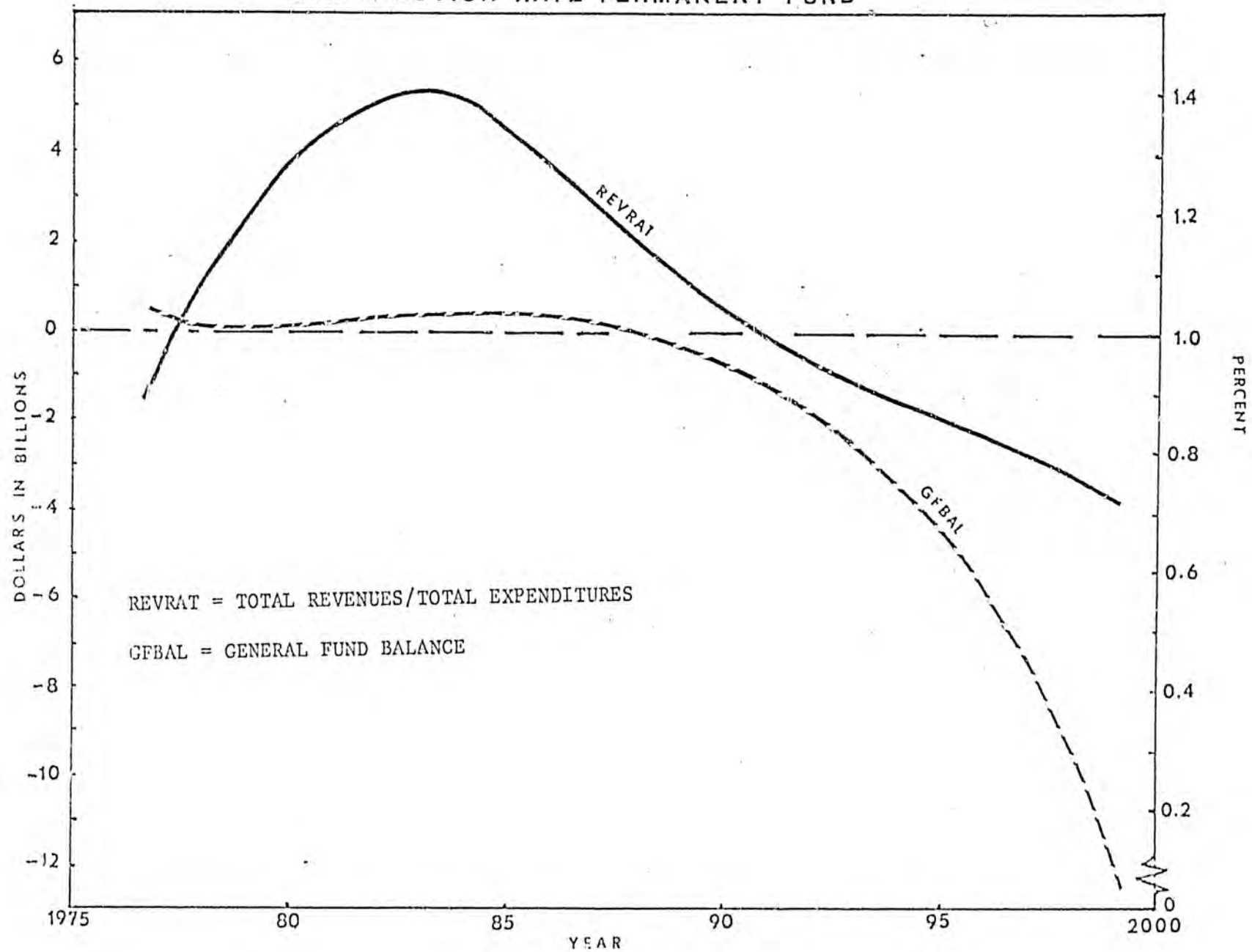


Figure 10 - IMPACT OF PERMANENT FUND WITHDRAWALS
ON ECONOMIC GROWTH

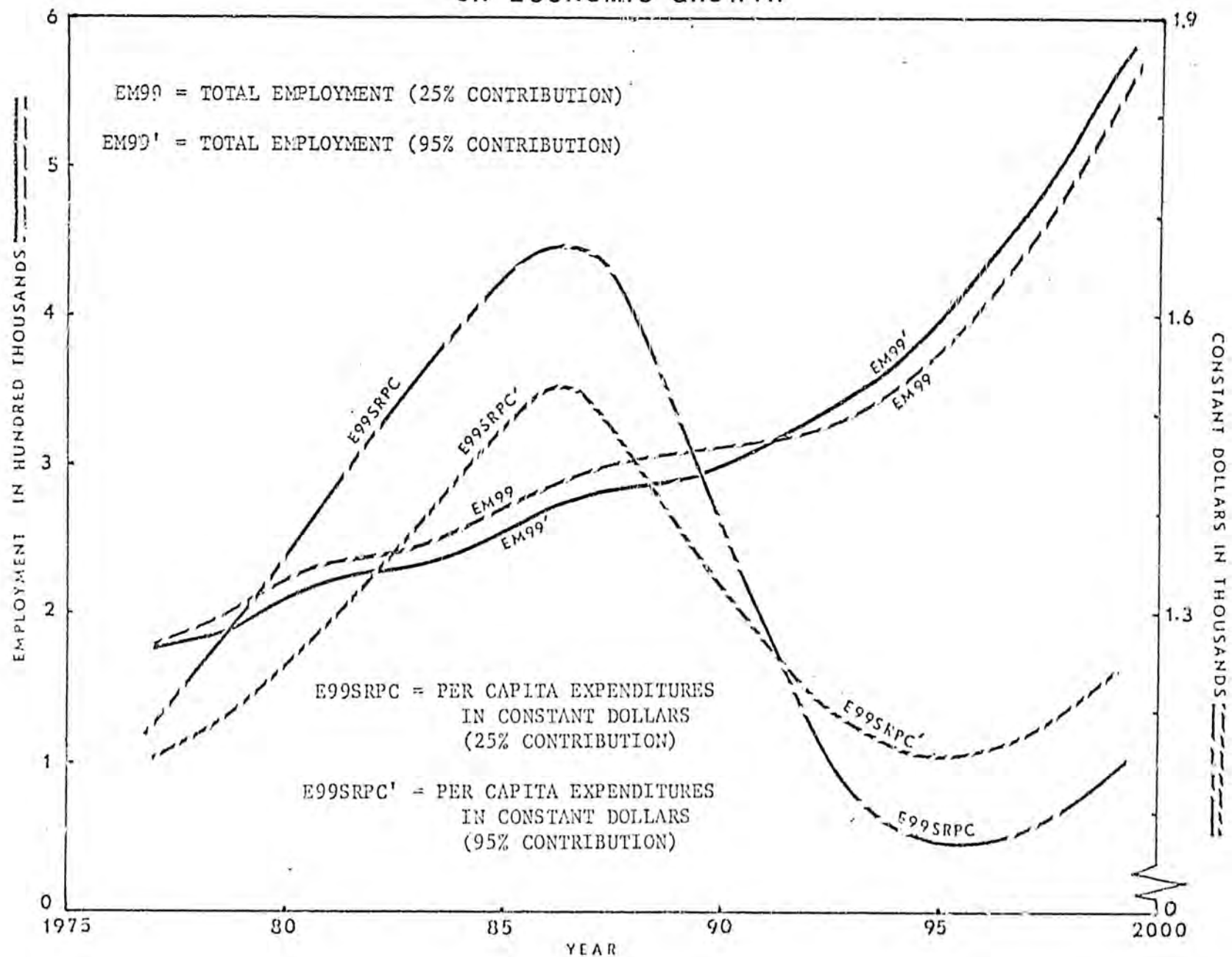


Figure 10.A - RELATIONSHIP OF PERMANENT FUND AND SUPPLEMENTAL FUND

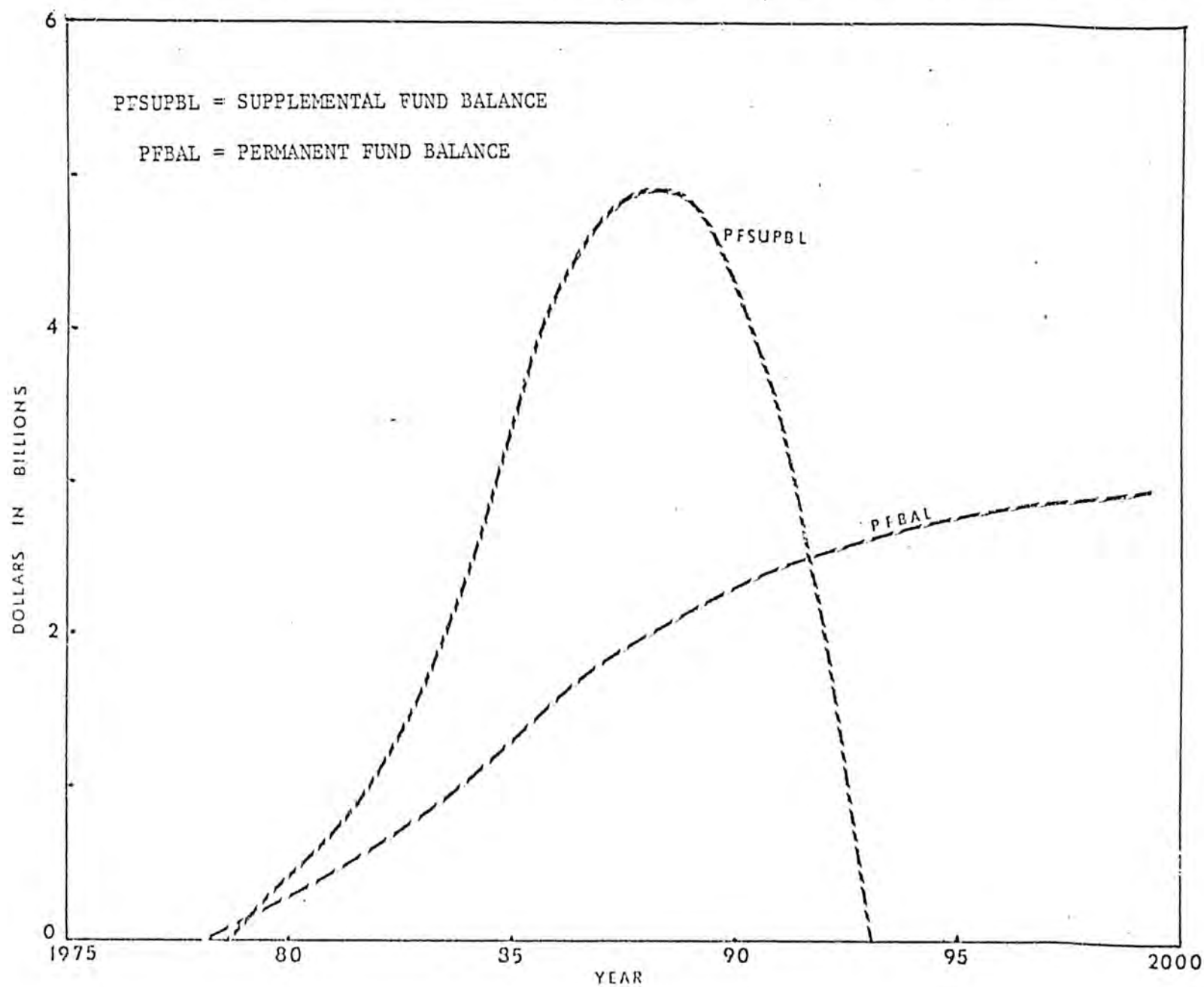


Figure 11 - POSSIBLE TARGET EXPENDITURE GROWTH RATE

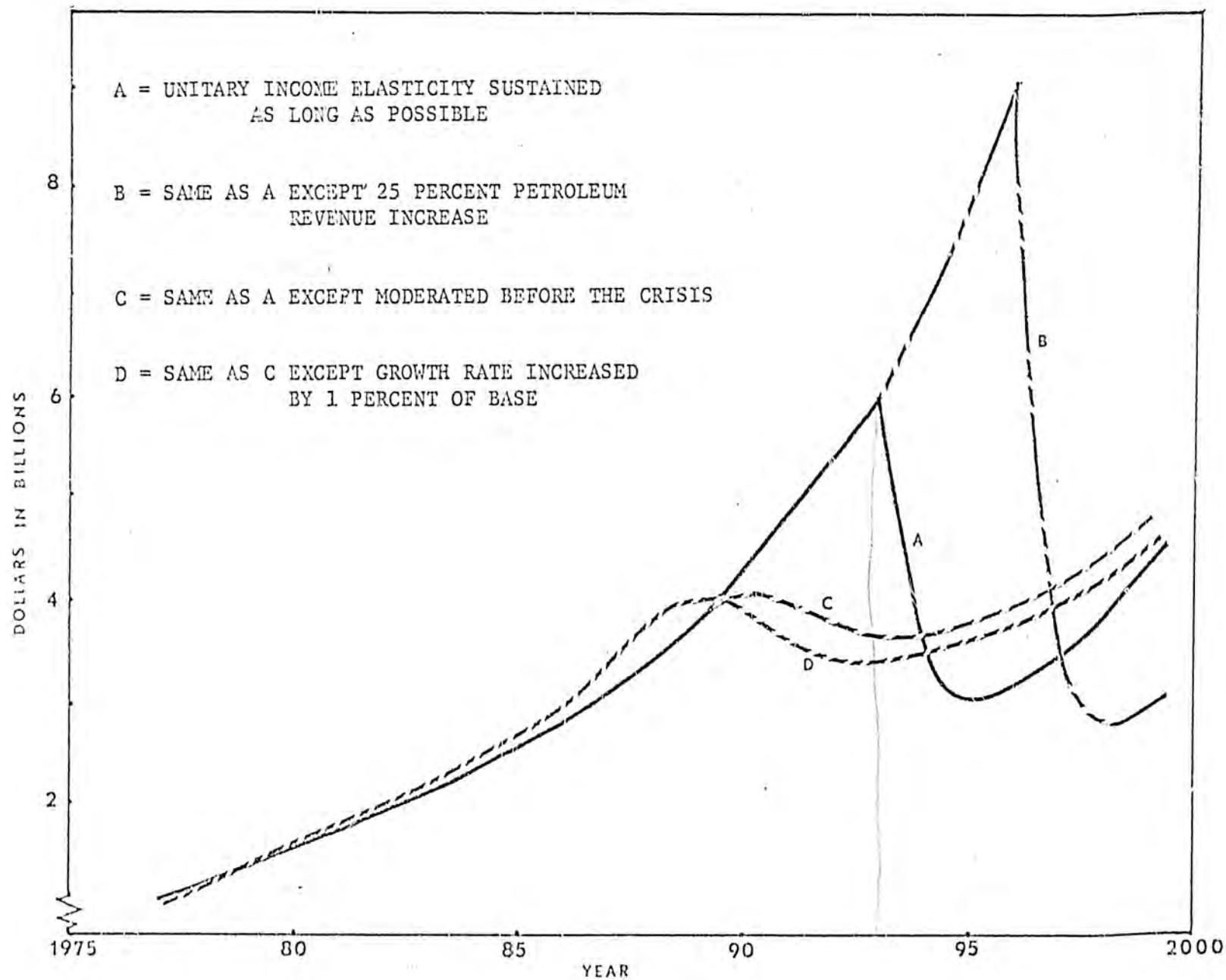
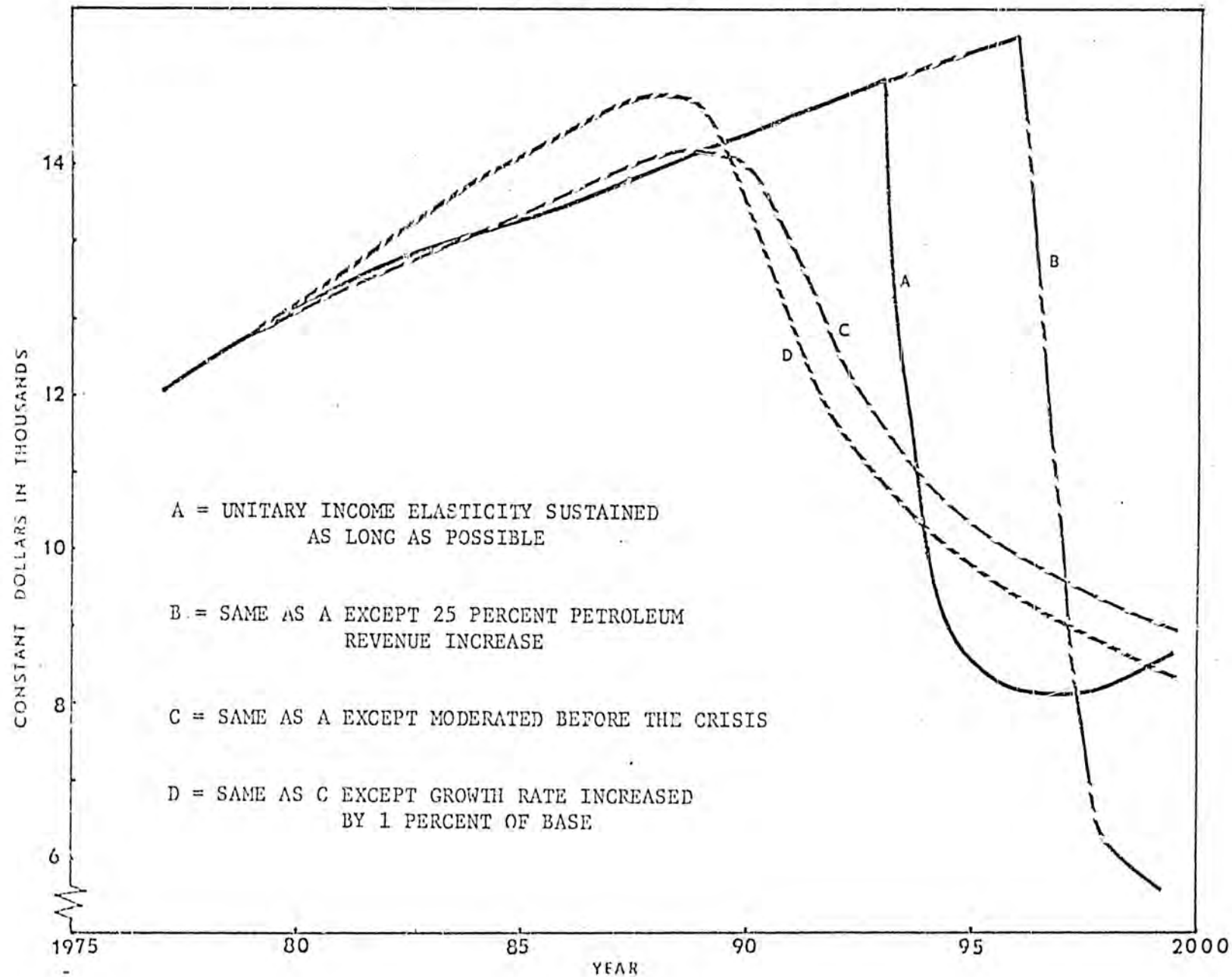


Figure 12 - LEVELS OF PER CAPITA STATE EXPENDITURES
IMPLIED BY TARGET GROWTH PATHS



M E M O R A N D U M

TO: Clark Gruening, Chairman, House Permanent Fund Committee
FROM: Lee Gorsuch, Director, Institute of Social and Economic
Research, University of Alaska

SUBJECT: Alaska Native Regional Corporations and the
Permanent Fund

*Need more
foundation
for admitting
conclusions
of this study into
the final PR report*

In late July, we agreed to include several questions related to the Permanent Fund in the study of regional corporations we are conducting in collaboration with the Alaska Native Foundation. The questions included were designed to (1) ascertain Native Regional Corporation views of potential Permanent Fund investment needs and of possible opportunities in rural areas, and (2) explore potential areas of cooperation between the Permanent Fund and Native corporation investments.

We have made no material changes in the responses we received, nor have we analyzed them. The responses constitute the views of selected executives of six of the twelve Native Regional Corporations. This memorandum summarizes the responses we obtained which included specific ideas and examples of investment opportunities and perceptions of the broader Permanent Fund policy issues.

While our overall study covers all Native Regional Corporations, we were only able to address the Permanent Fund related questions to six of them. This is due primarily to our survey

having already been completed in a number of regions prior to the add on of the Permanent Fund related questions in late July.

General Investment Policies and Goals

Respondents were asked for their opinions as to what Permanent Fund investment policies and goals should be in general and how they should apply to rural areas, in particular.

All respondents supported the concept of the Permanent Fund and generally regarded it to be of great potential value in meeting rural area needs.

Some Specific Comments

- The Fund should be used primarily to ensure that there is sound and steady growth in the economy of the state. Don't want rapid growth booms and busts...use the Fund to help stabilize the economy... help knock out the valleys and knock off the peaks on the economic growth of the state.
- The Permanent Fund should not be used to any great extent to subsidize something that cannot naturally occur or at least stand on its own after a brief period of time...don't like the idea of subsidized business, but could use the Fund to help get things going and then get out; that sort of thing.
- Remove from political spectrum.

- Can't differentiate between urban and rural areas and projects. Need to look at each individual investment...the availability of other funding in urban areas and lack of it in rural areas, will soon take the Permanent Fund to rural areas and small communities.
- Rates of profit are not commensurate with the risks that exist in rural areas...if the Permanent Fund has a goal of doing something for rural Alaska, it is going to have to accept something other than the maximum return. But this may be justified by reducing other costs or enhancing other returns to the public than directly in terms of Permanent Fund growth...rates of return can take into account broader values through shadow pricing.

Relationship Between Permanent Fund and Regional Corporations

All respondents expressed an interest in having Permanent Fund monies available to regional corporations in support of their in-state investments.

There was consensus that the Permanent Fund should be a source of funding, and perform a role comparable to that of a bank. It should provide funding on the basis of proposals and appropriate collateral, similar to EDA, FHA, state loan programs, etc.

While emphasis was on loan programs, the possibility of joint ventures were also envisaged. According to our respondents, under such circumstances the Permanent Fund should provide money only, not management. It would, in effect, become a limited partner with the applicant corporation functioning as the general partner. The respondents fully accepted the accountability associated with the partnership arrangement so long as the state was not directly involved in management of a particular enterprise.

Interest was also expressed in intermediate-term financing. Commercial banks generally finance projects on a 5-7 year term, maximum, and insurance companies lend for a period of 20-30 years. The respondents felt a void exists in the availability of 8-20 year money.

Respondents also emphasized the need to make money available expeditiously, without too much red tape and delay. (It was suggested that sometimes the real cost of "cheap" money (e.g., 5%) turned out to be about 20%.)

One respondent saw no reason to support Native corporations by virtue of their being Native corporations or just to put money into the bush. This respondent suggested that the Permanent Fund participate only when a beneficial investment can be shown. At the same time, this respondent felt that there were many opportunities for "beneficial investments" in rural areas and with Native corporations.

Financing Corporation Investments

An attempt was made to elicit specific examples of situations where the Permanent Fund could assist, or could in the past have assisted, with the financing of regional corporation projects:

- The Harbor View apartment complex in Kodiak is at this time financed by a credit union (50%) and by Koniag Corporation (50%). The project meets local needs, creates jobs - and is carrying itself. No commercial institution would touch the project initially, and public funds would have helped. Even today, Permanent Fund participation in the project's financing could free Koniag equity and enable Koniag to initiate other projects. As Mortgagor, the Permanent Fund's investment would be secured by a profitable real estate project.
- Similarly, Ahtna Lodge at Glenallen has a very high regional corporation equity. Additional financing was provided under the State Tourism Loan Program, by a private bank, and by CEDC. Refinancing of Ahtna's equity would also free its capital for further investments. If the interest rates of the new capital provided by the Permanent Fund were lower than current ones, profitability could be achieved earlier even with a higher level debt.

- Cook Inlet has several high yield projects, including office buildings and hotels, where conversion of equity into a loan, consolidation of existing debt and refinancing of existing medium-term notes could all have a very favorable economic impact on the corporation.
- Most of respondents regarded fisheries to be one economic activity in which Permanent Fund loans or guarantees could have made investments possible in the past and could still facilitate projects presently and in the future. In each case, capital requirements were viewed as having been or being too large to be borne solely by the regional corporations. Among the investment possibilities cited were a major high seas processing ship; boats and on-shore plants; and a large enterprise involved in harvesting, processing, and sales of sea foods.

Areas of Perspective Investment

Fisheries and mineral resources development and processing were mentioned over and over again as prime candidates for future Permanent Fund support in the various regions.

As might be expected, the principal emphasis in fisheries was on high seas and on-shore facilities related to taking full advantage of the extended (200 mile) fisheries jurisdiction in

the waters adjacent to Alaska. Great opportunities are seen for large-scale protein development, but concern exists about obtaining initial financing for what, in effect, will constitute a new approach to fisheries in the United States. Financing is seen as being required for large fleets, on-shore installations, transportation and marketing, research--in other words, everything to initiate broad utilization of off-shore fisheries.

A number of regions currently have mineral contracts with options to participate in production if exploration finds economically feasible resource deposits. Exercising such options will mean that regional corporations will have to pay a share of future costs. While under such circumstances private financing of what would likely be large capital requirements could probably be arranged, respondents felt the Permanent Fund could earn a high yield by financing such ventures...specific opportunities suggested for Permanent Fund involvement in the minerals area were the development and industrialization of the Beluga Coal Fields and the establishment of a cement manufacturing plant. Aside from these specific areas, others were mentioned but only in general terms. These included geothermal energy development, housing and investment guarantees, and OCS-related projects.

Other Comments and Suggestions

Human resources development was stressed by a number of respondents. While they pointed to job creation as a major goal

for rural areas, another respondent saw this factor pertinent only as a consideration if judging between two projects of equal merit, believing that most investments in Alaska would assist with local employment.

One respondent saw the lack of people with interest, attitudes, and skills appropriate to business and financial management as the greatest obstacle to development in rural Alaska.

A suggestion was made that the Permanent Fund could facilitate a sort of one-stop-financing service. The idea came up in connection with a discussion of constraints facing small business, where money may be available but is not getting to where it should or could be. Many existing financial institutions simply do not service rural areas. A servicing facility or process sponsored in connection with the Permanent Fund could actually facilitate the availability of commercial financing and of other funding sources such as EDA, SBA, BIA, and others.

The hope was also expressed that the Permanent Fund would encourage a greater understanding of rural investment opportunities and investment environment. It was pointed out that most of the demand studies and many feasibility studies done for rural areas are based upon urban notions of yield and, therefore, often greatly understate risks and misinterpret the return opportunities. Even the most skilled appraisers are not sufficiently qualified

to deal with rural areas to make appropriate judgements. If the Permanent Fund is to obtain good feasibility studies, our respondents felt it will need to develop its own capability to analyze economic and business opportunities, or sponsor somebody else in development of the appropriate analytic capability as does the World Bank and other international lending institutions.

In conclusion, I want to emphasize that ISER has not analyzed or endorsed the suggestions offered above, nor should they be interpreted to be an official position of the Alaska Native Regional Corporations, but rather the views of several executive officers of the corporations.

by: SY

TABLE 2

Year	Anchorage Consumer Price Index October 1967=100.0	Alaska Population ¹	Appropriations Act General Fund (\$ millions) ²	Per Capita General Fund Appropriations Act in Constant Dollars \$
1960	92.0	226,167	39.8	191
1961	92.9	238,000	46.3	209
1962	92.6	246,000	62.1	273
1963	93.3	256,000	76.7	321
1964	93.9	263,000	67.9	275
1965	94.2	271,000	84.7	332
1966	97.9	271,000	93.8	354
1967	100.0	278,000	103.8	373
1968	102.6	285,000	124.1	424
1969	107.3	296,000	154.1	485
1970	111.5	302,361	314.1	932
1971	114.4	312,930	292.1	816
1972	116.9	324,281	330.4	872
1973	123.8	330,365	353.0	863
1974	140.0	351,159	457.0	930
1975	157.4	404,634	553.6	869
1976	167.6	413,289	679.2	980
1977	177.3	398,000	797.8	1130

1. 1960 and 1970 figures based on April 1st census; 1961-1969 figures refer to estimated July 1st population contained in U. S. Bureau of the Census, Current Population Reports, Series P-25, No. 460, June, 1971; 1971-1977 figures refer to July 1st population estimates of the Alaska Department of Labor, Research & Analysis Section.
2. The figures are for the fiscal year following the listed calendar year, e.g. in 1960 the fiscal year 1961 appropriations act of \$39.8 million in general funds was signed into law.

TABLE 1
ANNUAL COMPOUND PERCENTAGE GROWTH

<u>Period</u>	<u>Anchorage Consumer Price Index</u>	<u>Alaska Pop.</u>	<u>Appropriations Act General Fund</u>	<u>Per Capita General Fund Appropriations Act in Constant Dollars</u>
1960-1977	3.93%	3.38%	19.29%	11.02%
1960-1969	1.72	3.03	16.23	10.91
1969-1977	6.48	3.77	22.82	11.15
1970-1977	6.85	4.00	14.24	2.79
"normalized" 1970-1977	6.85	4.00	19.14	7.21

TABLE 3
INFLATION RATE IN CONSUMER PRICE INDEX

<u>YEAR</u>	<u>ANCHORAGE</u>	<u>U.S.</u>	<u>DIFFERENCE</u>
1961	.96%	2.28%	-1.30%
1962	-.32	1.34	-1.66
1963	.76	1.10	-.34
1964	.65	1.20	-.55
1965	.32	1.61	-1.29
1966	3.93*	3.91	.02
1967	2.15	2.64	-.49
1968	2.60	4.55	-1.95
1969	4.58	5.59	-1.01
1970	3.92	5.83	-1.91
1971	2.60	3.81	-1.21
1972	2.19	3.27	-1.08
1973	5.91	7.90	-1.99
1974	13.09*	12.01	1.08
1975	12.43*	7.59	4.84
1976	6.48*	5.29	1.19
1977	5.79	6.47	-.68

*Anchorage rate greater than U.S. for these years.

TABLE 5.
Alaska's Population Growth Compared with Total
United States, Far West and Mountain States

Year	Alaska	Far West ^a	Mountain ^b	United States ^c
1880 (June 1)	33,426	1,176,844	430,848	50,155,783
1890 (June 1)	32,052	1,935,689	918,055	62,917,714
1900 (June 1)	63,592	2,459,027	1,314,081	75,994,575
1910 (Apr. 15)	61,356	4,274,179	2,019,987	91,972,266
1920 (Jan. 1)	55,036	5,644,278	2,564,182	105,710,620
1930 (Apr. 1) ^d	59,278	8,285,491	2,751,841	122,775,046
1940 (Apr. 1) ^d	72,524	9,733,262	3,008,677	131,669,275
1950 (Apr. 1)	128,643	14,646,610	3,484,141	150,697,361
1960 (Apr. 1)	226,167	22,624,000	4,317,000	178,464,236
1970 (Apr. 1)	302,647	25,915,000	5,005,000	203,185,000

NOTES:

^aFar West includes the states of Washington, Oregon, California and Nevada.

^bMountain includes Montana, Idaho, Wyoming, Utah and Colorado.

^cUntil 1970, population figures were for Continental United States, excluding Alaska and Hawaii.

^dThe census dates in Alaska were Oct. 1, 1929 and Oct. 1, 1939.

SOURCE: U.S. Department of Commerce, Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1957*, (Washington: U.S. Government Printing Office, 1960), Series A 17-21 and Series A 1230180; U.S. Department of Commerce, Bureau of the Census, *Statistical Abstracts of the United States, 1961*, (Washington: U.S. Government Printing Office, 1961) pp. 5, 12 and 13; and U.S. Department of Commerce, Bureau of the Census, *Current Population Reports*, Series P-25, No. 460, June, 1971.

TABLE 6.
Decennial Rates of Population Change -- Alaska, Far West,
Mountain States and Total United States
1880-1970

Decennial Period	Alaska	Far West	Mountain	United States
1880-1890	-4.1	64.5	113.1	25.5
1890-1900	98.4	27.0	43.1	20.7
1900-1910	1.2	73.8	53.7	21.0
1910-1920	-14.5	32.1	26.9	14.9
1920-1930 ^a	7.7	46.8	7.3	16.1
1930-1940 ^a	22.3	18.8	9.3	7.2
1940-1950	77.4	48.8	15.8	14.5
1950-1960	75.3	55.5	23.9	18.4
1960-1970	33.8	14.7	15.9	13.8

NOTE:

^aFor Alaska, as of Oct. 1, 1929 and Oct. 1, 1939.

SOURCE: Calculated from data in the first part of Table 2.

HOUSE SPECIAL COMMITTEE ON THE PERMANENT FUND

December 12 and 13, 1977

AGENDA

1. Report, Institute of Social and Economic Research
2. Discussion, Permanent Fund draft legislation
3. Discussion, Renewable Resources Development Fund draft

MEMORANDUM

TO: Clark Gruening, Chairman, House Special Committee on the Alaska Permanent Fund

FROM: The Institute of Social and Economic Research

SUBJECT: Alternative Approaches to Calculating Contributions to the Permanent Fund

November 18, 1977

Introduction: As part of ISER's contract with the committee to analyze the economic impacts of alternative investments and policies of the Permanent Fund, ISER is also to address the issue of how the legislature might go about determining the level of contributions to be made to the Permanent Fund beyond those constitutionally mandated.

As previous analyses of investments and expenditures using ISER's econometric models have already suggested, the determination of an appropriate pattern of state expenditures involves considerations far broader in scope than simply the provision of public services to satisfy the demands of a stationary population. Because state government plays a central role in determining the overall level of economic activity in the state, via direct employment and expenditures in other sectors of the Alaska economy, savings/expenditure choices confronting the Alaska Legislature are most appropriately considered within the context of the impact of alternative choices on the growth of employment, population and incomes in the state and on the ability of the state to sustain such growth in the long run. These considerations are of particular importance given that much of any expenditure growth is to be financed from revenues derived from depletable resources.

Two alternative approaches might be suggested in approaching the savings/expenditure choice. At the one extreme, one might adopt simple savings formulas, or rules, to minimize policy discretion over expenditure choices. At the other extreme, one might adopt a fully discretionary expenditure policy in which decisions on savings and expenditures are based solely on considerations of current economic conditions. Neither extreme is likely to be wholly adequate in serving both the goal of satisfying local demands for services by the existing state population and the long run growth goals of the state.

In order to satisfy the demands of the local population for public services, some simple formula approach might be deemed appropriate. However, to take into account the growth effects of state policy, some more elaborate, and more flexible, formulations would be required. This memo is intended to present some preliminary, simple formula approaches, as well as the limitations of such approaches. It also discusses the types of considerations which are relevant to the development of appropriate expenditure rules and which adequately capture the growth effects of any state savings/expenditure choice.

The following memorandum identifies these important variables and discusses how they are related to one another. These relationships can become quite complex and, when expressed in mathematical terms, confusing to the non-economist. For the purposes of this paper, we have attempted to minimize the use of professional jargon and mathematics and have focused on the basic principles of a formula approach.

Background: There are a variety of possible formulas to govern contributions of state revenues to the Permanent Fund. The simplest is, of course, a fixed percentage of state petroleum leasing revenues. Such a formula would build up the balance in the Permanent Fund at a relatively predictable rate, but it would ignore current as well as future state budget needs. A constant percent contribution, for example, could leave large balances accumulating in the general fund over the next several years; but it could also, within a decade, begin to cause substantial general fund deficits in succeeding years.

Another formula, although more complicated, could be constructed with the objective of stipulating that Permanent Fund earnings provide a specified percentage of state revenues by a certain date. If, for example, the goal of the Permanent Fund was to provide 25 percent of the state's revenue needs in perpetuity by the year 2000, the purpose of the formula would be to determine the annual contributions to the Permanent Fund required to accomplish this goal.

A third and similarly complex alternative formula could be devised with the objective of providing for a smooth, orderly growth of money available in the general fund in order to meet the operating needs of state government for the longest possible period. And a fourth alternative formula could conceivably be designed whose purpose was "countercyclical," that is, encouraging reduced general fund spending in boom times and increased spending during recessions in the state's economy.

Revenues contributed to the Permanent Fund under any kind of formula are kept outside the normal budgetary process in that they are not available for normal state expenditures. Thus, it follows that the larger the contributions to the Permanent Fund in any year, the less general fund revenues available for expenditures and vice versa. To the extent that the legislature limits each year's appropriation to the revenues available that year to the general fund, the Permanent Fund contribution becomes the key policy variable controlling spending from the general fund. Indeed, because state spending is a major factor in the state economy, Permanent Fund contributions must also be viewed a key policy variable affecting the state's economic growth and population.

An Illustrative Formula: Although ISER is now modeling the impact of such alternative formulas on the state budget and the Alaskan economy, for the purpose of illustrating the use of such formulas, the present memo concentrates on the third type of formula, that is, one which would allow a smooth and orderly growth of general fund spending by putting all revenues in excess of the projected current needs of state government into the Permanent Fund.

A smooth, orderly growth of state expenditures is one which reflects the normal growth of demand by Alaskan residents for the services of state government, the income transfers, such as payments under the public assistance program, and the expenditures of local government, to the extent these later two are supported by general fund expenditures. In absolute dollar terms, this demand for state expenditures will tend to grow in response to three factors: 1) growth of the Alaska population; 2) inflation; and, 3) growth of real income per capita.

Any formula governing Permanent Fund contributions which is intended to allow a smooth and orderly growth in the money available in the general fund will have to reflect these three factors as well as unanticipated new ones such as a significant disaster. If contributions to the Permanent Fund allow general fund surpluses to grow, the legislature will come under pressure to spend them. Conversely, if the formula does not leave money in the general fund sufficient to keep up with the demand in state services, the legislature will soon be compelled to "break" the formula.

It is not difficult in principle to come up with a formula to estimate the money needed in the general fund in a given fiscal year. One plausible formula for a target rate of growth in state spending would be one which formulates that the rate of growth of state expenditures (rEX) will be equal to the rate of growth in the population (rPOP) plus the rate of growth in prices (rPRICE) plus the rate of growth of personal income per capita (rYPC). Expressed mathematically, the formula would be the following:

$$rEX = rPOP + rPRICE + rYPC$$

According to the formula, a 5 percent increase in state population or a 5 percent increase in the price level or a 5 percent increase in real personal income would each require a 5 percent increase in general fund appropriations if the existing quantity and quality of state services were to be maintained. Correspondingly, if all three variables increased 5 percent, general fund appropriations would have to be increased 15 percent to provide commensurate services.

Experience over many years in other states indicates that citizens are not satisfied with a constant quantity and quality of state services. Rather, as time passed and real incomes increased, citizens expected more and better services from state government and demanded higher levels of real spending per capita. In other words, the demand for state services rose disproportionate to rise in real per capita income. This disproportionate demand for services as incomes rise is captured by the concept of the "income elasticity of demand" for state spending and can be mathematically expressed by the symbol e .¹ Modifying the above formula to allow for the "income elasticity of demand," it becomes: $rEX = rPOP + rPRICE + rYPC(e)$.

¹The income elasticity of demand is defined as the percentage rise in demand for services per one percent rise in real per capita income.

Thus, if the "income elasticity of demand" is estimated to be 1.2, a 5 percent rise in real personal income would result in a 6 percent increase in state spending per capita. ISER is presently investigating state expenditure data from other states in an effort to determine a reasonable income elasticity value for Alaska and will incorporate the value in its quantitative analyses.

None of the three factors determining the target rate of state spending does, in fact, move at a constant rate from year to year, and a target based on average growth rate established in previous years is likely to be "too high" in some years and "too low" in others. This need not be fatal, however, because the impact of population growth, inflation and higher citizen expectations tend to determine state expenditure patterns only over the long run and with some lag in any case. The kind of formula suggested here is, moreover, self-correcting to a large extent because any base expenditure figure selected ($EX(t-2)$) and the three commensurate growth rates can and would be continually updated as more recent information becomes available.

Conceivably, the legislature could find that the target figures are consistently too high or too low for several years running and that a persistent deficit or surplus was being built up in the general fund. For this reason, legislation establishing a formula might provide for redetermination of parameter e in the formula at periodic intervals--for example, every five years.

The preceding formulas establish only the target expenditures for each fiscal year. They do not by themselves establish the amount of the fiscal year surplus or deficit or the proportion of the surplus to be deposited in the Permanent Fund. To determine the size of the current fiscal year's surplus or deficit, we need to know what total state revenues will be, for both petroleum and non-petroleum sources. If the Permanent Fund contribution is to be determined in advance of the legislative budgeting process, it will be necessary to establish a definitive projection of state revenue and subtract from that projection the expenditure target for state spending. This approach adds another potential source of error to calculation (the revenue projection) and increases the risk that the formula approach would not in fact limit current spending sufficiently or, alternatively, would create irresistible pressures upon the legislature to "break" a formula they felt was intolerably restrictive.

A more workable approach might be to provide that all revenues, except the constitutionally mandated 25 percent of non-recurring mineral revenues that must be contributed to the Permanent Fund, accrue to the general fund up to the point at which general fund revenues equal fiscal year spending target. Once that level has been reached, all revenues from whatever source would be contributed to the Permanent Fund or to a contingent general fund reserve which could be called upon when a given year's target expenditures exceed the revenue remaining in the general fund after the mandatory contributions to the Permanent Fund and the other contingent

liabilities have been made. Under this approach, the legislature would not know in advance exactly how much money would be available in the general fund nor how much the Permanent Fund would be enhanced during the year. In its deliberations on the budget, both of these items would have to be estimated, and miscalculation for unforeseen developments would result in unexpected general fund deficits or surpluses which would carry over to later years. But, of course, that is exactly the situation that exists today.

Using a formula approach to Permanent Fund contributions, we would expect these contributions to be considerably more than half of petroleum revenues the state will receive over the next few years. Absent major new oil and gas discoveries on the state land or very large increases in real energy prices, the proportion to be contributed to the Permanent Fund could be expected to fall to a level below 25 percent by the mid-1990s. Eventually, the objective in maintaining smooth, orderly growth of monies available in the general fund would require withdrawals of accumulated earnings and ultimately of capital from the Permanent Fund. At some time in the future, therefore, the formula approach would no longer be viable, but the original concept of the Permanent Fund and its constitutional basis would have to be revised at that point in any case and this legal issue would likely be one of the least of Alaska's problems. The approach described here would be likely to postpone that day for the longest feasible time.

While the above illustration of a formula might create a "regularity" in the growth of state expenditures, it also serves to illustrate two serious limitations of a simple formula approach. First, such a formula fails to account for the long run viability of the chosen policy in the face of a depletable resource, and second, the formula might produce undesirable policy consequences should the economy enter a downturn. For example, the failure to consider the stabilization aspects of state expenditure policy by using such a formula would lead to declines in state expenditures at precisely the times when increases might be justified to offset the downward cyclical effect of, say, declines in pipeline construction.

Because of these limitations, it is essential that alternative formulas or rules be tested in policy simulations designed to anticipate the consequences of alternative rule specifications on both the short and long term growth of the Alaska economy. The ISER econometric model is designed to accommodate such alternative specifications and to test them.

ISER is completing several applications of the formula and will have the results available for the committee's review at its next meeting. As structured, both formula and the data sets related thereto are computerized and can be easily restructured to analyze the effect of policy choices the committee may wish to examine, such as allowing a 5 percent increase in state spending net of the formula's computation.

Professor Scott Goldsmith is the principal architect of the computer model and has served as the principal liaison with the committee. He is interested and willing to continue working with the committee in its efforts to assess the impacts of varying contributions to the Permanent Fund and of the Fund's investment options.

LG/m

w.o. 4350
12/9/77

1 IN THE HOUSE

2 HOUSE BILL NO.

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 TENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act relating to nonrenewable resource revenues; and
7 providing for an effective date."

8 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

9 * Section 1. AS 24.20 is amended by adding new sections to read:

10 ARTICLE IV. STATE INVESTMENT OVERSIGHT COMMITTEE.

11 Sec. 24.20.600. STATE INVESTMENT OVERSIGHT COMMITTEE ESTABLISHED.

12 The State Investment Oversight Committee is established as a permanent
13 interim committee of the legislature. The establishment of the com-
14 mittee recognizes the need of the legislature for technical review and
15 oversight of the performance of all agencies of the state which perform
16 lending, borrowing or investment functions.

17 Sec. 24.20.610. MEMBERSHIP. The committee is composed of eight
18 members: the president of the senate, the speaker of the house, and
19 three members appointed from each house by the respective presiding
20 officer. The membership from each house shall include at least one
21 member from each of the two major political parties. The committee
22 shall select its own chairman.

23 Sec. 24.20.620. TERM OF MEMBERSHIP. (a) The committee shall be
24 organized within 15 days after the organization of each legislature.
25 Members serve for the duration of the legislature during which they are
26 appointed. If a member is reelected or his term of office extends into
27 the next succeeding legislature, he continues to serve until reappointed
28 or the appointment of his successor.

29 (b) When a member of the committee files a declaration of candi-

1 dacy for an elective office other than that of member of either house of
2 the legislature, and he has not resigned from membership on the commit-
3 tee, his committee membership terminates on the date of filing.

4 Sec. 24.20.630. VACANCIES. When a vacancy occurs in the statutory
5 or appointive membership of the committee, the presiding officer of the
6 house incurring the vacancy shall choose a successor. If the office of
7 the president of the senate or speaker of the house of representatives
8 becomes vacant and a vacancy from the affected house occurs among the
9 membership of the committee, the remaining committee members from the
10 house incurring the vacancy shall appoint a new member.

11 Sec. 24.20.640. MEETINGS. The committee may meet during sessions
12 of the legislature and during the interim between sessions at such times
13 and places in the state as the chairman may determine. Members may
14 receive, for the minimum time required to get to and from meetings and
15 for the period while attending meetings, the same travel and per diem
16 allowances provided by law for members of the legislature when attending
17 sessions, except that members of the committee receive no per diem
18 during legislative sessions other than the per diem allowance paid to
19 other members of the legislature.

20 Sec. 24.20.650. POWERS. The committee has the power to

21 (1) organize, adopt rules for the conduct of its business,
22 and prescribe procedures for the comprehensive fiscal analysis, budget
23 review and post-audit functions over those agencies of the state which
24 perform lending, borrowing or investment functions;

25 (2) hold public hearings, administer oaths, issue subpoenas,
26 compel the attendance of witnesses and production of papers, books,
27 accounts, documents and testimony, and have the deposition of witnesses
28 taken in a manner prescribed by court rule or law for taking depositions
29 in civil actions;

1 (3) require all state officials and agencies of state govern-
2 ment to give full cooperation to the committee or its staff in assembling
3 and furnishing requested information;

4 (4) hold public hearings relating to the confirmation of
5 members of the Alaska Permanent Fund Board of Trustees, the Board of
6 Trustees of the Alaska Renewable Resources Corporation, and the Alaska
7 Enterprise Investment Fund Policy Board;

8 (5) prepare and distribute reports, memoranda, or other
9 necessary materials;

10 (6) make recommendations concerning the structure and operat-
11 ing practices of all agencies of the state which perform lending,
12 borrowing or investment functions;

13 (7) receive and review reports and post-audit analyses con-
14 ducted by the Legislative Budget and Audit Committee relating to all
15 agencies of the state which perform lending, borrowing or investment
16 functions.

17 Sec. 24.20.660. STAFF. The legislative audit division shall
18 provide staff reasonably necessary for the conduct of the committee
19 duties. The committee may hire and determine the salary of the adminis-
20 trative support staff it considers necessary within the limit of the
21 budget approved by the legislature.

22 Sec. 24.20.670. DUTIES. The committee shall

23 (1) report to the legislature its recommendations relating to
24 the confirmation of suggested appointees to the Alaska Permanent Fund
25 Board of Trustees, the Board of Trustees of the Alaska Renewable Re-
26 sources Corporation, and the Alaska Enterprise Investment Fund Policy
27 Board;

28 (2) annually review the long-range operating plans of all
29 agencies of the state which perform lending, borrowing or investment
30

1 (3) require all state officials and agencies of state govern-
2 ment to give full cooperation to the committee or its staff in assembling
3 and furnishing requested information;

4 (4) hold public hearings relating to the confirmation of
5 members of the Alaska Permanent Fund Board of Trustees, the Board of
6 Trustees of the Alaska Renewable Resources Corporation, and the Alaska
7 Enterprise Investment Fund Policy Board;

8 (5) prepare and distribute reports, memoranda, or other
9 necessary materials;

10 (6) make recommendations concerning the structure and operat-
11 ing practices of all agencies of the state which perform lending,
12 borrowing or investment functions;

13 (7) receive and review reports and post-audit analyses con-
14 ducted by the Legislative Budget and Audit Committee relating to all
15 agencies of the state which perform lending, borrowing or investment
16 functions.

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18 provide staff reasonably necessary for the conduct of the committee
19 duties. The committee may hire and determine the salary of the adminis-
20 trative support staff it considers necessary within the limit of the
21 budget approved by the legislature.

22 Sec. 24.20.670. DUTIES. The committee shall

23 (1) report to the legislature its recommendations relating to
24 the confirmation of suggested appointees to the Alaska Permanent Fund
25 Board of Trustees, the Board of Trustees of the Alaska Renewable Re-
26 sources Corporation, and the Alaska Enterprise Investment Fund Policy
27 Board;

28 (2) annually review the long-range operating plans of all
29 agencies of the state which perform lending, borrowing or investment

1 functions;

2 (3) review quarterly reports from the Alaska Permanent Fund
3 Board of Trustees, the Board of Trustees of the Alaska Renewable Re-
4 sources Corporation, and the Alaska Enterprise Investment Fund Policy
5 Board;

6 (4) present a complete report of investment programs, plans,
7 performance, and policies of the Alaska Permanent Fund Board of Trustees,
8 the Board of Trustees of the Alaska Renewable Resources Corporation, and
9 the Alaska Enterprise Investment Fund Policy Board to the legislature
10 within 30 days after the convening of each regular session.

11 Sec. 24.20.680. RECORDS. The committee shall keep a complete file
12 of all reports presented to it and all reports presented by it to the
13 legislature or any legislative committee.

14 * Sec. 2. AS 37 is amended by adding a new chapter to read:

15 CHAPTER 13. ALASKA PERMANENT FUND.

16 Sec. 37.13.010. ALASKA PERMANENT FUND. Under art IX, sec. 15 of
17 the state constitution, there is established as a separate fund the
18 Alaska Permanent Fund. The permanent fund consists of 100 per cent of
19 mineral lease bonuses after deduction of any amounts allocated to the
20 Alaska Native Fund under the Alaska Native Claims Settlement Act and
21 implementing state legislation and any amounts allocated by law to the
22 Alaska Renewable Resources Development Fund and 30 per cent of all
23 mineral lease rentals, royalties, royalty sale proceeds, and federal
24 mineral revenue sharing payments received by the state and any other
25 money allocated by law or appropriated to the principal of the fund.
26 The permanent fund consists of (1) the fund established in this chapter
27 to which five-sixths of the receipts from these sources is allocated and
28 (2) the Alaska Enterprise Investment Fund established in AS 44.55 to
29 which one-sixth of the receipts from these sources is allocated until

1 the amount so allocated reaches the sum of \$100,000,000. Thereafter the
2 total receipts from these sources is allocated to the fund established
3 in this chapter.

4 Sec. 37.13.020. FINDINGS. The people of the state, by constitu-
5 tional amendment, have required the placement of at least 25 per cent of
6 all mineral lease rentals, royalties, royalty sale proceeds, and federal
7 mineral revenue sharing payments and bonuses received by the state into
8 a permanent fund. The legislature finds that

9 (1) the permanent fund should provide a means of conserving a
10 portion of the state's revenues from mineral resources to the ultimate
11 benefit of future generations of Alaskans;

12 (2) the primary goal of the fund should be to maximize total
13 return while maintaining safety of principal;

14 (3) the permanent fund should be used as a savings device
15 until the future time when disposable income from the fund will be
16 needed to replace ~~depleting~~ mineral resource revenues.

17 Sec. 37.13.030. PURPOSE. It is the purpose of this chapter to
18 provide a mechanism for the management and investment of permanent fund
19 assets in a manner consistent with the findings established in sec. 20
20 of this chapter.

21 Sec. 37.13.040. ALASKA PERMANENT FUND BOARD OF TRUSTEES. There is
22 established the Alaska Permanent Fund Board of Trustees. The permanent
23 fund board of trustees is a public corporation and government instru-
24 mentality in the Department of Revenue but has a legal existence inde-
25 pendent of and separate from the state. The purpose of the board is to
26 manage and invest the assets of the permanent fund in accordance with
27 the guidelines established in this chapter.

28 Sec. 37.13.050. COMPOSITION OF BOARD OF TRUSTEES. (a) The board
29 of trustees consists of three members appointed by the governor and con-

1 firmed by a majority of the members of the legislature in joint session.

2 (b) The board shall annually elect a chairman from among its members

3 Sec. 37.13.060. TERM OF OFFICE. The members of the board shall be
4 appointed for terms of three years, and they may be reappointed. Terms
5 shall be staggered. Initial terms shall be one member serving for one
6 year, one member serving for two years, and one member serving for three
7 years.

8 Sec. 37.13.070. REMOVAL AND VACANCIES. (a) The governor may
9 remove a trustee from office by and with the consent of a majority of
10 the members of the legislature in joint session. A removal by the
11 governor shall be in writing and state the reason for removal. If the
12 legislature is not in session, the governor may suspend a member of the
13 board. Upon suspension, a trustee may not participate in board business
14 and may not be counted for purposes of establishing a quorum. A sus-
15 pended member shall continue to receive his salary as a trustee until
16 the legislature in joint session consents to his removal. The joint
17 session shall be held within 30 days from the date of removal if the
18 removal occurs while the legislature is in session or within 30 days of
19 convening of the legislature if the legislature is not in session. If
20 the legislature refuses to consent to his removal, the trustee shall be
21 reinstated to his position.

22 (b) A vacancy on the board shall be promptly filled by appointment
23 by the governor and confirmation by a majority of the members of the
24 legislature in joint session, and an appointee to fill a vacancy shall
25 hold office for the balance of the term for which his predecessor on the
26 board was appointed. If a vacancy arises on the board while the legis-
27 lature is not in session, the governor may appoint an interim trustee
28 who shall exercise all powers and receive the salary of a permanent
29 trustee until such time as the legislature in joint session fails to
30 confirm the interim trustee's appointment.

1 (c) A vacancy on the board does not impair the authority of a
2 quorum of the board to exercise all the powers and perform all the
3 duties of the board.

4 Sec. 37.13.080. QUALIFICATIONS OF TRUSTEES. (a) No trustee may
5 be appointed to the board who has not been a resident of the state for
6 at least three years.

7 (b) No member of the board may hold any other state or federal
8 office, position or employment, either elective or appointive, except as
9 a member of the armed forces of the United States or of this state.

10 (c) At least one member of the board shall be knowledgeable and
11 experienced in finance, investments, or other business management-
12 related field. No two members may be appointed to the board who share
13 substantially similar professional or occupational backgrounds.

14 Sec. 37.13.090. QUORUM. Two members of the board constitute a
15 quorum for the transaction of business and the exercise of the powers
16 and duties of the board.

17 Sec. 37.13.100. COMPENSATION OF TRUSTEES. Trustees serve without
18 compensation except that each member may be reimbursed by the fund for
19 travel and per diem expenses at the rate set by law for members of
20 boards and commissions.

21 Sec. 37.13.110. EMPLOYMENT OF PERSONNEL. The board may employ and
22 determine the salary of an executive director. The executive director
23 may, with the approval of the board, select and employ additional staff
24 as necessary. The executive director may not be a trustee. The execu-
25 tive director and all employees of the board are in the exempt service
26 under AS 39.25.

27 Sec. 37.13.120. CONFLICTS OF INTEREST. (a) Trustees are subject
28 to the provisions of AS 39.50.

29 (b) No member or employee of the board shall acquire an interest,

1 direct or indirect, in a corporation, company, association, or project
2 owned, controlled, or invested in by the permanent fund. If a member or
3 employee owns or controls an interest, he shall immediately disclose the
4 interest in writing to the board and refrain from participating in any
5 manner in any board activity relating to that interest.

6 Sec. 37.13.130. POWERS AND DUTIES. (a) The prudent-person rule
7 is applicable to the board in its management and investment of permanent
8 fund assets. In making investments, the board shall exercise the judg-
9 ment and care under the circumstances then prevailing which an insti-
10 tutional investor of ordinary prudence, discretion, and intelligence
11 exercises in the management of large investments entrusted to it not in
12 regard to speculation but in regard to the permanent disposition of
13 funds, considering the probable income from them as well as probable
14 safety of capital.

15 (b) The board shall seek to maintain a reasonable diversification
16 of type and maturity of investments in its investments.

17 (c) The board shall submit long-range and quarterly investment
18 reports to the State Investment Oversight Committee.

19 (d) The board may not borrow funds or guarantee loans made by any
20 other program or association.

21 (e) The board may, except as provided by (f) of this section enter
22 into and enforce all contracts necessary, convenient or desirable for
23 purposes of the fund.

24 (f) The permanent fund shall be used only for income-producing
25 investments. The board may contract only with private persons or
26 organizations to recommend or select investments for the permanent fund.
27 Investments shall be selected in accordance with (g) of this section.

28 (g) Subject to (a) of this section the board may invest its assets
29 in obligations of the United States or obligations for which the faith

1 and credit of the United States are pledged for payment of principal and
2 interest; loans secured by first liens on unencumbered realty or lease-
3 hold; and corporate stock and corporate obligations which under the
4 Securities Act of 1933 are freely tradeable.

5 (1) No portion of the assets of the fund may be used in the
6 purchase of stocks of any company whose primary business is the explo-
7 ration or development of oil or gas; nor in the purchase of stock of any
8 corporation which is not paying dividends on that stock in cash at the
9 time of purchase; nor in the purchase of bonds of any corporation, upon
10 which any regular interest payment has been defaulted at any time within
11 five years before purchase, except bonds never in default but which have
12 been outstanding for less than five years.

13 (2) No portion of the assets of the fund may be used in the
14 purchase of stocks of an issuer if immediately following the purchase

15 (A) the proportionate market value of all stocks of the
16 issuer held by the fund would exceed the greater of 2 per cent of
17 the fund's equity assets or 125 per cent of the proportionate value
18 which the securities of the issuer represent in the Standard &
19 Poors 550 stock index;

20 (B) the aggregate market value of all stock of the
21 issuer held by the fund would exceed 3 per cent of the aggregate
22 market value of the issuer's outstanding equity security; or

23 (C) the proportionate market value of all stocks then
24 held by the fund in the issuer's industry would exceed the greater
25 of 6 per cent of the fund's equity assets or 250 per cent of the
26 proportionate value which the securities of that industry represent
27 to the Standard & Poors 550 Stock Index.

28 (3) No portion of the assets of the fund may be used in the
29 purchase of corporate obligations of an issuer if immediately following

1 the purchase the aggregate value of all obligations of that issuer would
2 exceed the lesser of 2 per cent of the total corporate obligations held
3 by the fund or 3 per cent of the aggregate market value of the issuer's
4 outstanding obligations.

5 Sec. 37.13.140. GAINS AND LOSSES. At the end of each fiscal year,
6 the total amount of losses on the sales of securities, not offset by
7 gains on the sales of securities during that year, shall be computed,
8 with a portion of these losses to be deducted each fiscal year from the
9 interest and dividend income and the resulting amount of interest and
10 dividend income added to the principal of the fund. Losses taken on the
11 sales of bonds shall be accumulated over a period equal to the average
12 remaining life of the bonds sold, and losses taken on the sales of
13 stocks shall be accumulated within a period of five years, unless these
14 losses are offset by gains on future sales of securities. In any fiscal
15 year in which the gains on the sales of securities exceed the losses on
16 the sales of securities, the excess shall be added to the principal of
17 the fund.

18 Sec. 37.13.150. BOARD BUDGET. The board's operating budget is
19 from the general fund and is subject to the Executive Budget Act (AS
20 37.07).

21 Sec. 37.13.160. AUDITS. The Legislative Budget and Audit Commit-
22 tee shall conduct annual operational and performance evaluations (post-
23 audits) of the board's investments and investment programs and report
24 the results to the State Investment Oversight Committee.

25 Sec 37.13.170. REPORTS AND PUBLICATIONS. No later than the 20th
26 day of the legislative session, the board shall publish a report to the
27 governor, legislature, and the public in easily understandable language.
28 Each report must include financial statements audited by the Legislative
29 Budget and Audit Committee, a statement of the amount of money received

1 by the permanent fund from each investment during the period covered, a
2 statement of permanent fund investments, a description of permanent fund
3 investment activity during the period covered by the report, a com-
4 parison of the fund performance with the intended goals contained in
5 sec. 20 of this chapter, an examination of the impact of the investment
6 criteria of this chapter on the fund portfolio with recommendations of
7 any needed changes and any other information the board believes would be
8 of interest to the governor, the legislature, and the public. The
9 annual income statement and balance sheet of the permanent fund shall be
10 published in at least one newspaper in each judicial district. The
11 board may also publish other reports it considers desirable to carry out
12 its purpose.

13 * Sec. 3. AS 44 is amended by adding a new chapter to read:

14 CHAPTER 55. THE ALASKA ENTERPRISE INVESTMENT FUND.

15 Sec. 44.55.010. CREATION OF INVESTMENT FUND: FUNDING. (a) There
16 is created the Alaska Enterprise Investment Fund. The investment fund
17 is a public corporation and government instrumentality in the Department
18 of Revenue but has legal existence independent of and separate from the
19 state. The exercise by the investment fund of the powers conferred by
20 this chapter is considered an essential governmental function of the
21 state.

22 (b) One-sixth of the receipts of all mineral lease rentals, roy-
23 alties, royalty sale proceeds, and federal mineral revenue sharing pay-
24 ments and bonuses allocated to the permanent fund shall be paid directly
25 into the investment fund until a total of \$100,000,000 has been paid in.

26 Sec. 44.55.020. ALASKA ENTERPRISE INVESTMENT FUND POLICY BOARD.

27 (a) There is established the Alaska Enterprise Fund Policy Board con-
28 sisting of a person employed in the executive branch of state government
29 appointed by the governor and six public members appointed by the

1 governor with due regard for geographical representation and confirmed
2 by a majority of the members of the legislature in joint session. At
3 least two of the public members shall have broad experience in invest-
4 ment finance. The board shall elect one of the public members as
5 chairman and other officers they determine desirable.

6 (b) The six appointed members shall serve for four-year terms, and
7 they may be reappointed. Terms shall be staggered. Initial terms shall
8 be two members serving for two years, two members serving for three
9 years, and two members serving for four years. A member continues to
10 serve until his successor is appointed and confirmed.

11 (c) A majority of the policy board members constitutes a quorum
12 for the transaction of business by the board. Decisions of the board
13 shall be taken by a majority vote. The board shall hold at least one
14 public meeting each year.

15 (d) Members of the policy board receive \$_____ per meeting day if
16 they attend the meeting and are entitled to per diem and travel allow-
17 ances as are provided by law for members of state boards and commissions.

18 Sec. 44.55.030. REMOVAL AND VACANCIES ON BOARD. (a) The governor
19 may remove a policy board member from office by and with the consent of
20 a majority of the members of the legislature in joint session. The joint
21 session shall be held within 10 days from the date of removal if the
22 removal occurs while the legislature is in session or within 30 days of
23 convening of the legislature if the member was suspended. If the
24 legislature is not in session, the governor may suspend a member of the
25 policy board for cause. Upon suspension, a board member may not par-
26 ticipate in policy board business and may not be counted for purposes of
27 establishing a quorum. A suspended member shall continue to receive his
28 salary as a board member until the legislature in joint session consents
29 to his removal. If the legislature refuses to consent to his removal,

1 the member shall be reinstated to his position.

2 (b) A vacancy arising on the policy board shall be promptly filled
3 by appointment by the governor and confirmation by a majority of the
4 members of the legislature in joint session, and an appointee to fill a
5 vacancy shall hold office for the balance of the term for which his
6 predecessor on the board was appointed. If a vacancy arises on the
7 board while the legislature is not in session, the governor may appoint
8 an interim board member who shall exercise all powers and receive the
9 salary of a permanent board member until such time as the legislature in
10 joint session fails to confirm the interim member's appointment.

11 (c) A vacancy on the policy board does not impair the authority of
12 a quorum of the board to exercise all the powers and perform all the
13 duties of the board.

14 Sec. 44.55.040. DUTIES OF THE POLICY BOARD. The policy board
15 shall

16 (1) select and appoint the president and other members of the
17 Alaska Enterprise Investment Fund Investment Committee established in
18 sec. 50 of this chapter;

19 (2) annually review and approve long-range operating plans,
20 the budget for the forthcoming year, and the financial plan for the
21 following years;

22 (3) have responsibility on behalf of the bank for relations
23 with the general public, legislature, executive branch, local communi-
24 ties, and interest groups concerning all things excepting only those
25 matters that are the responsibility of the investment committee;

26 (4) review quarterly reports from the investment committee
27 concerning investment decisions and investment supervision, but the
28 board may not impose an investment decision upon, or override an invest-
29 ment decision of, the investment committee;

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(5) review, consider and approve policies;

(6) establish an audit committee, consisting of the commissioner of revenue and other members of the policy board to be designated by the commissioner, which shall select independent outside auditors, and receive all audit reports.

Sec. 44.55.050. ALASKA ENTERPRISE INVESTMENT FUND INVESTMENT COMMITTEE. (a) There is established the Alaska Enterprise Investment Fund Investment Committee, consisting of a president and four members appointed by the policy board. No member of the policy board may be a member of the investment committee. Members of the investment committee shall be persons of recognized competence and wide experience in investments, finance, and other business management-related fields. A member may be reappointed and continue to serve until his successor is appointed. The president and members shall serve for four-year terms. Terms shall be staggered. Initial terms shall be one member serving for one year, one member serving for two years, one member serving for three years, and one member and the president serving for four years.

(b) Four members of the investment committee constitute a quorum. Decisions of the committee shall be taken by majority vote.

(c) Members of the investment committee are in the exempt service under AS 39.25 and receive an annual salary within Range 30 in the salary schedule for state employees established by AS 39.27.011.

Sec. 44.55.060. DUTIES OF THE INVESTMENT COMMITTEE. The investment committee has sole responsibility to approve all investment proposals.

Sec. 44.55.070. BUDGET. The investment fund operating budget is from the general fund and is subject to the provisions of the Executive Budget Act (AS 37.07).

Sec. 44.55.080. PERSONNEL OF INVESTMENT FUND. Policy board

1 members, investment committee members, and officers and staff of the
2 investment fund are in the exempt service under AS 39.25.

3 Sec. 44.55.090. FINDINGS. The legislature finds

4 (1) that investment in financially sound small and medium
5 scale productive private enterprises and community development projects
6 in the state, particularly in rural areas, is of benefit to the citizens
7 of the state;

8 (2) there is a shortage of investment capital for financially
9 sound small and medium scale productive private enterprises, and com-
10 munity development projects particularly in rural areas of the state;

11 (3) that the investment fund working with private financial
12 institutions to supplement but not supplant their services can help to
13 alleviate this shortage.

14 Sec. 44.55.100. PURPOSE. The purpose of the investment fund is
15 to provide capital at market rates and terms for small and medium scale
16 productive private enterprises, and community development projects
17 particularly in rural areas of the state.

18 Sec. 44.55.110. POWERS OF THE INVESTMENT FUND. (a) In carrying
19 out the corporate purposes of the investment fund, the policy board has
20 power to

21 (1) adopt, alter and use a corporate seal;

22 (2) prescribe, adopt, amend, and repeal bylaws;

23 (3) sue and be sued in the name of the investment fund;

24 (4) borrow funds, and in that connection furnish such collat-
25 eral or other security as it determines, except that investment fund
26 borrowing may not exceed one-half of its paid-in capital;

27 (5) guarantee obligations of another corporation or legal
28 entity in order to facilitate their sale;

29 (6) enter into agreements necessary or convenient in the

1 exercise of its powers and functions;

2 (7) acquire, hold, use, lease, sell or otherwise dispose of
3 property of any kind, real, personal or mixed, or any interest in it;

4 (8) contract with state, federal and other agencies to
5 develop needed information and analyses;

6 (9) do all acts and things necessary, convenient or desirable
7 to carry out the powers granted or implied in this chapter.

8 (b) In carrying out the corporate purposes of the investment fund,
9 the investment committee has the power to

10 (1) invest, in such form and such amounts as it considers
11 appropriate, by purchasing the capital stock of, or lending money to,
12 projects, except that any investment in the capital stock of or other
13 ownership interest in a project may not exceed 49 per cent of the
14 capital stock of, or other ownership interest in, the project, and no
15 loan or other investment in the project by the investment fund may
16 exceed 90 per cent of the cost of the project unless, in the judgment of
17 the committee, additional amounts must be loaned to protect the inter-
18 ests of the investment fund;

19 (2) deposit funds, or invest funds through the permanent fund
20 in such obligations as it may determine;

21 (3) buy and sell securities the investment fund has issued or
22 guaranteed or in which it has invested;

23 (4) do all acts and things necessary, convenient or desirable
24 to carry out the powers granted or implied in this chapter.

25 Sec. 44.55.120. INVESTMENTS. (a) In making investments, the
26 investment committee and staff shall exercise the judgment and care
27 under the circumstances then prevailing which a person of ordinary
28 prudence, discretion, and intelligence exercises in the management of
29 his own affairs taking into consideration the probable income from the

1 investments as well as probable safety of principal.

2 (b) An amount equal to at least 150 per cent of all guarantees by
3 the investment fund shall be invested in investment-grade securities.

4 (c) The investment committee may invest not more than 50 per cent
5 of the resources of the investment fund to provide a reasonable pro-
6 portion of longer-term investment capital for financing the establish-
7 ment, improvement, and expansion of productive private enterprises which
8 will benefit Alaska, and for which sufficient capital is not available
9 from other sources on reasonable terms. These investments may take the
10 form of equity, debt, or debt guarantees.

11 (d) The committee may invest no more than 50 per cent of the
12 resources of the investment fund in financing a reasonable proportion of
13 the longer-term investment capital needs for community development
14 projects of municipalities and public corporate entities and private
15 dwellings in the state for which sufficient financing is not available
16 from other sources on reasonable terms. These investments may take the
17 form of debt or debt guarantees.

18 (e) The committee may not invest or guarantee obligations totaling
19 more than five per cent of the resources of the bank of \$1,500,000,
20 whichever is less, in a single project unless the legislature has
21 approved the investment by concurrent resolution.

22 (f) The committee may not undertake any financing for which, in
23 its opinion, sufficient private capital could be obtained on reasonable
24 terms.

25 (g) The committee may not assume responsibility for managing any
26 enterprise or project in which it has invested and may not exercise
27 voting rights for that purpose or for any other purpose which, in its
28 opinion, properly is within the scope of managerial control.

29 (h) The committee shall only undertake its financing on terms and

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1 conditions which it considers appropriate, taking into account the terms
2 and conditions normally obtained by private investors for similar fi-
3 nancing, the requirements of the enterprise or project, the risks being
4 undertaken by the investment fund, and the participation of other
5 investors unless the legislature has appropriated funds for subsidizing
6 investments which in the opinion of the investment fund are of such high
7 priority that special terms and conditions are appropriate.

8 (i) The committee may seek to revolve the investment fund's money
9 by selling its investments to other investors whenever it can appropri-
10 ately do so on satisfactory terms.

11 (j) The committee shall seek to maintain a reasonable diversifi-
12 cation in its investments.

13 (k) The committee shall only consider investment proposals after
14 the applicant for an investment has submitted a detailed proposal to the
15 committee's staff and the staff has prepared a written report recommend-
16 ing the investment after a study of its merits.

17 (l) The committee shall analyze the economic and other effects of
18 an investment decision, including the effects on employment, income
19 distribution, environment, health, social and other factors. The
20 committee shall be sensitive to the views of affected local communities
21 and shall include an analysis of those views in proposals for large
22 investments.

23 (m) The committee may guarantee qualifying loans made by financial
24 intermediaries in order to facilitate investment by the intermediaries
25 in specific enterprises or projects whose individual financing require-
26 ments are not, in the opinion of the committee, large enough to warrant
27 its direct supervision.

28 (n) The committee shall provide for operational and performance
29 evaluations (post-audits) of its investments and investment programs and

1 report the results to the policy board.

2 (o) Nothing in this section prevents the investment committee, in
3 the event of actual or threatened default on any of its investments,
4 actual or threatened insolvency of the enterprise in which the invest-
5 ment has been made, or other situations which, in the opinion of the
6 investment committee, threaten to jeopardize the investment, from taking
7 such action and exercising such rights as it may consider necessary for
8 the protection of its interests.

9 Sec. 44.55.130. INITIAL DETERMINATIONS. Before beginning its
10 financing operations, the policy board shall render a detailed report to
11 the legislature which shall

12 (1) define the sectors which need financing for expansion of
13 existing projects or the development of new projects;

14 (2) define the size and nature of projects which are feasible
15 for investment fund financing;

16 (3) determine specific projects which are feasible for invest-
17 ment fund and private financing;

18 (4) determine the availability of private investment capital
19 for the projects it determines are feasible;

20 (5) forecast the capital requirements of the investment fund
21 for the first three years of its operations.

22 Sec. 44.55.140. REPORTS AND PUBLICATIONS. The policy board shall
23 publish an annual report to the governor, legislature and the public.
24 Each report shall include financial statements audited by independent
25 outside auditors, a statement of the amount of money received by the
26 investment fund from each source during the period covered, a statement
27 of investment fund investments, a description of investment fund invest-
28 ment activity during the period covered by the report, an analysis of
29 economic and other effects of investment decisions including, but not

1 limited to, the effects on employment, income distribution, environment,
2 health, social and other factors, and any other information the policy
3 board believes would be of interest to the governor, the legislature and
4 the public. The investment fund may also publish such other reports as
5 it considers desirable to carry out its purpose.

6 Sec. 44.55.150. CONFLICT OF INTEREST. (a) Members of the policy
7 board and investment committee are subject to the provisions of AS 39.50.

8 (b) Members of the investment committee shall disclose their
9 financial interest in an investment proposal and disqualify themselves
10 from voting on any investment proposal in which they have a financial
11 interest. The committee may not make an investment in any project or
12 enterprise in which officers of the bank have a financial interest.
13 Members of the policy board are prohibited from all attempts to influ-
14 ence the investment committee, its president or staff in the discharge
15 of their ordinary operating duties. All officers of the investment fund
16 in the discharge of their offices owe their duty entirely to the invest-
17 ment fund and no other authority.

18 Sec. 44.55.160. POLITICAL ACTIVITIES. The members of the policy
19 board, members of the investment committee, and officers and staff of
20 the investment fund may not engage in partisan political activities.
21 The resources of the investment fund may not be used to finance any
22 partisan political activities.

23 Sec. 44.55.170. PUBLIC ACCESS TO INFORMATION. Information in the
24 possession of the investment fund is a public record, except that infor-
25 mation which discloses the particulars of the business or affairs of a
26 private enterprise or investor is confidential and is not a public
27 record. Confidential information may be disclosed only for the purposes
28 of an official law enforcement investigation or when its production is
29 required in a court proceeding. These restrictions do not prohibit the

1 publication of statistics presented in a manner that prevents the
2 identification of particular reports, items, persons, or enterprises.

3 Sec. 44.55.180. TAX EXEMPTION. The investment fund is exempt from
4 all taxes and assessments in the state. All security instruments issued
5 by the investment fund, their transfer, and their income are exempt from
6 all taxes and assessments in the state.

7 Sec. 44.55.190. DEFINITIONS. In this chapter

8 (1) "board" or "policy board" means the Alaska Enterprise
9 Investment Policy Board established by sec. 20 of this chapter;

10 (2) "business enterprise" means a private corporation, firm,
11 partnership or sole proprietorship;

12 (3) "committee" or "investment committee" means the Alaska
13 Enterprise Investment Fund Investment Committee established by sec. 50
14 of this chapter;

15 (4) "fund" or "investment fund" means the Alaska Enterprise
16 Investment Fund.

17 * Sec. 4. AS 39.25.110 is amended by adding new paragraphs to read:

18 (21) members of the policy board and investment committee, and
19 the president, officers, and staff of the Alaska Enterprise Investment
20 Fund;

21 (22) members of the board of trustees, the executive director,
22 and staff of the Alaska Permanent Fund Board of Trustees.

23 * Sec. 5. AS 39.50.200(9) is amended by adding new subparagraphs to read:

24 (NN) Alaska Enterprise Investment Fund Policy Board and
25 Alaska Enterprise Investment Fund Investment Committee;

26 (OO) Alaska Permanent Fund Board of Trustees.

27 * Sec. 6. This Act takes effect immediately in accordance with AS 01.10.-
28 070(c).

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Outline for Discussion
Organization of the Renewable
Resources Development Fund (RRDF)

Principles/Observations

1. Appropriate organization is a function of purpose.
2. Effective performance can only be provided by competent persons.
3. Legislation should clearly state purpose and leave performance to the people in the organization.
4. Competent people are attracted by autonomy, professional challenge and adequate remuneration, in that order.

Working Assumption

1. The purpose of the RRDF is to fund development projects and programs that will increase the proportion of Alaska residents who derive their livelihood from the use of renewable resources, without significant detriment to the use of the same renewable resources by other Alaska residents.
2. This assumption requires the following terms/phrases be defined:

fund --
development projects --
development programs --
Alaska resident --
livelihood --
use of renewable resources --
renewable resources --
significant detriment --
3. Measurement of the accomplishment of this purpose is possible if information can be accumulated about:
 - (a) The present number (proportion) of Alaska residents who derive their livelihood from the use of each renewable resource.
 - (b) The other use (and users) of each renewable resource.

Side Issue

The working assumption purpose implies that management and regulation of each resource remains the responsibility of other federal and state agencies. The RRDF will have the capacity to influence these functions, but not to control them.

Organizing to Manage the RRDF

Any institution created to fund development projects and programs will require staff for the functions of planning, evaluation, monitoring, internal administration, and reporting. A high level of performance of these functions will be insured by recruitment of the most competent people available. In addition, the detailed organogram, manning tables and procedures required can be left to the executive staff to determine.

Legislation should be primarily concerned with establishment of the purpose and of conditions that are intended to insure acceptable levels of:

1. Quality and quantity of performance.
2. Fiscal stewardship.
3. Oversight by persons with ultimate responsibility.

Quality and quantity of performance are primarily conditioned by (a) the clarity of perception of the purpose by those persons with ultimate responsibility for its achievement and those persons to whom the responsibility is delegated, and (b) the competence of the latter.

Fiscal stewardship is primarily conditioned by (a) absence of normal political processes from implementation, and (b) reporting and disclosure of actions and results.

Oversight by persons with ultimate responsibility is conditioned by clear retention of the authority to (a) refuse funds for planned uses inappropriate to purpose, (b) remove executives who do not understand or conform to the perception of purpose held by those persons with ultimate responsibility, and (c) regular, systematic review of plans and decisions.

An organization that meets the above conditions would be:

1. removed from the normal executive structure of state government agencies.
2. responsive to changing legislative perception of its purpose.
3. flexible enough to deal with a variety of renewable resources and users.

Outline for Legislation

Some of the provisions to be included in enabling legislation can be put in the form of a checklist:

1. Findings.
2. Purpose (derived from findings).
3. Legal form of organization corporation, agency, etc.
4. Legislative oversight.
5. Executive oversight.
6. Executive Budget Act.
7. Advisory committees.
8. Board with director powers.
9. Proper expenditures --
 - Operation costs
 - Loans
 - Grants
 - Equity
10. Requirements for and limits on diversification among renewable resources, users, projects and programs.
11. Status of personnel.
12. Reporting requirements.
13. Financial audit.
14. Operational.
15. Definitions.

P.B. McDowell
October 19, 1977

NAME	ADDRESS	PHONE
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1530

ALISON HORTON

2 MARINE WAY ROOM 11 JAL

586-1167

Shirley Rediger

127 So. Franklin - Juneau

586-6806

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Proceedings
of
The House Special Committee on the Permanent Fund

COMMITTEE MEETING

November 18, 1977

Anchorage

Rep. Clark Gruening, Chairman

Rep. Terry Gardiner, Vice Chairman

Rep. Ernie Haugen

Rep. Russ Meekins

Rep. Bill Miles

Rep. Leo Schaeffer

Rep. Rick Urion

GRUENING: This is the meeting of the House Special Committee on the Permanent Fund. I'd like to introduce myself, I'm Chairman Clark Gruening and sitting at the end of the table is Ernie Haugen from Petersburg. Ernie has been in the legislature a few more years than I have and sitting next to him is Leo Schaeffer from Kotzebue. That's a little bit north of here. To my immediate right is Mike Doogan who is the administrative assistant to the committee and, just walked in, is Bill Miles from Anchorage. Bill and I both represent downtown Anchorage.

We have today some people that know something about money management. The committee is now at the point where it is about to work on a draft for a piece of legislation that deals with the Alaska Permanent Fund, an institution we may call the Alaska Enterprise Investment Fund, and Renewable Resources Development Fund, which is an additional dedication of our oil revenue for a specific purpose. But there is a lot we have to learn about money management and we have essentially three groups today. One, the Hanover Trust, which is involved in kind of bank management. A gentleman from Minnesota named Mr. Blixt who represents a method of---a board that has a method of in-house or state ---public state investment of funds. And then representing

the Fidelity Management Group of Boston is Terry Magrath who is not in the room.

So, we'll just go---I think in the kind of order that we originally met you gentlemen so we'll start with the Hanover Trust people and maybe introduce yourselves again when you are speaking or testifying, use the microphone right at the end.

MCCANDLESS: Thank you, Mr. Chairman. Can I be heard standing or shall I sit?

GRUENING: It would be more comfortable sitting, I think.

MCCANDLESS: I'd like to identify myself. My name is Jake McCandless. I am vice president of Manufacturers Hanover Trust Company in New York and the purpose of my being here really is that my responsibilities include the development of new business opportunities in the public arena for our trust division.

GRUENING: Representative Osterback, would you like to join us?

MCCANDLESS: Before I introduce my colleagues from the bank, may I say first that we respect the opportunity that we have to

testify on money management before your committee. We are aware of the responsibilities that your committee shoulders as you look to the Permanent Fund and its future and, indeed, the fact that we have chosen to bring representatives from various segments of our management team, totalling at a group of four and, myself included, five, gives you some idea of the importance we place on the responsibilities that you as a committee and the citizens of Alaska shoulder when it comes to a decision on these matters.

If I may, as you face our group, from left to right, I would like to introduce our senior vice president, Mr. Willard Wheeler. Will is responsible for the employee benefit trust department in the trust division and in that department we are managing \$7½ billions of dollars in pension assets. We are using our experience in the area of pension fund management as a proxy for the investment guidelines to be established for the fund. And Will will begin our program in just a moment by describing some of the historical background on the development of these funds and how we look at the Permanent Fund in relation to the experience we have had with the pension fund.

Next to Will is Mr. Vic Melone. Vic is the senior vice president responsible for the investment philosophy, basically, of our division and his testimony before you will include our

basic investment approach, as well as the equity investment philosophy that our departments maintain.

Next to him is Harold deRopp. Skip heads our fixed income management team at the bank and has been with Manufacturers Hanover Trust Company since 1961. In his capacity as head of our fixed income team, of course, Skip has a very large group of support people that he will describe to you as he describes our approach to fixed income management.

Behind these three gentlemen, Dimitri, would you just raise your hand? Dimitri Balatsos is one of five economists in our bank's economics department and Dimitri will be talking to you during the course of his testimony about the capital and financial markets and also discuss some of the ideas we have regarding the investment of your fund.

Without further ado, then, let me introduce Will Wheeler, our senior vice president who has overall responsibility for \$7½ billion of investments. And I should point out to you that, before Will starts, our trust division is large. We are managing over \$11 billion in trust assets which makes us the sixth largest trust entity in the United States. Thank you, Mr. Chairman, and I will turn it over to Will Wheeler.

GRUENING: OK. Before Mr. Wheeler starts, we'd like to introduce Mr. Al Osterback who is the representative from Sand Point

which is considerably west of here. Thank you. If we could, none of us is an expert, if we could break in and ask for clarification in case the words get a little fancy for us. Would that fit into your presentation?

WHEELER: Sure. Please do. As Mr. McCandless has indicated, we think that perhaps there is a good deal of similarity between pension fund and your Permanent Fund. Where we find the similarity particularly is that, number one, pension funds for the most part are very large pools of money.

The second similarity, of course, relative to the Permanent Fund is that they are tax exempt as the Permanent Fund would be and therefore are invested differently than taxable pools of funds are.

And then, finally, pension funds, particularly since the recent legislation on pension funds, pension funds are not in the private domain. They are considered legally as in the public domain and those involved are responsible to the public in terms of their management and, again, we see a great deal of similarity between that and the Permanent Fund as well.

We have provided you with a booklet; I wonder if you could turn to page 4 where we have prepared a chart which tracks for the most part the historical, at least the recent

historical development, of the investment pension fund.

Now, actually, before World War II, pension funds were almost entirely insured. In other words, the concept in that point in time was that the pension to be paid over the lifetime of the employee was a fixed liability in which you promised the employee that you would pay him \$1, let's say, 25 years from now. And at that point in time you would place, let's say \$55 in an insured annuity contract and then at the end of 25 years the insurance company would pay the employee \$1.

And accordingly, almost all the assets that were funded prior to World War II in pension funds went into this kind of a single premium annuity contract, something similar to what you and I would buy as an individual. Now, after World War II, two significant things came to light in terms of pension funds viability. Number one, that in point of fact, if you were required over time as you improve people's compensation, it required over time to improve this pension benefit. In other words, the dollar that you promised really was not a significant amount of money and that you had to improve it and let's say as a result it became apparent you were going to have to pay him \$2.

Then, really a little later in time, as inflation began to become a problem and you found that not only did you have to improve his benefits, but you had to try to do something in terms of keeping him up with inflation. And typically, that had to do

with giving him an average of his final years of pay. And in many cases since then, with higher rates of inflation, this has actually resulted in increasing his benefits after he retires.

So, the liability that you thought you had that was fixed was no longer fixed. Actually it was a moving target. And accordingly, a simple, single premium-insured kind of funding was not appropriate for a moving target. Now we think this is a similar problem for the Permanent Fund in that certainly one of the things you are going to have to overcome in time is trying to offset inflation. Now inflation over the next 15 or 20 years is unpredictable. But nevertheless, I think most of us would agree that we'll have some sort of inflation over the next few years. So you can see when you refer to page 4 that the funding has switched from the insured type of funding to the non-insured type of funding. In fact, from the time period 1958 to 1975, as indicated on this chart, the insured assets grew at 413% rate, the non-insured assets of pension funding grew at a 537% rate.

If you turn to page 5, we have given you the statistic of state and local retirement funds, what we call public retirement funds and, if I may, just to digress for a minute, when we say private pension funds, we mean pension funds

established by a corporation or multi-employer, union negotiated funds. When we say public pension funds, that's just for state and local employees. And they have had, interestingly enough, they have had a significantly different history in their evolution. Now, we don't have the statistics on the insured versus non-insured as you can see on page 5 for the state and local retirement funds, but typically the state and local funds were not insured. In fact, typically when state and local pension funds were established, what they did was buy their own obligations. Their own municipal bond. Now the concept on this was, well, we'll try to save the taxpayer money by funding---using our---the taxpayers' funding of the pension fund to hold down---to buy our own bonds and hold down the interest rates. But this clearly was not appropriate because, as you know, state and municipal bonds are tax exempt and therefore the coupon on state and local bonds is significantly less than the taxable bonds, and if you have a pension fund which is tax exempt anyway, it's not logical to invest in a tax exempt type vehicle.

And so many of the state and local funds of course have been switching---rolling out of investments in tax exempt bonds. Do you have any questions on that up until now?

Alright, if you'll turn to page 6, we deal with---we have some historical information on what has happened in terms of the investment, the types of assets---the assets mix---used in the

non-insured portion of the assets. And again here we are dealing with private pension funds and what has occurred here, as you can see by the line, is that there has been a distinct rise in the use of corporate stock in an attempt by the funding agencies to overcome this moving target that I talked about---that the perception was the stocks would provide a higher return than bonds and therefore we would try to get as much yield for total return as we could in order to offset ever-growing inflation, and you can see on that blue line that corporate stocks has risen to approximately 60% of all of the assets invested for private pension funds. You can see, historically, back in '58 they---there was a higher investment in corporate bonds that has declined over time. Mortgages, as you can see over time, has never been a significant portion of the investments now for private pension funding. It has declined significantly.

I would only make this comment. That it's our conception that probably the use of corporate stocks for private pension funds has peaked. Now, probably over the next 10 or 15 years, you'll not see a big increase in the use of corporate stocks versus fixed income investments for private pension funds.

GRUENING: There are a lot of decreases.

WHEELER: Certainly there is a possibility for a decrease and that's a good question. The reason for that has been---is that over the last 12 years common stocks---the strategy to use common stocks has been unsatisfactory. In fact, instead of out performing corporate bonds or government bonds over the last 12 years, they have under performed bonds. Now, my only answer to that long term is that if---and this will be dealt with a little bit by Mr. Melone---but just let me give you the long term concept---is if common stock---if our type of capitalism remains in the form as it exists today in the type of pecking order in terms of balance sheet structures of corporations, that obviously the common stockholder is at the bottom of the list. And the axiom is that if you have a riskier investment you will get a higher return over time. If you do not, it would be irrational to invest in stocks. So it is our assumption that, over a long period of time, that common stocks will do better than bonds as long as the system stays in place as it is. Does that answer your question?

GRUENING: Well I see--I don't---you're not making any predictions, then?

WHEELER: Well, year by year, no. What I'm predicting is that long term, and I don't want to take too much on this because Mr. Melone is going to show you some statistics on that, long term

common stocks will do better than bonds, but they'll be more volatile. I do not think that there will be a large increase in the use of common stocks for private pension funds, nor do I think there will be a large decrease in the use of common stocks for pension funds.

On page 7, you will see that the history of the development of assets for state, local pension funds and you can see the blue line---it shows federal and state and local securities at 60% of all the assets originally invested in their own type tax exempt instruments and that has declined significantly and you can see the big rise over time in the use of corporate stocks. But you'll note that corporate stocks are only 20% of the total asset mix at this time. It would be my projection that, while there probably won't be any increase in the use of stock for private pension funds, there will be an increase in the use of stocks for public pension funds.

One other thing I just wanted to comment on was ERISA. The legal aspect of ERISA and how we see that applies judicially to this type of fund, i.e., a fund that belongs in the public domain. Now, if we make---it is unlikely that any of the type of protection---individual protection under ERISA---will apply to this type of fund because that has to do specifically with pension fund; entry, vesting, things

like that. We think it certainly unlikely that any of the funding assets of ERISA will apply to this type fund. But we think it highly likely that all the fiduciary standards set forth under ERISA will apply to this fund and---you know, over time will be tested that way.

Now, what I mean by fiduciary duties is ERISA has sent me this. It essentially says that a man---excuse me---any person involved in this type of fund is---must act as a prudent man would and I'll detail that a little bit in just a minute.

Number two is the funds must be operated exclusively for the benefit of the participants.

And three that the investments must be diversified.

Now they have not told us exactly what they mean by the investments must be diversified. In fact, we know more what it is not than what it is. But we do know they have a 10% rule. You can't invest more than 10% in any one issue. So that tells you one thing. It does not mean that you could not take a fund like this and invest it all in bonds. But what it would mean in our perception is that you couldn't invest it all in one bond and you would have to stagger your maturity and the type of bond---the problem is the type of bond you would invest in.

Now, in terms of the prudent man rule, that we now have what is called a federal prudent man rule. Before we had state and local prudent man rules. We now have a federal prudent man rule

and that's the way everybody is going to be measured as we see it. And all that really means is that you have to act responsibly with other people's money. And that's all the prudent man rule means. It's a common sense kind of rule. Now there is one new element to this prudent man rule. It says those people involved with other people's money must be familiar with the matters he acts on. Now this is a new hooker in the prudent man rule, in other words, ignorance is no defense is essentially what the law says at this point in time.

OK, given that as a background, I would like to turn it over to Vic Melone to discuss the assets as we see them and your opportunities.

GRUENING: Thank you.

MELONE: Alright, I'll talk about the investment process at Manufacturers Hanover. The system that we use to make decisions with respect to the kinds of assets we get involved with. I mentioned system. Why do we need a system? Why can't we use something like just seat-of-the-pants judgement or gut-feel or intuition or---we think that's fine and can be successful, but not running large pools of money. If you'll look briefly at the chart that is on page 7A of your

chart book, there is a table there showing the total rates of return. You got that? Page 7A. That table indicates the rates of return for different classes of assets in the period 1926 to 1976, both in nominal terms and then adjusted for the inflation that has persisted over this period of time.

I think it would be helpful if you could, as I have done here, bracket the fifth line down which is the consumer price index. The numbers above that line indicate the nominal return that has persisted for common stocks, long term corporate bonds, long term government and treasury bills in the fifty-one year period. The middle column indicates the volatility around that return as existed for those various classes and, of course, you've got a '66-'76 experience.

You'll notice first that inflation and volatility are the two items that pervade this table. Common stocks in the 51 years returned an average of 9.2%. However, the volatility around that totalled 22.4%, which meant that in 34 of the 51 years of this survey, the range of returns for common stocks went from a plus 31% to a minus 13%. So your average may be 9.2, but there was a great swing around that average. In the period the last 10 years, you'll see that the return on common stocks, the column on the far right, is sharply lower. You as treasurer...

MILES: Wouldn't it follow that the deviation---that deviation

percentage follow in the last 10 years or would that just relate to the 50 years?

MELONE: No, the deviation refers to the 51 year period.

MILES: There would be essentially no relationship to the current 10 years?

MELONE: We didn't calculate it, but if anything I would think the deviation is at least as great. In fact, the next two tables on pages 8 and 9, if you could take a quick look at that, you'll see the light blue line on page 9, referring to the years you are talking about. You can see the light blue line which represents the return from common stocks. And the pattern from '66 to '76, particularly the last four years of that, continues to show very wide swing. Treasury bills, which are considered to be totally risk free assets, returned a 2.4% annual return which was just about the inflation rate that persisted over this 51 year period. So, if you go down to the inflation adjusted return on treasury bills, the last line, you'll see that treasury bills, when you do account for inflation, return actually nothing. Now, there is no tax affect on this table either, that may not be important here, but for individuals,

they would have paid a tax, obviously, on the return they got from the treasury bills and then also have the impact of inflation. So, their return would have been below zero. After taxes. I won't detail each of the others. I think they are self-explanatory. Typically, you've got a lower rate of return from corporates and governments which your volatility, that middle column, was considerably below what it was for common stocks.

Mr. Gruening, your question on the future, the professors who did this calculation did make an estimate of what the return for common stocks might be like after the year 2000 and the projection was that it would approximate 12.2 or 12.4%, something like that. Higher than the 9.2% experience that we have experienced in a 51 year period. The inflation rate is there, including was, I believe, 5.3%, and the volatility factor remained very high. I don't remember what the...

GRUENING: You have a lower rate of inflation...?

MELONE: Than the most recent 10 year experience, yes. Well, when you are making assumptions for a 25 year period, things have a way of smoothing out. The volatility on the inflation rate would be as wide as the volatility on the return from equities. I think what this table indicates is that it's a little more difficult to pick the right assets, particularly for the right accounts. It's

a process that requires a system, a discipline, and we think a large organization, if we are talking about large pools of money. I think the charts on pages 8 and 9 are---clearly---graphically illustrate the volatility we talked about. It's particularly the impact you get from common stocks. The chart on page 10 is just a graphic illustration, really, of the table.

So, as I said, we believe that it requires a large resource, a commitment, etc., and I'm going to just take one or two minutes and---I don't think you want to hear about our organization in great detail---but let me tell you what we do at Manufacturers Hanover and try and anticipate the problems that are presented by this record.

Our commitment began first of all by having a senior investment committee which the senior policy making committee for the investment decisions. On that are three senior vice presidents, the executive vice president in charge of the division and the heads of all major departments in the trust division. There are 10 people total. The function of that committee is primarily to determine the overall economic forecast and to make forecasts of the direction of the capital market, short and long term interest rates, and of course the stock market itself. And we try to do this in detail for a two-to-three-year period. In this case, out to the

end of 1979. We are also working with long term factors as well, within which we look for deviations for the near term.

We get help in this task by a very large organization. Being the fourth largest bank in the country you might suspect we have a large economic department. And they provide a lot of economic input, do a lot of the interpretations for us.

In the equity management side, we have three groups. The first is a group of ten portfolio managers who specialize in equity investments. Two of them deal in small capitalization companies and one other in intermediate sized companies.

We have a staff of investment analysts who are industry specialists. There are 16 of those. They cover in detail 25 industries and well over 300 companies. And within the investment research department there is a great deal of specialty as well.

The third part of this equity management group is a special support group. We carry on very precise and again highly specialized analysis, whether it be in long portfolio theory, econometric studies, economic simulations, etc. We also have a team of six equity treasurers who themselves have specializations within that organization.

The fixed income staff, which is a third contributor to the work of the senior committee, is also broken into three groups.

We have, the same way, we have a group of portfolio managers

who specialize in the fixed income area.

The second group is a specialized support group which is headed by Skip Duarte that has within it a lot of fixed income specialists dealing with arbitrated lots, cash management, etc. Skip will talk more about that later.

The third part of this group is free credit analysts who do the work that might be familiar to you from the stock security analysis standpoint. It's the same kind of work. And they prepare a proprietary bond representative list for example which is used by our portfolio managers.

The final point is that a bank of our size obviously gets a lot of attention from the investment banking community on Wall Street and around the country. So that we can tap a lot of the resources from other people and we get a lot of attention with respect to blocks of stocks or bonds that may become available, can get specialized help.

Alright, now, we believe that in the senior investment committee we have to systematically analyse a whole series of risks and opportunities presented in the economic picture. We don't believe and we have not found that it's practical to take a particular economic forecast and say this is it and spill off from that a capital market forecast which suggests that bonds are going to do "x" and equities are going to do "y" and this is the way we go. What we have chosen to

do---it's our way of doing it, we're not saying it's the only way---we think it may be the best way. If we thought there was a better way we'd be doing it. But for us it has proved effective.

For us, we developed a series of four economic scenarios and these take into account the risks and opportunities if you will that are currently being talked about in the business community. And we present these in the senior investment committee. It was discussed in great detail and then they are given a probability of occurrence. And we do this by weighing each of the scenarios on the basis of objective information, some judgement from each of the 10 members of the committee, and we wind up with a weighting that can be applied to each of these scenarios.

Now what we are trying to do is to quantify uncertainties. And it's very rare that you find that everyone will agree that scenario one or three---whatever it is---is the one that makes the most sense; it has a 100% weight. If that were the case, it would be logical for us to take the capital market forecast that comes out of that economic scenario and say with 100% degree of certainty that we should tailor all of our investments to meet that particular conclusion. To the degree, however, that other forecasts are given weights and let's say equal weights across the board, then obviously the uncertainty that's in the system is taken into account.

GRUENING: Is there a rating system to compare your performance to, let's say--Mr. Blixt is sitting over there and, as I understand it, his operation is done mostly by state employees. Is there some way that you are rated along with him as to his cost overhead relative to results?

MELONE: Well, there are a number of organizations that do that kind of performance measurement. I don't know if our bank, our trust department, is in the same weighting system as the State of Minnesota. I couldn't answer that particular question. There are plenty of people we can be compared to because a lot of firms have made a great deal of money doing this. We do it ourselves when the results are available. We are interested in knowing how well we are tracking and how we can improve our system all the time.

GRUENING: I don't think this committee or the legislature will probably get into deciding who---a lot of these technical problems, but I do think it would be good to understand what are some of the groups that do investments outside maybe the operations of government---or not under---not state employees, so that's why---essentially what I'm interested in in a broad sense as to what you are doing.

MELONE: Right. I might say I think part of your question

was that this sounds like a very expensive organization and it is. But it is spread over assets that at the moment total about \$12 billion and that helps. But it is still expensive and we make it the kind of commitment you have to make to be in this business.

GRUENING: My original question was really---is there some way you measure your cost overhead relative to the results you provide your clients? In the same way could you compare it to some of the systems that are---some states use in which they use essentially state employees, although I realize in the equity area they probably contract that out.

MELONE: I personally don't know of any measurement system that ties in the cost of the procedure itself. Since---I just don't know of anything that's done that way. Cost effectiveness in effect.

GRUENING: But your customer---I mean, he gives you some funds, whoever he may be. I assume you invest state funds as well.

WHEELER: If I could answer the question for a minute. What you can do---to cut your question two ways---one is there are

plenty of---and I am sure your consultants are aware of this
---there are plenty of information on performance put out by
all bonds, by stocks, by type of bonds, and certainly we or
they could supply you with that information. And it is
readily available and doesn't cost anything. If you wanted
to compare the expense ratio of money management under an
organization like ourselves, all you have to do is take our
fee and crank it against whatever your projected market value
would be for your fund and then relate that to whatever---
people like Mr. Blixt will tell you what it costs to run
internally. Now, I don't have information on that and I
don't know exactly how you'd get the information. You'd
have to talk to those state funds to find out exactly how
much it costs for them to run it internally. But for
example, you could use a fee ratio for us, let's say one
tenth of one percent of the market value and that would
tell you how much it would cost. And that covers all this
cost. And then relate that to whatever help you could get
in terms of other costs.

GRUENING: Alright.

MELONE: If I could ask you to just look briefly to
page 15. This will demonstrate the four scenarios that we

are currently using and they are labelled: Delayed Expansion, Extended Expansion, Recession, Stagnation. And this chart shows that the real GNP growth forecast in the---that are currently being used by a dozen prominent economic firms or economists are represented by the shaded area in that table. And this indicates how the four scenarios we are working with cover virtually all of those possibilities. The chart on the next page, which has to do with inflation, the GNP deflator, shows similarly that three of our scenarios are assuming a wider range on the inflation front than is currently described by the 12 economic firms. Speaking of economics, I would like at this time to introduce Dimitri Balatsos, who is a financial and capital market expert in the economics department at Manny Hanover, and have him describe a little bit the process in some detail. And I think you'd be interested in his comments on the current economic scene. And maybe I can come back for a minute after that.

GRUENING: Thank you. Excuse the two gentlemen. They are probably going to have to read part of the transcript to catch up on all of it, but they are also on a committee called Budget and Audit which just called for a vote. They need a quorum. They'll be back, however. Go ahead, excuse me.

BALATSOS: It's alright. Mr. Chairman, I think your question

about justification given the overhead of the operation would quite appropriately be addressed by an economist. As you know economists the last few years have a rather poor record in terms of performance. However I don't feel that in our case you have to worry too much about it. After all, we are still a very small item in the bank's budget.

In addition to that you find, interestingly enough, that despite their record, the demand for economists, if anything, has increased. Now there are reasons for that. As a nation I think we have become quite a bit more sensitive to economists and let us not forget that last year's presidential election was the economics battleground. I don't have to take too much of your time to justify my presence here. What I'm supposed to do is take a few minutes and show you an example of how at Manufacturers Hanover we use economics and economic analysis in this otherwise murky environment.

So let me then start off by putting things in perspective. I'd like to refer to page 11 of the booklet. There you will see the recovery that is currently underway that started in the beginning of 1975, the blue line lies rather appreciably below the average of the previous recovery. What this shows is that, despite massive fiscal and monetary stimulation, our economic system has not performed---has not rebounded from the depths of the recession as rapidly as it did in the past.

Another way of looking at that is by comparing what we were actually doing economically today with what potentially our system could produce. There are many other paradoxes of this ongoing recovery that to a large extent explains why economic records have been so poor in the last few years. I'd like to refer you to the consumer pattern of spending. There you find tremendous strength in housing, in automobiles, other types of spending have failed to catch on. They're all going expansion. The same thing is true particularly with the business sector. I refer you to the table on page 12.

There you will see that with the ongoing recovery business outlays in real terms through fixed investments have fallen appreciably below the path of previous recoveries. Let's look at the employment-unemployment situation. For the last two and a half years, our economy has registered record gains in employment. And yet the level of unemployment continues to be severely high. Let's look at another example. What's happened to interest rates, the price of credit? Referring to page 13. There you will see the yield or the interest rates for short term commercial paper. As you can see in previous recoveries, there was an appreciable increase in money market rates as reflected by the commercial paper rate. This time around---depending---we had an overall decline until the last few months when the commercial paper rates started going up again. Also, let's look at the loans of

interest rates.

HAUGEN: Let me ask you a question.

BALATSOS: Yes, sir.

HAUGEN: When you talk about that commercial paper. Is that that short term for inventory and things of that nature that you are talking about?

BALATSOS: That's correct. The commercial paper used by companies to fund short term working type capital requirements. Let's look on page 14. There you see the course of long term interest rates as reflected by AA utility bonds, long term. Again the same path---overall declines this time around instead of the increases. Also, quite significant is the fact that three years into the recovery course if anything our deficit in the federal budget is expanding, it is not shrinking. And I'm referring to the expanded debts as projected for 1978 fiscal year.

Now what I want to emphasize then is that the nature or the structure of our economic system is changed and has changed in a rather fundamental way. And for the purpose of these hearings today I can only refer very briefly to two or three

underlying causes. The first one is the rate of inflation. This is something that economists have a great deal of difficulty coming to grips with. And by very, very contemporary standards, meaning the last two or three years, the rate of inflation today, roughly about 5 to 6 percent is appreciably below the 12+% we had in '74. Yet, when you compute it with the kind of inflation we had in previous recoveries, this is about three times higher. And inflation is a problem because it destroys the stability of the relationships between let's say income and spending and all these other economic variables that economists count on.

Part of this inflation package, if you wish, is of course the leaping energy cost. To put it very briefly, the system is still trying to adjust to steeply higher energy costs, something that was not the case in previous recoveries. There is another thing, too, that economists use, let me brush over very quickly, and this is a poor rate, poor state rather, of liquidity and the extended use of debt. To put it differently, in order to produce a unit of output today, our system consumes a great deal more debt. And this is a crucial aspect because it raises the question and it raises the requirement of very careful financial market analysis. Analysis of corporate balance sheets, analysis of consumer's finances and so on and so forth.