SCOMM

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LEGISLATIVE ADDRESS
POUCH V
JUNEAU, ALASKA 99811
TELEPHONE (907) 465-3734
465-3779

Alaska State Legislature

HOME ADDRESS
4603 SAN ROBERTO
ANCHORAGE, ALASKA 99504
TELEPHONE (507) 337-7942

REPRESENTATIVE BILL MILES

April 22, 1977

Mr. Gilbert C. Powers
Vice President
Kidder, Peabody & Co.
4100 Seattle First National Bank Building
Seattle, Washington 98154

Dear Mr. Powers:

Thank you for the letter and information concerning the Alaska Permanent Fund. I especially appreciate the work you must have done to come up with the names of Robert E. Blixt, John Hitchman, Daniel Forrestal III, and Beirne Chisolm...and the fact that they would be willing to come to Alaska without consulting fees, being reimbursed for travel expenses only.

I'm forwarding a copy of your letter to Representative Hugh Malone, the Speaker of the House of Representatives and Representative Clark Gruening, Chairman of the House Permanent Fund Committee for their comments. When we have finalized our schedule for summer work, I'll get back to you.

Again, many, many thanks for the information.

Sincerely yours,

Bill Miles

BM:jad

Enclosure

cc: Representative Hugh Malone
✓Representative Clark Gruening

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4100 SEATTLE FIRST NATIONAL
BANK BUILDING
SEATTLE, WASHINGTON 98154
TELEPHONE
(206) 628-8811

April 15, 1977

Representative William Miles
Alaska State Legislature House
120 - 4th Street
Juneau, Alaska 99801

Dear Bill:

Thank you for your patience in awaiting this response with regard to who might be appropriate and available to consult the Legislative Committee on the Alaska Permanent Fund's structure. Please appreciate that after extensive investigation into who would have these important qualifications, the real difficulty came in making the contacts and establishing communications.

The following individuals are most experienced and eminently qualified to discuss and advise on state fund structure. I can assure you that the newness and unique composition of the Permanent Fund would make the structuring of same a personal professional challenge for anyone who might be involved in a consulting capacity. It is always gratifying to be in the creative stages of a pioneer project that is so close to one's experiences.

This was made quite clear to me by Robert E. Blixt, Executive Secretary of the Minnesota State Board of Investment, who would be not only interested, but complimented to consult. Bob's excellent credentials are enclosed for your perusal. He is very close to Kidder, Peabody & Co. and we, of course, have absolute confidence in recommending him to you.

That same confidence can be expressed for John A. Hitchman, Executive Secretary-State Finance Committee for Washington State. John is a good friend of ours and would be most happy to offer his experience and foresight in permanent fund structure.

Daniel J. Forrestal III, President of First International Investment Management, Inc. of Dallas, Texas, is also eminently well qualified and strongly versed in the management of state funds which derive their revenues from "analagous" sources. Dan would be most willing to be called upon.

Kidder, Peabody & Co.
Incorporated

Representative William Miles
Page 2
April 15, 1977

On a source-of-funds basis, the University of Texas Permanent School Fund would, of course, be quite parallel. I am confident that, with your authorization and on your behalf, we could solicit a most valuable contribution from the administrators of that fund.

At Kidder, Peabody & Co. the most experienced person in the area of fund management and structure would be Mr. Beirne O. Chisolm, President of Webster Management Corporation. Webster Management is a wholly-owned subsidiary company of Kidder, Peabody & Co. registered under the Investment Advisors Act of 1940 and is responsible for the management of what is currently about $500,000,000.00 in private funds.

I know that these individuals would be most willing to contribute their time and energies without consulting fees and would look only for the defrayal of travel expenses. They would not expect to be paid fees and in most cases it would represent a conflict of interest.

Certainly, all can help with the development of one phase or another, whether it be setting up a system of checks and balances in investments, the creation of a harmonious advisory committee, the establishment of logical percentages of permanency, or the difficult tasks of deciding what to own and what pitfalls to avoid.

Please know that at a moment's notice I will be most pleased to provide any introductions or arrange any meeting that might be desired. I sincerely hope this has been helpful and do hope you know we are most anxious to help to the extent that we are able.

Both Ernie Burgess and I look forward to hearing from you soon.

Very truly yours,

Gil Powers

Gilbert C. Powers
Vice President
Resident Officer

GCP:pe
Enc.

CC Ernest A. Burgess

#18

INVESTMENT MANAGEMENT
FOR ALASKA'S SECOND DECADE

Text of remarks made by Robert A. Krantz Jr., Vice President and General Counsel of Kidder, Peabody & Co. Incorporated, before the Tenth Annual Convention of the Alaska State Chamber of Commerce, Ketchikan, Alaska, October 4, 1969

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276-3665

INVESTMENT MANAGEMENT FOR ALASKA'S SECOND DECADE

It is a great privilege to be here. The questions that you are considering at this annual meeting are of critical and profound importance to the entire future of Alaska. The decisions that the State must make as to the application and investment of the fund of capital that is so suddenly being created will affect not only the lives of each of you but the lives of your children and grandchildren and every successive generation thereafter. I would like to take this opportunity to share with you some serious and sobering thoughts on the nature of the responsibilities that you must assume in making these decisions and on the investment philosophy that should accompany their implementation.

Before getting to this subject, however, I want to take a couple of minutes to address myself to two questions that I think you have a right to ask and which may well have crossed many of your minds this morning. The first question is this: What do you, Mr. Krantz, or your firm of Kidder, Peabody, want to get out of Alaska? In short, why are you here? Let me be perfectly frank about this. We want to do business with this State and its People in the future. More specifically, we want the opportunity to compete with others for the investment and securities business that you will have to offer on a basis that is sound for the People and the State today and that will remain sound tomorrow. I assure you that having this on a sound basis is as much in our long-range interest as it is in yours.

The second question that you might appropriately ask is what gives me, an "outsider", any right to come up here and tell you what decisions you should be making? To this question, I would reply first that neither I, nor Kidder, Peabody, nor any "outsider" has any right to *tell* you what you should be doing with this money. It would be exceedingly presumptuous for us to even try to do this. Nevertheless, we have been asked to present our views on a subject which we feel very strongly about and I am going to try to describe these to you. If it should sound as though I am *telling* you, rather than suggesting to you, what you should do with *your* money, I hope you will simply blame this fault on the strength of the speaker's convictions.

I also think I should admit right here that there are a great many problems that will confront the State of Alaska in the application and utilization of its funds that I am not at all qualified or prepared to discuss. In previous discussions with officials of the State, our firm has explained these by reference to a concept of two funds and I would like to use the same concept today. One fund, which we shall call Fund A, is the treasury of the State of Alaska. This fund—

Text of remarks made by Robert A. Krantz, Jr., Vice President and General Counsel of Kidder, Peabody & Co. Incorporated, before the Tenth Annual Convention of the Alaska State Chamber of Commerce, Ketchikan, Alaska, October 4, 1969.

your "General Fund"—already exists, of course, and is comprised of revenues from your various State taxes, license fees, etc., plus "miscellaneous income", including income from mineral resources which even last year already accounted for something in excess of 15% of total state revenues. Under your State Constitution, some of these revenues—specifically those which fall within the category of "proceeds of any state tax or license"— are required to be deposited in this general fund and may not be dedicated to any special purpose except to the extent required by the federal government in order to participate in federal programs. I understand that earlier this year your Attorney General rendered an opinion that royalties, rental payments or bonus receipts from oil and gas leases are not comprehended within this Constitutional limitation. If this is so, it would seem clear that your Constitution does not require that the State continue to hold in Fund A the proceeds from the sale on September 10.

Under your present statutes, the proceeds received into the State treasury are required to be invested in interest-bearing U.S. government obligations. There is no doubt whatever in our minds that as a matter of sound State administration and capability to meet current State operating requirements, the reasoning behind this requirement—which places prime importance on the assured liquidity of State funds—is impossible to dispute. This is not to say that you have a perfect statute in this respect,—if it were up to me, I would seriously consider broadening the permissible range of investments of your General Fund in the interest of increasing yield while at the same time assuring that it continues to be a ready source of liquid funds.

I do not propose to focus today on the investment of Fund A, however. Instead I would like to describe what we shall call Fund B. This Fund, which has not yet come into existence, would complement Fund A in ways which I shall come to, but would be held and administered entirely separately and would be constituted and maintained as *a perpetual and permanent capital fund for the continuing development of the State of Alaska.*

What do I mean by a "perpetual and permanent capital fund"? Simply a fund in which the capital is required to be maintained intact at all times, and is not subject to appropriation for any purpose whatever. The income of this Fund B would, of course, be available for whatever uses may be deemed appropriate by the legislature and the executive department in the interests of the people of Alaska. Furthermore, investments in Alaskan companies or projects could well be given a measure of priority over out-of-state investments. But the Fund would be designed from the outset to conserve and increase capital and to insure the flow of income from now to eternity.

In recent weeks, a number of representatives of our firm have had discussions with various people in Alaska on the subject of investment and utilization of the proceeds from the State's oil and gas interests and in these discussions we have been gratified to find that so many responsible people in the State are thinking along these same lines. Presumably their reasoning is much the same as ours. In the investment banking world, we are constantly exposed on almost a day-to-day basis to situations which demonstrate the insatiability of the demand for funds once they become available and the ease with which capital can be dissipated. This is found at all levels—unfortunately in our own homes as well as within business and philanthropic organizations. It is at the government level, however, that we find this intense pressure for current expenditure in its most extreme degree. This is perhaps an inevitable product of our political system, and we do not wish to be on record as either for or against it. It is simply a fact of life. In considering what is best for Alaska in the long run it is obvious to us, however, that the danger of dissipation of capital through appropriations from capital to meet current operating demands is most acute in the very type of situation in which Alaska suddenly finds itself. We suggest that strong self-imposed discipline is most called for at a time such as this and that is why we regard it as essential in securing the greatness of the future of Alaska that the major portion of the proceeds derived from the sales last month be permanently removed from the type of pressure we have described. This is what we would hope that Alaska could accomplish through forming what we call "Fund B".

In this same connection, I also want to emphasize that although $900 million is clearly a large amount of money in an absolute sense, it is not large in relation to the dimensions of the problems inherent in the long-range development of the State of Alaska. The vast needs of the State underscore the importance of seizing upon this opportunity to establish for the State a permanent capital base which will in turn provide a perpetual flow of investment income which can be utilized to support the financing of local as well as State development projects and to attract new industry and capital investment into the State.

While the approach I am suggesting would be bold and far-reaching, it would certainly not be unprecedented. The Permanent University Fund set up by the State of Texas more than one hundred years ago is perhaps the most strikingly analogous situation. This Fund, which was originally endowed with certain lands in 1839, even before Texas became a state, was subsequently augmented by the transfer to the Fund of two million additional acres, including one million acres of semi-arid land in the western portion of the State. As on your North Slope, great areas of this land proved to be oil producing. Pursuant to requirements set forth in the Texas Constitution, the proceeds of sales and leases of these land grants, together with all royalties on the oil and gas interests, were—and are even today—required to be invested and maintained as a permanent capital fund, with the investment income being available only for the construction of permanent improvements for the University of Texas System and the Texas A and M University System. Today the assets of the Fund include cash and securities valued at more than $500 million as well as its interest in royalties on oil and gas lands which are producing 40 million barrels of oil and 100 billion cubic feet of gas annually.

I refer to the Permanent University Fund in Texas not only because it is analogous to the type of Fund B that we have in mind but also because we believe it will be important for the State of Alaska to avoid some of the errors that we believe were made by the State of Texas in the formulation and continued management of its Fund. As I have already said, we firmly believe in the wisdom of the basic approach, which was to preserve and build capital forever and not permit diversion of capital for any purpose. The first error, however, was made in restricting so tightly the permissible use of the income. Since the Texas Constitution provided that investment income could be used only for permanent improvements, the University was for at least 100 years in the position of depending upon annual legislative appropriations in order to meet its recurring operating deficits. Freedom to increase faculty salaries, for example, was denied to the Board of Regents notwithstanding its annual investment income of more than $20 million from the Fund.

A second major error that we believe was made in the case of the Permanent University Fund was more understandable in terms of prevailing investment philosophy in 1876 when the first enabling provision in the Texas Constitution was adopted. At that time, and well into this century, investments of the Fund other than in the original lands and oil and gas interests themselves, were strictly limited to U. S. Government and Texas State bonds. Not until 1956 was it possible to amend the Constitution to permit a broader range by substituting a "prudent man" test with a further specific allowance that up to 50 per cent of the Fund might be invested in corporate bonds and stocks.

This history of permissible investments of the Texas Permanent University Fund is typical of the historical trend of legal limitations imposed by other States, not with respect to investment of State funds, such as Fund A, but with respect to investments by State pension funds, insurance companies, savings banks and other institutions which do not have need for readily available funds at all times. A review of these changes over the years compels us to the recommendation that from the outset exceedingly broad discretion should be delegated by the State of Alaska with respect to investment of the principal of "Fund B". As you may realize, the prevailing philosophy earlier in this century, when the soundness of the dollar was assumed, was to assure the preservation of institutional capital—by savings banks, insurance companies, special state funds, etc.—by enactment of rigidly defined legal investment statutes. The State of New York was the leader. Its legal list was copied by a number of other states and provided, among other things, that these types of institutional capital could be invested only in the "safest investments"—government and state obligations plus utility and railroad bonds. With the depression of the nineteen thirties and the resulting defaults and reorganizations of hundreds of railroads and utilities, the concept that a legal list would protect capital was shattered. In many cases this led to even more conservative fund management—investment only in government obligations. The history of the capital markets since World War II has vividly illustrated the folly of this approach. We have now been in a period of fairly steady inflation for twenty-five years. Again legal limitations which emphasize safety of principal and assurance of income have failed to provide protection against deterioration of institutional capital set aside in legal portfolios. Within the past decade, this has led to the amendment of dozens of legal list statutes in favor of the standard of the hypothetical "prudent man"—in other words, the tendency in recent years has been to amend these laws to permit such investments as the ordinarily prudent man might make in the management of his own affairs. During the same period it has also become generally acknowledged that this hypothetical prudent man would be concerned by the continuing erosion of the dollar and would therefore concentrate an increasing percentage of his portfolio in equity investments. This reaction has most recently been reflected in the appearance of the "go-go" or "performance" concept of institutional fund management. This philosophy has produced a growing pressure in every state to liberalize legal investment laws to permit state pension funds, insurance companies, banks and other regulated institutions to participate in "performance-oriented" investment programs. It is still too early to guage the success of this approach on its record. In many cases it would appear to us that too much emphasis is being placed on timing of transactions and too little on the intrinsic value of the investments. Another reactionary wave may well be coming.

I certainly do not wish to suggest that I or my firm, more than anyone else, possesses a crystal ball, but we would urge that there is little reason to adopt by legislation rigid criteria of safety or investment yield which would inhibit flexibility of investment. Instead, for a permanent fund such as the "Fund B" we are discussing, the law of Alaska should allow wide latitude in the range of permissible investments and seek safety more in the way investment decisions are made than in limitations as to what types of investments may be acquired.

I do not wish to be misunderstood in this regard—we do not advocate rampant speculation of State funds, nor do we suggest that the more aggresive "go-go" approach is compatible with the long-range objectives of a fund such as Fund B. I want to stress, however, that limitation of the areas in which investment decisions are permitted to be made will invariably result sooner or later in reducing the rate of investment growth.

By its nature, Fund B would be the antithesis of what I have called Fund A. In Fund B, soundness of investments is essential but liquidity is not. In investment terms, this means that Fund B would not be required to, and generally *should* not, sacrifice either yield or the opportunity for capital appreciation, to liquidity of investment. For example, thousands of debt securities of major corporations are sold privately each year. In tight money markets such as the one we are presently in, with bonds selling at record lows and correspondingly record yields, corporate debt purchased privately will yield anywhere from as much as ½ of 1% more than corresponding public issues of the same quality. It is important to understand how much this can mean. If, for example, you can purchase $1 million of 20-year bonds in the private market which yield 6½%

instead of 6%, the return on the additional ½ of 1% interest will amount to $104,000 over the 20-year life of the bonds. What you may have to give up in turning to this kind of market is, of course, the right to resell your bonds at any time without complying with the registration requirements under the Securities Act of 1933. Alaska's Fund B should be in a position, however, to take advantage of the extra yield made possible by foregoing the instant liquidity which it really does not need in this kind of investment.

A second major area in which yield could be maximized at the expense of liquidity, is in direct investment in prime real estate or in debt secured by mortgages or other liens on income-producing real estate. This is a vast area, offering a variety of choices and high yields to every type of investor. Again, however, you have to realize when you invest in land or in real estate mortgages that it will not always be possible to liquidate your investment by re-selling whenever you need the cash. If Fund B is constituted as we recommend, however, this consideration will be unimportant and I would think that investments in income-producing real estate, in first mortgages on such real estate, or in first mortgages on property leased to the U. S. government or major corporate tenants, should constitute a significant percentage of its portfolio.

In money markets such as the one we have been experiencing over the past eighteen months, and which shows little signs of changing in the near future, the types of investments I have just been describing frequently offer added attractiveness as a hedge against inflation. Institutional investors with immediately available and lendable funds are today able to demand not only high interest rates but also, even in quality-grade investments, additional consideration in the form of an interest in the issuer's future growth. This may and often does take the form of warrants or options to purchase the borrower's stock which may be exercised at a predetermined price within a given number of years. Convertible issues, of course, offer an alternative technique for achieving equity participation while at the same time realizing a handsome current return. In recent months, even mortgage lenders on prime real estate backed by government guarantees of repayment have been able to insist upon a similar type of conversion privilege or overriding participation which will enable them to benefit from projected appreciation in land values. The investment limitations imposed upon Fund B should, of course, be sufficiently flexible to permit it not only to take this type of interest into its portfolio but also to exercise its options or conversion privileges when and as this becomes attractive in the future and to continue to hold the interests so obtained.

What about investments by Fund B in common stocks? Here the important question is not whether this should be allowed—clearly it should, both as a matter of authorizing a flexible approach to investment decision-making and as a matter of enabling Fund B to arrange its investment portfolio with a view to neutralizing the long-term effects of inflation. Instead, the important question is the *extent* to which this should be authorized and the types of safeguards that should be imposed in order to protect the stream of income from the Fund. We have already referred to the experience of the Permanent University Fund in Texas which until last year limited to 50 per cent the portion of its portfolio which could be invested in corporate securities. In addition, the Texas Constitution also imposed a blanket restriction which prohibited any purchase of common stocks which were not listed on an exchange or issued by a bank or insurance company, and further prohibited any investment in common stock which had not paid dividends for at least ten consecutive years. By constitutional amendment adopted last year the overall 50 per cent limitation was repealed and the ten year dividend requirement was reduced to five years. This is today a common standard and, for that matter, this same requirement is presently imposed by the State of Alaska for investments in common stocks by domestic insurance companies. (In addition, Alaska requires that such investments be only in stock of companies whose net earnings over this five year period have been at least 1½ times as great as their average annual fixed charges, including debt service and preferred dividend requirements.) Should Fund B be subjected to these types of requirements? In answering this question you must bear in mind that although one objective of Fund B is to preserve capital—which would include preservation of the value of its capital—it will also be designed as a fund to generate income for development of the State. Although I strongly urge broad flexibility, it may be important to build in restrictions against investment in non-dividend paying common stocks in order to assure the continuity of a substantial income stream. If Fund B is to be allowed to invest any portion of its funds in stocks which do not have established dividend records, the percentage should be very tightly limited—I personally would consider 2% to be liberal in this respect.

In my comments thus far, I have concentrated on the philosophy of Fund B and its investment and tried to stay away from questions concerning the ways in which its income should be utilized on the theory that the people of Alaska are experts on the needs of the State and their priorities and I am not. At the risk of rushing in where angels fear to tread, however, I would like to suggest for your consideration one application of the income which would produce important collateral benefits to the State at minimal cost, perhips no cost at all. This suggestion is that the income initially generated from investment of the bonus payments, together with the future income-producing capacity of Fund B, be contingently pledged to support payment of principal and interest on future general obligation bonds issued by the State. The objective of such a contingent pledge would be to increase the credit rating of the State's bonds from their present Baa status to AAA quality as soon as possible. In view of the relationship of current state expenditures and debt service requirements to projected State revenues over the next decade—which will include greatly increased income from severance taxes and royalties—the likelihood of ever actually having to draw upon Fund B's income to fulfill on the pledge seems remote indeed. Yet if we assume that this pledge technique could lead to AAA rating, the annual savings could amount to as much as 1% of the principal amount of all future State bond issues.

It is logical next to ask—and for that matter we have been asked—whether this same type of approach might also be utilized to strengthen the credit of Alaska's municipalities, boroughs and other local taxing districts, and thereby facilitate the financing of local improvements. In other words, if it makes sense to pledge the income of Fund B in support of State obligations, why does it not equally make sense to enter into the same kind of commitment on behalf of local government units, perhaps on a subordinated basis? Let me say that something along these lines may well make sense and might be of great value to the future development of the State, but only if it is conceived and established within a framework which takes into account the basic problem of facilitating local solutions to local problems without encouraging uneconomic projects and without impairing local fiscal integrity. It seems self-evident, even to an outsider, that, a subordinated contingent pledge or a debt service reserve of the income of Fund B to repay any and all bond issues for local improvements, without regard to the financial feasibility of the specific project involved or the ability of the community to meet its obligations under the issue, would not be in the best long-range interest of the State and might well lead to early deterioration of the income generated by the Fund. One obvious approach would be to create a special agency or commission of the State which would be vested with authority to pass upon the quality of each proposed local bond issue and determine whether the income of Fund B should or should not be pledged to support the issue. Frankly, I would be troubled by this approach. First, I am afraid it would lead to an unfortunate combination of too much dependence by local government upon a state agency and too much control by the state agency over the local community's control of its own development. Secondly, the state agency would be exercising frightening powers—its refusal to back a local project with a pledge of Fund B's income would in all likelihood constitute the kiss of death for the particular project involved. It would be naive not to recognize the tremendous political pressures that would be brought to bear on the members of any state agency having such sweeping powers.

Although we have given considerable thought to these problems, I certainly am not prepared at this time to offer any one solution as the best one. Indeed, within Kidder, Peabody itself there is a healthy divergence of ideas in this area. One thought that has occurred to us is that these potential problems might be alleviated by relying upon banks or other institutional investors, or upon the municipal bond market in general, to assess the intrinsic quality of proposed local government issues. This technique has been utilized in a number of programs sponsored by the federal government and for that matter in certain state government programs in Alaska. For example, the authority of your State Development Corporation to make loans is in effect conditioned upon the applicant being able to persuade an Alaska bank to lend a given percentage of the funds on the same basis. Since the Development Corporation does not subordinate its loan to that of the bank, it is able to rely upon the bank's independent determination that the loan is economically sound. There are a number of ways in which this same technique could be adapted to local government financing. One approach would be the establishment of a State Municipal Finance Corporation, which, like the State Development Corporation, would have authority to purchase a given percentage of any local bond issue but only on the condition that the balance of the issue be purchased by independent investors. If this approach were adopted, a subordinated pledge of Fund B's income might well be extended to all of the bonds issued by what I call the State Municipal Finance Corporation, in which event any savings in interest or financing costs might be remitted to the local government issuer or applied against its interest payments to the corporation.

Something developed along the lines I have described might tend to reduce the dependence of the financially stronger local governments on Juneau, and at the same time permit them to share in the benefits of strengthened credit stemming from Fund B's flow of income. For this reason, I believe this idea is worthy of further consideration. In candor, however, I must say that this approach has been criticized by some of our people whose views I thoroughly respect on the ground that it would in effect benefit only those municipalities and local districts which least need help and would do nothing to help those which have demonstrated their inability to obtain financing in the public markets. This criticism may well be valid. When it was first expressed, some of us thought that the proper reply was that even though the State undoubtedly has an intense interest in the development of these poorer communities, and even though State aid or grants, or low-interest rate loans, might be appropriate, the extent of this type of direct assistance should be determined and directly controlled by the legislative and the executive branches of the State Government and not by a semi-autonomous State agency. It may be, however, that a special state corporation such as the one I have described, should also be authorized to participate in this type of direct assistance function. For example, whatever portion of the income of Fund B that the State deems appropriate might be dedicated to a special reserve fund to support a special series of bonds issued by such a corporation, the proceeds of which would be earmarked solely for assistance to the poorer local governments—those which are unable to finance their local development at prevailing interest rates but which would be able to do so if, for example, they could borrow funds at lower-than-market interest rates. In this way, the State might share with the local community a portion of the cost of development without assuming control of that development.

I sincerely hope that you will not construe the comments I have been making as anything more than preliminary thoughts on approaches that might be considered in trying to facilitate development at the local level through use of the revenues generated by Fund B. These are certainly not definitive or complete. Having introduced the subject, however, I thought it only fair to tell you some of the ideas that have been crossing through our minds.

The final aspect that I want to comment upon this morning involves the manner in which investment decisions will be made by the State of Alaska and the determination of who will be responsible for such decisions and for the investment record of the Fund. The problem is not only to insure that the State receives the benefit of expert investment thinking and research. It also encompasses the development of procedures designed to assure the people of Alaska that decisions as to the investment of their funds are made solely from the standpoint of what is best for the State and by people who have no conflicting responsibilities. Perhaps the worst thing that can happen for any institutional fund such as Fund B is for its investors—and here I refer to the people of the State—to lose confidence in the integrity of the Fund's managers, the people who are investing their money. It is perhaps unfortunate that even the slightest doubt or suspicion as to investment motives can tend to have this effect. Within the past few days, we have witnessed a manifestation of this on the national level with the appointment of a nominee to the Supreme Court thrown into question because of a personal investment. The same kind of thing can happen, and perhaps will happen, in Alaska unless the most scrupulous care is taken in seeing to it that the persons retained and paid to manage Fund B are fully independent and have no competing interest to serve.

How should you go about this? We are strongly of the opinion that in the long run the most satisfactory solution from every standpoint is for Alaska to develop its own in-house investment expertise with the responsibility for investment decision and management placed squarely on the shoulders of an independent investment committee whose sole concern is the investment of the Fund. Hopefully, the membership of such a committee could be appointed in a way and for terms of office which would minimize the political pressures that could be brought to bear upon it. Such a committee and full time staff should, of course, have the benefit of a continuous flow of the investment ideas and research of those nationally recognized securities and investment firms which would serve the State as broker and agent in the handling of the Fund's securities transactions. I can personally assure you that in the handling of an account such as Fund B any recognized securities firm would fully expect to provide this type of expert research and investment advice as an integral part of the service it would perform. This advice should be carefully evaluated by the investment staff of the state committee, however, and the actual decision as to each proposed purchase or sale should be made only by the committee or its chief executive director or officer. Delegation of this authority should not be permitted.

The principal difficulty with this approach is, of course, that it takes time to find the right people to serve on and staff such a committee and during whatever time this process consumes there will be funds to invest. It is therefore difficult to avoid the conclusion that as an interim solution the State will have to look to a paid independent outside investment counseling or advisory organization to provide the expertise which is so clearly needed. In making this selection, we would strongly urge that in addition to scrutinizing the record of the particular adviser and the qualifications of the particular people who would be assigned to advise the State, the State should also carefully consider the independence of the adviser from competing interests. In all likelihood, any advisory organization that the State might consider for this appointment will have a multitude of other advisory clients to whom it also owes responsibilities. Although this type of competing interest is what the State should be trying to get away from in developing its own in-house investment capability, it will inevitably be encountered in looking to outside advisers. We would suggest that the retention of any advisory organization which has additional types of competing interests in other areas of the securities business, however, would invite criticism.

One final thought. From more than a hundred years in the securities business and more than a quarter century of that under the jurisdiction of the Securities and Exchange Commission, we have come to recognize that the surest solution to many of the problems of investing other people's money is complete and prompt disclosure of what is done. The people of Alaska will be entitled to full and complete disclosure of the operations and investments of Fund B and giving them the right to such disclosure should go a long way encouraging their confidence in the Fund. Such disclosure should be required by law.

In concluding, let me express my appreciation and that of Kidder Peabody for the opportunity given us to participate in the discussions at this annual meeting. Your second decade will be one of excitement and challenge and I consider it a privilege to have been able to contribute some of our thoughts on an important aspect of this challenge.

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4100 SEATTLE FIRST NATIONAL
BANK BUILDING
SEATTLE, WASHINGTON 98154
TELEPHONE
(206) 628-8511

September 9, 1977

Rep. Clark Gruening, Chairman
Special Committee on The Alaska Permanent Fund
528 West 5th, Suite 270
Anchorage, AK 99501

Dear Mr. Gruening:

Thank you for taking the time to visit with me during my recent trip to Anchorage.

As per our discussions during my visit, we have spoken again with Mr. Robert Blixt, Executive Secretary, Minnesota State Board of Investment, and he would indeed be willing to travel to Alaska to provide advice, where meaningful, to your Permanent Fund Special Committee. Mr. Blixt would welcome your telephone call to discuss this subject and he advises us that a convenient time to call him would be 11:00 a.m. Anchorage time on Wednesday, the 21st of September. (Mr. Robert E. Blixt, Executive Secretary, Minnesota State Board of Investment, Room 105 - MEA Building, 55 Sherburne Avenue, St. Paul, Minnesota, 55155. Mr. Blixt's secretary is Caroline Peabody, telephone numbers (612) 296-3328 or 3329. If no answer, try (612) 296-6252.) If you find this time inappropriate, please call me so I can rearrange the schedule. If you do not call, I will assume Mr. Blixt will be hearing from you on the above date.

For your information, I have enclosed a copy of the original letter and material sent to Mr. William Miles covering our ideas on people who might be of service to your Special Permanent Fund Committee. Also enclosed, please note speech made in 1969 covering thoughts on the investment management of Alaska's earlier receipt of oil lease sales monies.

If I or Kidder, Peabody can be of further service, please don't hesitate to ask for our help.

Sincerely yours,

Ernest A. Burgess

Ernest A. Burgess
Vice President

EAB:pe
Enc.

The
Research
Department

Kidder, Peabody & Co.
INCORPORATED

Monthly Valuation Data

ERNEST A. BURGESS
Kidder, Peabody & Co.
Incorporated
4100 Seattle-1st Nat'l. Bank Bldg.
SEATTLE, WASHINGTON 98154
628-8557

AUGUST 1977

The Kidder, Peabody Equity Valuation Model has been in use in its present form for more than two-and-a-half years. The methodology itself was refined from work begun in 1973, based largely on that of the early theorists in security analysis. This is the fourteenth publication of these valuations since 1974. They were issued on a roughly quarterly basis until last month, when we switched to a monthly schedule because of the spreading interest in quantitative investment-selection methodologies.

As before, our analysts calculate for each company a normalized earnings base, an estimated long-term growth rate, and an estimated dividend payout rate. The analysts are also asked to suggest a risk group ranking in a range of 1 to 5, which the Portfolio Strategy Group then considers in relation to the total universe. These data are projected into the future and then discounted to present value using what we regard as appropriate discount rates or rate of return requirements for each company. The discount rate for each company is assigned in line with the risk group ranking in order to align the required rate of return with the risk assumed. Theoretical price/earnings ratios and present values are then compared with actual stock prices *for guidance* in identifying overvalued and undervalued stocks.

This month's data are based on market or average discount rates of 12% and 13%, unchanged from last month. We have been using a 12% discount rate with a lean toward 13% since early in the year. This "lean to 13" reflects our overall investment policy, which has emphasized rising risks in the equity area. (For pertinent details, see *Investment Policy* and *Portfolio Strategy* studies of May 5 and June 24.)

In the past, when we were using a single number as the average discount rate, we normally used plus or minus 15% as the breakpoints around theoretical present value. In other words, the price of a stock was deemed too high if it was more than 15% above theoretical value and too low if it was more than 15% below. Because we are, for this report, using a discount rate range of 12% to 13%, the plus or minus 15% breakpoint is less applicable. We continue to suggest, however, that investors use the data with discretion, rather than simply responding to bald statistics. We are therefore continuing to use a "range of value" approach with a breakpoint of plus or minus 7%. That is, stock prices would appear to be too high if they are more than 7% above the range, and would seem to be too low if they are more than 7% below the range. On this basis, of the 189 companies covered in this issue, the prices of 104 look about right (within the range of value) while 26 look too high and 59 look too low. For perspective here, if we were to use a straight 13% discount rate (and a breakpoint of plus or minus 15%), 117 would be within the range while 40 would look too high and 32 too low.

Use of such ranges of value should be particularly interesting during this difficult period for the market. Stock prices that are well outside the range (indicated by + or − signs) should be intensely scrutinized as *possible* sell or buy candidates.

Portfolio Strategy Group
William J. Gillard, CFA-Director
Barre W. Littel, CFA
Jerrold H. Mulder, CFA
Linda H. Cherico, Research Assistant

Portfolio Strategy

Equity Valuation Model Applied to 189 Companies

	Projected			Theoretical PERs		Base-Period	Theoretical Present Values		Price
	Growth Rate	Dividend Payout	Risk Group(a)	13% D.R.	12% D.R.	EPS(b)	13% D.R.	12% D.R.	8/4/77
Basic Industries									
Alcan Aluminium	10	30	5	6.7	7.5	4.25(N)	28	32	27
+Alcoa	10	30	5	6.7	7.5	5.50(N)	37	41	51
–Armco Steel	8	40	4	7.2	8.1	4.25(N)	31	34	24
–Bethlehem Steel	8	30	4	6.4	7.3	4.50(N)	29	33	23
Betz Laboratories	15	30	3	13.9	16.7	1.90	26	32	30
–Boise Cascade	12	30	4	9.4	11.0	4.10	39	45	27
–Champion Intl.	10	30	4	7.5	8.5	3.00(N)	23	26	20
Crown Zellerbach	8	40	4	7.2	8.1	4.40	32	36	35
Georgia-Pacific	12	30	3	11.0	13.1	2.65	29	35	28
–Great Northern Nekoosa	10	30	4	7.5	8.5	4.00	30	34	27
Inland Steel	8	40	4	7.2	8.1	5.50(N)	40	45	39
Kaiser Aluminum¶	10	30	4	7.5	8.5	4.75(N)	36	40	34
National Steel	8	40	4	7.2	8.1	5.00(N)	36	40	35
Phelps Dodge	8	40	4	7.2	8.1	4.00(N)	29	32	28
–Republic Steel	8	40	5	6.5	7.2	4.40(N)	29	32	23
Reynolds Metals	10	30	4	7.5	8.5	4.50(N)	34	38	37
St. Regis Paper	9	40	4	7.8	8.7	3.45	27	30	30
–Union Camp	12	30	3	11.0	13.1	5.50	61	72	52
–U.S. Steel	8	40	4	7.2	8.1	5.50(N)	40	45	35
–Weyerhaeuser	15	30	3	13.9	16.7	3.00(N)	42	50	32
Capital Goods/Construction									
+Babcock & Wilcox	10	30	4	7.5	8.5	4.75	36	40	48
Black & Decker	12	30	4	9.4	11.0	1.50(N)	14	17	16
Browning-Ferris	12	30	5	8.1	9.4	1.05	9	10	9
Bucyrus-Erie	11	30	4	8.5	9.8	2.50	21	24	21
Carrier	8	30	4	6.4	7.3	2.30(N)	15	17	17
Caterpillar Tractor	11	30	3	9.8	11.4	5.20	51	59	53
Chicago Bridge & Iron	11	40	3	10.7	12.3	4.75(N)	51	58	59
Combustion Eng.	10	40	4	8.3	9.3	5.90	49	55	58
–Deere	10	30	4	7.5	8.5	4.50	34	38	27
Emerson Electric	11	50	2	13.3	15.6	2.45	33	38	34
–Envirotech	15	30	4	11.8	13.9	4.00	47	56	40
+Foster Wheeler	8	40	4	7.2	8.1	2.85	21	23	26
+Gardner-Denver	10	40	4	8.3	9.3	1.50	12	14	17
–General Electric¶	11	50	2	13.3	15.6	4.75	63	74	55
General Signal	12	30	3	11.0	13.1	2.33	26	31	28
W.W. Grainger	15	20	3	12.8	15.5	2.30	29	36	30
Ingersoll-Rand	10	50	3	10.2	11.5	5.60	57	64	64
–International Harvester	7	30	4	5.9	6.7	6.90	41	46	31
Johns-Manville	10	30	4	7.5	8.5	4.50(N)	34	38	36
–Masco¶	15	20	3	12.8	15.5	2.00	26	31	21
–Massey-Ferguson	10	30	5	6.7	7.5	5.00(N)	33	38	20
–McGraw-Edison	7	50	3	8.2	9.2	3.65	30	34	26
–Owens-Corning	12	20	3	10.1	12.1	7.10	72	86	65
Peabody Intl.	15	20	4	10.7	12.8	2.25	24	29	23
Reliance Electric	10	40	3	9.3	10.5	3.30	31	35	32
–Sherwin-Williams	10	40	4	8.3	9.3	4.40(N)	37	41	32
+Square D	10	50	4	9.1	10.2	2.45	22	25	27
+Trane	8	30	4	6.4	7.3	4.25	27	31	39
–Waste Management	15	30	4	11.8	13.9	1.60	19	22	16
Westinghouse	7	40	5	6.0	6.7	3.00	18	20	20
Consumer Durables									
Champion Spark Plug	8	50	4	7.9	8.9	1.35	11	12	11
–Chrysler	5	20	5	4.0	4.4	4.50(N)	18	20	16
Ford¶	5	30	4	5.1	5.8	9.30(N)	47	54	44
–General Motors	5	60	3	7.8	8.7	10.20(N)	80	89	68
Genuine Parts	12	40	2	14.1	17.0	2.45	35	42	34

	Projected			Theoretical PERs		Base-Period	Theoretical Present Values		Price
	Growth Rate	Dividend Payout	Risk Group(a)	13% D.R.	12% D.R.	EPS(b)	13% D.R.	12% D.R.	8/4/77
Maytag	8	70	3	10.4	11.5	2.60	27	30	30
–Snap-On Tools	12	30	2	13.1	16.0	2.30	30	37	27
Sunbeam	8	40	4	7.2	8.1	3.15	23	26	23
–Whirlpool	11	40	3	10.7	12.3	2.90	31	36	23
Consumer Nondurables									
–Avon Products	12	60	2	16.1	19.1	3.30	53	63	48
–Chesebrough-Pond's ¶	12	40	2	14.1	17.0	1.90	27	32	22
Colgate-Palmolive	12	40	3	12.0	14.1	2.20	26	31	26
+Gillette ¶	7	40	4	6.7	7.5	3.00	20	23	27
Int. Flav. & Frag.	15	40	3	15.0	17.8	1.20	18	21	21
Johnson & Johnson	15	30	2	16.7	20.4	4.15	69	85	70
+Noxell*	8	40	4	7.2	8.1	1.75	13	14	18
Procter & Gamble	11	40	1	14.6	17.3	5.95	87	103	81
Revlon ¶	12	40	2	14.1	17.0	3.00	42	51	40
+Tampax*	8	50	4	7.9	8.9	3.25	26	29	35
Consumer Services									
–Amer. Broadcasting	12	30	4	9.4	11.0	5.25(N)	49	58	45
Capital Cities	12	10	3	9.1	11.1	5.10(N)	46	57	49
–CBS	12	40	3	12.0	14.1	6.00(N)	72	85	60
Dayton-Hudson	10	30	4	7.5	8.5	4.50	34	38	36
Dow Jones	12	50	3	12.9	15.1	2.25(N)	29	34	34
Eckerd (Jack)	12	30	4	9.4	11.0	2.10	20	23	22
Federated Dept. Stores ¶	9	40	3	8.7	9.8	3.80	33	37	38
–Gannett	15	40	2	17.8	21.6	2.60	46	56	36
–Knight-Ridder Newspapers	12	30	3	11.0	13.1	3.45	38	45	34
K Mart	15	20	3	12.8	15.5	2.15(N)	28	33	28
–Longs Drug Stores	15	30	3	13.9	16.7	1.85	26	31	23
Lowe's Cos.	15	10	3	11.7	14.3	1.75	20	25	22
May Dept. Stores	8	40	4	7.2	8.1	3.35	24	27	26
Payless Cashways	15	10	4	9.7	11.7	1.50	15	18	16
Penney, J.C.	9	40	3	8.7	9.8	3.35(N)	29	33	36
Petrie Stores	15	40	4	12.8	15.0	6.20	79	93	75
–Revco D.S.	15	20	4	10.7	12.8	1.90	20	24	18
–Rite-Aid	15	20	4	10.7	12.8	1.80	19	23	16
Sears	9	50	3	9.6	10.7	2.85	27	30	30
Standard Brands Paint	15	20	2	15.5	19.1	2.35	36	45	34
–Times-Mirror	12	30	3	11.0	13.1	2.44(N)	28	33	24
Energy									
–Atlantic Richfield	15	30	4	11.8	13.9	6.00	71	83	57
Cities Service	8	35	4	6.8	7.7	8.50	58	65	58
Continental Oil	9	30	4	7.0	7.9	4.25	30	34	32
Eastern Gas & Fuel	9	30	4	7.0	7.9	3.00(N)	21	24	21
Exxon	9	40	3	8.7	9.8	6.40	56	63	52
–Gulf	9	40	3	8.7	9.8	4.50	39	44	28
–Houston Natural Gas	12	30	3	11.0	13.1	3.70(N)	41	48	32
Marathon Oil ¶	9	30	4	7.0	7.9	7.00	49	55	55
–Mobil	9	40	4	7.8	8.7	9.75	76	85	68
–Phillips Petroleum	12	30	4	9.4	11.0	3.80(N)	36	42	32
Pittston	9	30	4	7.0	7.9	4.00(N)	28	32	27
–Royal Dutch	8	30	4	6.4	7.3	11.30	72	82	59
Shell Oil	8	30	4	6.4	7.3	5.15	33	38	32
–Standard of Cal.	10	40	3	9.3	10.5	6.00	56	63	44
Standard Oil (Ind.) ¶	9	40	4	7.8	8.7	6.70	52	58	52
Sun Oil	8	35	4	6.8	7.7	6.40	44	49	45
–Texaco	9	50	4	8.5	9.6	3.75	32	36	29
Union Oil of Calif.	8	30	4	6.4	7.3	7.40	47	54	55

	Projected			Theoretical PERs		Base-	Theoretical Present Values		
	Growth Rate	Dividend Payout	Risk Group(a)	13% D.R.	12% D.R.	Period EPS(b)	13% D.R.	12% D.R.	Price 8/4/77
Financial Services									
–American Express¶	15	30	3	13.9	16.7	3.65	51	61	40
BankAmerica	11	30	3	9.8	11.4	2.70	26	31	25
+Bankers Trust NY	5	50	5	5.8	6.4	4.80	28	31	37
–Beneficial Corp.	6	30	3	6.3	7.1	4.20	26	30	23
C.I.T. Financial	7	50	4	7.4	8.2	4.75	35	39	36
+Chase Manhattan	7	40	5	6.0	6.7	3.50	21	23	33
Chemical NY R									
–Citicorp	12	30	4	9.4	11.0	3.30	31	36	28
+Connecticut General	8	20	4	5.7	6.5	6.00(N)	34	39	53
Continental Illinois	10	30	4	7.5	8.5	4.00	30	34	28
First Bank System	10	30	3	8.5	9.6	4.50	38	43	36
First Chicago	10	30	4	7.5	8.5	2.75	21	23	21
First Intl. Bancshares	11	30	3	9.8	11.4	4.25	42	48	42
Walter E. Heller Intl.	6	40	4	6.2	7.0	2.70	17	19	20
Household Finance	7	30	3	6.7	7.6	3.00	20	23	20
Jefferson Pilot	10	20	2	8.7	10.2	3.05	27	31	30
+Lincoln National Corp.	6	40	4	6.2	7.0	4.40	27	31	38
–Manufacturers Hanover R									
Morgan (J.P.)¶	11	30	3	9.8	11.4	5.30	52	60	50
NLT Corp.	10	20	2	8.7	10.2	3.05	27	31	26
Southwestern Life	10	20	2	8.7	10.2	2.15	19	22	18
Wachovia	10	30	3	8.5	9.6	1.90	16	18	17
Health Care									
American Home Prod.	11	55	1	16.1	18.9	1.95	31	37	29
Bristol-Myers Co.	12	35	3	11.5	13.6	2.75	32	37	33
Lilly (Eli) and Co. R									
Merck	12	40	3	12.0	14.1	3.65	44	51	54
–Pfizer Inc.	12	40	3	12.0	14.1	2.65	32	37	26
+Schering-Plough	8	40	4	7.2	8.1	3.15	23	26	32
+SmithKline Corp.	12	40	4	10.3	12.0	2.85	29	34	7
Squibb	10	40	3	9.3	10.5	2.60	24	27	26
–Upjohn	12	40	3	12.0	14.1	3.20	38	45	34
+Warner Lambert	10	40	3	9.3	10.5	2.30	21	24	28
Technology									
Automatic Data Proc.	15	30	2	16.7	20.4	1.75	29	36	28
Beckman Instruments	15	20	4	10.7	12.8	2.15	23	28	28
Eastman Kodak	11	50	2	13.3	15.6	4.50	60	70	58
–Fairchild Camera	15	20	5	9.1	10.7	4.00(N)	36	43	27
Hewlett Packard	15	10	2	14.3	17.9	4.75(N)	68	85	80
+Honeywell	8	30	3	7.3	8.2	5.90	43	48	52
–IBM	12	60	1	19.1	22.8	17.90	342	408	269
Motorola Inc.	15	30	4	11.8	13.9	3.80	45	53	45
+NCR	8	20	4	5.7	6.5	4.80	27	31	45
Perkin Elmer	12	30	3	11.0	13.1	1.60	18	21	20
Polaroid	12	30	4	9.4	11.0	2.80	26	31	29
–Sperry Rand	11	20	3	8.9	10.4	4.70	42	49	36
–Tektronix	15	20	2	15.5	19.1	2.75	43	53	34
Texas Instruments	15	30	2	16.7	20.4	5.50	92	112	90
Varian Assoc.	15	20	4	10.7	12.8	1.70	18	22	18
Xerox	10	30	3	8.5	9.6	5.00	43	48	51

	Projected Growth Rate	Projected Dividend Payout	Risk Group(a)	Theoretical PERs 13% D.R.	Theoretical PERs 12% D.R.	Base-Period EPS(b)	Theoretical Present Values 13% D.R.	Theoretical Present Values 12% D.R.	Price 8/4/77
Transportation									
Burlington Northern	10	20	5	5.9	6.6	7.00(N)	41	46	49
–Chessie System	10	30	4	7.5	8.5	5.65(N)	42	48	37
–Consolidated Freight	12	30	3	11.0	13.1	3.70	41	48	23
–McLean Trucking	12	20	3	10.1	12.1	3.20	32	39	20
–Missouri Pacific Corp.	10	30	4	7.5	8.5	8.15	61	69	45
–Norfolk & Western	10	30	4	7.5	8.5	4.25(N)	32	36	28
+Rio Grande Industries	10	30	4	7.5	8.5	2.60	19	22	24
–Roadway Express	15	20	2	15.5	19.1	2.45	38	47	30
Santa Fe Industries	10	30	4	7.5	8.5	5.30(N)	40	45	38
–Seaboard Coast Line	8	30	5	5.7	6.4	7.20	41	46	33
Southern Pacific	8	40	4	7.2	8.1	4.65	33	38	36
Southern Railway	10	40	4	8.3	9.3	7.00	58	65	57
Union Pacific	12	40	3	12.0	14.1	4.70	56	66	52
–Yellow Freight	15	20	2	15.5	19.1	2.85	44	54	31
Utilities									
Allegheny Power Sys.	4	60	3	6.9	7.7	2.70	19	21	22
American Tel. & Tele.	5	60	2	8.7	9.7	6.80	59	66	63
Carolina Power and Light	5	60	3	7.8	8.7	3.10	24	27	25
+Central & South West	5	60	4	7.1	7.8	1.95(N)	14	15	17
Cinn. Gas & Elec.	6	70	3	9.1	10.1	2.80	25	28	24
Cleveland Electric	5	70	4	7.7	8.5	4.20	32	36	33
Commonwealth Edison	5	70	3	8.5	9.4	3.10	26	29	31
+Florida Power and Light	6	40	4	6.2	7.0	3.30	20	23	27
General Tel. & Elect.	7	60	3	9.0	10.0	3.70	33	37	33
+Gulf States Utilities	5	60	4	7.1	7.8	1.65	12	13	14
Houston Industries	7	50	3	8.2	9.2	4.30	35	40	34
Illinois Power	5	70	3	8.5	9.4	3.00	26	28	28
Middle South Utilities	5	70	4	7.7	8.5	2.15	17	18	17
+Oklahoma Gas & Electric	5	60	4	7.1	7.8	1.90	13	15	19
+Pacific Gas & Electric	4	50	5	5.2	5.7	3.10	16	18	25
Public Service of Ind.	6	60	3	8.4	9.4	3.20	27	30	31
+Southern Calif. Edison	4	50	5	5.2	5.7	3.60	19	21	26
Texas Utilities	7	50	3	8.2	9.2	2.50	20	23	21
Wisconsin Electric Power	7	60	3	9.0	10.0	3.35	30	33	30

Note: At the close on August 4, 1977, the Dow Jones Industrial Average stood at 888 and the *S&P 500* at 98.7.

\+ The stock is currently more than 7% above the theoretical present value range.

– The stock is currently more than 7% below the theoretical present value range.

R Figures omitted because of SEC or other legal requirements.

(N) Normalized to exclude extraordinary cyclical or other nonrecurring influences.

(a) The risk group reflects our assessment of both fundamental and market risk. On a 1-to-5 scale, 5 indicated the highest risk.

(b) Earnings on which long-term growth rate is based. Typically, the numbers in this column are our fully diluted estimates for calendar 1977.

† Kidder, Peabody & Co. Incorporated was manager or co-manager of the most recent public offering of securities of this issuer.

* Kidder, Peabody & Co. Incorporated usually makes a market in these shares and accordingly may have a position in them which may be increased or decreased from time to time.

¶ Kidder, Peabody Securities Limited, a wholly owned subsidiary of Kidder, Peabody & Co. Incorporated, usually makes a market in the convertible Eurobonds of this company and accordingly may have a position in them that may be increased or decreased from time to time.

Appendix

PERs Specified by Equity Valuation Model Using 10% Discount Rate(#)

Projected Annual Growth in Earnings Per Share(%)

Projected Dividend Payout Ratio(%)	3	5	7	8	10	12	15
10						17.3	22.4
20			9.3	10.2	12.0	18.4	23.7
30		8.6	10.2	11.1	13.0	19.5	25.0
40	6.7	9.4	11.0	12.0	14.0	20.6	26.3
50	7.4	10.2	11.9	12.9	15.0		
60	8.1	11.0	12.8				
70	8.8	11.8					

Note: This table reflects the following assumptions regarding terminal multiples:

Growth Rate	3%	5%–10%	12%-15%
Terminal PER	7.5	10.0	13.[illegible]

PERs Specified by Equity Valuation Model Using 11% Discount Rate (#)

Projected Annual Growth in Earnings Per Share(%)

Projected Dividend Payout Ratio(%)	3	5	7	8	10	12	15
10						13.9	17.9
20			8.0	8.6	10.2	14.9	19.1
30		7.5	8.8	9.5	11.2	16.0	20.4
40	5.9	8.2	9.6	10.4	12.1	17.0	21.6
50	6.6	9.0	10.4	11.2	13.1		
60	7.3	9.7	11.2				
70	8.0	10.5					

Note: This table reflects the following assumptions regarding terminal multiples:

Growth Rate	3%	5%-10%	12%–15%
Terminal PER	6.8	9.1	11.7

Appendix (Cont'd)

PERs Specified by Equity Valuation Model Using 12% Discount Rate (#)

Projected Annual Growth in Earnings Per Share(%)

Projected Dividend Payout Ratio(%)		3	5	7	8	10	12	15
	10						11.1	14.3
	20			6.8	7.4	8.7	12.1	15.5
	30		6.5	7.6	8.2	9.6	13.1	16.7
	40	5.3	7.2	8.4	9.1	10.5	14.1	17.8
	50	6.0	7.9	9.2	9.9	11.5	15.1	
	60	6.6	8.7	10.0				
	70	7.3	9.4					

Note: This table reflects the following assumptions regarding terminal multiples:

Growth Rate	3%	5%-10%	12%-15%
Terminal PER	6.3	8.3	10.1

PERs Specified by Equity Valuation Model Using 13% Discount Rate(#)

Projected Annual Growth in Earnings Per Share(%)

Projected Dividend Payout Ratio(%)		3	5	7	8	10	12	15
	10						9.1	11.7
	20			5.9	6.5	7.6	10.1	12.8
	30		5.8	6.7	7.3	8.5	11.0	13.9
	40	4.8	6.4	7.4	8.1	9.3	12.0	15.0
	50	5.4	7.1	8.2	8.9	10.2		
	60	6.0	7.8	8.9				
	70	6.6	8.5					

Note: This table reflects the following assumptions regarding terminal multiples:

Growth Rate	3%	5%-10%	12%-15%
Terminal PER	5.8	7.7	8.9

Appendix (Cont'd)

PERs Specified by Equity Valuation Model Using 14% Discount Rate(#)

Projected Annual Growth in Earnings Per Share(%)

Projected Dividend Payout Ratio(%)		3	5	7	8	10	12	15
	10						7.5	9.7
	20			5.2	5.7	6.6	8.5	10.7
	30		5.1	5.9	6.4	7.5	9.4	11.8
	40	4.3	5.7	6.7	7.2	8.3	10.3	12.8
	50	4.9	6.4	7.4	7.9	9.1		
	60	5.5	7.1	8.1				
	70	6.1	7.7					

Note: This table reflects the following assumptions regarding terminal multiples:

Growth Rate	3%	5%-10%	12%-15%
Terminal PER	5.4	7.1	7.9

PERs Specified by Equity Valuation Model Using 15% Discount Rate(#)

Projected Annual Growth in E[illegible]nings Per Share(%)

Projected Dividend Payout Ratio(%)		3	5	7	8	10	12	15
	10					5.1	6.3	8.1
	20			4.6	5.0	5.9	7.2	9.1
	30		4.6	5.3	5.7	6.7	8.1	10.1
	40	4.0	5.2	6.0	6.5	7.5	8.9	11.0
	50	4.5	5.8	6.7	7.2	8.2	9.8	
	60	5.1	6.5	7.4	7.9			
	70	5.7	7.1					

Note: This table reflects the following assumptions regarding terminal multiples:

Growth Rate	3%	5%-10%	12%-15%
Terminal PER	5.0	6.7	7.1

(#) When 12% is used as the average discount rate, Risk Group 1 multiples are found in the 10% matrix, Risk Group 2 in the 11% matrix etc. When 13% is used as the average discount rate, Risk Group 1 multiples are found in the 11% matrix, Risk Group 2 in the 12% matrix, etc.

The Research Department

Kidder, Peabody & Co.
INCORPORATED

August 16, 1977

ERNEST A. BURGESS
Kidder, Peabody & Co.
Incorporated
4100 Seattle-Ist Nat'l. Bank Bldg.
SEATTLE, WASHINGTON 98154
628-8557

Selected Stock Notes

Major forest products company continues attractive for aggressive growth.

BOISE CASCADE CORPORATION
(NYSE-BCC)(a)
(29.5 million shares outstanding)

1977 Range	Recent Price	Earnings Per Share 1976	1977(E)	1978(E)	P/E Ratio 1977(E)	1978(E)	Dividend Rate	Current Yield
34-25	26	$3.30	$4.10	$4.50	6.3	5.8	$1.10	4.2%

(a) Options traded on CBOE and Philadelphia Exchange.

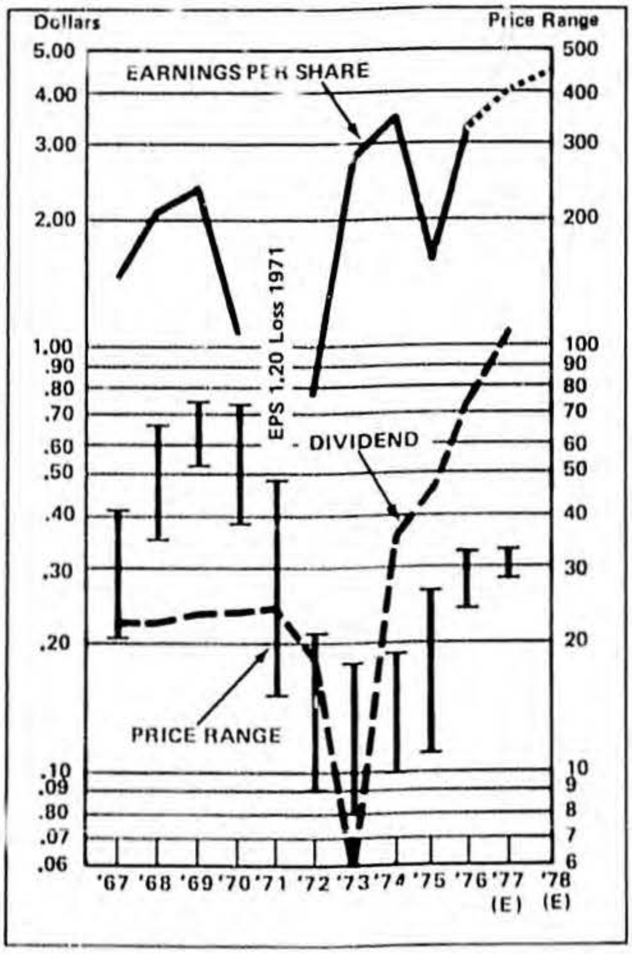
- **Second-quarter earnings in line with expectations.**
- **Profit forecasts for 1977 and 1978 unchanged.**

EARNINGS REPORT AND OUTLOOK

On a 16% year-to-year increase in sales to $591.3 million, Boise Cascade recently reported second-quarter earnings of $1.10, 17% ahead of the 94 cents earned in the second quarter of 1976. As in the first period, the building materials division turned in the best performance, with revenues ahead 35%, reflecting continued strength in the housing market in the western states. The paper and pulp division reported a year-to-year sales gain of 10.8% reflecting, in part, the revenues of two acquisitions made last year. Second-quarter results were penalized 5 cents by the absence of the contribution from nonforest product investments in South America which were sold. Costs increased at a slightly slower rate than sales, widening pretax margins slightly, but the tax rose from 40% to 40.9% to reflect an increase in operating profits relative to capital gains income.

For 1977 as a whole we continue to expect a 19% rise in sales to $2.3 billion, with the paper group contributing the largest portion of operating profits. Because of the company's high sensitivity to housing starts, the outlook for 1978 continues to depend importantly on growth in the overall economy.

The Kidder, Peabody Economics Group expects a slight rise in 1978 housing starts, which should



Kidder, Peabody & Co.
Incorporated

Boise Cascade Corporation
Operating Results
(Dollars in millions)(a)

	Three Months Ended June 30			Year Ended December 31				
	1976	1977	Change	1976	1977(E)	Change	1978(E)	Change
Net Sales	$509.6	$591.3	16.0%	$1,931.5	$2,300.0	19.1%	$2,597.5	12.9%
Net income	27.6	32.6	18.1	97.3(b)	121.0	24.4	132.0	9.1
Earnings per share	$ 0.94	$ 1.10	17.0	$ 3.30	$ 4.10	24.2	$ 4.50	9.8

(a) Except per-share data.
(b) Before extraordinary gain of $3.5 million or $0.12 a share in 1976.

positively affect prices for wood products, manufactured housing, and kitchen cabinets as well as the building materials distribution operation. Our one-point forecast for 1978 earnings is $4.50 per share, 9.8% ahead of the $4.10 projected for this year.

INVESTMENT SUMMARY

Boise Cascade Corporation, after a disastrous experience as a conglomerate, installed new management that has sold or eliminated losing operations, reduced debt, and returned the company to reliance on forest products and paper operations. Long-term debt, as a percentage of total capital, is well below the average for most forest products companies. Boise management plans to continue its large capital spending program, begun in late 1973, without reliance on equity financing and keeping within a debt to equity ratio of 37.5%. With rising earnings and dividends, investors should again perceive the company as an attractive investment, a prospect that augurs well for potential capital appreciation.

EQUITY VALUATION

Boise's longer term earnings growth rate is projected at 12%, with the expectation that dividends will represent 30% of earnings. In the Kidder, Peabody Equity Valuation Model, Boise common is assigned to a risk category of 4, mainly reflecting the fact that it has a smaller timber base than some industry participants.

Using these assumptions, the model computes a theoretical present value of 45, based on a discount rate of 12 for the market in general. If we raise the market discount rate to 13, the theoretical present value for Boise becomes 39. The mid-point of the 45 to 39 range is 62% ahead of current quotes. We continue to recommend the common for accounts seeking aggressive capital appreciation.

Michele M. Witt

Dow Jones Industrial Average (8/15/77):	**874.13**
Standard & Poor's 500 Index (8/15/77):	**98.18**

References: *Investor Services* "Recommendations" (July 17, 1975), "Selected Stock Notes" (April 1, May 24, and September 29, 1976), "Selected Stock Report" (January 7, 1977), "Selected Industry Report" (April 11, 1977) on Forest Products Industry, and "Selected Stock Notes" (June 8, 1977) on Boise Cascade Corporation.

The Research Department

Kidder, Peabody & Co.
INCORPORATED

ERNEST A. BURGESS
Kidder, Peabody & Co.
Incorporated
4100 Seattle-1st Nat'l. Bank Bldg.
SEATTLE, WASHINGTON 98154
628-8557

August 18, 1977

BOISE CASCADE CORPORATION
(NYSE-BCC)
(29.5 million shares outstanding)

Recent Price	26	Dividend	$1.10
1977 Price Range	34-25	Yield	4.2%
1976 Price Range	34-24		

EARNINGS PER SHARE (a)(b)		PRICE/EARNINGS RATIO	
1978 Estimated	$4.50	On 1978 Estimate	5.8
1977 Estimated	$4.10	1977 Estimate	6.1
1976 Actual	$3.30(c)		

(a) Fiscal year-end December 31.
(a) All stock prices in this report are as of August 17, 1977, unless otherwise noted.
(c) Before extraordinary gain of 12 cents a share.

- **Second-quarter earnings of $1.10 cents a share reflected profit improvement from the first period in all major groups.**
- **Full-year estimate of $4.10 a share being maintained.**
- **1978 earnings estimate remains $4.50 a share, although the per-share range has been reduced to $3.60 to $5.00, a share, from $3.90 to $5.50 previously, to reflect increasing uncertainty over the rate of economic growth and level of housing starts in 1978.**
- **Elimination of capital gains treatment of profits on the cutting of timber would reduce company earnings modestly by approximately 6%, or 25 cents a share, this year and next.**
- **Cash flow projections for 1977 to 1981 suggest the company will greatly expand its capital spending program from the current annual rate of $225 million, further supporting our 12% longer term earnings growth rate forecast.**
- **Dividends are expected to continue to rise faster than earnings until a sustained payout rate of 30% is achieved.**
- **Stock continues to sell under theoretical present value range of 39 to 45.**

SECOND-QUARTER 1977 RESULTS

Boise Cascade reported second-quarter sales of $591.3 million, 13.4% ahead of first-period sales and 16.0% higher than year-ago results (see Tables 1 and 2 for selected quarterly statistics).

Timber And Wood Products

Compared with the first quarter, unit sales volume of company plywood and veneer rose 9.2% to 438 million square feet and that of unconsolidated joint ventures, 42.9% to 40 million square feet. (Unit sales data are provided in Table 3.) While the strong plywood sales gains were made relative to the seasonally slow and weather-depressed first quarter, the statistics for wholly owned facilities represented the highest quarterly level in at least the last four years. Compared with the second quarter of 1976, plywood sales were

Company Follow-Up

Table 1
Boise Cascade Corporation

Quarterly Income Statistics
(Dollars in millions)(a)

	1975				1976				1977	
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.
Revenues										
Net sales	$315.3	$369.2	$396.9	$376.7	$399.9	$509.6	$518.4	$503.7	$521.2	$591.3
Interest and other income	5.1	2.2	8.5	10.0	5.5	7.1	15.8	1.8	3.2	4.6
Total revenues	$320.4	$371.3	$405.4	$386.7	$405.3	$516.8	$534.2	$505.5	$524.4	$595.9
Cost and expenses										
Cost of sales	$242.7	$280.7	$309.4	$302.2	$308.4	$396.4	$415.1	$386.4	$404.9	$455.4
Depreciation and cost of company timber harvested	12.8	13.8	14.6	14.8	15.9	17.3	19.2	20.0	20.0	[illegible]
Selling and admin. expense	39.7	43.4	45.1	43.2	46.3	49.3	50.8	52.7	49.6	54.6
Interest expense	5.3	5.6	5.6	5.7	6.6	7.8	8.8	8.8	9.0	9.6
Total costs	$300.5	$343.5	$374.7	$366.0	$377.2	$470.8	$493.8	$467.9	$483.6	$540.7
Income before taxes	$ 19.9	$ 27.8	$ 30.7	$ 20.7	$ 28.2	$ 46.0	$ 40.4	$ 37.6	$ 40.8	$ 55.2
Income taxes	7.6	9.6	11.0	7.0	11.3	18.4	15.0	10.1	16.8	22.6
Net income(b)	$ 12.3	$ 18.2	$ 19.7	$ 13.7	$ 16.9	$ 27.6	$ 25.4	$ 27.5	$ 24.1	$ 32.6
Earnings per share	$ 0.42(b)	$ 0.61	$ 0.67	$ 0.46(b)	$ 0.57	$ 0.94	$ 0.86	$ 0.93(b)	$ 0.82	$ 1.10
Dividends per share	0.13	0.13	0.16	0.16	0.16	0.20	0.20	0.20	0.20	0.275
Cost of sales as % of sales	77.0%	76.0%	78.0%	80.2%	77.1%	77.8%	80.1%	76.7%	77.7%	77.0%
Pretax margin	6.3	7.5	7.7	5.5	7.1	9.0	7.8	7.5	7.8	9.3
Tax rate	38.2	34.5	35.8	33.8	40.1	40.0	37.1	26.9	41.2	40.9
Net margin	3.9	4.9	5.0	3.6	4.2	5.4	4.9	5.5	4.6	5.5
Dividend payout ratio	31.0	21.3	23.9	34.8	28.1	21.3	23.3	21.5	24.4	25.0
Inventories	$245.8	$230.3	$251.6	$261.9	$280.9	$284.1	$291.3	$313.3	$332.0	$313.2
Debt/invested capital(c)	27.4%	27.7%	27.6%	27.0%	28.2%	31.4%(d)	31.5%	31.7%	32.0%	31.3%

Source: Company published data.
Note: Numbers may not add to totals because of rounding.
(a) Except per-share data.
(b) Before extraordinary items.
(c) Excludes realty debt.
(d) Increase from first quarter reflects borrowing for acquisition of Oxford Paper.

relatively flat, reflecting about capacity operations in both periods. The high level of unit plywood sales in the second quarter of 1977 was achieved during a three-month period when inventories in the field were generally undergoing liquidation after an abnormally large winter buildup.

Production at lumber facilities moved to virtually full capacity during the second quarter, helping to raise unit sales volume 8.3% to 208 million board feet, from the seasonal and weather-depressed first-quarter level of 192 million board feet. Lumber output of joint ventures was flat with the first quarter, at 15 million board feet. Prices of lumber and plywood in the second quarter averaged 10% to 20% above those of the year-ago period. The one notable area of price weakness was in sanded plywood, prices for which increased only 5% on a year-to-year basis in the second quarter. The company has shifted its plywood production mix to contain only 25% sanded, compared with 40% several years ago.

Production of other solid wood products was also strong during the second quarter, especially of fiberboard and particleboard. The capacity of the latter (160 million square feet of industrial-grade board for furniture) is booked out for several months, in sharp contrast to the situation that prevailed throughout 1976.

Boise Cascade accelerated its timber cut in the Pacific Northwest during the first three months of the year, taking advantage of exceptional weather to build log inventories to a level of one month larger than normal. With the threat of labor disruptions past, and fire closures likely to be less severe than initially anticipated, the company reduced log decks somewhat in the second quarter. Boise Cascade plans to cut approximately 370 million board feet of fee timber in 1977, slightly less than the 387 million board feet cut last year. Overall, higher volume and improved prices raised second-period timber and wood product profits against those of both the first quarter and the year-ago second three months.

Building Materials

Revenues from the building materials distribution system advanced 35% in the second quarter over the year-earlier level. The higher volume reflects the strong housing environment in the Western states, where the building materials distribution centers of Boise Cascade are concentrated. With the sales advance, margins have risen. Manufactured housing shipments have moved ahead as well, especially in the Western region. Full-year production is expected to advance 15% to 20% to approximately 10,000 manufactured housing units, during which time price rises will cover costs. A mix improvement is also occurring with the sale of a greater percentage of larger sized units Furthermore, the company has achieved efficien. ies of production from the 1976 closure of two plants. Kitchen cabinet volume rose 30% in the second quarter, although cost pressures have retarded margins. Overall, the building materials group seems to have experienced a healthy rise in second-quarter margins and profits on a year-to-year basis.

Paper

Paper and market pulp unit sales increased 5.3% in the second quarter to 473,000 tons, compared with 449,000 tons in the first three months. Compared with the year-earlier period, second-quarter unit sales were 10.8% higher. This significant gain reflected, in part, revenues of two acquisitions made in 1976. The second-quarter unit sales improvement occurred despite downtime totaling approximately 10,000 tons of newsprint and 3,000 tons of market pulp.

In the second quarter, business papers accounted for roughly 137,000 tons, or 29% of total paper sales; printing papers contributed 22%, or

Table 2
Boise Cascade Corporation

Second-Quarter Income Statement Comparison
(Dollars in millions)(a)

	1976		1977			Change 1977
	Dollars	% of Revenues	Dollars	% of Revenues	Change 1977/76	2nd Qtr./ 1st Qtr.
Revenues						
Sales	$509,610	98.6%	$591,270	99.2%	16.0%	13.4%
Interest and other income	7,140	1.4	4,620	0.8	(35.3)	44.4
Total revenues	$516,750	100.0%	$595,890	100.0%	15.3%	13.6%
Costs and expenses						
Cost of sales	$396,390	76.7%	$455,420	76.4%	14.9%	12.5%
Depreciation and cost of timber harvested	17,340	3.4	21,130	3.5	21.9	5.7
Selling and admin. expenses	49,290	9.5	54,550	9.2	10.7	9.9
Interest expenses	7,750	1.5	9,560	1.6	23.4	5.8
Total costs	$470,770	91.1%	$540,660	9.07%	14.8%	11.8%
Income before taxes	$ 45,980	8.9%	$ 55,230	9.3%	20.1	35.2%
Income taxes	18,400	3.6	22,640	3.8	23.0	35.2
Net income	$ 27,580	5.3%	$ 32,590	5.5%	18.2%	35.3
Earnings per share	$ 0.94		$ 1.10		17.0%	34.1%
Dividends per share	0.20		0.275		37.5	37.5

Source: Company data.
Note: Numbers may not add due to rounding.
( ) Parentheses denote decline.
(a) Except per-share data.

Table 3
Boise Cascade Corporation

Quarterly Unit Sales

	Boise Cascade			Unconsolidated Joint Ventures		
	Paper and Market Pulp(a)	Plywood and Veneer(b)	Lumber(c)	Paper and Market Pulp(a)	Plywood and Veneer(b)	Lumber(c)
1977						
2nd quarter	473	438	208	190	40	15
1st quarter	449	401	192	187	28	15
1976						
4th quarter	433	408	202	203	41	44
3rd quarter	408	434	207	196	36	35
2nd quarter	427	435	209	177(R)	34	12
1st quarter	259	417	191	155(R)	25	12
Year	1,527	1,694	809	731	136	103
1975						
4th quarter	270	382	185	173	21	7
3rd quarter	331	373	166	189	8	12
2nd quarter	316	330	150	164	6	11
1st quarter	302	322	102	151	6	10
Year	1,219	1,407	603	677	41	40
1974						
4th quarter	342	359	115	174	13	8
3rd quarter	361	399	147	85	19	3
2nd quarter	332	395	177	191	17	4
1st quarter	371	381	175	182	19	5
Year	1,406	1,534	614	632	68	20
1973						
4th quarter	327	419	183	179	19	3
3rd quarter	253	427	191	178	14	3
2nd quarter	375	400	198	162	14	3
1st quarter	356	429	184	177	6	2
Year	1,311	1,675	756	696	53	11

Source: Boise Cascade Corporation.
Note: Data on joint-venture paper and market pulp output exclude Bataan, Philippines, mill.
(R) Restated.
(a) Thousands of tons.
(b) Millions of square feet; company restated numbers to eliminate intrabusiness veneer sales.
(c) Millions of board feet.

about 106,000 tons; newsprint 20%, or 95,000 tons; paperboard 18%, or 85,000 tons; converting papers 8%, or 36,000 tons; and a small amount of market pulp totaling 3%, or roughly 14,000 tons. The paper group operated at 101% of the theoretical 1.87-million-ton available capacity, a rate well above the industry average and somewhat above the 96.0% rate of the first quarter.

In joint-venture operations, paper production was allocated as follows: paperboard, 41%, or 78,000 tons; market pulp 29%, or 55,000 tons; converting papers 16%, or 30,000 tons; newsprint 11% or 21,000 tons; and business papers 3%, or 6,000 tons. Thus, based on second-quarter sales of 190,000 tons, and annual capacity of 870,000 tons, we believe the joint-venture paper mills operated at about 87% of capacity, with the major weakness being market pulp. On a combined basis, the total paper capacity of Boise Cascade and its joint ventures of 2.74 million tons operated at 96.7% in the second quarter. Relative to the first quarter, unit volume sales gains occurred in business papers, newsprint (despite the downtime), and paperboard. In joint-venture operations, gains in paperboard more than offset a decline in converting papers, while sales of market pulp, newsprint, and business papers were generally flat.

On the paper pricing front in the second quarter, the company raised prices 4% to 5% on uncoated, white, free-sheet grades and 10.3% on linerboard. Since the company sells approximately one-third of its linerboard in the open market, the May 1 hike had only a modest positive impact overall in the quarter, although the increase did boost the profits of the paper group. The higher unit volume sold, plus selected price hikes, are estimated to have raised the operating income of the paper group in the second quarter over the first and clearly above the level of the year-earlier period.

Packaging and Office Products

In the packaging and office products category, composite can volume increased year to year in the second quarter, partly because of the success of the new peanut butter can. The division instituted an 8.5% price increase in mid-March after prices had been raised for metal cans, thus helping to offset advancing costs. Corrugated box volume rose only 1% in the first half of 1977 over the initial six months of 1976. This gain, which is somewhat less than the 3.7% average realized by the industry, reflects management's decision to give up some volume to maintain its overall margins. Reflecting this strategy, price increases of 3% had been realized by Boise Cascade on its corrugated boxes by the end of June, in comparison with about only a 2% average industrywide advance. While the price boost was not sufficient to offset the steep rise in linerboard costs, the normal six-week inventory delayed the impact of the increase on profits until mid-June. Envelope operations continued to register a profit improvement. Office products distribution sales rose 18% year to year in the second quarter, partly due to the favorable impact of the sales from two relocated distribution centers. Overall, the operating profits of the packaging and office products group rose modestly in the second quarter over both those of the first and year-earlier periods.

Absent from second-quarter results was the contribution of last year from nonforest product investments in South America, which have been sold. This has penalized earnings an estimated 5 cents a share. Consolidated revenues advanced 15.3% year to year in the second quarter, while costs rose at a slightly slower rate of 14.8%. The increase in costs reflected gains of 14.9% in cost of sales, 23.4% in interest expense (primarily reflecting increased borrowings to finance acquisitions), 21.9% in depreciation, and 10.7% in selling and administrative outlays. The latter was achieved despite the fact that the annual raise in wages of salaried employees occurs in April. A comparison of figures for the first three months of 1977 with the seasonally stronger second quarter of this year reveals that total revenues rose 13.6%, while expenses increased 11.8%. The slightly faster increase in revenues than expenses leveraged second-quarter pretax profits upward by 20.1% relative to that of a year earlier, and in comparison with pretax income in the seasonally slower first quarter of 1977, shows a 35.2% gain.

Offsetting the comparative gain in pretax earnings was a tax rate for the quarter that was slightly higher than the rate of a year ago (40.9% versus 40.0%). A year-end tax adjustment made in the fourth period of 1976 to reflect a larger-than-expected investment tax credit indicates that the second-quarter 1976 tax rate should actually have been lower than was reported. The year-to-year rise is owing to an increase in operating profits relative to captial gains income. Compared with the initial three-month interval, the tax rate declined slightly (from 41.2% to 40.9%), reflecting a more refined estimate of the 1977 tax liability. As a result, second-quarter net income of $32.6 million was 18.2% higher than the year-earlier period and 35.3% above the seasonally weak first quarter of 1977. Second-quarter earnings to $1.10 a share, a company record, were 17% above those of a year-ago period, when Boise Cascade earned 94 cents a share.

OUTLOOK FOR 1977 AND 1978

The sales and earnings estimates for 1977 and 1978 included in Table 4 are predicated on the following economic assumptions: real GNP growth of 5.1% in 1977, slowing to about 4.2% in 1978; housing starts of 1.85 to 1.95 million units in 1977, with possibly a slightly higher level in 1978, plus or minus 100,000 units; and inflation averaging 5.7% this year, increasing to between 6.5% and 7.5% in 1978. As shown in other tabular summaries, 1974 data are included in Table 4 to illustrate trends from the previous peak year.

The 1977 outlook remains basically unchanged from our prior projection (see *Company Follow-Up* of May 12, 1977). In general, sales are forecast to rise 19.2% to $2.3 billion. The paper group is expected to contribute the largest portion of operating profits (37%), although the gain from 1976 is projected at 20.9%, somewhat below the

Table 4
Boise Cascade Corporation

Income Statements
(Dollars in millions)(a)

	1974	1975	1976	1977(E)	1978(E) High	1978(E) Low
Sales						
Timber and wood products	$ 433.2	$ 420.5	$ 588.6	$ 680.0	$ 775.0	$ 635.0
Building materials	323.7	337.0	462.0	615.0	700.0	650.0
Paper	415.9	398.4	558.4	650.0	735.0	700.0
Packaging and office products	424.3	446.2	505.8	600.0	675.0	640.0
Latin American investments	15.7	16.7	20.2		—	—
Other operations	17.7	20.3	27.3	30.0	40.0	35.0
Subtotal	$1,630.5	$1,639.1	$2,162.3	$2,575.0	$2,925.0	$2,660.0
Intercompany elimination	(176.9)	(181.1)	(230.8)	(275.0)	(325.0)	(270.0)
Total sales	$1,453.6	$1,458.0	$1,931.5	$2,300.0	$2,600.0	$2,390.0
Cost of sales	$1,081.0	$1,135.0	$1,506.3	$1,775.0	$1,975.0	$1,865.0
Depreciation and depletion	48.8	56.1	72.4	85.0	100.0	100.0
Allocated SG&A	109.0	121.2	140.1	170.0	195.0	190.0
Allocated costs	$1,238.8	$1,312.3	$1,718.8	$2,030.0	$2,270.0	$2,155.0
Operating profits						
Timber and wood products	$ 24.6	$ 7.4	$ 56.2	$ 85.0	$ 105.0	$ 70.0
Building materials	7.0	2.5	15.8	35.0	43.0	28.0
Paper	111.4	73.3	82.7	100.0	121.0	90.0
Packaging and office products	48.2	37.3	30.9	33.0	39.0	30.0
Unconsolidated joint ventures and affiliated companies	8.5	3.9	11.5	14.0	17.0	13.0
Latin American investments	13.0	19.3	13.5	—	—	—
Other operations	2.2	2.0	2.0	3.0	5.0	4.0
Total operating profits	$ 214.8	$ 145.7	$ 212.7	$ 270.0	$ 330.0	$ 235.0
Corporate overhead	$ (39.1)	$ (47.6)	$ (60.5)	$ (65.0)	$ (73.0)	$ (70.0)
Eliminations	(0.4)	1.0	(0.1)	—	—	—
Pretax income	$ 175.3	$ 99.1	$ 152.1	$ 205.0	$ 257.0	$ 165.0
Income taxes	(71.7)	(35.2)	(54.8)	84.0	110.0	59.0
Net income(b)	$ 103.6(b)	$ 63.9	$ 97.3(b)	$ 121.0	$ 147.0	$ 106.0
Earnings per share(b)	$ 3.51(b)	$ 2.16	$ 3.30(b)	$ 4.10	$ 5.00	$ 3.60
Dividends per share	0.375	0.575	0.76	1.10	1.30	1.15
Cost of sales as % of revenues	74.4%	77.9%	78.0%	77.2%	76.0%	78.0%
Pretax margin	12.1	6.8	7.9	8.9	9.9	6.9
Tax rate	40.9	35.5	36.0	41.0	42.8	35.8
Net margin	7.1	4.4	5.0	5.3	5.7	4.4
Dividend payout ratio	10.7	26.6	23.0	26.8	26.0	31.9

(E) Kidder, Peabody & Co. Incorporated estimates.
( ) Parentheses denote subtraction.
(a) Except per-share data.
(b) Before extraordinary gain of $1.3 million, or $0.04 a share, in 1974 and $3.5 million, or $0.12 a share, in 1976.

company average. However, this will be significantly better than the earnings gain of the paper industry in total, partly because of acquisitions, and also because of the strong orientation of the company toward white paper grades—currently the strongest segment of the paper industry. The ability of management to maximize the profitability of the paper operations must also be considered an important factor in the earnings gain. Strong earnings improvements are forecast for the timber and wood products group, and especially from the building materials area. Only a slight earnings gain is anticipated in the packaging and converted products area owing to margin pressure, especially in corrugated boxes, in the second half of this year. Overall net income in 1977 is projected to rise approximately 24% to $121 million, generating per-share earnings of $4.10, compared with $3.30 in 1976. The range around our one-point estimate is $3.70 to $4.40 a share (see Table 5 for estimate of quarterly earnings). Since the annual dividend was raised 37.5% in the first quarter to $1.10 a share, a further increase is not likely until early 1978.

The outlook for 1978 has become clouded by the growing uncertainty surrounding the magnitude of real growth in the economy and the level of housing starts. This divergence of opinion is the basis for our rather broad earnings range for 1978 of $3.60 a share to $5.00 a share. Utilizing the Kidder, Peabody Economics Group forecast of a slight rise in housing starts year to year (although peaking in the first quarter at a 2.05-million-unit annual rate), wood product prices could rise another 5% to 10% while the unit volume of lumber and plywood sold rises slightly. Although log and other costs will rise, the increased price realizations should be sufficient to generate a modest advance in pretax profits of the timber and wood products group. Similarly the volume and profits of manufactured housing, kitchen cabinet and building material distribution operations are also expected to advance modestly. In paper operations, price increases should keep pace with or slightly exceed cost increases as volume improves somewhat, which could result in a 10% to 15% earnings improvement. This environment should also increase volumes and prices sufficiently in the packaging and office products group to generate what should be a slightly slower gain in pretax profits than in the paper area. Overall per-share earnings are projected on a one-point basis at $4.50, 9.8% higher than the $4.10 estimated for this year. Under these circumstances, the dividend could be raised to an annual rate of at least $1.20 a share.

As previously mentioned, Table 4 contains a range of estimated sales and earnings. At this time, the possibility of a year-to-year earnings decline cannot yet be discounted. If housing starts decline more rapidly than now forecast (the projected annual rate in the fourth quarter of 1978 is 1.9 million units), wood product and building material profits could decline from the level estimated for this year. Furthermore, in the paper area, a significantly slower rate of economic expansion could create a situation where the combination of volume and price improvement does not offset rising costs, which would reduce earnings. On the other hand, housing starts could very well exceed our 1978 expectations, and the profitability of the paper segment could recover with more rapid advances in volume and price. These alternate possibilities form the basis for our estimated range of 1978 earnings of $3.60 to $5.00 a share.

Table 5
Boise Cascade Corporation

1976 and Estimated 1977 Quarterly
Per-Share Earnings

		1977(E)		
	1976	High	Current	Low
1st qtr.	$0.57	$0.82(A)	$0.82(A)	$0.82(A)
2nd qtr.	0.94	1.10(A)	1.10(A)	1.10(A)
3rd qtr.	0.86	1.25	1.15	0.93
4th qtr.	0.93	1.23	1.03	0.85
Year	$3.30(a)	$4.40	$4.10	$3.70

Source: Company quarterly reports.
(A) Actual.
(E) Kidder, Peabody & Co. Incorporated estimates.
(a) Before extraordinary gain of 12 cents a share.

FINANCING FUTURE GROWTH

In November 1973 the management of Boise Cascade announced a five-year (1974-78), $1.13-billion capital spending program. Approximately 23% of this total, or $260 million, has been allocated to necessary projects, including pollution control. The remainder, or about $870 million, has been directed into projects with a required hurdle rate of 12% after taxes on a discounted cash flow basis.

Table 6
Boise Cascade Corporation

Statement of Changes in Financial Position
(Dollars in millions)

Line		1975	1976	1977(E)	1978(E)	1979(E)	1980(E)	1981(E)	1977-81 Total
1	Net income before extraordinary gains	$ 63.9	$ 97.3	$121.0	$132.0	$118.0	$148.0	$171.0	
2	Less: dividends	18.3	22.7	32.7	35.5	37.8	44.4	52.0	
3	Less: adjustments(a)	4.4	11.2	13.3	16.5	14.2	19.6	22.0	
4	Retained earnings—as adjusted (1-2-3)	$ 41.2	$ 63.4	$ 75.0	$ 80.0	$ 66.0	$ 84.0	$ 97.0	
5	Additions to property and equipment	$162.5	$227.3	$195.0	$210.0	$180.0	$225.0	$240.0	
6	Additions to timber, timberland, & timber deposits	16.1	36.1	5.0	15.0	20.0	25.0	35.0	
7	Total capital investment (5+6)	178.6	263.4	200.0	225.0	200.0	250.0	275.0	$1,150.0
8	Less: depreciation, depletion, deferred taxes, other	74.5	78.5	195.0	115.0	130.0	148.0	170.0	
9	Net property additions (7-8)	$104.1	$184.9	$105.0	$110.0	$ 70.0	$102.0	$105.0	$ 492.0
10	Change in other assets—net	3.4	(28.5)	(25.0)	(24.0)	(22.0)	(32.0)	(38.0)	
11	Change in realty and South American assets—net	(20.5)	(153.3)	(20.0)	(15.0)	(15.0)	(10.0)	(2.0)	
12	Change in current working capital (adjusted)—net(b)	(2.8)	73.2	30.0	36.0	25.0	39.0	48.0	
13	INTERNAL FUNDS SELF-SUFFICIENCY (4-9-10-11-12)	$ (43.1)	$ (12.9)	$ (15.0)	$ (27.0)	$ 8.0	$ (15.0)	$ (16.0)	$ (65.0)
	Financed by:								
14	Debt additions	$ 44.7	$274.2	$ 30.1	$ 10.0	$ 11.9	$100.4	$ 3.8	$ 156.2
15	Less: repayments	48.7	158.7	26.1	26.0	31.9	30.4	23.8	138.2
16	Net change in debt financing (14-15)	$ (4.0)	$115.5	$ 4.0	$ (1[illegible])	$ (20.0)	$ 70.0	$ (20.0)	$ 18.0
17	Equity financing—net	—	—	—	—	—	—	—	—
18	Total financing—net (16+17)	$ (4.0)	$115.5	$ 4.0	$ (16.0)	$ 20.0)	$ 70.0	$ (20.0)	$ 18.0
19	Net change in nonworking capital (13-18)	$ (47.1)	$102.6	$ (11.0)	$ (43.0)	$ (12.0)	$ 55.0	$ (36.0)	
20	Increase (decrease) in marketable securities	(30.5)	76.7	—	(43.0)	(12.0)	55.0	(36.0)	
21	(Increase) decrease in notes payable and current portion of long-term debt	(16.5)	25.9	(11.0)	—	—	—	—	—
22	Net change in nonworking capital (20+21)	$ (47.1)	$102.6	$ (11.0)	$ (43.0)	$ (12.0)	$ 55.0	$ (36.0)	
23	Marketable securities	$ 6.5	$ 83.2	$ 83.2	$ 40.2	$ 28.2	$ 83.2	$ 47.2	
	Incremental Capacity Financing Capabilities:								
24	Debt as a percentage of invested capital	30.8%	31.7%	30.0%	27.4%	25.2%	26.7%	24.2%	
25	Additional financing possible with debt 37.5% of invested capital			$176.7	$ 73.9	$ 68.1	$ 7.8	$ 75.8	$ 402.3
26	Working capital requirements of incremental capital assets (25 x 13.0%)			23.0	9.6	8.9	1.0	9.9	52.4
27	Additional capital investment possible with debt 37.5% of invested capital (25-26)			$153.7	$ 64.3	$ 59.2	$ 6.8	$ 65.9	$ 349.9
28	Potential capital investment possible with debt 37.5% of invested capital (7+27)			353.7	289.3	259.2	256.8	340.9	$1,499.9
29	Potential of increase in capital investment (27÷7)			76.9%	28.6%	29.6%	2.7%	24.0%	30.4%

Source: Boise Cascade 1975 and 1976 annual and 10-K reports; Kidder, Peabody & Co. Incorporated estimates.

( ) Parentheses denote reduction, unless otherwise indicated.

(a) Equity in earnings of joint ventures and affiliated companies, minority interests in income (losses).

(b) Change in current assets (less change in marketable securities) minus change in current liabilities (less change in notes payable and current portion of long-term debt).

Little return has been realized on this portion of the money to date. Assuming the company realizes a 10% to 12% return by 1981 on the $870-million investment, net income would be almost double the 1976 level. (For further details of this investment program, see our *Company Follow-Up* report on Boise Cascade of November 19, 1976.)

With less than a year and a half to go on the current program, it appears propitious to examine the capital spending potential of Boise for the next five years. Management has stated it plans to continue funding a large capital program beyond 1978 without issuing equity and while remaining within a debt-to-invested-captial ratio of 37.5%. The data in Table 6 include projections of the changes in financial position of Boise Cascade through 1981. Assumptions on net income have been kept close to the conservative end of the likely range (line 1). Total capital investments are generally projected to average $230 million annually, about in line with the current five-year program level of $225 million (line 7). We have assumed liquidation by 1981 of all realty assets (line 11). The working capital necessary to support the rising level of sales through 1981, as well as a dividend payout rate rising to 30% (line 2), have been included in the calculations of internal funds self-sufficiency (line 13). On balance, a capital program of this magnitude ($1.15 billion) over the 1977-81 period could be financed almost entirely by internal sources, leaving a cumulative shortfall of only approximately $65 million (line 13).

To finance this shortfall, the company started 1977 with marketable securities of $83 million (line 23). However, the debt repayments over the period will require $138 million, in addition to the $65 million shortfall in internal funding of investment and dividend needs. Over and above the modest annual debt additions, the company is expected to issue $100 million in long-term debt, possibly in 1979 or 1980. This debt financing, plus a reduction in marketable securities of $36 million and an increase in notes payable of $11.0 million, would be sufficient to finance the continued capital expenditure of $230 million annually, while raising the dividend 129% over the 1976-81 period. Again, no equity financing is assumed.

However, this analysis ignores the fact that with a rising earnings trend, only an $18-million net increase in debt over the 1977-81 period would reduce long-term debt to 24.2% of invested capital by 1981, compared with the year-end 1976 level of 31.7% (line 24). To determine the capital investment financing capability of Boise Cascade over the 1977-81 period, we have assumed a debt-to-invested-capital ratio of 37.5%—the management-imposed limit. We have subtracted the incremental working capital necessary to support the incremental investments. In total, the company could finance about $350 million in capital investment during the 1977-81 period over and above the $1,150-million total suggested by continuance of current spending levels. Although we expect that the company will not borrow up to its self-imposed debt limit, *we do anticipate announcement by the company of a significant increase of its capital investment program for at least the 1979-81 period.* We believe the company has a sufficient number of investment opportunities that will absorb the funds while providing a 10% to 12% aftertax return on a discontinued cash flow basis. However, this higher level of spending is expected to require some public debt financing. *The anticipated level of spending over the 1977-81 period is expected to support a longer term earnings growth rate of 12% and a dividend payout rate of 30%.*

VALUATION

The previous analysis as well as others of prior reports have documented our projection for Boise Cascade of a 12% longer term earnings growth rate. We have also detailed our forecast of a somewhat faster increase in dividends, at least until the payout rate reaches 30% on a sustained basis. We have assigned a risk factor somewhat above the average of the market. This assessment, which is based on both market and fundamental factors, includes: 1) past diversification mistakes; 2) internal operating leverage, which produces significant earnings volatility over the economic cycle; 3) timber self-sufficiency somewhat less than that of several other forest product companies; and 4) a potential requirement for significant capital spending to convert paper manufacturing facilities to alternate energy sources. Predicated on these fundamentals, the Kidder, Peabody Equity Valuation Model suggests a theoretical present value of 45. Based on the current price, the differential from the theoretical value is 38%. The Kidder, Peabody Portfolio Strategy Group has increasingly emphasized the growing uncertainty with respect to the political economic environment for business

Table 7
Boise Cascade Corporation

Valuation History

	Earnings Per Share(a)	Dividends Per Share	Dividend Payout Ratio(b)	Price High	Price Avg.	Price Low	Price/Earnings Ratio High	Price/Earnings Ratio Avg.	Price/Earnings Ratio Low	Relative to S&P 500 High	Relative to S&P 500 Avg.	Relative to S&P 500 Low	Average Yield
1977(E)	$4.10	$1.10	26.8%	34	30	25	8.3	7.2	6.1	0.85(c)	0.78(c)	0.70(c)	3.67%
1976	3.30	0.76	23.0	34	29	24	10.3	8.8	7.3	0.94	0.87	0.79	2.62
1975	2.16	0.58	26.6	27	19	11	12.5	8.8	5.1	1.02	0.80	0.57	3.05
1974	3.51	0.38	10.7	19	15	10	5.4	4.1	2.8	0.48	0.45	0.41	2.53
1973	2.89	0.06	2.2	18	13	8	6.2	4.5	2.8	0.42	0.34	0.25	0.46
1972	0.78	0.19	24.0	21	15	9	26.9	19.2	11.5	1.45	1.09	0.73	1.27
1971	(1.02)	0.25	—	49	32	15	—	—	—	—	—	—	0.78
1970	1.08	0.24	22.2	74	59	39	68.5	52.3	36.1	3.76	3.22	2.67	0.41
1969	2.35	0.24	10.0	76	65	54	32.3	27.7	23.0	1.76	1.63	1.49	0.37
1968	2.03	0.23	11.3	67	52	37	33.0	25.6	18.2	1.75	1.48	1.20	0.44
1967	1.48	0.21	15.5	41	31	21	27.7	21.0	14.2	1.51	1.23	0.94	0.68
1967-76 average			14.6%				22.3	17.2	12.1	1.31	1.11	0.91	1.26%
1972-76 average			17.3				12.3	9.1	5.9	0.86	0.71	0.55	1.99

(E) Kidder, Peabody & Co. Incorporated estimates.
( ) Parentheses denote deficit.
(a) Before extraordinary items.
(b) Cash dividends as percentage of earnings per share.
(c) Based on the Kidder, Peabody estimates for the *S&P 500* of $11.00 in 1977.

in general and thus the risk associated with owning equities. As a result the discount rate on the market may be approaching 13%. Assuming such a rate for the market as a whole, the theoretical price/earnings ratio for Boise Cascade drops to 9.4, and the theoretical price to 39. However, this is still a price differential of 33%.

Investor concern about strength of real economic growth as well as a peaking of housing over the next 18 months have negatively impacted the performance of Boise Cascade common. Possible elimination of capital gains income have raised investor concerns. Such an elimination without other offsetting changes in the tax laws would have reduced company net income 8.5% on average, over the last 5 years. The estimated reduction in 1977 per share earnings from elimination of capital gains is 25 cents a share or less, or equal to about 6% of projected earnings. However, we believe there is currently a high probability that some compromise will be reached with respect to this issue, limiting the negative impact on the company.

We believe this, as well as other short term concerns will be eliminated or sharply reduced in the next 6 to 9 months. Emphasis on the strongly positive long-term fundamental value of the stock during this period of near-term uncertainties continues to make it a recommendation of the Kidder, Peabody Portfolio Strategy Group.

George H. Boyd III, CFA