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The House Special Committee on the Permanent Fund

COMMITTEE MEETING

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Anchorage

Rep. Clark Gruening, Chairman

Rep. Terry Gardiner, Vice Chairman

Rep. Ernie Haugen

Rep. Russ Meekins

Rep. Bill Miles

Rep. Leo Schaeffer

Rep. Rick Urion

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

We have today some people that know something about money management. The committee is now at the point where it is about to work on a draft for a piece of legislation that deals with the Alaska Permanent Fund, an institution we may call the Alaska Enterprise Investment Fund, and Renewable Resources Development Fund, which is an additional dedication of our oil revenue for a specific purpose. But there is a lot we have to learn about money management and we have essentially three groups today. One, the Hanover Trust, which is involved in kind of bank management. A gentleman from Minnesota named Mr. Blixt who represents a method of---a board that has a method of in-house or state ---public state investment of funds. And then representing the Fidelity Management Group of Boston is Terry Magrath who is not in the room.

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

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

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

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

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

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

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

Next to Will is Mr. Vic Melone. Vic is the senior vice president responsible for the investment philosophy, basically, of our division and his testimony before you will include our basic investment approach, as well as the equity investment philosophy that our departments maintain.

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

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

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

GRUENING: OK. Before Mr. Wheeler starts, we'd like to introduce Mr. Al Osterback who is the representative from Sand Point which is considerably west of here. Thank you. If we could, none of us is an expert, if we could break in and ask for clarification in case the words get a little fancy for us. Would that fit into your presentation?

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

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

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

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

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

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

Then, really a little later in time, as inflation began to become a problem and you found that not only did you have to improve his benefits, but you had to try to do something in terms of keeping him up with inflation. And typically, that had to do with giving him an average of his final years of pay. And in many cases since then, with higher rates of inflation, this has actually resulted in increasing his benefits after he retires.

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

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

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

Alright, if you'll turn to page 6, we deal with---we have some historical information on what has happened in terms of the investment, the types of assets---the assets mix---used in the non-insured portion of the assets. And again here we are dealing with private pension funds and what has occurred here, as you can see by the line, is that there has been a distinct rise in the use of corporate stock in an attempt by the funding agencies to overcome this moving target that I talked about---that the perception was the stocks would provide a higher return than bonds and therefore we would try to get as much yield for total return as we could in order to offset ever-growing inflation, and you can see on that blue line that corporate stocks has risen to approximately 60% of all of the assets invested for private pension funds. You can see, historically, back in '58 they---there was a higher investment in corporate bonds that has declined over time. Mortgages, as you can see over time, has never been a significant portion of the investments now for private pension funding. It has declined significantly.

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

GRUENING: There are a lot of decreases.

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

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

WHEELER: Well, year by year, no. What I'm predicting is that long term, and I don't want to take too much on this because Mr. Melone is going to show you some statistics on that, long term common stocks will do better than bonds, but they'll be more volatile. I do not think that there will be a large increase in the use of common stocks for private pension funds, nor do I think there will be a large decrease in the use of common stocks for pension funds.

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

One other thing I just wanted to comment on was ERISA. The legal aspect of ERISA and how we see that applies judicially to this type of fund, i.e., a fund that belongs in the public domain. Now, if we make---it is unlikely that any of the type of protection---individual protection under ERISA---will apply to this type of fund because that has to do specifically with pension fund; entry, vesting, things like that. We think it certainly unlikely that any of the funding assets of ERISA will apply to this type fund. But we think it highly likely that all the fiduciary standards set forth under ERISA will apply to this fund and---you know, over time will be tested that way.

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

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

And three that the investments must be diversified.

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

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

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

GRUENING: Thank you.

MELONE: Alright, I'll talk about the investment process at Manufacturers Hanover. The system that we use to make decisions with respect to the kinds of assets we get involved with. I mentioned system. Why do we need a system? Why can't we use something like just seat-of-the-pants judgement or gut-feel or intuition or---we think that's fine and can be successful, but not running large pools of money. If you'll look briefly at the chart that is on page 7A of your chart book, there is a table there showing the total rates of return. You got that? Page 7A. That table indicates the rates of return for different classes of assets in the period 1926 to 1976, both in nominal terms and then adjusted for the inflation that has persisted over this period of time.

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

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

MILES: Wouldn't it follow that the deviation---that deviation percentage follow in the last 10 years or would that just relate to the 50 years?

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

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

MELONE: We didn't calculate it, but if anything I would think the deviation is at least as great. In fact, the next two tables on pages 8 and 9, if you could take a quick look at that, you'll see the light blue line on page 9, referring to the years you are talking about. You can see the light blue line which represents the return from common stocks. And the pattern from '66 to '76, particularly the last four years of that, continues to show very wide swing. Treasury bills, which are considered to be totally risk free assets, returned a 2.4% annual return which was just about the inflation rate that persisted over this 51 year period. So, if you go down to the inflation adjusted return on treasury bills, the last line, you'll see that treasury bills, when you do account for inflation, return actually nothing. Now, there is no tax affect on this table either, that may not be important here, but for individuals, they would have paid a tax, obviously, on the return they got from the treasury bills and then also have the impact of inflation. So, their return would have been below zero. After taxes. I won't detail each of the others. I think they are self-explanatory. Typically, you've got a lower rate of return from corporates and governments which your volatility, that middle column, was considerably below what it was for common stocks.

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

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

MELONE: Than the most recent 10 year experience, yes. Well, when you are making assumptions for a 25 year period, things have a way of smoothing out. The volatility on the inflation rate would be as wide as the volatility on the return from equities. I think what this table indicates is that it's a little more difficult to pick the right assets, particularly for the right accounts. It's a process that requires a system, a discipline, and we think a large organization, if we are talking about large pools of money. I think the charts on pages 8 and 9 are---clearly---graphically illustrate the volatility we talked about. It's particularly the impact you get from common stocks. The chart on page 10 is just a graphic illustration, really, of the table.

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

Our commitment began first of all by having a senior investment committee which the senior policy making committee for the investment decisions. On that are three senior vice presidents, the executive vice president in charge of the division and the heads of all major departments in the trust division. There are 10 people total. The function of that committee is primarily to determine the overall economic forecast and to make forecasts of the direction of the capital market, short and long term interest rates, and of course the stock market itself. And we try to do this in detail for a two-to-three-year period. In this case, out to the end of 1979. We are also working with long term facto as well, within which we look for deviations for the near term.

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

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

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

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

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

We have, the same way, we have a group of portfolio managers who specialize in the fixed income area.

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

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

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

Alright, now, we believe that in the senior investment committee we have to systematically analyse a whole series of risks and opportunities presented in the economic picture. We don't believe and we have not found that it's practical to take a particular economic forecast and say this is it and spill off from that a capital market forecast which suggests that bonds are going to do "x" and equities are going to do "y" and this is the way we go. What we have chosen to do---it's our way of doing it, we're not saying it's the only way---we think it may be the best way. If we thought there was a better way we'd be doing it. But for us it has proved effective.

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

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

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

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

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

MELONE: Right. I might say I think part of your question was that this sounds like a very expensive organization and it is. But it is spread over assets that at the moment total about $12 billion and that helps. But it is still expensive and we make it the kind of commitment you have to make to be in this business.

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

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

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

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

GRUENING: Alright.

MELONE: If I could ask you to just look briefly to page 15. This will demonstrate the four scenarios that we are currently using and they are labelled: Delayed Expansion, Extended Expansion, Recession, Stagnation. And this chart shows that the real GNP growth forecast in the---that are currently being used by a dozen prominent economic firms or economists are represented by the shaded area in that table. And this indicates how the four scenarios we are working with cover virtually all of those possibilities. The chart on the next page, which has to do with inflation, the GNP deflator, shows similarly that three of our scenarios are assuming a wider range on the inflation front than is currently described by the 12 economic firms. Speaking of economics, I would like at this time to introduce Dimitri Balatsos, who is a financial and capital market expert in the economics department at Manny Hanover, and have him describe a little bit the process in some detail. And I think you'd be interested in his comments on the current economic scene. And maybe I can come back for a minute after that.

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

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

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

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

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

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

HAUGEN: Let me ask you a question.

BALATSOS: Yes, sir.

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

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

Now what I want to emphasize then is that the nature or the structure of our economic system is changed and has changed in a rather fundamental way. And for the purpose of these hearings today I can only refer very briefly to two or three underlying causes. The first one is the rate of inflation. This is something that economists have a great deal of difficulty coming to grips with. And by very, very contemporary standards, meaning the last two or three years, the rate of inflation today, roughly about 5 to 6 percent is appreciably below the 12+% we had in '74. Yet, when you compute it with the kind of inflation we had in previous recoveries, this is about three times higher. And inflation is a problem because it destroys the stability of the relationships between let's say income and spending and all these other economic variables that economists count on.

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

Again, I want to take you then through some of the ways that we incorporate in the bank, simply the emphasis that has been placed on financial market analyses and use those inputs on investment decision processes. So, as Mr. Melone, my associate, indicated, the whole process is basically a two step approach. This investment committee ascribed or puts or places odds to three or four alternative economic scenarios. This way, we get a handle on the risk factor, the uncertainty factor, then using the most probable scenario, we try to implement our investment decision.

Let me refer you to page 14A. There we have laid out for you four alternative economic forecasts. I realize that this is not an economic forecast session. I just want to very briefly touch on the two extremes, the so-called extended expansion to which we ascribe a 49, almost 50% probability, the first column. And then the other extreme is the recession which, as you can see, is a 34% chance.

I don't have to again give you all the justifications why we put a 49% probability that the ongoing recovery will stretch through 1978. You hear a lot of talk about the fact that the economy---that the recovery is already three years old. It seems the average expansion of the post war period lasted about three years. There is a rising group of economists that says another recession is just around the corner. Well, the answer to that is that economic recoveries do not die of old age. They usually fall victims to imbalances. So after we've done our homework we discover that there are no excesses on the horizon, no excesses on the outside, any significant excess. We don't have a kind of bottleneck, a kind of instability and so on that we had back in 1973. So, I think you can make a strong case, 50% chance that the recovery will stay here so long as those excesses on the outside particularly do not materialize.

To go to the other extreme and look about recession again very briefly, we have given a rather high probability to that outcome because of two basic downside risks. The first one, again you don't hear much about that, is our growing deficit in our balance of payments. Roughly $30 billion will be paid out to foreign countries this year. And although all the imports we bring in show up as goods and services consumed by our system, the wages and salaries that go to support that kind of consumption at a loss to subsidize to the foreigners.

Another basic downside risk is the chart I showed you earlier, the very sluggish performance of business investment. Unless we see some steam build up in that particular category next year, I think we will have a recession later on in 1978.

And there then we list the five or six key variables in that determine investment performance starting with the GNP, the Gross National Product, on down, pressures on the inflation front in terms of unit label cost, corporate profits which are the lifeline of dividend payments, and then of course interest rates which determine the mix between bonds and stocks. Unless you have any questions, I would like to return the microphone back to Mr. Melone to take you a little bit more carefully about the investment decision process.

HAUGEN: Let me ask one question. On corporate profits, do you feel that minus ten there, does that mean that corporate profits are dropping? Is that what that means?

BALATSOS: If we have a recession in 1978 and '79, you can see that by '79 corporate profits will be declining 10% or will decline in the year of 10%.

HAUGEN: Can you give a reason for showing that figure? What is your analysis of it?

BALATSOS: Well, the analysis starts with sales, what kind of sales we expect in 1979, which you see a decline in sales obviously in the face of rising costs, it's going to bring about declining profits. Profits in the case is nothing more than sales minus costs. If sales come down and costs keep rising, you are bound to see some squeeze in profits.

That's why we have the 10% in 1979. Across the board if you go for scenario three and four. There is usually a slow down in corporate profits as the business cycle matures and the expansion continues because what you are doing in effect is spread your sales volume over a relatively higher cost factor here. A slower growth in your sales is spread over a higher volume of cost. And that's why the slowdown in profits is inevitable in every economic expansion, but it turns into a decline if your sales volume drops as well.

GRUENING: I'm sympathetic with a client who told me one time he wanted to see a one-armed attorney and I can appreciate--- I'd like to see a one-armed economist who is not on the other hand...

BALATSOS: Mr. Chairman, this has been a serious session. I have some anecdotes because I like to do things in perspective for the use of anecdotes, but I think I'm going to skip them...

GRUENING: Thank you.

MELONE: There are several pages of descriptions of economists somewhat like the one you just made.

Let me just summarize again the use of this weighted forecast. It is first of all to describe the uncertainties that exist in the minds of professional investors, investors and economists and to somehow quantify that uncertainty so that it has an impact on our capital market forecast. The second thing is that it gives our portfolio managers an opportunity to assess whether the outlook that we are looking for not only is the most probable outlook but across the span of these four forecasts, whether the eventualities of that have already been discounted in the marketplace.

You know, very often things will happen exactly as you expect, yet nothing will happen to stock prices or bond prices. Or on the other hand stock prices or bond prices will do something entirely inconsistent with the facts as they seem to be presented. And what we've tried to do here is to take that into account and realize that the opportunities of catching the single best set of circumstances, or the single most accurate are very remote. And we're trying to understand the uncertainties in the world and quantify it in our decision making process.

If you will look for a moment at table 14A, you can understand a little bit how this is used. For example, under the first scenario under 1978, the S & P 400 index would range from 102 to 132---it is currently about 102. If scenario two, delayed expansion, which is the most favorable in effect, were to have a hundred degree of certainty or probability, the range would be 118 to 152. And then you have the two recession oriented scenarios and here you see that the range from the low end drops to 85 and 86.

The chart on page 17, I'm sorry, page 18, shows in graphic terms where each of the scenarios would lead you in terms of the 1978 stock market. The shading indicates the range that comes out of the weighted scenario. The blue line, extended expansion, whic is the most probable, is leading to a midpoint in effect. Now the band around it shows what the weighting of the other three probabilities does to the capital market forecast that would ordinarily spill out of this. And you can see through the shading that it is skewed downward because of the weighting that our portfolio managers and the senior policy committee have given to the recession possibilities.

OK, let me just take another minute or two to talk to you about the equity side. All of these disciplines and overview procedures are really preambles to get us to decision making processes---the selection of stocks or bonds. I mention that we have a very large and effective research department covering about 25 industries. These analyses are given our most probable forecast and working through that and understanding the relationships of various parts of the economy to the industries that they follow, they attempt to develop earnings and divident forecasts. We have found that---and they use a lot of tools for this, the usual analytical tools, balance sheet and income statement analysis, study of unit growth, price growth, competition and they talk to the management, they talk to experts in many fields. What we are looking at here is to get the best estimate we can of corporate earnings and dividends. Now we have found and studies have shown that the tracking of earnings growth and dividends growth is the best determinant of future stock prices. We've got three charts and I'm afraid I've got three or four more to show you.

On page 19 you see a chart depicting the growth and earnings per share---the red line, and the growth and dividends per share. Earnings here are compounding at 4.4% over the 51 year period and dividends at just about 4%.

GRUENING: Wait a minute. The red line is what, now?

MELONE: Earnings per share, using the S & P index as a proxy for stocks. So that there is a parallel growth in earnings and dividends.

The second chart...

GRUENING: Earnings includes the appreciation of stocks?

MELONE: No, that would be the appreciation of costs, so that would come out first.

GRUENING: What's the difference between the earnings and dividends?

MELONE: Earnings per share, the profitability of the company.

GRUENING: Oh, OK.

MELONE: The next chart on page 20 shows the relationship between dividends and stock prices. You will see here that in the period stock prices generally track the rather short moves we've had in dividends, so there seems to be a relationship between the two except when you come to 1971. And you see there that dividends, at least in nominal terms, continued to go up but the market has come down over that period of time. This chart does smooth some of the wiggles a little bit.

GRUENING: It's about time the state took a bath.

MELONE: There were a lot of people in the tub at that time.

GRUENING: I think there is somewhat of a bias up here because...

HAUGEN: A year later though they kind of hung on there, could have come out a little bit better, you know.

GRUENING: Sure.

MELONE: Well, that's why I say this smooths a lot of the pattern. There were very wide swings in the period after 1970. You did get a lot back and you gave a lot away again in the '74 period and it came back sharply in '75.

HAUGEN: Well, I think the reason for that was that the people got excited from the political point and jumped on the fund manager and he started to unload, you know. Some of it they should have unloaded ahead if we wanted the top half of it back, you know. Anybody can do that.

GRUENING: Plus they had a cash flow problem, they had to liquidate.

HAUGEN: Well, I want to talk about it a little later.

MELONE: Well, I don't have to mention what happened to the price of oil and in Anchorage I am sure you are aware of that. That did influence things quite a bit.

But the next chart is the one on page 21. I think at least partially explains that anomaly of dividends going up with the stock market going down. You can see that if you adjusted the dividends for inflation they actually turned down in 1966 and at least partially this would be a reason for the market not performing as well as it had in the past. This is investor perception that they were not getting in real terms the kind of dividend returns they were expected to or needed to stay in the stock market.

Now in addition to this kind of work where we track the dividends and earnings carefully and in real terms, we rank the industries that we follow in the chart which shows the top 12 and the bottom 12. Here we are talking about the increase in corporate profits year to year. We have found that it makes sense for us to concentrate our holdings in those industries and companies which rank in the top quartile. At the same time the system gives us an opportunity to introduce a selling discipline. You don't hear a lot about this generally. But in the same way that it makes sense to concentrate your stock in the top third of this ranking by industry and by company, we found that we ask questions of our analysts and our portfolio managers as to why we continue to own companies that are continuing to show up in the bottom third of this ranking. It is not an automatic system. If the portfolio manager or the analyst doesn't have a good reason for holding that stock or holding it in that amount, the senior policy committee will then take an issue with it and either reduce or eliminate those stocks. So it is asking the proper question is the important thing that comes out.

Finally, one more chart, the last one by me, page 22, the product of all of this system and all of the special talents that are in the division has produced and is aimed at producing an equity portfolio which can graphically be described as you see on page 22. The green bar represents the portfolio and the black bar represents the S & P 400 so that we can and have---this is an existing portfolio---put together a portfolio where the stocks in that portfolio show an historic growth over the past five years of 17.9% compared to the market of 12.2%. And more important, an estimated future growth rate---the next bar---that's about 50% higher than for the market itself.

GRUENING: What's the period of time that this thing is covered? Covering?

MELONE: What?

GRUENING: What's the period of time that this graph is covering?

MELONE: It's a five year historic where it's indicated and five year future.

GRUENING: From what...

MELONE: This is an existing portfolio as of September 30th, the last time it was calculated---this is not a performance, this is a graphic description of the security, the actual stock in the portfolio. Taking into account and weighting each security.

GRUENING: This is your total stock portfolio, of just one...

MELONE: This is a portfolio, but it is a representative portfolio or a group trust which is a representative portfolio of all our trust programs in fact.

GRUENING: And that was from what, this year five years back. This is a five year period and a selected portfolio?

MELONE: This is really, if you will, a snapshop of what the stocks in that portfolio look like with these characteristics at the moment. OK?

GRUENING: OK.

MELONE: It's not a trend or a movement or a performance.

It's just the---certain financial or growth characteristics of the company itself. So, moving further down you see the historic dividend growth has been twice as high in stocks that we own in this portfolio compared to the S & P. And the estimated growth in dividends is 9.9% versus 6%. So it's 66% gain. There are two profitability or qualitative ratios here as well. The five year return on capital is 30% higher than it is for the S & P. And debt as a percentage of total capital, the final column, shows that these companies are considerably more liquid in their balance sheets than are stocks in general.

The next to the last column, the estimated PE shows that despite the higher growth, the higher dividend and the stronger qualitative aspects of the stocks in this portfolio, that the multiple that were paying for those stocks is 10 times versus 8.1 at the moment for the S & P 400 which is not, in our opinion, a very big risk.

OK, if there are no questions, I'd like to get to Skip deRopp who is our senior man in the fixed income area in charge of the special support group for fixed income and I'd like to say the architect of one of the best bond records in the institutional field today. Skip.

GRUENING: OK. We've kind of advised our three main witnesses today that we are trying to keep everyone down to an hour and that's exclusive of questions. So, go ahead. We're approaching your hour.

DEROPP: Well, I'll give you a quick 1-2-3. I'll be as quick as I can. The central philosophy for managing fixed income portfolios at least is to try to preserve capital and maximize total return---I'll explain what I mean by that in a minute. And also to the extent possible preserve purchasing power through active management techniques. Total return is the concept of investment return which is not only cash in hand but also price change---we apply this to bonds as well as stocks.

The number of active management techniques to achieve this management bond portfolio---and I'll just touch on those in a moment. But there are two realities a manager of a fixed income portfolio has to keep in mind in facing his task. And one is the profound important, interest rates fluctuate. If you turn to the chart on page 23 which shows historically yields of new AA industrial bonds 1969 to 1976 and almost every year there has been a fluctuation of yields of interest rates of 100 basis points or more. So this is of utmost importance in terms of timing, the committing of new cash or else in lengthening and shortening of maturity.

The chart, table on page 23A, shows that the impact on the total return of a bond given 100 basis point change in interest rates, 100 basis points is the same as one full percentage point, like from 7% to 8%. It is a function of maturity. In other words, the longer the maturity of a bond, the greater the impact a change in interest rates has on the price of that bond. And what we have in effect done here is net the coupon income with the price changes, so that's the total return. So 100 basis points change increase, bond price will decline. Of an increase in rates for a 5 year bond, the total return would be 4.8% for a 20 year bond, the total rate of return would be a negative 1%. In other words the price change decline of the bond would exceed the coupon income that was received.

Now a second reality in the marketplace is the fact that there are changes in credit ratings of corporate securities and we have plotted here very briefly the number of upgrades and downgrades that Moody's assigned to industrial and utility issues. You can see that during the recessionary period of '73 to '75, for the number of downgrades increased markedly, reflecting a deterioration of credit conditions and substantial increased use of debt as corporations found it necessary to do so in a highly inflationary environment as business slowed down. The situation improved somewhat in '76.

The table on page 25 shows just some elements here of the principal involved in active management techniques and basically this involves positioning the portfolio: anticipation of interest rate changes by varying maturity, by varying quality, and by varying representation in certain sectors of the bond market, for example, industrial bonds, utility bonds, government bonds, finance obligations, etc.

The second important technique here is arbitral swapping: exchanging one bond for another bond, otherwise quite similar, in order to gain an incremental return and these opportunities are made available in the marketplace as a result of abberations and peculiarities incurred in temporary supply and balances, the dealer having been caught on the wrong side of the market in a short position and wants to cover, technical factors of that sort.

The last thing is the element here is avoiding losses resulting from credit deterioration. We go to a chart on page 26. It shows long term interest rates, intermediate term interest rates and short term interest rates. What the pattern has been since 1970 and, again emphasizing the fact that it is very important to pay attention to---to try to anticipate---changes that occur in interest rates in the position of the portfolio properly.

The chart on page 27 is a relative chart. It shows the yield of AAA, AA, A, and BAA industrial bonds compared to governments, the spread. In other words the latest figure would show that the top line, which is a sort of purple red, looks like it is about 75 or 80 basis points higher yield than the treasury obligations.

GRUENING: Where are you?

DEROPP: I'm sorry, am I going too fast?

GRUENING: No, I just---incidentally, the $11 million or so that the Permanent Fund has accumulated is invested largely in treasury bills as the commissioner of revenue was telling us between 6 3/4, I would guess. That's what he claims. So what does this red line represent?

DEROPP: The red line represents our forecast of where we think 90-day bills are going. It must not be shorter maturity bills you are apparently investing in.

GRUENING: They must be longer. OK. So the longer term treasury bills would---would would 6 3/4 usually be?

DEROPP: Well, close to a year on this kind of basis.

HAUGEN: I don't think they fiddle around with 90-day bills in government management, do you?

DEROPP: Sure we do, occassionally. Certain types of accounts...

GRUENING: The point is, was the 90-day treasury bill possible?

DEROPP: This is really just a proxy for short rates. I mean, that's just one indicator for short term interest rates---we happened to select 90 days. We could have selected commercial paper.

GRUENING: Oh, I see. OK. I didn't know the purpose of the graph.

DEROPP: Well, just to show you how the---the relationship between short rates and long rates, how they could change. When you have periods of very tight money as in '74 and '75, why short rates can actually exceed long rates. And then when you get a restorational equity of assessment then short rates normally back away from long rates. And this is what you would expect. In other words, the longer maturity of the investment you make, the more you should expect to be compensated, the greater the risk you take. Not only in terms of money market, in fact, but also in terms of credit deterioration if you are investing in the corporate circle.

GRUENING: What was the reason in '73 that we had that what looks like an unusual swing?

DEROPP: In short rates?

GRUENING: Yeah. Between '72 and---well, actually maintained late into '73 before the short term started to...

DEROPP: Well, that's actually---yeah---in '73. Well, we had as you recall, we had a commodity---a world-wide commodity inflation and...

GRUENING: Is this the result of oil prices, essentially?

DEROPP: Yeah, it started---got it away before that and that certainly aggravated it. The corporations were concerned that they would not have enough raw materials in many cases to be able to fill their orders, so they started buying and trying to buy in advance. This increased the working capital requirements, therefore they had to borrow more money and this placed pressure on the short term credit market. The monetary authorities were trying also to contain the thing, the vigorousness of industrial activity.

HAUGEN: They also have to take into consideration the federal government, the federal reserve bank. The national fund deficit. Doesn't that play an important picture in...

DEROPP: Yeah, well, that really came later when we had a magnitude of...

HAUGEN: You have two competing for the money---that...

DEROPP: That's a very important consideration. Any more questions on that?

The table on page 27 is a relative chart. It shows a yield spread between AAA, AA, A, and BAA industrial bonds. Different sectors in the bond market against government bonds. The government bonds are the base credit market for the whole system. That's suppose to be the best credit in the system---you measure other things off of that. At the present time, the BAA industrials, which is a sort of purple line at the top---we're starting about 80 basis points off of long governments. And if you go back to 1974, why there were as wide as 235 basis points---I'm sorry, as wide as 325 or 330 basis points off long governments.

The point is that when you have very tight credit conditions and you have a lot of other factors going on there at the same time---concern about England and the possibility of a credit collapse occurring, investors got very nervous and insisted on highest quality obligations and also---they also wanted it quick---short term obligations. So, the spread actually---the point of this chart is to show how the spread widened between AAA industrials, which is the light blue line on the bottom and BAA industrials which is the sort of purplish line. And that was about 235 basis points at its widest during the period and essentially it has since narrowed down to about 55 basis points. So that demonstrates quality shares and how they change.

The next chart on page 28 shows the yield spreads really between some different sectors of the bond market, not only governments but also industrials and AAA utilities. And if you look at '70 and the point of extremes, particularly on interest rates, why investors still would rather own government bonds because of the risks perceived to exist than even AAA utilities so that there is 150 basis points spread between long governments and AAA utilities. As credit conditions improve and liquidity came back into the system from the extreme pressures that existed in '74, why that spread narrowed down. Also, investors would with cash looking for yield increasingly

---put their money into higher yielding obligations as equilibrium returned and the risks were abating. AA industrials followed pretty much the same pattern in relation to governments as AAA utilities.

Don't forget that in an economic cycle and this past cycle we had was a very deep one, one of the deepest, well two deepest, but not the deepest, in the post war period. The earnings of industrial companies, many of them were very cyclic. And particularly highly leveraged ones, so there's more concern, there has to be more concern arise in a period of general credit concern and for obligations in many industrial companies we have had.

Now in connection with credit evaluation, it is very important as an investment organization that you have the ability---the capability of monitoring along a substantial list of credits. And to be sure that you are not holding in a portfolio any credit that may encounter severe problems. We develop a computerized ratio ranking system for monitoring the credit we follow. We divided---determined that there were eight financial ratios which portray the profitability, the basic profitability of the company. Do you go with that company and incur additional debt and the asset protection of the bond holder? These actual projected ratios are listed there on the left hand corner of the page. We computed the ratio---each ratio for each of the companies---600-odd companies that we follow. And we ranked them in the deciles. So if there are 500 companies, why obviously a company who has the highest ratio will rank in the first decile, etc.; they are ranked in that order. And then simply by adding up the decile ranking which is the number that appears here on the page, you can decide company "A", for example---the first ratio it appears in the 8th decile, in other words will down the list---ranks pretty well. You add up all those decile rankings for each of the financial ratios and the total score of 54 gives it all down to one number the overall financial standing of that company. And we rate that---that would rate down on company "A", for example, 54.

We compare the latest years of financial ranking with the three year average, which is useful to do so, (a) to determine a trend and (b) to see in case of a cyclical company to try to normalize it. We can compare the total score of each company with a score for its industry to see how it ranks within its industry and also how each industry ranks---how the industries rank with other industries and how the---an individual company compares with other comparably rated companies by the public rating agencies. In other words, is that score high or low compared to the ratings that apply or the score achieved or comparably rated companies by a standard score as Moody's.

And the summary of those scores appears in the two right hand columns---how it ranks with other "A" rated companies, how the industry ranks, we also attempt to look out ahead and our analysts---credit analysts---try to give us an indication here of whether they view the companies overall financial position as either improving, declining or remaining unchanged. So this is a pretty central part of fixed income management. You've got to make your own decisions with ranking credit.

MCCANDLESS: Skip, I'd skip to the last chart.

DEROPP: Alright. We have on page 31---it's a very brief form---make up a profile of a suggested portfolio in very general terms that oversimplifies what is really involved in coming up with a portfolio. We did this pretty blind. We don't have enough detailed information on how much accumulated funds there are, how they are now invested and we don't have the data on the cash flow or financial investment data. In making up this portfolio, we wouldn't want to rule out the possible use of common stocks. But based on the limited information we have, it seemed like this kind of portfolio profile made sense.

As you can see here, we have 50% of it in Government National Mortgage Association mortgage backed securities which are backed with the full faith and credit of the United States. Another 40% of the portfolio is AAA industrial securities and finance securities and 10% in the AA companies. We think the quality spread now as indicated in the previous charts is sufficient to indicate that you are not being compensated sufficiently to take athe additional risks involved in, you know, buying lower rate securities.

At this point we just want to leave this with you based upon very...

GRUENING: The commissioner of revenue just walked in. Just as I had a question you could answer. Sterling, the mortgages that we put in the pension fund are invested in---like the state employee's pension funds---are they Government National Mortgage Association backed, or what...?

GALLAGHER: No, they are private mortgage insurance backed mostly. Either that or the bank participates.

GRUENING: OK.

DEROPP: Well, these are readily marketable rates in a very closed and very tight market. The market building factor here is a lot higher than...

GRUENING: We'd like you to join us, John. We're going to take a break here. I want to thank you very much and we may have questions of you later. We'll take a pause for the cause and we'll hear from Mr. Blixt after that.

MCCANDLESS: Mr. Chairman. May I point out that we have the booklet that basically we have developed with this group available and we'll give each of you a copy of that which says verbally what we've been saying here or...

GRUENING: Thank you very much. I hope you can stay. I'm sure the other gentlemen may have some questions then. We'll just take a break now.

BREAK

GRUENING: Call the meeting to order. We have at the end of the table Mr. Robert Blixt, the executive secretary of the Minnesota State Board of Investment. The new people that have come in, Bob, are the Speaker of the House, Hugh Malone, and you've been talking with the Commissioner of Revenue Sterling Gallagher and Jim Rhode who is sitting right to your left there is an assistant to the Finance Chairman Steve Cooper. So, the floor and the microphone is yours.

BLIXT: Thank you very much. It is an honor to be here, but I must say I don't know exactly why I'm here. I certainly have nothing to sell. But on the other hand, it's good to be here. And I hope that we will be able to tell you a little bit about what we are doing and I hope it interests you. And maybe a different aspect of the situation to look at.

First I want to say that I recognize most of the people behind me and they are the financial leaders of the nation. I don't pretend to compete with them. I operate out of a little set of offices like this except we have sort of plywood board with paper on top of it that looks like wood. And the rugs aren't as thick as this. And still I feel that we can do a better job within the state than these folks can in New York because they are at my beck and call too. They are here all the time.

Now you just told me, for example, sir, that you don't have a college education---you played football. Why don't you call Washington and get a real politician here in the legislature? If you're too young to run the legislature, why don't you call somebody in Washington and say, now we'll handle things just fine. I'm sure you aren't as versed in government as the speaker of the house he gets in Washington, but what I say is baloney, isn't it? Because all of the time you have to talk to the people of Alaska about Alaska. About their money. And you folks get advice all the time and say the best thing to do is turn on Wall Street and buy stocks and bonds and watch it grow and the people of Alaska say, wait a minute, it hasn't been explained to us. Maybe we can give Alaskans business.

Have you ever had pressure? Boy have I had some my 17 years. The people in Minnesota always say we don't want stocks and bonds, we need minority housing. We need this industry. We need to help this distressed area. We need homes in this area. Still I'm trying to point out we need an investment. So what does it take? It takes going around to the churches and the civic organizations and the Kiwanis Clubs and everybody else and telling them the story. Telling them why we have something to do in saving our Permanent Trust Fund. And I think that's what you have right here. I sent out a little piece of paper, now we don't have time in Minnesota to send this out for everybody. You notice up here I put, "Representative Clark Gruening, Chairman." Don't feel you're a big shot because of that. If I was in Minnesota and we were at the Presbyterian Ladies Aid, it would be "Mrs. Uplift, Chairman."

Why? Because we go to the Presbyterian Ladies Aid and say, folks, we have something to sell. We want something that is good for the State of Minnesota. We want something here that's going to have that support. And that's the only reason I've been able to be there for 17 years. Everything on earth has happened to us. We've been condemned, we've been criticized, I've been worked over, I was going to say by the Republicans and the Democrats. I've had five Democratic board members; I've had five Republican board members and the only way I can get going I've found is in that state you have to be able to speak faster than Hubert Humphrey, Orville Freeman and Fritz Mondale put together or you don't have a fighting chance. That's why we are here.

Folks, I am convinced that in Alaska you can do something for Alaskans. I'm not selling anything. For God's sake, we're not going to sell the Minnesota Investment Board. But these folks are magnificent. We need them for investment work. But when I go to New York, I'm the little Bob Blixt with his little briefcase and says, "Say, folks, I need a little help, we'll be able to give you some business, or maybe we can put a measly deposit in your bank by putting in a little in the First Bank at St. Paul and they can put a few million in your bank or a few hundred thousand." For some unknown reason they're willing to open the door. I'm able to get in. I'm able to talk to them.

But at the same time, just as important than meeting the people in New York, it's going to be meeting that Kiwanis Club in Fairbanks. Maybe you should go up north and talk at

Prudhoe Bay once and a while. Maybe you should go to some of the churches in Anchorage. Just a few minutes ago, for example, we had a little question come up---what was it? On treasury notes. I don't mean to criticize you, sir, that's the last thing to do here, but you say, "We're doing pretty well on treasury bills, 6 3/4%." Right. Right. That's good. But the first thing I'd like to say to you folks is my goodness, if it is the Permanent Fund, the last thing we want is treasury bills. They're due in 90 days or 6 months and then it's down.

And in 1974 I had a legislator say, "Buy treasury bills, Bob, they're up at 10%. Commercial paper is at 13%." And it was exactly the wrong thing to buy. Because that's the time we could have gotten long-term bonds for 30 years up at 9% and 10% and I found it's best to buy the things that yield the least. When treasury bills yield 12, buy something that yields 10. The long term bonds. Sometime when treasury bills yield 3¼, that's the time to buy treasury bills. Because long term bonds might yield only 5½ or 6. Wait until the bills go higher, but then the long term bonds will go higher, too. If I don't want to buy long term bonds yielding 6% and be locked in for 30 years after interest rates go up to 8%.

But folks that has to be explained to each Kiwanis. It has to be explained to the men's clubs. Because you folks aren't operating in a vacuum and here I guess I can talk like any politician who has been there quite a few years. Folks, you can have any kind of high standard you want. You can be convinced that you know exactly how to run the Alaska Permanent Fund and if you are knocked out of office, what good does it do? You've got to be able to relate to these people. You've got to be able to tell them how you think it should be done. If you don't know the details of finance, fine. You can find that out in a hurry. But are you in a position to look at their needs? And I guess that's all I'm going to talk about this afternoon. Economic charts, yes we can go over that. But we've been able to build up a department. I have everything in here including my budget. What we're doing this year, what we started out with and I'd like to tell you a little bit about Minnesota and how Minnesota is very comparable to Alaska.

We got in this business about 100 years ago. They set up a Permanent School Fund for Minnesota. I'm sure you've heard of a permanent fund. We were one of the first states to have this. One section of land in every 36 in Minnesota was put in the Permanent School Fund and the Permanent University Fund.

But we had a very unusual state, nobody in Minnesota liked to pay taxes. They said, let's not pay taxes, let's sell off this land. Oh, if we only had it now. One square mile happened to be all of downtown Minneapolis at the present time. But they sold this stuff for one buck an acre. Well, we got rid of most of it. It was a disgrace. But I'm sure we had in Minnesota a hundred years ago people exactly the same as you have in Alaska today. They say, come on, local development. You don't want to invest in New York. Local development. You know, there's not a single thing like a railroad between St. Paul and Minneapolis?

So ten companies were formed to build a railroad between St. Paul and Minneapolis. All this money out of the permanent fund. They all got five miles along and quit. So what happened? We had issued some bonds. The defaulted. Minnesota had to default on its credit rating, so some years later it took the whole permanent swamp land fund to pay off the bondholders and that's the thing.

We did exactly what I advised you not to do. We sold every bit of the land from the permanent fund for one buck an acre except some old ranch lands we owned in northern Minnesota that were so worthless we couldn't find any fool that would pay one buck an acre for it. And I'm sure 25 years ago it you had tried to sell a whole area around Prudhoe Bay for a buck an acre, you'd have had trouble. But what happened under those sand hills? That, folks, is the Mesabi Range. You know what happened. Iron ore and the First World War and the Second World War built it up to about $250 million, which was a lot of money in those days.

But then we had everybody working---just like I'm sure you are working here in Alaska today---and during the 1950s they said, let's not build it up, let's spend it now. We have more school problems. So we did decide to use part of the money for school aid, but then of course you've heard what happened in the Mesabi Range. It completely dried up. But that was the beginning of the fund in Minnesota. This $250 million Permanent School Fund which has been stable ever since.

When I took over in the late 1950s---I was negotiating, I took the job in 1960, we had a Permanent School Fund that was not growing, all invested in treasury securities yielding 2 3/4%. With a nice constitutional provision that said this fund must be inviolate and undiminished. And, according to the lawyers, that meant I couldn't sell anything at a loss. So, if interest rates changed and the bottom went down from par to 99, I couldn't sell it. I had to wait until it went down to zero, then I could write it off. Now that's really fine investment management.

Well, we first changed the constitution, so instead of inviolate it said perpetual. And inviolate. But not undiminished. I don't know what perpetual means. I don't know what that phraseology means. Well, we decided that it means that if I build it up I can sell at a loss. So now I sell at a loss every year. I sell these old, old coupon bonds, but on that new income gradually build it up over a period equal to that of the maturity of the bond. It works out just fine. But how do you explain that one---that I'm not getting rid of the permanent trust fund by selling out those 2½s which I did in the 1960s. At 58¢, 68¢ on the dollar. That works, folks, included talking to the Presbyterian Ladies Aid Society of Minneapolis, to the school boards, the PTAs, all over the state. And I think that's the way you get things done.

I believe you are honestly in the situation where in handling money it's not necessarily ignoring everything. Now I'll just have to admit today that I'm sure the folks behind me know a lot more about finance than I do. But it's also a matter of communicating that knowledge to the citizens of your state who have the votes and are able to tell you what to do or elect you---I don't mean it's all a political thing. I'll admit I spend 99% of my time on politics and one percent on investments if I have time. But still you need that kind of operation with a basic knowledge of investments. And with a staff that's pretty good and that's what I'd like to present this afternoon.

On the first page we have the fund that we have in Minnesota. If you want to talk about budget today, I'm going to leave out all of my chat about economics and what's going to happen because you can hear that from the others. I'm just going to talk about this little department.

When they hired me on the staff, they put up a whole $30,000 for the whole department in 1960. I got $12,500 a year at that time. I took a secretary, an analyst for $5,000, a bookkeeper from the Treasury Department and some used furniture. That was it. Now it's built up until our annual budget is about three quarters of a million dollars. But of course we have to plead for that the whole way through.

Now, the department is not just an investment department, but we've been able to keep ourselves completely independent. For example, the person in the state, the commissioner of finance. I presume I have a job similar to yours. Or the commissioner of revenue. We would tend to argue a little bit. But we want the investment department completely separate because we went to go our own way, so to speak. Still, we want to be very good friends. We must be that. But we find it good to have this separate department, separate apart from everybody and not under the commissioner of finance or the administration.

I have five members on my board: the governor, auditor, treasurer, secretary of state and attorney general. Nobody in the department has civil service. Nobody has any tenure. All 29 of us could be fired in one minute and told to leave. Now that keeps you on your toes. Any three of my five board members could fire all of us at any time. And still we've existed under all Democrats, all Republicans, all kinds of mixtures. I'll admit that I've had two wanting to fire me most of the time. But, unless I have one or two wanting to fire me, I feel I'm not doing my job. But if three ever want to fire me, wow, that's bad. But you just have to operate that way and have to be willing to explain what you are doing.

You go as far as you can and then you have to cut back a little bit. But that's the way it is. It works out fine. But we have to be able to explain what we're doing and explain in terms that people can understand.

You'll notice on the first page here our permanent trust fund is now $263 million. We can go up to 20% in common stocks there and we have that. We have quite a few corporate bonds and you heard the Ginny Mae mortgages mentioned in the last presentation. We use quite a few of them because we are very dependent upon income here for the schools.

Then you will notice the various retirement funds now total $2 billion, $77 million in Minnesota. Here we have quite a large common stock percentage, 49% which is nearly comparable with the percentage in equities that some of the banks have of 60% and 70% in New York. We are, I suppose, one of the public funds that's the highest in common stock percentages in the nation. Now, many will say, well isn't that dandy. Maybe. I guess we'll have to look into the future. But we have found that by buying yield stocks recently and buying in the lows of '74 and now---and not trying to beat everybody that's on this growth binge, we've found that we've been able to lower our average costs to the point where as of today I think our common stocks might be even a little bit above, even though we bought a lot the last two or three years at very high levels and then of course in the '72-'73 era at very high levels, we're as---our bonds still show a little of a loss for the simple reason that all of the bonds that we bought in the 1960s still are 5%, 5½%, 6%, 6½% couponed. We've traded out of some of them, but we feel there is a good argument for equities.

Then you'll notice the highway funds, $215 million. These are trust funds for the highways, various departmental funds, $210 million, that includes almost a hundred different funds, by the way, and then the current tax receipts, $398 million. By the way, Minnesota is one of the few states that has a treasury surplus. In other words, our legislature ---they're like you are, they're mostly Democrats, liberals, like to spend, they still can't spend as much money as we take in. You know, that's great. And when we sell a bond issue, you don't know what it is to say, well, now, look, what do you have behind this. We have a $300 million surplus, we have $3 billion investment funds and, of course, Minnesota has a AAA rating. And, I'd like to present that to you, too.

If you're going to be borrowing money for improvements, if you're going to be doing anything to help Alaska generally, a nice, well-managed fund certainly helps. Because they know all these assets are behind it.

Let's turn to the second page. The second page shows what has happened to our little fund in Minnesota. You will notice in 1959 they had only $139 million; now we are over $2 billion. That's in the retirement fund. Now the trust fund is in addition to this and with the invested treasurer's cash we actually have over $3 billion.

The this shows what happens with funds that have growth. If you will notice that first four years, pardon me, two years, it went up 35%. Then by December 31, '65, the growth was an additional 71%. The next four years, 100%. The next four years, 85%; the next four years 74%. We're looking for funds totalling about $3.6 billion by 1981. Then another 80% growth the next four years. So these public funds are just astounding as to their growth and you have to have departments that are able to handle huge amounts of money. In other words, we don't try to piddle around with the small stocks, the tiny companies. It just takes too much time. We must concentrate on the leading stocks, on the bigger ones, that's the only ones worth it.

Now, will you turn to the next page. You'll notice the difference we have between the investments in the private pension fund and the state and local retirement fund. We are similar here, but you'll notice how fast these funds are becomming. The chart on the left, and this is from the latest Federal Reserve bulletin, shows that the public funds throughout the country are now at about $125 billion. This does not include the Alaskan trust fund or the Minnesota trust fund or New Mexico---and they are about the three that have them, and then, of course, we have Texas with the oil. That would add a comparatively small amount, about $2 billion. But you'll notice the state and local funds total about $125 billion, whereas the private pension funds only $160 billion. So, we're catching up on them right away. This management sometimes is local and sometimes it's with the big banks and mutual fund operations. But you'll note here that the percentage in common stock has gone up very high recently in the public funds as with the private pension funds. Admittedly, we've had some rough stock markets lately. But you'll notice we're still going in there and still have quite a bit of faith.

On page 4, you'll note here we have the asset diversification of the various bonds. First the basic retirement fund. And I do advocate a centralized investment office because the investment work here is so similar and you are able to use the same people for these funds.

In Minnesota, we have separate teacher's retirement fund, public employees, police and fire, state employees, highway patrolmen, judges retirement fund. All with different groups, all with their own executive secretaries; all are great lobbyists, as you know, especially our judges, if I may say so. And they are all going full blast all the time, but they have similar needs. So our job in there is to work with all of them, try to get their funds invested.

Then, of course, we have this adjustable fixed benefit fund. I know what you think, if something is fixed in government and then is adjustable, you know there is something wrong with it, most likely crooked. It isn't really. All this means is all the money for retired people is transferred---all the retirement fund when a guy becomes 65 years old from then on, if the market goes up or the income goes up above 5%, which is the actuarily assumed rate, then they get more than their regular pension.

HAUGEN: Let me interrupt you. In other words, the general fund doesn't build in an inflation factor against this...

BLIXT: No. This isn't the general fund at all. But in Minnesota, we have the employees contributing 4% of their salaries to a retirement fund. The state government contributes 4%. In addition, because the state government has not contributed in previous years, we have another 2% makeup. So, in essence, we have 10% of everybody's paycheck going into a centralized retirement fund. Well, when that individual becomes 65 years old, then out of the retirement fund, whether there is enough money to fund his benefits in an entirety, the total amount on an actuarily sound basis to fund those benefits at a 5% rate is transferred to this separate fund called the adjustable fixed benefit fund. Then we have to play with the benefits, but we better not do too much playing. But it depends on the two year ratio of stock prices to the cost of the stock; it depends on the bond yield and that type of thing. In the early 1970s, we gave very significant increases, about a 13% increase, in pensions based on this. And then, of course, we had the downswing in 1974. It looks as if we shouldn't have given anything for a while. Now it's coming up again so we're going to give another 4% increase in pensions this coming January and we feel in another couple of years we'll be able to do that. So the purpose of this fund, this adjustable fixed benefit fund of $758 million ---you see it's sizable, three quarters of a billion---is entirely to pay pensions based on market action.

Now we have fallen into trouble here frankly. You can imagine how a 78 year old public employee with cancer who's going to pass away next year says, "Well, I realize I don't get an increase this year when the market went down." Nope, that's not the way to look at it. They want it every year. So, I think we're going to change this. We find that we can give about a 3% increase in pensions every year and do it on an actuarily sound basis to more or less match the cost of living increase. Not quite, but it is certainly going to satisfy everybody. It looks as if a 3% or 4% increase is possible. But there again this is something---you need a centralized investment department to work with the heads of the various retirement funds, to beat the prices, talk to the Minnesota Educational Association ---I'm sure you have your Alaskan Educational Association or teachers here. We have to talk to the teachers union, we have to talk to legislative groups, again the Kiwanis Club, the Lions Club and everybody else to explain what we are doing to try to get this straightened out.

Then you'll notice we have these supplemental funds. And those are interesting... Yes?

HAUGEN: One question before you get there. Does your employee put into the social security system?

BLIXT: Yes.

HAUGEN: Oh, OK. That's all.

BLIXT: Some do not. Our policemen and firemen do not. And

I think you are aware of that big debate going on throughout the nation.

They want a lot of benefits without it. I don't handle police and fire funds directly except those that have elected to join a state police and fire fund. Otherwise I regret to say we have about 400 independent funds in the state. And my, when the legislature meets to try to control the police and firemen, I don't know how it is here, but they all come with the uniforms and the guns and the night sticks and they say, "Whoopee, don't you dare cut our pension." Well, then what we have been able to do there is help them along in their investment and still let them have their individual police and fire retirment fund. The way we do that is next.

You'll notice the Minnesota supplemental retirement fund---an income share account, growth share account and fixed return account. They're like little mutual funds and anybody who wants to invest there can do so. Now, would you take out this little prospectus here while we're on that. The little white page I use there---we send this out every year and these policemen and firemen, if they want to invest with us, they don't have to. If you tell them they have to then they don't like it. If you say they can if they wish, oh, that's completely different. And they can buy units in this fund. In the late 1960s we set up a growth stock fund which of course is supposed to double every year. You know what happened. We're lucky---it's worth about what it was in 1970. We're luckier than most. But some people still want it. You'll notice the income share account which has been most popular begins on page 10 of this prospectus. It's 50% in bonds, 50% in stocks. The yield here is about 691 and units of this are purchased by the various police and fire funds and invididuals in deferred income plans.

You see when you have a centralized investment department you can do so many things right there. I don't know if you have that here yet or not, but some legislators for example from the Minnesota legislature---or, for example, we have a man by the name of Pillsbury. I don't know if you ever hear of that name, but his income isn't primarily from his legislative salary. Let's put it that way. And the way we do it with Mr. Pillsbury, he wants it all put away for when he retires. So he gets no salary. He puts it all out in one of these funds. And, of course, the Department of Revenue knows and that's OK and therefore it's not taxed. It's a terrific benefit. And we do all of that through these funds. We use it for police and fire funds, for this deferred income business, anything else.

Then we also have recently a fixed return account. If you turn to page 14 in this prospectus---you know in the last few years nobody likes stocks anymore. Everybody likes bonds. So, if they want a green suit, we turn on the green light. I don't advocate all bonds, but everybody wants all the bonds. So we said, OK folks, let's do it. So we set up this little bond, the yield is 8.72%. I'm trying to build up reserve ---you'll notice all these AAAs here---you folks in back will have to admit that's pretty good. We don't want risk. So we just want the people here that just want income. They don't like the stock market and out of this 782, we're able to guarantee them about a 8.1 to 8.3% return. And, needless to say, that's good for these funds. But again, it takes somebody locally to explain it, to go out and talk to all these folks and say you have an advantage in working through us and, of course, we print about 10-20-30,000 copies of this little handout every year and it's given to these people and they feel some incentive to work in the schools or the local government or the state, of course, of Minnesota.

Then let's go on here. We have the variable annuity fund. Now that's a concept that came up at exactly the wrong time. But this shows what happens in a state when you do something that you admit is wrong and then have to back out of it. In the late 1960s, everyone realized you didn't need a guaranteed benefit. All you needed was to put money in the hot stocks and, of course we all knew they'd double next year or the year after that. We decided to buy some stocks like

IBM and Minnesota Mining and they're less than I paid for them now. We bought an awful lot of Eastman Kodak and that's the lowest stock in our portfolio now. We bought a little Buckley Meers, which is a local company which is in television screens, and I remember it got up to 44 and I got a call from a teacher at one of our colleges, said, "Blixt, you stupid fool, why are you buying all these big companies. Put it all in Buckley Meers, it's at 44 today and it'll double by next week." Well, I explained that it might be speculative, I think the stock sells at 3 today and has most of the time since. You've got to get the people out of that thing. But still, they wanted the variable annuity. Well, they couldn't understand how that thing went up and down whenever the variable annuity went up, it's because I was lucky. When it was down, it was, "That stupid Blixt." And that was going on all the time. Especially because we had a two year moving average for our variable annuity. We decided it was wrong to take the market price at any one time. So instead we have a two year moving average.

Let me show you the trouble I got into on that one. Turn to page 4 and 5. You know the market really hit the skids in late '74. What they didn't realize was with every two month average we were showing this thing in '75 and '76. And in 1976 some people called me and said, "Blixt, how can you be so stupid?" You showed a minus 0.10% income even though the market went up last year." I had to say, yeah, but we still have the '74 figures in there. Well then, this last year the market went down quite a ways, but you notice we showed a 15.94% increase. Well, you need just a little book like this to explain.

Well, needless to say the variable annuity concept is not one that is going over. Wisconsin with a $500 million variable annuity is going to eliminate theirs this year. This has been half eliminated. Teachers can only put in half of their salaries. Some still want it. But again there is a lot of hand holding. This is the first time we came up with a separate annual report on this, July 1, '77. We are taking it to the legislature. We expect them to more or less eliminate it from the standpoint of new money this coming year.

But here again, if you need something, explain something. The school teachers were going to the legislators. "What's wrong, why do you have that stupid investment man? Why don't you legislators get good investment laws?" You see how it helps to have something float for a few years. And, of course, I have to speak to the teacher's union; I had to speak to the Minnesota Educational Association, give them copies of this, of all the information so their field representatives could go out to the schools of Minnesota to explain the situation.

This is evidence that my department is partly an investment department, isn't it? But also a hand holding department, public relations department and really we have to do in a sense what you do in the legislature---it's selling your program. It's selling what you know is right. But it is selling. It is not just doing what you know is right. Or you won't get elected. And when we are in business like we are, we have to look at both sides of it. I don't mean compromise with what is right. I don't mean that at all. But if you want to do a program and if you want to do it true and want to do it the right way, you simply have to be able to get the public behind you and that's the reason for all this stuff. We don't have fancy brochures or anything. We have to do it on green newsprint or white newsprint in state offices. But it works. And we get the message across.

OK, then to this little handout here, Permanent School Fund shows our other investments and we pretty well go through our stock and bond portfolio.

On the next page, page 5, I inserted this for no particular reason except that it is more detail of where we were at the end of October. This is just a little worksheet that is put out in our department every month that we look at, my analyst can see what we have, the money that is coming in, the growth in funds and that type of thing.

And then I'd like you to turn to page 6. This is an exerpt from our new annual report. As you know, people have different ideas as to what makes good investments, depending on what has happened lately. Four years ago, nobody asked me what the yield was. Nobody asked me. They asked me just one thing. What has your performance been lately? How much has your account grown? How long did it take your account to double? Now nobody asks that. They ask what is the yield. Until it's time to explain that, look the yield is going up, we don't want an 8% yield. If we had an 8% yield on a long term bond; if Carter gets in trouble and has to fire Burns and it goes back to 3% interest rates, give me a few years. The telephone bonds are sure to be refunded right away. They have 5 years. The other corporate bonds will be refunded in 10 years. We're going to have just a 4% or 5% yield again. "I want something more than that." Folks, won't you please go along with me and give me time.

Well, in our annual report we're going to have a chart like this. You'll note it has a sort of gentle movement upward. And when the folks come in and say what's happened to the yield, I say, no, we don't give 8%, we don't give 9%. But please look at the general trend of the chart. Now they are so accusing me of stock market action that you'll notice ---now this is the first draft of my annual report. This is the cover that's going to be on it and then you'll have--- this is the new annual report. The old one is the green book. But this adjustable fixed benefit fund went down so much with the stock market decline, you don't find a graph of this showing this terrible canyon so to speak right here. But I'm saying that isn't an accurate resume really of what happens to the stocks. We cannot base what we do on the fact that the market goes from 580 to 1050 and back to 800. What I'm interested in are the dividend increases coming through every year. So we keep good track of them this year for example the dividend increases along---that's the little dollar or two, pardon me, cent or two, that comes in per share in addition to what we had before. Those dividend increases might give off $5 million so far this year. I say that's what we want in the growth. So that I want to keep that income coming in.

As you'll notice, from 1956-7, it was 2.9%. Then about 1960 it was just a little over 3%. Now the yield is over 6% in these Permanent Funds. We feel we'll be able to continue this until about 7% with this present portfolio. If we keep in stocks, we aren't going to be able to increase much above that because, of course, stock yields just aren't that high. But many said, "Oh, it went down. That must be when the market crashed." Not at all. It was just the opposite. We put these here to show what happened when the market went up. If you'll notice that peak was reached in '71 and then it went down in '72 because when we started buying stocks at these extremely high priced earnings ratios in 1972, until early '73, the yield went down. So I'm trying to show the folks from the legislature there that this yield we hope to keep in the general swing upward. But that it will tend to go down a little bit when you have an extremely high market simply because when the Dow Jones is at 150, of course, or 1050 rather, and the yields are 2%, you don't get the current yield in the account.

On the next page, you'll see a little bit about the money we handled. You'll notice we have short term money of $819 million in governments and $250 million in corporate bills. I just have two men handling that. They do a very good job. For a while I think we were the 10th largest short term fund in the country, right under Bank of America. We had over a billion bucks. You know for a while we had a surplus in our treasury of about $600 million in Minnesota. And then we had the $250 million highway fund and we had $150-$200 million in the various retirement accounts. So the short term money debt is just a lot of fun. I have two people handling it; they do a good job. Then you'll notice we keep in equities, common stock, about 32%, fixed income 35%. And then in the big circle on the bottom, you notice our Permanent School Fund is only 8% of our assets. But we're able to use the same department because we have similar types of investments in all of these funds.

Would you turn to the next page. So many of you are asking something that I am sure is very important. What do you have to do to get a department internally? As you know, my salary and the salaries of all my clerks and everything else are public knowledge, so I just put it on paper here. Some of you ask what does it cost. I don't think you could compare our department with what you need up here. I guess we had folks running around making speeches all the time, some spending their time in the legislature, holding hands as I mentioned with every teacher group and Kiwanis Club, attending meetings of the various retirement associations. We had to work out financing for a national park, we also tried to work out financing for this reserve mining problem there. And it is a sort of overall financial and investment advisory office. It's going up from three people back in 1960, four actual little files, to 29 people at the present time. But this is our budget for this year and I'd like to explain what we're doing. Obviously, I would suggest nothing anywhere near this large for Alaska if you were starting a permanent fund. First you have to get your feet on the ground.

But I'd like to mention two things that are important. You've got to pay salaries to get people that are adequate. I mean, you can't hand somebody $200 million a year and give them $10,000 and a canoe and say you can have all the fishing you want up here, I mean that doesn't work.

Secondly, you've got to give them some travel money. You can sit on the phone and take calls from brokers who say I've got this today, it's a good deal. No. He has got to get to the financial centers. He would have to get to New York, to Chicago, to Los Angeles, San Francisco and meet some of the people. Meet the people you are dealing with. Meet the correspondents and the bankers, make it to some of the banks there. That I would say is important and our budget is a little weak there. You will notice the general administration of our department, which is 29 people. There is myself, the state pays me $41,000 a year. I might say the wages in Minnesota---I don't know they compare with yours---our governor gets $59,000, our attorney general gets $49,000. We have somebody that seems to be comparable to your position, he's called the commissioner of finance. But it's a political thing.

GALLAGHER: Ed Rymer?

BLIXT: What?

GALLAGHER: Ed Rymer?

BLIXT: No, Rymer is the commissioner of taxation or of revenue. Now he gets $41,000, which is what, about the top 10 of us get. But there is one above that, the commissioner of finance, who works on the budget and he can get thrown out, he will get thrown out, with every governor.

So he gets $45,000, mostly because of that lack of tenure. Rye Murphy is going to stay on because he's a good professional man, our commissioner of administration will stay on, Democrats or Republicans. So there are about 10 of us getting $41,000 a year. We get more than the treasurer or the auditor, they get about $29,000 a year. The other department heads in the state get about from $30 to $34,000. I don't know how that works in Alaska, but you see where we are.

Then I have an assistant executive secretary that gets $35,000; he does most of the portfolio work. The portfolio coordinator is a young lady who seemingly is able to deal with the legislature, brokers, everybody else a lot better than I can and she's a real brain. So you'll notice we pay her quite a bit, $22,000 a year. My main secretary is called an administrative assistant, we pay her $12,800. And the secretary to Art is getting $10,000. Our short term money department: the head man gets $24,000, the, pardon me, $34,000, the second man gets $24,000. Our fixed income group: the department head gets $28,000, we have two analysts getting in the mid-twenties, an accounting coordinator---he's a CPA by the way. He does a real fine job at trying to work out all these accounting problems with bonds. He's a young man, gets $22,000. In the equity department, we have a department head that gets $32,000, five analysts and the treasurer and then in investment operations you'll notice we have a director, transaction supervisor, three accountants, a secretarial staff of five people and a computer operator. Salary costs to the department are $590,000 this year, with our retirement and group insurance we have $667,000.

Then on the next page---you know for rent space---I don't know what it is in Anchorage---we get our rental for about $5.95 a square foot per year. We rent space because there is not room in the capitol. But then we mostly have a Xerox lease, market information, all this other information here you see where it is---travel. $198,000. Office supplies, equipment purchases, our budget is $875,000. You wouldn't need that here in Alaska to start with by all means. I would say $250,000 would get you a very good investment department at the present time.

Could we turn back to some of the other information. One thing we find it is extremely important to do is to work with the legislature and the people in our work and show them what we are doing, not only from an investment standpoint, but also from a distribution of business standpoint. I know in Minnesota, and I suppose it is the same here, you all have people who say, "But I have an office in Anchorage. You've got to butter me up first. I have an office in Fairbanks."

Or maybe you have something like we have in Minnesota ---they're called local bankers. I have a bank here therefore I need a deposit of so many hundred thousand dollars or so. That frankly stymied our investment program to begin with until we had a Republican, Bell Bjorenson, the governor, Orville Freeman, maybe you've heard of him, he's the secretary of agriculture, who simply went around to the bankers associations---the two of them---a Republican and a Democrat---in 1960 and said folks, we've had enough. We can't have our deposits in your bank. At that time it was 1% by the way. We can get more. And they still cried and say, "Yeah, but you're doing so much for the state of Minnesota." Well, they say, well then we aren't going to do that for the state of Minnesota, but I am the leading Republican and this guy is the leading Democrat and you bankers better vote socialistic then because we're going to take the deposits out of your bank. We did. And put them in long-term governments and other things that have worked out very well.

But it was bad. The ramifications were tremendous. We had to take the time deposits out over a stage of two years. The bankers literally wouldn't give us our money all at once. We withdrew half of it, two years later we withdrew the rest of it. Then one bank said, "Now about governments, you have to do it through us because we've always had the state accounts." So we always did it through them and found that they always went to New York to one particular investment house because that bank had its chairman of the board on the board of this investment house.

So it took another four years to pass legislation requiring us to go out for bids and offerings every time we traded in governments. We had all kinds of fights until the early 1970s and then we simply went out to the banks with bids and said you will handle this amount for how much. We've taken all the accounts back from the various banks in Minnesota except when we have an analysis made. One bank will handle the investment work. One bank might handle the account for the welfare department. One bank might handle something else but in a general account, a bank, you know, that we caught on to financial management and said you can---we'll do all your work for a zero balance. They didn't realize that that's the way we worked it. The zero balance. We had a previous auditor that meant zero on the books, but of course after you pay school aids, which we do in Minnesota and did last week of $350 million, you know your books can say zero, but really you have $350 million still in the banking system until the mail comes back. And I don't know how you are here, but we always have a superintendent of schools in Minnesota who gets his check for $2½ million and, instead of cashing it and investing it as he should, he puts it in his pocket and goes to Lions Club, "Say you guys, have you ever seen a check for $2½ million?" I mean that's sort of baloney. It takes 2½ weeks until we get the money back. So what we do now is actually invest that money and keep it entirely invested and the poor bank found they were operation on a zero balance. So they gave up the accounts the last year on a bid basis and now another bank has it. Yes sir?

MALONE: Thank you. Mr. Blixt, what did the banks do with the money when they had it if it was doing so much for the state? Was it invested within the state or was it invested in something else?

BLIXT: Now that's an interesting question and I would hate to say something to you, sir, that---a banker would say I'm a liar. But they always say, "We are investing in Minnesota businesses!" Especially independent bankers of which we have 400 in Minnesota. But when you start looking at their banking statement, their loans to Minnesota people were about 54%. And Poppa would sell the bank to the son or otherwise when he died the son got it. Instead of Minnesota, the son was always in Hawaii in the winter, he was up here shooting big game in the summer. He had half the bank assets in treasury bills and was he really invested in Minnesota? No. Not our independent banks. Northwest Banco and First Bank stock were, yes. But they're the big ones everybody is fighting. But we found that we could put all this money in Minnesota banks and yes, some of it came out, but were they investing in

Minnesota and the answer is no, no sir, they weren't. They were investing in treasury bills and municipal bonds and that type of thing. Admittedly most of the municipal bonds were Minnesota municipal bonds because the bankers got double tax benefits, you see, both on their state income tax and the federal income tax.

But when somebody says you've got to invest in Alaska for Alaskans, mind that you're in the legislature sir, you decide who in Alaska should get the money. Maybe it's somebody that needs relief here or somebody that needs help here. If you believe in the trickle down theory, you give enough to the bankers and after you've given him $10 million, he's apt to let a little trickle down, that's fine. We didn't find it that way in Minnesota, sir. It just didn't work that way.

But we have some very good bankers and I don't mean to criticize the banking community. We found our leading bankers, the folks at Northwest Banco and First Bank Stock Corporation, our First Bank System is called now, are just marvelous. They were asking for account analysis all through these years. They said, "Look, we would like to open a bank in this little town. We would like to serve it better." But of course every time they go before the banking commissioner, there would be five little independent banks in that town. Three of them say, "We're serving this community, don't let the big holding companies in." Now we have a silly situation. Our governor, Perpich, who, as you know, is quite a rabid Democrat. He's up there advocating the big bank holding companies and some of the others, some of the little independent banks, all the state's assessments are all mixed up at the present time, and of course the leading contributors, the leading politicians on both sides, it's a very delicate question. But folks, you just---because you put idle balances in a bank does not mean that that money will be invested in Alaska. They might be buying treasury bills and other government debts which will pay for all the boats that are on Midway Island and the Battle of Midway that have been down there for 20-30 years. I guess that's where we got our national debt.

But is that for Alaska? No. Treasury obligations, federal loan bank bonds, lots of municipal bonds, maybe from here or somewhere else. I don't mean to get off on banking, you'll notice my temperature goes up. We have those same arguments there and I think you face them here. They're in every state in the nation.

GRUENING: I just want to follow up on that. Are banks selectable for portions and if so how are they selected?

BLIXT: Banks get no balances in Minnesota today on any of these funds. None of the funds I've mentioned to you have a single time deposit. We don't have one dollar in the time deposits in Minnesota. The state treasurer does have balances in banks, but instead of banks all over---you know in the old days you said every county had to have a local bank for something, recent handle costs, everything. Now we've gone down from 300 banks to less than 100 and we have banks only in areas where we have a state institution, where we actually need that bank. If we have a university or state college, if we have a department of highways office there, we might have a little balance in local banks to handle the payroll. We want to treat them fairly in every way. But our balances have gone down---I think for a while they were a hundred million dollars in the early 1960s. Now the dollar is worth more and we've come down to about $60 million, $40 million, and now you'll find $10-20 million. And that's plenty.

GRUENING: How do you select those banks that do manage the...

BLIXT: On a term basis. We'll let them all come in---we hired a man who knows something about banking. He used to work for the banks. We've been able to do a real good account analysis and analyze did on this type of thing, how much they charged per check, how much per item the whole way through and we compare the data and give it to them on that basis. We don't care whether the banker is Republican, Democrat, who he supported in the last campaign, that doesn't bother us at all. It's completely open, all the banks can be there, they can all see the figures and they can see what the competition said. And it works marvelously and, frankly, we get on much better terms with the folks at Northwest Banco and First Bank systems since all this happened. It works, it works very, very well the whole way through.

OK. I see I have just a few minutes left. I would like to explain how our board works. My bosses are the five top elected people in the state: governor, auditor, treasurer, secretary of state and attorney general. Obviously, they have changed parties many times, but my position has to be non-political.

We also have an advisory committee of 10 leading people---I didn't mean to talk about bankers---they're going to shoot me. The trust department people, they're wonderful. Trust department people are my best supporters there. You'll notice our advisory committee includes all the bank trust department people, the top managers of money in the Twin Cities, the insurance company people, we're all the very best friends, I must have to say we've got a lot of our advice on bank management, so to speak, if you want to call it that, from these people. These folks meet every two months, under a recent law they're going to meet every month to give advice, these meetings begin at nine in the morning, all morning, through noon, until two in the afternoon. So it's a long meeting. We go over everything.

And I'd like to show you something more in this annual report. A few people want their palms greased. By the way, I might mention, when banks and brokers get together to fight, it gets a little rough. We had the little attorney general there, he came in in 1962 and wanted to handle this bank thing. And it's the only thing he really lost in his life. Finally it got so bad that he said he was never going to take them on again. Well then luckily, our then governor, a Norwegian by the name of Rolag, appointed him a senatorial job at the time, or I don't think he'd been reelected---you might have heard of him---Fritz Mondale---and he was a dandy board member, but he was trying to solve this stuff and he just couldn't do it. But this is what I'm saying he told me to do---please turn to page 35 in this report, please.

It says give out the business to anyone you want, be he Republican, Democrat or anything else. Just be able to justify it and tell them exactly what you do. So if you'll notice here on page 35, 36, 37, 38 and 39, 40 and 41, we tell just how we distribute the business. Then on page 43, 4, 5, 6, and 7, we have every order mentioned. But we gave it to them. Now there's a fine representative, I am sure he wouldn't do it here, will come up to me, "Blixt, uh, my brother-in-law works for this corporate shop in Anchorage and, you know, he's having a hard time getting things started. Now I'm sure if you give him an order for a thousand shares now and then, it will work." Hell, I say, you know, fine, you know that'll just work very well. We'll just put a little footnote, "This order placed at the request of Representative Clark Gruening." For some unknown reason, the Clark Gruenings in Minnesota have never asked me to do it. It works beautifully. And we have found that if you just keep everything above board, it works well.

Now we have another senator who wasn't as good as the other. It's the first time we ever had politics enter it. I'm going to show you who that senator is who literally told me that his palm had to be greased. He now heads the retirement commission in Minnesota. It got a little difficult. But what do you do with something like that? Well the way we did it is in our recent report---take out the loose leaf folds here---pass a little bill that says that my council members have to be honest. Well, on page 41, we list why we think our people are honest. If you have a pencil maybe you should underline that a little bit. Then on this next page, halfway down, we list the representatives names who even work for a brokerage house, even if we give them no business. You'll notice the investment department has been informed, I'm talking about this third paragraph down, of only two members of the legislature who work for brokerage houses that deal with the State of Minnesota and therefore may present an appearance of a conflict of interest. And then we list the two people, one of whom is very innocent and one of whom is guilty as sin. But it says here a senator has no direct benefit from the state account, we have been informed of bla, bla, bla. But by simply putting his name there we don't deal with him by the way, we deal with the firm, but I think it will do a little bit to inform---to keep it that way.

I don't mean this in sarcasm, and I don't mean this in a way in which a bureaucrat is doing something that maybe elected officials wouldn't like. But my top bosses have read through this, that is, the governor, auditor, secretary of state, attorney general, and the man in your position, the commissioner of finance, that says, "Bob, you've got to do it. You've got to do it. If there's anything that pushes you, put it right out in print and then it becomes honest." And folks, that's something else that I think would help you very much here in Alaska. You're going to get pressure from banks, you're going to get pressure from brokerage houses, you're going to get pressure of other things.

I'm leaving copies of both of these. This won't be printed until next week. You'll notice I just have the cover with some Xerox copies which aren't too good. I'll send you the final copies when they're ready.

But I think we'll point out the things we do to try to inform the people of Minnesota of what we are doing. Obviously these reports are too expensive to send to everybody. We give them to the legislature, we give them to anybody that wants them, the entire borkerage community. By the way, this distribution of business is interesting; we send it to 10 German libraries every year. They want to know just how Minnesota---or how a United States public fund is handled. And we sent it to public funds throughout the country. So we find there is some interest in there.

As far as our operation, I have mentioned that we have a board, we have an advisory council, we have a pension retirement commission made up of 10 legislators, we deal with other legislative groups all the time, so we're under all kinds of controls. We do everything in-house. We have a legislative auditor. I don't know if you have that. You should have an auditor directly under the legislature. Not under the government---if there's some fraud ---I don't mean---the administration. The legislature gets there too. He comes and goes all over our books.

I place all these orders but I'm not allowed to pay for one dime of it. See, I place the orders. And somebody in my staff then writes a memo to the treasurer. The treasurer then gets our memo and then a couple of days later gets billed by the brokerage house. And it's the treasurer that pays for it. Then, not only do we have that double check on ourselves, but then the legislative auditor comes in. So, I think it's a pretty good check and we have all the various departments.

GRUENING: Is that a---would you list that as one of the prime reasons to separate the revenue and investment functions of government?

BLIXT: I think they should be separated. And I think the investment function should be completely separate. There are so many things there, if taxes go down, or say if oil receipts go down, we want to do something with the investment. And, by the way, I have another suggestion that I want to pass out which may be wrong and maybe you haven't heard before.

Folks, I would cut down your investments in your---pardon me, in your Permanent Fund portfolio in the oil industry tremendously. We just don't use iron ore stocks in Minnesota. For one reason. Our politicians are always fighting the iron companies. They always want more taxes out of them. They always want this and that. And if I had U. S. Steel and Inland Steel, we'd be going up there fighting them all the time saying we're stockholders, we're going to come to your meeting and everything else. In the paper last night, they're still disagreeing here about the taxes to be paid on that pipeline. Why in the dickens do you want to get mixed up in the oil industry? Do you realize your investment is so fantastic in the oil industry right now that if somebody discovered you could run an automobile on hot air or steam, if somebody decides to use nuclear power plants entirely, the oil industry might be out of business. I don't expect it. But on the other hand, you are so invested in oil right now that I don't think you should just follow the charts of an average investment portfolio and say, well this percentage in oil is something else. I would cool your oil investments. You're invested up to here right now. Your revenues are so dependent upon the oil industry. Why don't you diversify in other areas? And you're here literally in the center of the world, you folks should be looking at Japanese investments. You're so close to that economy. You could get all kinds of information. You should be looking maybe at British and French investments.

GRUENING: That would be a switch. If we bought up in Japan.

BLIXT: Then next time they declare a war and attack Pearl Harbor, you won't have to worry that they're going to bomb Anchorage next. You'll own half the place.

GRUENING: We'll have a proxy battle and win, huh?

BLIXT: If you have a proxy battle, it'll mean the legislature will be able to appropriate funds and those legislators will go to Tokoyo, you know.

Now, I don't mean to be facetious, gentlemen. But I don't think you should get a double whammy by investing that way. I think there again, I would suggest that you tailor your investments to Alaska. Not just because---oh, Manufacturers does this, First National City Bank does this, First in St. Paul does this, Blixt does this. No. No. What I do isn't right for you. You folks might want a heavier investment in iron ore, a heavier investment in steel. I would cut way down on your oil investments in your portfolio because you are so invested already. Again, I think your portfolio should be handled entirely, as I said, for Alaskans and for a special use here.

I would like to spend just a couple of minutes, and I see that's all I have left, on some of the pressures we've gone through. We've had tremendous pressures from the municipal bond agents and the Twin Cities who let the bonds. They're tax exempt. We've been threatened. We do not buy municipal bonds from any Minnesota municipality or the state or anything else. We keep that out. The state finance agency, a housing agency, wants to buy housing bonds. Of course not. We can sell housing bonds on the tax exempt market. Why should we use trust funds that we can invest in corporate bonds ---we're getting over 8%, when our housing agency can sell bonds at about 6%. So, therefore, we do it on that basis and, by the way, we're able to get better rates on our state debt because we have the state retirement fund and the state trust fund invested at a higher interest rate.

Also there is always the pressure on us to invest in some local interest. Somebody wanted us to put up a paper plant in northern Minnesota. All I have to say is I don't know how to run a paper plant and we didn't do it. But what we really had in the line of pressure was someone that came to us and said invest in Cedar Riverside and Jonathan and some housing projects. We said no. There were some of these young towns, maybe you've heard of them, they've all gone bankrupt throughout the country, but we waited until we got a U. S. government guarantee. Then we bought it. Sure they've gone bankrupt. But we buy these government guaranteed securities and don't take the risk. We use some government guaranteed shipline bonds, government guaranteed hospitals, government guaranteed Ginny Maes, and it works out very well. But with the state investment here you can work out everything. The banks said they needed help in student loans, so we helped buy student loans in the sense by using student loans rather than government paper. Somebody said you've got to get into the Small Business Administration loan. I don't want to get into that, it's too political. So we have a bank representing the Minnesota Bankers Association taking these small business loans. The banks will take the 10%; they'll sell to us only the 90% that's fully guaranteed. We buy that at a good market rate and if anything happens the banks handle that for us. So you see, we're able to handle things by being a state department and working through these agencies so very well without taking any risk at all.

MALONE: You were talking about young towns a moment ago. Alaska is in the process---a long drawn out process---of relocating its capitol city. I take it from your remarks you wouldn't advise investing in that.

BLIXT: Not with permanent school money. For the simple reason that you have so much welfare, so much permanent school coming in, I think you should sell bonds on the full faith and credit of Alaska and do it on a municipal bond basis. A tax exempt basis. And the---let the folks in high income brackets, have the banks, have the insurance companies, buy those full faith and credit Alaska bonds, and one thing that will add to that full faith and credit will be a real good investment portfolio in governments, in Ginny Maes, in AAA corporates and some common stock. Now I think that you defeat your purpose by taking money that can earn 8% and putting into a project where you could get the money at maybe 5%, 5½%---what would a full faith and credit Alaskan bond sell at today?

GRUENING: I don't know. Ask the commissioner

GALLAGHER: 5¼%.

BLIXT: 5¼%? OK. Well, if you can get over 8% and a U.S. government guarantee, why do you put something in a security when you could get the money at 5¼%? You see you can just make 3% on the difference there. By all means...

GRUENING: Unless you want to get around the voters. That's one way. I'm not advocating that.

BLIXT: Why don't you have a local investment man, and a finance man, and a few others go and talk to all those voters at the Presbyterian Church and the Lions Club? You know, the people in Alaska aren't all that stupid. I really feel that way. I think if you can talk to them...

GRUENING: I agree with you.

BLIXT: ... if you have a local base of operations so to speak and are able to explain it. It's so logical. But you need a little enthusiasm right here. We do in other states. Why don't you do it here? You're not any more stupid than any of the rest of us. We're so much afraid of being Swedes in Minnesota.

GRUENING: We have a couple Norwegians.

BLIXT: Well, they're worse, of course. I say I went to a Norwegian school, I'll have you know. Pay no mind... OK, I think maybe I've said all I needed here except that I would strongly suggest that you resist the pressure for higher yield in a diversified portfolio, review your revenue projection, the loan fund activity that you've already done ---sure---I think it's extremely good. I would of course suggest that second thing down, as you can presume any investment man would suggest, that---the second column---on page---right here? The investment one? I think it's a good ---this is a very good brochure by the way, whoever did it. And be careful with what you do, but keep control here. But have an agency that's working under you so that they can be subject to your ideas and can do studies for you to help your commissioner of finance or the administration and taxation do a better job in that way.

On the last page I have just mentioned a few thoughts which I don't mean to include anything you haven't thought of already. But you'll notice if you hold incoming oil wealth as a permanent investment, it provides a stable source of income, it would contribute toward minimizing future economic problems. And of course it minimizes the amount available for these current purposes, but I point out why that might be a minor disadvantage. If you'll notice the problems involved with using this money for Alaskan development just like in Minnesota is that a loan or guarantee often becomes an outright subsidy. We found that so often in northern Minnesota. Investment risk often becomes confused with political practicalities and pressing current needs become less mandatory when viewed from the future.

I then mention here the tax exempt bonds that could be used for many of your projects. I point out that there are disadvantages from a long-term investment standpoint and that citizens do not often understand why you would put your money in investment and then borrow money. But I think they could be educated.

My conclusion, you'll notice that the last page, is that leaders of all states with trust funds recognize the validity of holding funds for the future under proper investment management. Yet many states have modified or stopped accumulating all funds during periods of low interest rates such as we experienced in the 1940s and the 1950s or when demands to satisfy current needs that seemed paramount. It is logical to hold as much as possible for future generations, but holding any amount is better than holding nothing.

Legislators may take a course which is politically feasible in order to protect and save whatever possible for future generations of state citizens. To protect a part of the assets is better than to lose everything because of public demands for current expenditures. And I think you people are doing a tremendous job. And these programs here---you're saying we may have to spend a certain amount for current expenditures. We have to build up our government, but on the other hand I think that you're doing a tremendous job in just going through everything and looking at what other states are doing. I have copies here of some of the Minnesota statutes that may interest you.

GRUENING: What all is in here? Is this---cover all the investment statutes?

BLIXT: Our investment statutes, rule like proxy. Let me try to find the one here, I guess this is the one I have. The first page here is just the Minnesota constitution where we have an old Permanent School Fund, the words now perpetual and inviolate that I talked to you about which is interesting there.

The next page, first on page 152, you'll find the Permanent

School Fund investments. A very conservative investment policy as outlined here, 20% in equities, 80% in bonds, and only 40% in corporate bonds. So, in other words a good part of this fund must be in governments. But that includes Ginny Mae mortgages of course and we can get a higher yield there than in many other things. Then you'll notice on the next page, 153, we have a general appropriation language for all the investment programs. On page...

GRUENING: On mortgages, I just want to interject...

BLIXT: We have no mortgages allowed here.

GRUENING: OK.

BLIXT: For a very good reason. You say, why? I don't want to be the guy that kicks a welfare mother and 10 children out on the streets of St. Paul when it's 30 below zero. Everybody all wants us to buy a mortgage. We have more mortgage salesmen in the state than anything else. But I don't want to buy a mortgage unless it's a government guarantee because I don't want to make that decision.

Now, by the way, there are more people in there trying to sell us mortgages in Minnesota than any other kind of security and they always mention that they gave $100 to the governor's latest fund raiser. They mention that first and then they show us the mortgage. The governor told me not to listen to them. Because if it was a really good mortgage the banks and the insurance companies and others would be in there.

Now at least we could have bought the real estate. And you know real estate has done far better than stocks and bonds. In fact a year ago I talked to the Continental Illinois Bank and they said they were going to set up a little fund of farms in Minnesota, Iowa, Wisconsin and asked if we'd like to buy it. I said, oh, that's just fine. Our secretary of agriculture a few months ago, as you know, and the first thing he did was complain that some vicious corporation was out to buy farms in the upper Midwest. And he didn't realize that it was me and my equivalent in Wisconsin and Iowa and Illinois that were going to do that. So, we haven't been able to get into real estate that way. But I don't want to hold the mortgage unless it's a government guarantee behind it. Ginny Mae, yes. We tried to buy a lot of Ginny Maes of Minnesota mortgages. Do I---yes?

GALLAGHER: How about the PMI? Private Mortgage Insurance?

BLIXT: We have not goine into that yet at all. My legislature has said cool it. We do use Ginny Maes on some hospitals. We buy a few bonds which are really mortgages. Like for example one insurance company, I believe it's Gulf Life in Florida, sold a bond issue a few years ago which really is a mortgage. But they felt they had hot enough analysts that they could buy some secondary securities and they knew they'd get an AA rating so we bought in essense a mortgage on their life insurance building, but it was presented in the form of a bond.

We have no mortgages in Minnesota. The demand has been tremendous, but every time the legislature looks at it and thinks that the state could be in there kicking people out on the streets when it's 10 below zero, that's the argument. They say they just want no part of it because there is enough capital in Minnesota. The banks can always get from correspondent banks in New York or Chicago, the savings and loans are very strong in Minnesota. I realize that it's an individual situation. We may get in there yet. We may have a mortgage committee. It's being talked about all the time, but we don't have a cent in mortgages today except the government guaranteed ones. We feel it is advisable and far less political.

If you want to go through the statutes, we have treasury statutes---I don't want to go into the time for the next people here---on page 155, just about---by bond---then you'll notice the state bond fund is mentioned on page 156. The retirement system is generally on page 157. That would be our main investment statutes right there. Then we have modifications, for other funds. Like the highway bonds on page 160, the various retirement funds, the supplemental fund is on page 161, we have the income share account, the growth share account, and the fixed return account there.

GRUENING: Is your statutory framework in here, too? The---

BLIXT: Of my department?

GRUENING: Yes.

BLIXT: Yes, How I'm set up is right in these statutes. I regret to say there is not a good order because, I bet it's just like Alaska. You pass a statute this year and it's put on the end of the chapter. And the next statute goes on the end. We really should have a modification. Yes, sir?

MALONE: Thank you, Mr. Chairman. You may have mentioned this, but I didn't hear it, Mr. Blixt. The expenditures of the investment program are appropriated by the legislature like any other state expenditures?

BLIXT: In great detail. Yes, yes sir. Yes, they question me on everything. Frankly, I disagree with them a little bit. They tend to have more people than I need. I have one or two extra people this time that I'm not going to hire. I don't get what I need for travel.

MALONE: But it is part of the general...

BLIXT: But it's part of the budget. It's a line item, sir.

GRUENING: Does the operation expenses come from the actual investment income or what we call the general fund which is...

BLIXT: It's been coming from the general fund, but we've had a debate there. A few years ago, because the governor wanted to save on the general fund budget, he said, wouldn't it be better to take "x" amount from the highway funds, "x" amount from the invested treasurers cash, a certain amount from each retirement fund ---that would be better. That way you have no general expenditures. You're just out of income. Well, everyone said, well that's fine, but then the treasurer's fund earns more, the highway department earns more, and by the way, we ended up with a bunch of people like this in the capitol who said, well the highway department does work for this and this, let's transfer money from all the departments to the highway department. And welfare does something for them---let's transfer that in. We decided we'd have to have a floor on the new building just to have accountants transfer money back and forth.

Now the legislature wants to question me and boy do they do it. I'll spend an hour in a session like this with a grilling of---even the subcommittees are composed of about 12 people down there. As you know we have a 200 person legislature. It's a big one. And we really get grilled on everything. But it's a line item budget.

GRUENING: What committees do you report to? Is there a specific oversight committee that you report to? What's your first---how do you go through the gears there?

BLIXT: Well, we have many gears. An appropriations---in the House, appropriations committee, a Senate finance committee. We have subcommittees of both committees that look at my budget in detail.

Then beside that we have a House operations committee and a Senate operations committee which are concerned with general state operations. Now all the pension law, retirement fund law, must come through the operations committee. They in turn have subcommittees. One is on---well, five persons in the Senate, five in the House that are on legislative subcommittees looking into pension law. Now those five senators and five representatives meet together, which I hear maybe you don't do here so much---I think it would be very good of the Permanent Trust Fund legislation---I enjoy those smiles, but really in Minnesota, some of the time the representatives and senators are on speaking terms, really they are. And they meet together and they've even been known to have meetings together if it's something more or less non-controversial. The five senators will say, "Yeah, I'll move ---let's go with the House members---yeah, OK." So they have one hearing together and then they go through their respective operation committees.

But that's generally the framework. Now, as I described it, I've gone before tax committees, all kinds of committees, rural committees on farming, committees on housing and everything else because when you have a state investment department, you literally end up going to every committee in the legislature talking about something.

But that's generally the framework, but it is a line item budget and we have to send it first to the commissioner of finance, then the finance department, then the staff who works for the legislature and they're rough.

GRUENING: Which legislators and which committees seem to have, if any, the greatest understanding of which your operations takes?

BLIXT: You still have---boy, this is a blunt question you are asking me to criticize my bosses, but I will. I hope there is no members of the press here from Minnesota. There used to be a group of people in the Senate and House on the pension committee which were just fantastic. They were from the banking community, insurance community and wanted to do a better job. And my first 10 years, which was very smooth sailing.

Recently we got some new people and they got in mostly on the basis of telling people they'd increase pensions. So here one of them says they'd double and quadruple pensions without thinking of actuarily accounts and feasibility and then they got in some difficulties. At that point I'd say the really rough question was supervision of me tended to go more toward the finance committee and appropriations committee rather than the pension committee.

And in finance and appropriations we have some people who have spent just enough years listing the people wanting funds, wanting appropriations. So they can just smell out something that's false. I don't know if you have that here. But soon they can just see a crooked request on paper. Yes, they really question you. And they ask you about these policies. Is it necessary? Do you need people for this. Do you need bond analysts. Do you need stock analysts? Do you need to go to New York and shouldn't you have more of a phone bill? Do you need this subscription? God, they'll be very pointed in their remarks.

But, as you know, I suppose you have it here too, you have a few people become experts---and we also have a few people who think they are experts and they give us a rough time. We have some of those including this one broker who has his hand out and he's giving us a terribly rough time at the moment. But generally we've had very, very good response from the appropriation and finance committees. Now I've taken too long. I've gone into the next deal here. I have a lot of things...

GRUENING: If there are any questions...

BLIXT: I appreciated the opportunity...

HAUGEN: Yes, I just wanted to ask one quick question. What's the total state budget?

BLIXT: It's up in the billions at the moment. I believe it's ---the last legislative budget was about $6 billion. For two years $3 billion.

HAUGEN: Bi-annual? $3 billion a year? Relating it to the number of state employees.

GRUENING: One other thing on the competition of banks for management of these department funds, is that statutory or is that regulation or is that---how does that...?

BLIXT: They set up a new finance department 4 years ago and took this power away from the elected treasurer. The finance department is now under the governor. And yes, now we must do it on a bid basis. Below this will be explained. I'm going to send a copy here to your committee...

GRUENING: Is that including the statutory material---how the due processes work?

BLIXT: No. But I could send it to you. That is under the executive council, under the treasurer and the commissioner of finance. It's not in investment board statutes. By the way, a little bit of how we operate, I'm just going to send---these are copies of my latest annual---or my latest board meeting. You'll notice tab runs here of every purchase, of every treasury bill, including who we bought it from and the commission. And this was given to the Minneapolis Star, the Tribune, the Pioneer Press, Associated Press every time. I'm going to---yes?

MALONE: Mr. Blixt, how often is that generated?

BLIXT: This board meeting is every two months. And that's a board meeting there. We also have a meeting of our advisory committee every two months and my analysts turn out this material on every stock we have which is similar to what the big bank trust departments have---we don't pretend to be in detail---like you have heard this afternoon, but I want my analyst to keep track of it. If you just want to send this around too, it shows some of that material.

I have some other information, but---oh, yes, and when my advisory committee meets, they want to know generally what's in the fund. We have a marvelous computer system so if the market is closed today, in another hour or two I can have a run of every asset I have in all the accounts. The computer is right in our office, including tonight's prices on the New York Stock Exchange, the dividends, the yields and everything brought up to date. And we give this to our advisory committee. Also, this is not real recent, it's November 4th, it's not real late either, but this is from our last committee. It's what we used there in managing funds and I think the main story we have there is we simply...

GRUENING: Is this the advisory committee?

BLIXT: The advisory committee is 10. Ten people chosen by the State Board of Investment, the leading institutional people.

GRUENING: And they're per diem---they're not full time?

BLIXT: No per diem, they get no expenses. It started a volunteer committee, one man comes from Duluth, one from Rochester, we try to give them the equivalent of a train fare. Except there is no longer a train there. They don't get much. They are on their own entirely and they've done a tremendous job. We feel it's in the interest of these financial institutions to try to keep the state in good financial order. We've never had any problems getting the best advisors in the state.

I appreciate so much the opportunity to appear here. As I say, I still don't know why I was asked. I have nothing to sell and I assure you Minnesota doesn't want to take over the Alaskan funds. I've had a lot of fun. We've had a lot of fun being here, I've talked to folks all over the nation on this. There is about 10 of us that manage state funds throughout the country that like to speak with others.

I guess you might say we're missionaries in a sense because I think we are able to accomplish quite a bit by just dealing with people. By being available to talk to legislative committees. By being available for the church groups and the Lions Clubs as I mentioned. Because whenever you have a program like this it's so important to have the citizens of the state realize that it's better to put the money away for the future generations than to spend it on them so they can buy booze tonight. And you know that's a very difficult thing to get across. Thank you very much.

GRUENING: Thank you very much. Mr. Speaker.

MALONE: Mr. Chairman, Mr. Blixt, I'd like to thank you for a very articulate presentation.

BLIXT: Thank you. It was a lot of fun being here.

GRUENING: Are you headed back to your home state or what? What are your plans?

BLIXT: I'll be honest. I'm a tourist. I get up to Alaska so seldom that when you folks were nice enough to pay a plane fare, I'm going to stay here a couple of days and see what Anchorage is like.

GRUENING: Well, welcome to Anchorage. Terry Magrath has been waiting patiently in the back and it's running a little late. Terry would you like to...?

I should say a little bit about the hospitality Terry gave me in Boston. I came up the day and he showed me around the place and he talked to me a little bit about their operation and he represents a management group that is not---it sounds pretty progressive and I would like to maybe just relax a second. Those that want to get coffee can go get it. And we'll start in just a second. Terry?

MAGRATH: Ready to begin? Well, as Clark mentioned, the reason I am here is that he came to visit Fidelity in Boston and mainly to ask us to describe to him more or less the state of the art of large institutional investing to give him a framework and his people a framework so that as you go down the line in setting up legislation for your opportunities here, you would at least see sort of what is happening.

Fidelity is a money management organization. Manufacturers Hanover---one of their functions is money management, but Fidelity's sole function is money management---that's all we do. One portion of Fidelity manages about a billion dollars in assets for a large corporate pension funds as such. The part I'm responsible for is---manages international assets for this same type of client.

Now, I'm not here really representing Fidelity. There is nothing really we can do for you at this point. If at some point down the line you are interested in seeking outside management for a particular function or something, we would be glad to participate or compete just like Manufacturers Hanover, or anything.

All I'm really here to do is to respond to Clark's and Beldon's request to more or less lay out the general framework of institutional investing more or less so you can see some of the problems, some of the structures you're going to have to face as you set this up. As I mentioned, Mr. Blixt has pretty much covered most of what I wanted to say and I'd like to cordially invite him to come talk to the Massachusetts Legislature and see if he can bring some of his efforts to bear at our zero credit rating state.

One other point, Clark did say that when he was down there that he would like me to come up and talk to you people and that if I came up here he would show me a polar bear. He promised to show me a polar bear. He then suggested that I stay at the Captain Cook Hotel and after I got to the lobby and saw that stuffed polar bear I realized why he had asked me to stay there. Actually I do want to say---this is an incredible state and I'm very personally pleased to have been asked to come up here. I think you people have a wonderful state and it looks like the way you are going you will be able to keep it that way.

About asset management, I was going to cover a little bit of the history which Manufacturers Havover has already covered. Some of the current state of the art. And some of the trends in force in institutional investing. And I think this is an important point. You saw a lot of investment verbage today, some of the ins and outs, some of the particularly professional things that go on in institutional investment. Seventy percent of the market today is institutional investors. You people coming in with what---$2 to $8 billion---are going to be a very key factor in this market.

One major point I want to leave with you is that you---this is a profession. It is just as difficult a profession as the legal profession, dentistry, lawyering, medicine, etc. You're going to have to get professional management to run these funds. There are lots of ways to structure this. You can hire it out, you can contract with an organization or you can go in-house as Mr. Blixt has done.

The second point is the trends are such that it's not so much the individual day-to-day investing that's making the key difference. What's making the difference is the policy. Setting up the basic policy under which the funds will be managed. By policy, this could be a debt-equity structure, constraints on the funds. In setting policy you are really setting the primary deterrents of how these funds will be managed. These are big bucks. A little bit of difference can make an awful lot of investment difference down the road.

In setting policy, I understand you have a legislative problem that is facing you right now. Arbitrarily limiting the investments for political reasons may be a necessity, but the penalties can be enormous. If there is any plea I would like to leave with you, it is you set the policy structure or mechanism so that you can change it somehow as conditions change.

You heard a presentation from Manufacturers Hanover which, if there is any one theme that was constant in what they said, is that investments change. There is a time for growth stocks, there is a time for this, there is a time for that. Mr. Blixt showed how he had to change his portfolio to bring it up to date from when he had the 2½% bonds. I know it's a difficult task, but I do know that if you structure the investment policy by limiting your investments, there will be a point down the road that you will really wish you hadn't.

Alright, from this point, let me go on to just lay out a little bit of the function you're going to set up. Now I'm talking about an investment management function. You can think of a little company over here---Fidelity is a company that runs investments. We have a department for fixed income, a department for equities, my department is in international securities, one group runs nothing but pension funds, etc. The components of this organization or the organization you are going to have to set up as Mr. Blixt has, or the organization you may hire out, has to have administration. Now the administration means control, the review, the handling of the funds, the accounting of the funds.

The second major component is a planning function. And here I alluded to it---it's one thing to execute the investments. It's another to be able to plan the policies or constraints under which the investments are going to be made. Now, there are tools that are available and that are becomming available that makes the planning function a lot easier. Makes it a lot more "scientific", if you will. Access to these tools I think would be critical so that you can more or less have some independent way to oversee the evolving and planning of the fund.

And the last function in asset management is the investment management function itself. This is the staff that Mr. Blixt has or, if you hired an outside manager, this would be the actual staff---the staff that he has.

Now in today's market---and I won't spend much time because it's quite late---in today's industry, investment industry, there are two polar types of investments. Two polar types of investment organizations or ways to invest money. There are shades of gray in between. You have a particular problem. You may want to take a shade of gray. The two poles are the following: One is totally in-house. Hire a staff, hire a set of professionals. Run them, control them entirely in-house so to speak. This is the way Minnesota does it; this is the way the U. S. Steel pension fund does it. I used to be an investment manager with the U. S. Steel pension fund. There were nine of us. We managed $4 billion, which is in your ballpark. We ran it---we were effectively a subsidiary of the steel corporation doing nothing but managing these pension assets for U. S. Steel.

GRUENING: Excuse me, Terry. Doesn't Mr. Blixt, if I understood it, contract some of the equity out? I may be wrong, I just had the impression that there were some people being contracted by your department.

BLIXT: No. In one case we buy... It's just for information. And from brokerage houses all over the country we get all the information.

MAGRATH: In generating the information for their internal investment decisions, they will use what is known as soft dollars, commission dollars to pay brokerage houses to get research to help them in their decisions. In that extent they are.

GRUENING: It's still considered...

MAGRATH: It is still considered in-house. We at Fidelity do the same thing. We have a large in-house staff of investment analysts, but we also will use brokers to buy investment research in certain areas that we want to have special advice on.

The other pole is the multi-manager approach. Now, this is the, by far and away, the mainstream or the current way that very large pools of money are being handled. The multi-manager approach means that you hire outside managers, usually quite a number of them, depending on the size of the fund and the purpose of the fund. You hire the outside managers to run particular portions of the fund in accordance with how you want it done. This is American Telephone, for instance. Out of the top 200 corporations, I believe there is only 10 to 12 that run it inside. All the rest use the outside management approach.

I'll go over just briefly the pros and cons of both and how they might apply to Alaska because, while Mr. Blixt's solution seems good at first blush, you may have some particular problems up here being where you are and also with the growth of the assets you may not be able to gear yourself up quite readily. As Mr. Blixt may confirm, to build an organization requires a good long period of time. You have to get the right people, pay them the right amount and give them the incentive to do this.

Alright, first off, the multi-manager approach. As I say, this is by far and away the way that is done more so than any other way. What you require here to do this would be a central administrative staff. And these must be high quality people, people like Mr. Blixt, and a good core than understand Alaska's problems, work for Alaska, that's controlled by the limitations, etc., imposed on them---on him by you. The central administrative staff hires managers, sets policy according to the guidelines that you set, measures performance and effectively manages the managers. The managers report to them.

Say Fidelity or Keystone or Manufacturers Hanover, whoever it may be, would report to this central administrative staff, the ongoing progress of the funds. The advantages of this approach is low overhead---low direct overhead. You have a lot of flexibility. Hiring somebody is a commitment to somebody's career. If you've hired the wrong person, you have hurt yourself and the person. So it's a way to more or less rent somebody until you may get yourself better situated into knowing how you want to go. You provide competition between managers and also you can select specialized managers. Manufacturers Hanover showed you some of the areas where they are special in. There are other organizations that provide, say, real estate investment advice may be one thing. If ever you want to go international, I can show you some of the things that we do. Different managers can specialize and, as I said earlier, this is a profession you are dealing with and just as doctors can specialize in certain areas, so you will find investment managers that can specialize and do a lot better job than a generalist.

The disadvantages of this type of approach---there is a very high service cost. Investment management, just like lawyering and doctoring, does not come cheap. You're more or less duplicating your cost in the sense that if you want to run $4 million, they can do it with a staff, but if you're going to run 10 pieces of $400 million, you are more or less funding each of the ten managers. Their fees are on an asset basis or a funding basis.

Administration is complex. Ford Motor Company has 25 managers. They have a staff of three people. And when we go to talk to Ford Motor Company, they give us a presentation. They tell us where we are, where their objectives are, what we have to do to hit certain objectives. It's gotten to be a very sophisticated business, the idea of matching the investment manager to the ongoing needs of the fund in itself.

And the other disadvantage is the central staff is fairly critical. If you can hire Mr. Blixt to do it, as a matter of fact, that really may solve your problem for you.

The other side is internal management. Which has already been well covered by Mr. Blixt. You are really here setting up a separate company, just like an entire investment company, except you don't have a marketing department. This company is working for you, for the state of Alaska, just like the central staff of the multi-manager approach. Here you have a staff that is doing nothing but worrying about the investments of Alaska. You have relatively low cost. Some of the advantages of this---relatively low cost. But now you've got to weigh the cost of investment management with the difference in return. Think of a 1%---if you could increase the investment return by 1% on your $8 billion by spending more money on investment management, I think you will find that you can pay your investment managers an awful lot of money. So cost, when you are talking investment management, really has to be subjugated to the benefit that you are getting. You really have to look at the benefits or the incremental return that you can get from buying very good management.

GRUENING: Yield or net return, is that what you are talking about?

MAGRATH: Total return. We deal in total return. You can look at it in yield for capital appreciation, but just think of a 1% increase in return on your portfolio of $8 billion is one year's worth: $800 million? $80 million? This---when you look at some of the return figures and differences of yield, you apply that to $8 billion and you are talking about a lot of money. So it may behoove---forgetting the governor's salary, forgetting a lot of things, it may behoove you to spend well to set up good investment advice. Because it will pay for itself if it is done correctly.

GRUENING: How do you go about analyzing the state of the art as you say in terms of comparing Mr. Blixt's performance to your performance in some areas. It becomes all very subjective to me.

MAGRATH: There are very objective ways to measure investment performance. We didn't touch---Mr. Blixt didn't touch on it, but---the performance of the funds. There is all sorts of ways. You can look at this---there are services that do this. And it would behoove you, in any case by the way, whether you set it up entirely or whether you buy multi-managers, it would behoove you to have independent investment management service to look at how well they are doing. Almost an ombudsman for the state.

GRUENING: It's complicated because your time frame is important. As Mr. Blixt pointed out that things are very faddish. Somebody will say why aren't you in the stock market, look I could get this and that. And I can realize that. So are the analyses, are they sophisticated enough to give...?

MAGRATH: It's tied into policy, Clark. You have the luxury---with the amount of assets you have and the long time frame which you have---you have the luxury of being able to look longer to set up your structure or your investment policy so that you can have a better chance of maximizing your longer-term returns.

GRUENING: One of the problems we have in terms of analyzing that is that we haven't determined yet what we are going to do with the income. The constitution provides that it is reinjected in the general fund, so technically right now, all it's doing is used for operating expenses. The committee will consider tomorrow, I think, just some general thoughts on what to do with it. One suggestion might be reinject it into the fund. Use some of it maybe to meet current needs, whether that's to leverage additional funds I don't know yet. It's very complicated. The governor had Alaska, Inc. So we don't have that as a criteria to measure investment policy. It's the one odd thing about this. Maybe you have a comment on that.

BLIXT: I have a comment. We have three outside firms measuring our performance. We do just as you do many different ways. One way is simply to compare us with the IDS fund and with the banks in the Twin Cities. If they fire me and went locally or went to places that they've got to hire, would they do better or worse? Then we take these overall services in which they compare us to others. Merrill, Lynch has it, Hamilton has it, Becker has it, we deal with local organizations besides.

GRUENING: Is that mandated in your statutes?

BLIXT: No. But we feel it is mandated individually because somebody that's against our department is going to come in all the time and ask what it is. We want three different records on hand all the time.

GRUENING: Thank you. Go ahead, Terry.

MAGRATH: It is important to have an investment performance management and it can be done. And it can be done in the context of the risk levels that you have set or the ---once again the policy level which you have set.

GRUENING: Sterling, do you have a comment?

GALLAGHER: We use Becker's Services.

MAGRATH: The other particular problem you may have---and this has already been touched on---in setting up an internally managed fund that you could solve easily and it would behoove you to do so. One is that your location, while it is absolutely one of the most beautiful locations I have ever seen, is a desert as far as an investment professional is concerned. It would be difficult to have a team of good investment professionals up here. Your time frame---you have to be up and going when the markets are up and going, which is five hours different from the central market here in the United States.

You have to be in day-to-day contact with other investment professionals and have a good communication network. So, if you do go internally, you may even want to consider not having it located here. For instance, with U. S. Steel, when I was investment manager with the U. S. Steel pension fund, the corporate headquarters was in Pittsburgh, but the pension fund was on Wall Street. And it was quite important to be able to do that.

The second we have already touched on is the fees---the salaries you'll have to be paying for a good qualified staff. I was quite---I congratulate you, sir, I was quite surprised at the fees Minnesota pays. I don't know what the turnover is, they must be quite high quality people looking at the result. To get that quality of person, I think you are going to have to pay at least a few of them more than the governor. Just like you have to pay a doctor more than the governor if you had a full-time doctor on your staff.

So these two factors may prove a problem for you. I'm not sure. The other disadvantages is you have little flexibility. If you get the wrong person or the wrong team, you've made a career commitment to these people and you cannot turn them over at the drop of a hat. You build a staff---you build a business like this slowly, carefully, and make sure you have the right people and you must make sure they can work together.

The second is, I understand your asset basis will then be growing quite rapidly. That means you're going to have to be gearing up and doing something quite rapidly. I don't know how fast you can set up an internal staff.

There is some middle ground. One way---Yale University did some years back---and that is to contract their large funds. They went to an organization and contracted out setting up their fund to be managed. In other words, the other---it wasn't Yale, it was another organization, I'm sorry. Yale did something else. But this organization went to a money management organization and effectively---the money management organization set up a separate company if you will, affiliate, that could draw on the money management organization's capability and feed this capability in as the assets grew. In other words, you really set up a joint venture. And here you have a lot of the advantages. You have a group that would be doing nothing but managing Alaska's money. You could be drawing on the substantial capability. You heard from Manufacturers Hanover just some of the capability you need to run a big amount of money. Well, this organization had that capability, so this one management organization had that capability, so that the endowment fund came---set up a joint venture and, as the assets grew and were funnelled in, the money management organization could draw from its capability to apply it to the running of these funds. It's flexible. You can terminate the deal whenever you start to build your own organization. You are not committed to people. It is relatively low cost compared to your multi-manager approach.

That's essentially the three options I thought you had. At least the two polar options and the various shades of gray in-between. If there are any other questions. I just want to summarize by saying a couple of things.

No matter how you do it, you've got to get good professionals working only for the state of Alaska.

Number two, they have to be independent. You don't---they shouldn't be turned over, they shouldn't be under political pressure ---at least minimized as much as possible. As Clark knows when he first came to us, we won't even talk to states. With one exception, the State of Oregon, which is a very well run organization. But normally, if a public fund came to us and wanted us to talk about managing, we wouldn't talk to them. Mainly because of the turnover of the personnel of a political nature. What you people are doing ---I commend what Minnesota is doing, I commend you in Oregon. Maybe it has something to do with cold air, I don't know, but you seem to be doing it quite well.

GRUENING: A mixture of hot air and cold air.

MAGRATH: The third thing I want to leave you with is that planning is getting to be a very important function. And that you ought to have some of these tools at your access to help you meld your end use of the funds, the cash outflows if you will with the investments you have so that the two can be put on---am I making myself clear on that? OK.

It's a bit of a digression, but there are computer models available which you can more or less model the future. Set up a lot of circumstances. What if you wanted the fund to amortize over "x" number of years? What if you wanted it to stay at a certain level or to grow? What are the cash flow buildups going to be in this fund? That's more or less your asset side. Your liabilities. What are you going to be paying out? How do you want these things to be done? Well, given these two, you can then see what the implication of various debt-equity ratios would be. What if you went all equities? What are the probalities of getting this return "x" number of years out? What if you went all debt? What are you giving up by doing all debt or all short term cash? You'll find it will be substantial.

But no single---no two funds are the same. And what I'm suggesting to you is that there are vehicles available. Fidelity does not have one of these, by the way. There are independent consultants that have them. But there are vehicles available that would enable you to better plan the constraints that you are going to be putting on these funds.

The last point I want to make is that if at all possible, try not to put fixed constraints. If you go back in any point in history the constraints that you would have put on at some point would have been wrong at a later point.

GRUENING: Thank you, Terry. Aren't there some constraints---I mean, literally, you could open it up to any kind of investment. I mean, obviously, there are some constraints. Are you meaning like percentages on equity investments or what do you mean by constraints?

MAGRATH: Alright. Let's say you put in a constraint of 15% ---no more than 15% equities. Alright. Right now that might be a very politically advantageous thing to do. If you put it into a statute like that, there may be some point down the road that you may find that this has seriously curbed or impaired your investment performance substantially.

Let me give you one example that happens to be the area that I'm involved in. Most U. S. corporate pension funds have a constraint of no foreign securities. It was an arbitrary constraint put in way back when they thought it was a bad thing to do, to go into international markets. There has been a vast amount of work done that shows that a small amount of international diversification of your portfolio has a lot of bang for the buck. It reduces the risk substantially. It spreads the risk on markets outside the country. So now instead of having a highly volatile returns, you have some of it balanced in the Japanese market, the German market, and it smooths them. It smooths the return substantially. And this adds substantially to the potential for your return. These are fairly technical things which I don't want to spend---I don't want into too much here, but it has now become clear that a small amount of foreign assets makes a lot of sense. As a result a number of corporations are going back and having to go through the agony of amending their trust agreements, which is a difficult thing, to allow this type of investment.

So, all I'm trying to say is if you minimize the arbitrary constraints and more or less focus on the mechanism to set policy and let that be your controlling guide, I think you'd be a lot better off.

GALLAGHER: You talked about foreign investments. Do you think it's appropriate for public funds to have this option?

MAGRATH: Would there be an emotional bias against it? You mean to buy options or underwrite options? A lot of U. S. corporate pension funds are indeed underwriting options. Yes. Now five years ago that would have been an anathema. There may be a place for options. There may be a place for private placements. I don't know. But at certain times this may make sense. Markets change. The options market was not available to pensions five years ago because there was no options market. Now there is a viable options market and some of them are good.

I'm not saying it's appropriate. We don't do it. But some are seeing it as an appropriate investment.

GRUENING: Doesn't the rule of diversification---it's a principal that comes up---require limitations in these areas anyway? As long as you are stating---maybe restating the rule of diversification---it may have some political value. And it may not hurt. There must be some point where you are violating the investment policy to put a lot of money in the stock market. I mean a high percentage. Especially if it's money that has to turn over. Now, there probably is a bias in this state even though pension funds are invested in the stock market. But I'm wondering---isn't there the rule of diversification requires some limitation anyway? Even though it isn't stated statutorily?

MAGRATH: No. The rule of diversification almost implies the opposite. If you really truly wanted to diversify, say in equities, you would have 60% in the United States market and 40% outside the United States.

GRUENING: OK. Does diversification cut across investment categories?

MAGRATH: In other words, here you are looking at two different things. If you want to buy, let's say 20% you want to be in bonds, 80% in equities. OK. That's a policy decision. And inside these two classes of securities, you want to diversify. For instance, you wouldn't want to buy one bond.

GRUENING: No. I understand that. But does good investment policy---doesn't it demand in terms of classes or types or kinds of investments that only a certain percentage go into it? I mean, I can see you can diversify your equity holdings, but if they are all in equities, they are not very diverse within categories.

MAGRATH: One way to handle this is to put outer limits and allow a shift. You saw Mr. Blixt's presentation. You saw a big change in the various mixes as he went through time.

GRUENING: That's what I was talking about. No more than a certain percentage now. What is the outer limit?

MAGRATH: Here is briefly just a Xerox just in case. This is how we have allocated assets around the world over the last two years.

HARGEN: Let me ask a question right now. Are you saying that you don't---I may not understand you---are you saying that the legislature shouldn't put a straight jacket on the way the fund managers operate? There ought to be some---I can agree with that. But sometimes I think I'm by myself. Everyone's got different ideas. You get the emotional problems and everything built in to---that's talking---just like here you would say why don't you invest in capital markets. I'll just use myself as an example. I spent four years and eight months fighting the Japanese. I'm not that inflexible but now I did feel that way.

MAGRATH: This chart shows how we have invested assets around the world over the last two years. The basis chart is in color. I'm sorry I couldn't get it reproduced that way. On the left and right columns you'll see a neutral position. Insteas of a constraint, we have a neutral position here. In other words, that's a preferred position. We can deviate from that position. As you travel through here you will see the international situation very clearly. You can see the Japanese---we've moved above a neutral position in Japan and then in the late---late '76 there was a major run up in the Japanese market which we participated in. You can---backing up you can see France. You can see the political problems that developed in France and we pulled out of France. Certainly you wouldn't want to have any constraints that says you couldn't be in France. Because if ---you'd be sitting there with the potential of having all the money abscounded by the Communists so to speak. Then the political situation changed and over here on the right we start to build a French position. What I'm trying to say is, instead of setting constraints on our international policy, the same things goes for our domestic policy, we set a neutral or preferred position and then can deviate within bounds. We'll go maybe twice a weighting in any one particular country. But by setting bounds you are allowing a manager flexibility to work within a framework.

GALLAGHER: Do you usually go in U. S. dollar denominations securities or...?

MAGRATH: Oh no, these are yen and duetchmarks or whatever. These are the investment capsules. We have a staff in Japan, a staff in London, etc. But this is just---I'm not suggesting international securities for you at all. This is just an example of...

GALLAGHER: If we allow under our statutes that maybe U. S. dollar demoninations...

MAGRATH: Well that's not really---Canada follows very closely to the U. S. and we are really not diversifying very well. The Canadian market and the U. S. market are very highly correlated. We are much better off to go in Japan than in Canada. That's another issue. Once again, I'm just doing the international thing just as an example of something way out in left field to show that if you set constraints you may wish you hadn't at some point down the road. That's all I have unless there are some more questions.

GRUENING: OK. Are there any questions? Terry, thanks a lot. Thank you everybody for going through there and bearing out this room. It's rather stuffy and hot. We'll be in adjournment until 9:00 o'clock tomorrow sharp and we'll start on the---recess until 9:00 o'clock---and take up a piece of draft legislation.