

ALASKA LEGISLATURE COMMITTEE FILES 1993-1994 8672

8150 ○ HOUSE STATE AFFAIRS ○

415

Randy Welker
June 28, 1993
Page 23

The contention that an agency is barred from use of money "constructively received" unless the legislature first authorizes the money's receipt and expenditure will prevail, it seems to me, only if (1) the first sentence of article IX, section 13 looks past the form to focus on the substance of the financing transaction, thereby requiring prior legislative sanction of disbursement of the "constructive revenue" in question, or (2) the courts conclude, based on a reading and application of some questionable precedents, that the second sentence of that section imparts a "rule of strict construction" such that an agency is generally limited to the exercise of the powers that have been expressly granted by its enabling statutes together with those other activities that may reasonably or necessarily be implied from the powers expressly granted, that the agency may exercise under that grant of authority only the collateral powers that are incidental to the act that has been authorized, and that agency action involving financing arrangements that involve the raising and expenditure of capital by third-party contractors is inconsistent with a fair application of the rule. (Alternatively, the courts may hold that financing arrangements involving lease-purchases are a form of state debt, though, even if so found, in this instance the Department of Corrections arguably incurred state debt for acquisition of a capital improvement, a purpose authorized by the state constitution's article IX, section 8.)

With respect to the first argument, because, as noted earlier, recent Alaska case law in this area gives some reason to believe that the court is disposed to extend protection of the legislature's appropriation authority beyond state money to transactions involving all state assets, there is some reason to conclude that the courts may similarly act with respect to money constructively received. With respect to the latter, the answer will come only if the courts determine both that the provision supports a strict construction rule and set parameters on that rule.

JBC:mi
93-092.mai

DAVIS WRIGHT TREMAINE

Lawyers

2300 First Interstate Bank Tower
1300 Southwest Fifth Avenue
Portland, Oregon 97201
Telephone: (503) 241-2300
FAX No.: (503) 778-5299

CONFIDENTIAL MEMORANDUM

TO: The Honorable Bruce M. Botello
Deputy Attorney General
State of Alaska

FROM: George Mardikes, Barbara Kraft

DATE: August 13, 1993

SUBJECT: Response to the Legislative Counsel's Memorandum, dated
June 28, 1993, relating to Wildwood Correctional Facility

This Memorandum is in response to the Memorandum dated June 28, 1993, from Jack Chenoweth, Legislative Counsel, to Randy Welker, Legislative Auditor. The Memorandum from Mr. Chenoweth is a limited analysis that only analyzes the role of the Departments of Natural Resources and Corrections with respect to the Wildwood Correctional Center. It should be noted at the outset that such a limited analysis confuses the actual nature of the financing involved, and also the impact of the Legal Memorandum with respect to other outstanding financing by the State of Alaska.

There is clear authority for the State of Alaska to lease/purchase property in AS § 36.30.080(b) and (c). It is pursuant to this authority of the State of Alaska to lease/purchase property, authority granted by the State legislature to the Department of Administration, the Alaska Court System and the State Legislature, that lease/purchase financing has historically been done in the State of Alaska. No reference to this authority was cited in the Memorandum.

With the passage of SB 120, effective August 25, 1993, the legislature will be required to approve all lease/purchase financings by the Department of Administration which involve real property, regardless of the dollar amounts involved in the

acquisition. The earlier version of the statute allowed the Department of Administration to proceed with lease/purchase financings without legislative approval so long as the annual obligation was less than \$1,000,000 and the aggregate obligation was less than \$10,000,000.

In addition to Wildwood, the Department of Administration and the Alaska Court System have engaged in lease/purchase financing of:

-the Seward Student Services Center (real property including improvements thereon where ASHA is the nominal title holder)

-Equipment

-Spring Creek Prison in Seward (real property including improvements thereon where the City of Seward is the nominal title holder; these are lease revenue bonds issued by the City of Seward where the Department of Administration has an annual obligation to make rent payments subject to appropriation)

-Palmer Courthouse (real property including improvements thereon where the City of Palmer is the nominal title holder; these were lease revenue bonds issued by the City of Palmer where the Alaska Court System has an annual obligation to make rent payments subject to appropriation)

-Kenai Courthouse (real property including improvements thereon where the City of Kenai is the nominal title holder; these were lease revenue bonds issued by the City of Palmer where the Alaska Court System has an annual obligation to make rent payments subject to appropriation)

In all the State has probably in excess of \$75,000,000 principal component of rental payments of lease/purchase financing outstanding. The State of Alaska and its Legislature has solved many capital financing problems with the use of lease/purchase financing. Any unfavorable analysis of lease/purchase financing will have an effect upon outstanding lease/purchase agreements of the State, especially the ratings on them. In addition, it is likely that other financings under which the State provides a "moral obligation" such as the Alaska Bond Bank financings would also be down graded or put on to some type of credit watch.

Various structures have been used for in the past for the lease/purchase financing by the State. All of these agreements, including the Wildwood transaction, are subject to annual

appropriation so that the state's obligation under the agreements may be terminated annually should the state legislature fail to appropriate money for the following fiscal year's rental payments.

what differs from prior transactions in which lease/purchase financing has been done by the State of Alaska is that the Department of Natural Resources is involved as the nominal lessor of the property to Department of Administration (or Alaska Court System). In the past this role has been handled by a variety of entities. Often private companies have served as the lessor, such as Ford Motor Credit Corporation or National Bank of Alaska, other times municipalities, such as the City of Kenai, City of Seward or the City of Palmer, have been involved and served in the role as lessor. In addition in the past, Alaska State Housing Authority has served as the nominal lessor. In all of the transactions that have been involved, ultimately it has been the State of Alaska through the Department of Administration or the Alaska Court System who has been primarily responsible for the transaction and the financings. The role of the nominal lessor is one in which there are basically no obligations of the lessor and the lessor assigns its interest off either to a single investor, in which case there is a simple assignment, or if the financing is such that it makes sense to break the rental payments up into smaller increments for multiple investors in order to lower the cost of the financing, it is assigned to a trustee who then executes and delivers certificates of participation which are delivered to the ultimate investors. In either approach the role of the nominal lessor is such that there are really no continuing obligations in the transaction with all liability in the transaction being assumed by the lessee.

There are some real disadvantages as to who the nominal lessor might be. For example, an indian tribe or a private corporation may subject the property to property taxation which would then be passed on to the State and increase the cost of the financing substantially. In other situations having a municipality as a nominal lessor can delay the project because of demands that the municipality will place upon the State in order to serve as the nominal lessor. Demands can include a fee for serving in that capacity. In addition, there is usually the cost of the municipalities' counsel in the transactions.

Given the state's ongoing use of lease/purchase financing, it made sense to set up some type of master documentation so that each time a lease/purchase financing was done by the State, the State, its staff, and all of the other parties involved, including the trustee, did not have to recreate documents and the transaction from scratch. This also streamlines review by rating agencies and minimizes costs of trustee and others. The mechanism for doing this is to set up a Master Trust Agreement with standardized documents, which can then be used each time there is

08/13/93 18:00

503 778 3409

PST Portland,OR

005

another lease/purchase financing by the Department of Administration (or the Alaska Court System). In setting up the Master Trust Agreement, it was felt that we needed a nominal lessor which would serve the various types of transactions involved in which the State might want to lease/purchase. Having a private entity in there was cumbersome because private entities usually are only involved in the actual financing they have any interest in; having a municipality did not make sense since the State would be lease/purchasing in numerous municipalities across the State. It seemed that the only entity that really made sense and that had the authority in which to hold title in the State was the Department of Natural Resources. The basic role for the Department of Natural Resources in the transaction was to hold title. All other obligations were assumed by the Department of Administration or Alaska Court System. All rights of the Department of Natural Resources are assigned off to the trustee. Given the limited nature of Department of Natural Resources' involvement, it is quite clear that the Department of Natural Resources has the ability to hold title to property in the State of Alaska.

The Memorandum by Legislative Counsel focuses on primarily two issues: that the nature of the lease/purchase transaction creates invalid debt under the Alaska Constitution and that the transaction is invalid because the moneys relating to the transaction need to be appropriated by the Legislature.

Lease/Purchase Agreements By The State Do Not Create Debt

The issue of whether or not a lease/purchase agreement with a non-appropriation clause in which the State of Alaska is the lessee creates debt has been consistently over the years viewed as not creating debt. This view has been held by prior attorney generals, as well as the current attorney general, as well as numerous bond counsel to the State over the years. The legislature has, on numerous occasions, continually appropriated rental payments on lease/purchase agreements that have been subject to annual appropriation, and each year it is necessary to go through the appropriations process to continue those agreements.

Legislative Counsel relies on a few decisions in other states and the dissent in a State of Washington decision to raise speculation that nonappropriation lease/purchase agreements "may" create debt under Alaska's Constitution. The position that such agreements create debt is contrary to the vast majority of case law in the 50 States that have reviewed this issue. With respect to debt limitations for cities, counties and school districts, the vast majority of case law is in agreement that non-appropriation clauses prevent such agreements from becoming debt under constitutional limitations. Mardikes, McLaughlin and Gorman, Governmental Leasing: Surveys of Federal Tax Law, Federal Securities Law and of Legislation and Case Law in the Fifty States

08/13/93 18:01

2503 778 5409

WT Portland, OR

0000

(ASSOC. Gov't Leasing & Fin. 1993).

More important though than case law in other jurisdictions is case law in the State of Alaska. In Moreno v. Municipality of Anchorage, 704 P.2d 199 (Alaska 1985), the court upheld a lease/purchase agreement in which the Municipality of Anchorage was lessee. The agreement was subject to annual appropriation. The court noted in its decision the existence of the constitutional debt limitation, but did not invalidate the lease/purchase agreement under that limitation. Id. at 203. The language of that limitation is practically identical to the limitation applicable to the State. Article IX, Section 9, of the Alaska Constitution states:

LOCAL DEBTS. No debt shall be contracted by any political subdivision of the State, unless authorized for capital improvements by its governing body and ratified by a majority vote of those qualified to vote and voting on the question.

The language of Article IX, Section 8, of the Alaska Constitution states:

STATE DEBT. No state debt shall be contracted unless authorized by law for capital improvements . . . and ratified by a majority of the qualified voters of the State who voted on the question.

The operative provisions are identical.

Trust Funds Do Not Require an Appropriation Prior to Their Expenditure.

Legislative Counsel's analysis regarding the possible need for an appropriation turns on the application of Article IX, Section 13 of the Alaska Constitution to the funds generated from the sale of the Certificates of Participation ("COPs"). That section of the Alaska Constitution provides as follows:

EXPENDITURES. No money shall be withdrawn from the treasury except in accordance with appropriations made by law. No obligation for the payment of money shall be incurred except as authorized by law.

The application of the second sentence to the funds raised by the sale of the COPs is discussed below.

Money obtained from the sale of the COPs is never placed

In the treasury of the state. It is sent directly from the Underwriter to the trustee. The trustee holds the funds in accordance with specific instructions approved by the Underwriter (as purchaser of the COPs) provided to trustee in the Master Trust Agreement (to which the Department of Administration is a party) and the Assignment. Thus, these funds never become property of the state. They are trust funds which could not be placed in the treasury as the terms of the documents require that they be paid to the trustee and that the trustee administer them in accordance with the terms of the Master Trust Agreement.

This argument presupposes the question then, n^o whether the money raised from the sale of the COPs should have been placed in the treasury. The Memorandum acknowledges the position of the Attorney General with regard to trust funds, but tries to distinguish the funds raised from the sale of the COPs because the State is not a "co-trustee" and because the decision to issue the COPs was made by a state official acting in the course of his/her duties. Memorandum at 10, n. 7. The Memorandum also acknowledges that the position of the Attorney General has substantial support in the case law of other jurisdictions. Memorandum at 10. He proceeds, however, to discuss the minority view found in New York and Pennsylvania as support for his conclusion.

The Attorney General's opinion of April 2, 1991 cites several cases in support of its view that such funds are trust funds and not state property. See n. 6. Likowisc, the Attorney General's opinion of July 1, 1976 also discusses cases in several states which also indicate that in these situations, such funds are not property of the state. See pp. 6-8.

Other cases which support this view include McClelland v. Pima County, 849 P.2d 1378 (Ariz. App. 1992). In McClelland, taxpayers challenged the payment of additional retirement monies to retired state employees as being made with state money which must be appropriated. The Court rejected this argument holding that because those amounts were paid from current assets of the state pension plan, they were not public state money and were not subject to appropriation. Likewise, in Moran v. State, 534 P.2d 1282, 1283 (Okla. 1975) persons who had paid into the state's worker's compensation fund challenged an attempt by the legislature to appropriate funds held in the state's worker's compensation insurance fund. These funds are typically administered by the state, meaning that state employees made decisions regarding the payment of claims and collection of revenues while acting in their official capacity. Id. at 1287. The court adopted the general view which differentiates between public funds which are administered by public bodies, yet are not public money to be used for and on behalf of the state. Thus, the money paid into the fund constitutes trust funds which are not available for the general or other purposes of the State and are not subject to appropriation by

08/13/93 18:02

503 778 5409

DWT Portland. OR

008

the legislature. Other cases which support the conclusion that some money although expended within the state for the benefit of the state, is not subject to appropriation include Opinion of the Justices to the Senate, 378 N.E.2d 433 (Mass. 1978) (attempt to make federal funds subject to appropriation is constitutionally defective); City of Sand Springs v. Dept. of Public Welfare, 608 P.2d 1139, 1150 (Okla. 1980) (citing State ex rel. Hawkins v. Oklahoma Tax Commission, 462 P.2d 536 (Okla. 1969)). See generally, 81A C.J.S. States § 233 (1977) ("it is generally held that constitutional provisions as to appropriations do not apply as to special funds devoted to special purposes.")

Similarly, the funds received from the sale of the COPs are paid to the standby trustee to be held in trust for the benefit of the sellers of the property or for persons performing improvements on the property. The generation of these funds is authorized under Alaska Stat. § 36.30.080. They cannot be placed in the general fund as the terms under which they were paid require these funds to be expended only on the costs of acquiring the property, making improvements and paying the costs associated with the acquisition. Likewise, when the Department of Administration raises funds through lease purchase financing for the acquisition of equipment¹ the funds are paid directly from the investor/underwriter to the vendor of the equipment.

¹ This was done on October 21, 1991 in an issue amount of \$615,201.00 and April 17, 1992 in an issue amount of \$1,784,617.00. No one has ever asserted that the money generated from these lease purchase agreement had to be paid to the state to be later appropriated for payment to the vendor. Such an assertion would be contrary to the operating principles of lease purchase financings and would make Alaska Stat. § 36.30.080 a nullity as no vendor would be willing to release equipment subject to an uncertain promise to pay. In lease purchase financings the risk of payment is born by the financing entity.

Perhaps an analogy to an every day transaction such as buying a house would help. While the bank financing the purchase (the underwriter) is willing to take its chances that the buyer (the state) will not make its monthly mortgage payments (annual lease purchase payments), FNMA, AHFC or a similar entity providing the funds to the bank (the investors) is not willing to allow the bank (underwriter) to give the proceeds of the note (COP funds) to the buyer (State) for the buyer (State) to pay or not pay as the buyer sees fit (subject to the whims of the legislature and the governor). Thus, the funds are paid directly from AHFC to the bank to the title company to the seller. The borrower or purchaser of the house never has the right to demand those funds, and his or her checkbook balance is never increased by the amount of those funds.

Legislative Counsel's analysis of the second sentence of Article IX, Section 13 of the Alaska Constitution fails because the obligation to pay the rentals under the lease/purchase agreement is an obligation of the lessee (either the Department of Administration or Alaska Court System), which by its terms is payable solely if the Legislature appropriates the rentals. The Department of Natural Resources' position is only as nominal lessor with no payment obligation.

(Intentionally left blank)

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

P.O. BOX 5
JUNEAU, ALASKA 99811-0400
PHONE: (907) 465-2300
TELEFAX: (907) 465-2389

October 11, 1993

Mr. Randy S. Welker, Legislative Auditor
Alaska State Legislature
Legislative Budget and Audit Committee
Division of Legislative Audit
P.O. Box 113300
Juneau, AK 99811-3300

RECEIVED
OCT 11 1993

LEGISLATIVE AUDIT

Dear Mr. Welker:

This is a joint response from the members of the State Bond Committee (Committee) to your preliminary audit report titled Department of Corrections Wildwood Correctional Center Acquisition July 9, 1993, Audit Control Number 20-4471-93. Committee members are: Paul Funs, Chair; Darrel Rexwinkel, Secretary; and Nancy Usera, member.

We acknowledge and generally agree with the preface of the Auditor's Conclusion stated on page five of the report. The conclusions were as follows:

- Legislative Council presented an excellent analysis of the many issues in question and that for many questions there is no clear opinion as to how the Alaskan Courts would rule.
- There are no clear answers to several of the legal issues that are primarily constitutional questions.
- This report takes a conservative position from the perspective of protecting legislative prerogative.
- We found no indication that the State Bond Committee acted contrary to any financial or legal advice provided to them.

Bond Counsel responded on August 13, 1993 to Legislative Counsel's analysis of legal questions dealing with the State's capability to enter into lease/purchase financings. This response was due to a recent lease/purchase financing that was concluded in August, 1993. Bond Counsel disagreed with Legislative Counsel's position that lease/purchase financing might create an invalid debt for the State. Bond Counsel pointed out that there is legal precedence in Alaska that a lease/purchase transaction subject to annual appropriation does

not establish a debt liability for a public entity. Furthermore, Bond Counsel noted that the vast majority of case law decisions hold that lease/purchase financings do not establish a debt liability.

As Bond Counsel stated, a nominal issuer and lessor has no financial obligation to a lease/purchase transaction. The financial obligation is assumed by the lessee. Bond Counsel correctly points out that Department of Natural Resources' (DNRs') obligation as nominal issuer and lessor was to only hold title to the Wildwood property. Therefore, there is no financial obligation on the part of DNR. The statements on page 15 of the report are incorrect where it indicates that there is a significant difference between DNR's and a municipality's role as nominal issuer and lessor. A municipality that has acted as a nominal issuer and lessor to a transaction is not responsible for satisfying a debt obligation. If the lessee defaults on their payment obligation, a creditor's only recourse is with the collateral supporting the financial transaction. The cities of Kenai, Palmer and Seward have the same role as DNR with respect to lease/purchase financings with the State; they would not serve in that capacity if there was any financial risk.

The other major issue in the Wildwood financing relates to the issue of splitting the transaction. The Committee believes there is another side to the allegations stated on page seven of the report. It is alleged that 1) the Wildwood financing package was intentionally reformatted to bypass legislative approval and 2) the action is a classical example of circumventing both the legislatures' constitutional power to appropriate and the legislatures' involvement in the establishment of correctional policy.

The intent behind the dual issuance was for financing and marketing purposes that met the intent and financing parameters established by AS 36.30.080. We have attached letters from Financial Advisor, Bond Counsel, and Underwriter that were in response to the Office of Management and Budget's report Wildwood Acquisition Review; Report No 20-04. These letters discuss and support the financial and marketing reasons for two separate transactions. These documents provide sufficient evidence to conclude that the overriding decision to use two financings were for marketing and financial reasons initiated by the environmental issues and final determination of necessary improvements to the property.

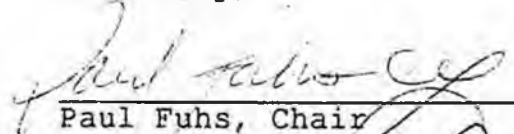
From the Committee's perspective, it seems the timing of the offering is confusing the issue of why the transaction was split into the acquisition and the improvement issues. It is the Committee's understanding that the financing structure was conceived and committed to in the summer of 1992 for valid financing considerations that would result in cost savings to the State.

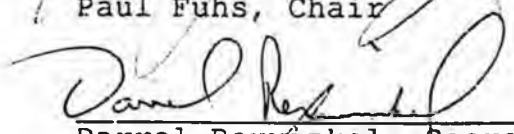
The Committee's review of the evidence is that there was no rush to complete the financing because each issue met the then existing and new requirements that were to take effect on September 24, 1992. It appears that parties closely involved with the transaction knew of the September 24, 1992 legislative effective date. When that date was near there were discussions and communications of the requirement. The Committee believes that the activity at that time has been misconstrued to mean that the issue was split at that time to avoid legislative oversight.

Finally, the Committee would like to respond to the environmental issue by saying that all parties involved in Wildwood transaction independently reviewed the nature of the State's liability of the environmental issues and became satisfied with them. In fact, Moody's Investors Service used their own legal counsel to review the environmental concerns before issuing a credit rating for the transaction. One concern was the issue of asbestos. Monies were set aside in the acquisition issue for asbestos removal. Another issue was subsurface contamination which the federal government and Kenai Native Association has committed to cleaning up.

The Committee would like to thank Legislative Audit for allowing us to comment on the report.

Sincerely,


Paul Fuhs, Chair


Darrel Rexwinkel, Secretary


Nancy Usera, Member

Enclosures

Government Finance Associates, Inc.

71 Broadway, Suite 1301
New York, New York 10006
(212) 809-5700
FAX (212) 809-6317

April 16, 1993

TO: ALASKA STATE BOND COMMITTEE
FROM: GOVERNMENT FINANCE ASSOCIATES, INC.
SUBJECT: WILDWOOD ACQUISITION REVIEW; REPORT NO. 20-04

Government Finance Associates, Inc. has served as financial advisor to the Alaska State Bond Committee (the "Committee") for nearly a decade. Over this period, we have been involved in a wide variety of activities and bond sales for the purpose of implementing the most effective debt management and credit improvement programs for the State.

In addition to the Committee, this firm serves as overall financial advisor for similar programs to many other large, substantial domestic governments and non-profit entities, including Boston, Buffalo, Detroit, Louisiana, Vermont, Princeton University, many public authorities, among others. In these cases, we are frequently evaluated by our clients using the following standards: Credit standing of the client, efficient financings, and overall debt management costs. We believe that we have been helpful in assisting the State to achieve goals in these discrete areas. For example, in July, 1992, Alaska's investment grade rating was increased to "AA" by Standard & Poor's Corporation, one of the nationally recognized credit rating agencies; Alaska was the only state to be upgraded by either of the nationally recognized credit rating agencies over an eighteen month period.

The above paragraphs are presented as background to the financing for the Wildwood Correctional Center ("Wildwood"), which financing has now been reviewed by the Division of Audit and Management Services of the State Office of Management and Budget in a report, dated April, 1993 (the "Review Report"). We have examined the findings of that report, and we would like to submit the following comments.

In the "Summary" of the report, a statement is made that "It is likely that the issue was divided in order to avoid the requirement for legislative approval. . . ." This comment appears to us to be the substance of the conclusions regarding the lease financing. As financial advisor to the Committee, we would like to take issue with this conclusion for the financing for reasons set forth below.

As an introductory comment, we suggest that the Committee consider the quite serious ramifications that would have been present for the financing "in the absence of" a

Government Finance Associates, Inc.

division of the components of the financing between acquisition and improvement certificates of participation. Most importantly, we are certain that the transaction would have been more expensive for the State and considerably less efficient, two significant criteria when conventional standards are used in evaluating debt transactions.

Following the Wildwood transaction, this firm prepared a post sale analysis that reviewed the cost-effectiveness of the debt obligations sold for the envisioned purposes. We encourage you to review this letter in the context of that post sale analysis, for many of the points herein are drawn from the material contained in that document.

1. Credit Matters:

Among other matters, we think it would have been most appropriate for the Review Report, issued by the Office of Management and Budget to, among other items considered, have addressed the credit circumstances in which the State and the financing were involved at the time. For example, as financial advisor to the Committee, we would have been especially reluctant, less than four months after the rating increase by Standard & Poor's Corporation, to have taken any steps or recommended any action that would have brought the financing approach by the State under questionable scrutiny by the rating agencies. Of course, the possibility that the issues would have been divided for the purpose of circumventing legislative authority clearly qualifies as a matter that could have caused the rating agencies to question the integrity of the financing. Would the financial advisor have proposed an action that could have tainted the State's credible image, in the eyes of the agencies, in the aftermath of the extensive negotiations and communications with the agencies, including personal visits and written evaluations, that had only so recently been conducted by the advisor and had resulted in a rating upgrade?

By way of further explanation, ratings are not just a set of economic quantifications completed by the agencies. One primary concern is always the credibility and perceived integrity of the borrower. Because of the long-term, open and substantive communications that have existed between the State and the rating agencies in recent years, the image of the State with the rating agencies has improved over time, and this factor was instrumental in the rating increase that had been so recently awarded the State. We can unequivocally say that we would not have put the State and the rating in jeopardy through financial advice that meant to circumvent required governmental action.

2. Marketing Matters:

In the post sale analysis, we set forth the reasons and benefits, from a marketing perspective, that the transaction was divided into two segments, consisting of both acquisition and improvement debt. To quote from that analysis, "Thus, as the financing progressed, the financing team concluded that the potential environmental hazard at the site would pose a risk to the normal marketing process for the COPs". Our viewpoint was premised on the fact that the "weakest link" in any transaction frequently becomes the basis for the pricing and marketing of the related securities. Clearly, the "weakest link" in the marketing of the transaction on the open market could have been the environmental problems so germane and integral to the Acquisition portion of the debt issue. So that the "virus" of the environmental issue would not adversely affect the marketing of the Improvement debt, the bond issues were divided.

We concur with the Review Report's finding that: "Indeed, the financial advisor indicated that the reason the issue was split was to compartmentalize the environmental risk, thus increasing the marketability of the issue." It goes without saying that environmental issues have taken on particular importance and increased visibility in the financing of public infrastructure in recent years. To dramatize this enlarged significance to the matter, Moody's Investors Service, the rating agency, uses an outside counsel to consider environmental matters of the type that surrounded the Acquisition COPs, and that counsel was in fact brought into the deliberations covering the environmental matters in the Wildwood transaction. We would like to quote a publication from Moody's to further emphasize a primary reason that it has become important for problematic environmental aspects to be isolated: "It is axiomatic that 'no one buys a lawsuit'". As financial advisor, this sensitivity to market concerns surrounding these environmental issues drove our opinion regarding the division of the transaction into two issues.

3. Integrated Financing Approach

The third conclusion in the Summary portion of the report states that "In our opinion a negotiated (rather than a competitive) sale was reasonable because of the environmental problems with the Wildwood property." While on the surface, it would appear that the issues of a negotiated sale and the division of the transaction into two parts can be separate and distinct elements, it should be emphasized that the reason that a negotiated sale was selected was also the reason that we supported a separation of the transaction into Acquisition and Improvement

Government Finance Associates, Inc.

certificates of participation. Quite simply, environmental problems create marketing obstacles that argue for negotiated sales, and those same problems would create higher interest costs if not appropriately isolated and limited.

As the Review Report stated: "In September 1992, on the recommendation of the Government Finance Associates, Inc. (financial advisor), a decision was made by the Department of Revenue to pursue a negotiated sale of the Certificate issue. . . ." If we recommended a negotiated sale for marketability reasons, then it is a natural extension for us, as financial advisor, to try to contain the adverse marketing effects of the environmental problems through a sale of two separate debt issues, also for marketability reasons. In the absence of that conclusion, we would not have had an integrated financing approach to the transaction.

In conclusion, we would like to emphasize two important other points. First, approximately 75% of our clients, representing some of the more substantial and complex governmental entities in the country, have utilized GFA for seven years or more. We believe that this statistic indicates the long-term professional advice and integrity that our clients can assume when our assistance is requested, and the provision of any questionable recommendations for the purpose of circumventing existing governmental reviews would be contrary to the trust that has developed with our clients over the years. After all, a financial advisor has only trust and professionalism to offer as business products to the type of client that GFA has historically enjoyed.

Second, we strongly suggest that financings, themselves, do not constitute public policy. They are, at their best, economic constructions that result in low cost, efficient transactions that implement political, governmental decisions. On that basis, we think that the Wildwood debt issues should primarily be judged, and using this criteria, the Committee should be pleased and gratified with the end product.

We appreciate the opportunity to serve the Committee. If we can provide any additional information or clarification, please do not hesitate to contact us.

Government Finance Associates, Inc.

cc: Paul Fuhs, Commissioner
Department of Commerce and Economic Development

Nancy Bear Usara, Commissioner
Department of Administration

Darrel Rexwinkel, Commissioner
Department of Revenue

Brian C. Andrews
Debt Manager

DAVIS WRIGHT TREMAINE

LAW OFFICES

2300 FIRST INTERSTATE TOWER · 1300 SW FIFTH AVENUE · PORTLAND, OR 97201-5682
(503) 241-2300
FAX: (503) 778-5299 · TELEX 185224

GEORGE M. MARDIKES

April 14, 1993

VIA FAX NO. 907-463-3454
ORIGINAL VIA MAIL

The Honorable Walter J. Hickel, Governor
State of Alaska
P.O. Box 110001
Juneau, Alaska 99811-0001

Re: Wildwood Acquisition Review, Report No. 20-04, April 1993

Dear Governor Hickel:

Davis Wright Tremaine serves as bond counsel to the State Bond Committee. As such we were actively involved in the structuring of the two recent lease/purchase financings for the Wildwood Correctional Facility ("Wildwood"). We also provided opinions on the validity and tax-exemption of both financings. We are in receipt of the Wildwood Acquisition Review, Report No. 20-04, April 1993 (the "Report"), prepared by the State of Alaska, Office of Management and Budget, Division of Audit and Management Services. We felt it appropriate that we respond to the Report. What follows are some of our comments with respect to the Report and the financings.

It should be noted at the outset that when discussion first arose of projects concerning Wildwood Correctional Facility ("Wildwood"), there were three distinct projects discussed. The first project was the actual acquisition of the property, all five parcels, by exercising the purchase option (the "Acquisition") under the then current lease with the Kenai Native Association ("KNA"). The second project was improvements to be made in the near future under the master plan to the Wildwood properties. The third project was a dormitory on Parcel 3. Under federal tax law, the State could finance improvements so long as it reasonably anticipated spending the money on the improvements within three years of the date of issuance. The improvements would have to be determined prior to issuance of the financing, but could be subject to modification. The State would have to be committed to the improvements to be financed. The State was not yet committed to the third project for the dormitory on Parcel 3 so that project was put on hold. We carved out Parcel 3 so that it would not be encumbered under the Acquisition. Given the favorable market condition, discussion was had whether the second project (the "Improvements") could go forward at the same time as the Acquisition. The cost savings of going to market once, as well as the historically low interest rates, were sufficient factors in speeding up the Improvements and combining them with the Acquisition. The State seemed to be committed to the Improvements, it was just a matter of better defining what they would be.

The Honorable Walter J. Hickel, Governor
April 14, 1993
Page 2

We do not agree with the analysis of the Report relating to the methodology used in determining whether the Acquisition and the Improvements were "stand alone" projects. The initial response when the new legislation was passed was to review the circumstances surrounding the projects to determine whether legislative approval would be required. Clearly if this property was not currently being used as a prison and needed the Improvements prior to its use as a prison, the projects would not be distinct and both would require legislative approval. But that was not the case and we believe we had an obligation to review the facts and circumstances involved with the two projects, especially since the projects were initially brought to us as two distinct projects. It was only after presentation of much information concerning the nature of the Acquisition and the nature of the Improvements that we were sufficiently satisfied that the two separate projects could go forward without legislative approval.

There were various factors that were taken into consideration. The first and foremost concern on the nature of whether the two projects "stood alone" is whether the State could nonappropriate the Acquisition financing without nonappropriating the Improvements financing and vice versa. The documents are quite explicit that the State can do so without any legal constraint. An overriding concern that we had with respect to the Acquisition financing was to make sure that the State didn't tie up (as security) all of the property and the existing improvements it had invested in the property with one financing. For this reason, we made sure that certain parcels were excluded as security from the Acquisition financing so that the State would not be in a dragnet situation of losing everything in the event it wanted to nonappropriate on the Acquisition financing. In addition to the Improvements that were contemplated, the State was contemplating putting a dormitory on Parcel 3 in the future so that parcel was also not included as security for the Acquisition.

There was also discussion of whether the two projects would go forward absent the other. The State has already invested substantial amounts of money in improvements to the property (recently valued by the Division of Risk Management at a replacement value of \$34,949,656) even without fee ownership of the property. It seems that the Report assumes that the definition of "stand alone" requires that it be necessary that the State be able to finance the Improvements without consummating the Acquisition. This could have been done by subleasing the State's interest in the lease or granting a leasehold deed of trust. Another \$4,715,000 of Improvements to the properties could easily be financed by the State without the exercise of the purchase option under the lease with KNA. However, this requirement that the Improvements could be done without doing the Acquisition was not a requirement in our legal analysis.

On page 14 of the Report, it states "As a result, the letter [from Bond Counsel] indicated that the issuance of the certificates for improvements might have to be postponed until the Department of Corrections was able to define the nature and scope of the improvements." This fact that the Acquisition would proceed without the Improvements was very important. After completing the Acquisition, could the State three months later, six months later or three years later decide to do the Improvements? Could the State use the property acquired under the Acquisition without the Improvements? The answer to both questions was yes. The final question for us was simply whether the State could close both Projects at approximately the same time saving the costs and expenses, including title insurance and State employees staff time, associated with projects of this type. We could see no logical reason why the State couldn't. Had the negotiation and drafting of the Purchase and Sale Agreement with KNA not taken longer than anticipated, the Acquisition would have closed prior to the Improvements since the State wanted to terminate payment of rent to KNA as soon as possible and the

The Honorable Walter J. Hickel, Governor
April 14, 1993
Page 3

State was quite delayed in assembling the detailed description of the Improvements.

There seems to be some confusion as to the structure incorporated into the Department of Transportation and Public Facilities Attorney's October 14, 1992, memorandum. We were not consulted in the preparation of this memorandum and therefore were not privy to the assumptions set forth therein. The structure of the Acquisition and the Improvements as finally closed was structured in late September, with input from the Attorney General's Office, and had "gelled" at least as of October 2, 1992, as reflected in the draft of the preliminary official statement then in circulation with the working group, which included a representative of the Attorney General's Office. The structure was the result of the simple fact that there was a single lease with KNA that had a purchase option and that the nature of the acquisition was the exercise of the purchase option for the property under the lease with KNA. A memorandum, dated October 16, 1992, from the Commissioner of Corrections to McKie Campbell stated:

"In other words, we would go forward to seek funding for either the purchase or the renovation funding, although we feel it is in the best interests of the state and the department to seek both."

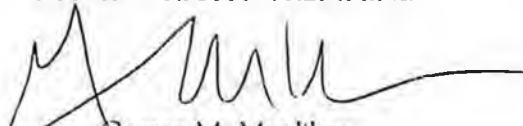
We received a copy of this on October 20, 1992, with instruction to once again proceed with the projects. This Memorandum confirms our understanding that the structure that was proposed in late September was the same structure anticipated by Department of Corrections subsequent to the October 14, 1992, memorandum of the Department of Transportation and Public Facilities' attorney.

Even though there was this apparent mistake in the facts set forth in the October 14, 1992, memorandum, the basic conclusions, supported by the Commissioner of Corrections memorandum set forth above, are the same. The Acquisition would proceed with or without the Improvements and the Improvements would proceed with or without the Acquisition.

If you have any further questions or would prefer a more detailed analysis of the Report, please let us know.

Very truly yours,

DAVIS WRIGHT TREMAINE



George M. Mardikes

GMM:raf

cc: Mr. Paul Fuhs, Commissioner
Department of Commerce & Economic Development
Mr. Shelby Stastny, Director
Office of Management & Budget
Mr. Brian Andrews
Debt Manager

m:\users\mardg\hinkle.ltr

Stephens Inc.

April 19, 1993

The Honorable Walter J. Hickel, Governor
State of Alaska
Post Office Box 110001
Juneau, Alaska 99811-0001

RE: Wildwood Acquisition Review, Report No. 20-04, April 1993

Dear Governor Hickel:

Stephens Inc. served as underwriter on the \$5,655,000 Certificates of Participation, Series 1992, Wildwood Correctional Center Acquisition and as a co-underwriter with the U.S. Bank of Washington, National Association on the \$4,990,000 Certificates of Participation, Series 1992, Wildwood Correctional Center Improvements.

Stephens Inc. was retained by the State of Alaska and its Financial Advisor, Government Finance Associates, Inc., to underwrite the financings to purchase and improve the Wildwood Correctional Center, portions of which had been leased and improved by the State since 1983. From that point forward, until closing on December 10, Departments of Revenue, Administration, Natural Resources, Inc., and Davis Wright Tremaine, the State's bond counsel, to structure each financing to ensure the highest possible ratings, favorable market reception and the lowest possible interest rates. We worked closely with Tom Boutin, the Debt Manager of the Treasury Department, and he did an excellent job of coordinating a large team in a very complex financing.

When Stephens Inc. first became aware of the financing in March of 1992, it appeared on the Alaska Debt Calendar as a single issue. At the time Stephens Inc. was contacted to begin working on the transaction, Government Finance Associates, Inc., bond counsel, and the various state agencies had concluded the transaction would have to be structured as two separate issues due to the considerable environmental concerns associated with the property. Stephens Inc. agreed from a marketing and underwriting perspective that the transaction would have to be structured as two different transactions and began working with the finance team on two separate transactions, one to raise funds for the acquisition of the Wildwood Correctional Center and one to raise funds for improvements to the Center. The financings were submitted to the rating agencies as distinct financings and each was rated as an individual issue -- Standard & Poor's assigned an A+ to each issue

APR 20 '93 10:21AM DSI

April 19, 1993

Page 2

and Moody's assigned an A. Each issue is secured by different collateral.

At closing on December 19, 1992, Stephens Inc. and the U.S. Bank of Washington, National Association relied upon representations by the Department of Administration and the Department of Natural Resources in the Certificate Purchase Agreement dated December 2, 1992, that all legal requirements for the issuance and sale of the Leases had been met. These representations and warranties were confirmed on December 10, 1992, prior to funding. In addition, we received an opinion from the State's Attorney General dated December 10, 1992, that stated, in part, "The State of Alaska, Department of Administration, is authorized and has the power under state law, AS 36.30.080, to enter into the Lease."

It is somewhat disconcerting to have worked hand in hand for several months with five divisions of Alaska's Executive Branch and the State's financial advisor on a very complex financing, which was well received by the two rating agencies, was sold aggressively and was well received in the marketplace, only to have another division of the Executive Branch second-guess the wisdom of the above five divisions and the State's financial advisor. A great deal of time and effort was spent by our office doing due diligence with representatives of Alaska state government, (which included retaining an environmental attorney) and obtaining representations, warranties and opinions from those representatives in order to ensure that the public was investing in securities issued by Alaska state government upon which the public could rely.

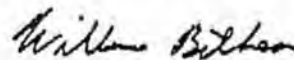
We are pleased that the report does not identify any violation of Alaska's laws, since that was the conclusion reached by the Alaska Attorney General and the four other divisions of Alaska state government at closing on December 10, 1992, since Stephens Inc. and U.S. Bank of Washington, National Association purchased the securities on that basis. While a review of prior governmental actions is always proper and is to be encouraged, a self-acknowledged "limited review" which concludes "it is likely..." and states that "...in our opinion legislative approval should have been obtained..." when the Attorney General specifically stated that the particular state statute mentioned in the report was complied with only serves to confuse the investing public. Also, the fact that each issue received separate ratings and each is well-secured on its own belies the conclusion that "... the resulting financing structure does not result in two issues which 'stand on their own'..."

Representatives of Stephens Inc. have cooperated with the staff of the Office of Management and Budget and it will be glad to answer any other questions which that office may have. Stephens

April 19, 1993
Page 3

Inc. was proud to have been able to participate with the State of Alaska in a very complex financing which was well received in the marketplace and which will help the State meet federal and state requirements for housing its prison population in the future.

STEPHENS INC.



By: William Bethea
Senior Vice President

ALASKA STATE LEGISLATURE

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Division of Legislative Audit



P. O. Box 113300
Juneau, AK 99811-3300
(907) 465-3830
FAX (907) 465-2347

October 21, 1993

Members of the Legislative Budget
and Audit Committee:

We requested responses to our preliminary report from the Department of Law, the Department of Corrections, and the State Bond Committee (SBC). SBC was the only entity which submitted a response.

We have reviewed the response of SBC and have the following comments.

SBC has stated in its response:

The statements on page 15 of the report are incorrect where it indicates that there is a significant difference between DNR's and a municipality's role as a nominal issuer and lessor. A municipality that has acted as a nominal issuer and lessor to a transaction is not responsible for satisfying a debt obligation. The cities of Kenai, Palmer and Seward have the same role as DNR with respect to lease/purchase financings with the State: they would not serve in that capacity if there was any financial risk.

We again reiterate that there is indeed a significant difference between the State of Alaska's (in this case the Department of Natural Resources) involvement in the Wildwood acquisition and the local governments of Palmer, Kenai, and Seward when acting in the dual role of nominal issuer and lessor.

As elaborated on page 15 of the report, this was the first time the State acted in the dual role of acquiring capital and also that of lessor/lessee. In the past the State leased and lease-purchased properties from local governments subject to annual appropriation. Those local governments obtained the capital themselves and assumed the associated risk. All three local governments of Palmer, Kenai, and Seward performed a critical and necessary measure before issuing debt instruments to obtain capital to construct the facilities. In the Palmer case, there was a local plebiscite in which the residents voted on a measure authorizing the "City of Palmer [to] incur debt and issue lease revenue bonds. . .". Secondly, and most importantly, all three local governments' legislative body — the city council — adopted a resolution authorizing the issuance of debt for construction and authorizing the execution of a lease with the State.

Herein lies the critical and significant difference between the State's lease/purchase of the Wildwood Correctional Center and the lease transactions with the local governments: there was no legislative involvement in the transaction authorizing the State to issue debt instruments or to proceed with the acquisition of the facility.

In regard to the splitting of the COP issue, SBC has stated:

It is the Committee's understanding that the financing structure was conceived and committed to in the summer of 1992 for valid financing considerations that would result in cost savings to the State.

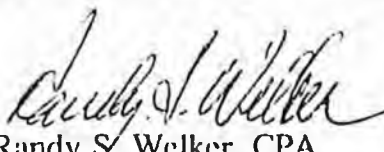
and,

It appears that parties closely involved with the transaction knew of the September 24, 1992 legislative effective date. When that date was near there were discussions and communications of the requirement. The Committee believes that the activity at that time has been misconstrued to mean that the issue was split at that time to avoid legislative oversight.

We believe the available evidence is clear in that a one-issue package was contemplated until early September 1992. We have received no evidence from the SBC, the Department of Revenue, Department of Law, Department of Corrections, or Department of Natural Resources that supports the SBC understanding that the dual issue was committed to in the summer of 1992. There is evidence that in the summer of 1992 at least the Department of Revenue was discussing other lease-financing options and avoiding legislative approval. On June 12, 1992 the commissioner of the Department of Revenue corresponded with the governor discussing the possibility of obtaining capital for new facilities. The correspondence states in part:

The Department of Revenue believes that an opportunity exists for the State of Alaska to finance the construction of public projects by refinancing existing lease obligations on State owned assets. This concept has the advantage of not requiring legislative approval which could otherwise be required on new project financing. These refinancings would generate proceeds which could be used for new facilities.

To us, it appears there was consideration of lease-purchase transactions and avoiding legislative approval. We concur with legislative counsel that transactions of this type required legislative involvement.


Randy S. Welker, CPA
Legislative Auditor

HB

373

HOUSE COMMITTEE REPORT

(7)

Date Referred: January 14, 1994

FURTHER REFERRALS:

Finance

Date of Committee Action: 3-5-94

The STATE AFFAIRS Committee considered:

HB 373

HOUSE BILL NO. 373

PERMANENT FUND INVESTMENTS IN REAL ESTATE

"An Act relating to investments of the permanent fund involving equity interests in and debt obligations secured by mortgages on real estate; and providing for an effective date."

RECOMMENDATIONS:

be replaced with _____ the same title
 a new title

have attached amendments(s)

do pass

do not pass

no recommendations

individual recommendations

additional referral to the _____ Committee

ADOPTS: _____ letter of Intent

ATTACHES NEW FISCAL NOTE(s): (Dept)

APPROVES PREVIOUS: (Dept/Date)

fiscal impact _____

fiscal note(s) _____

zero fiscal note Revenue

zero fiscal note(s) _____

SIGNING DO PASS	DP	OTHER RECOMMENDATIONS	DNP	NR	AM
<i>[Signature]</i>	✓				
<i>[Signature]</i>	✓				
<i>[Signature]</i>	✓				
<i>[Signature]</i>	✓				
<i>[Signature]</i>	X				

[Signature]
 CHAIRMAN'S SIGNATURE

FISCAL NOTE

**STATE OF ALASKA
1994 LEGISLATIVE SESSION**

BILL NO. House Bill No. 373

Revision Date: _____
 Title: "An Act relating to investments of the permanent fund involving equity interests in and debt obligations secured by mortgages on real estate; and providing for an effective date."

Dept. Affected: Department of Revenue
 BRU: APFC

Sponsor: House Rules Committee by Request of the LB&A Committee
 Requestor: House State Affairs

Component: APFC
 COMPONENT SERIAL NO. 109

Expenditures/Revenues:

(Thousands of Dollars)

OPERATING	FY95	FY96	FY97	FY98	FY99	FY00
PERSONAL SERVICES	-0-	-0-	-0-	-0-	-0-	-0-
TRAVEL	-0-	-0-	-0-	-0-	-0-	-0-
CONTRACTUAL	-0-	-0-	-0-	-0-	-0-	-0-
SUPPLIES	-0-	-0-	-0-	-0-	-0-	-0-
EQUIPMENT	-0-	-0-	-0-	-0-	-0-	-0-
LAND & STRUCTURES	-0-	-0-	-0-	-0-	-0-	-0-
GRANTS, CLAIMS	-0-	-0-	-0-	-0-	-0-	-0-
MISCELLANEOUS	-0-	-0-	-0-	-0-	-0-	-0-
TOTAL OPERATING	-0-	-0-	-0-	-0-	-0-	-0-

CAPITAL:	-0-	-0-	-0-	-0-	-0-	-0-
-----------------	-----	-----	-----	-----	-----	-----

REVENUE FUND SOURCE:	-0-	-0-	-0-	-0-	-0-	-0-
-----------------------------	-----	-----	-----	-----	-----	-----

FUNDING:

(Thousands of Dollars)

1002 Federal Receipts	-0-	-0-	-0-	-0-	-0-	-0-
1003 GF Match	-0-	-0-	-0-	-0-	-0-	-0-
1004 GF	-0-	-0-	-0-	-0-	-0-	-0-
1005 GF/Program Receipts	-0-	-0-	-0-	-0-	-0-	-0-
1006 GF/MHTIA	-0-	-0-	-0-	-0-	-0-	-0-
Other	-0-	-0-	-0-	-0-	-0-	-0-
TOTAL	-0-	-0-	-0-	-0-	-0-	-0-

POSITIONS:

FULL-TIME	-0-	-0-	-0-	-0-	-0-	-0-
PART-TIME	-0-	-0-	-0-	-0-	-0-	-0-
TEMPORARY	-0-	-0-	-0-	-0-	-0-	-0-

Estimate of current year (FY94) Impact: \$ -0-

ANALYSIS: (Attach a separate page if necessary)

Prepared by: William H. Scott, Executive Director *W. H. Scott* Phone: 465-2047
 Division: Alaska Permanent Fund Corporation Date: January 31, 1994
 Approved by Commissioner: Darrel J. Rexwinkel, Commissioner *D. J. Rexwinkel* Date: 1/31/94
 Agency: Department of Revenue

PREPARER TO PROVIDE ALL DISTRIBUTION COPIES TO GOVERNOR'S LEGISLATIVE OFFICE
 For further distribution information call the Governor's Legislative Office

MAR 3 1994



Alaska Permanent Fund Corporation


P.O. Box 25500 Juneau, Alaska 99802-5500

(907) 465-2047

MEMORANDUM

DATE: March 4, 1994

TO: Representative Al Vezey
Chairman, House State Affairs Committee

FROM: William H. Scott
Executive Director 

SUBJECT: **House Bill No. 373**

HB 373 would amend the Permanent Fund's list of authorized investments to provide for up to 100 percent ownership in real estate investments.

As of January 31, 1994, the Permanent Fund had a market value of \$16 billion - \$1.1 billion of which is invested in real estate. That means real estate investments equal less than 7% of the total value of the Fund. The Legislature in 1983, when it originally approved real estate investments for the Fund, authorized the Board of Trustees to invest up to 15% of the Fund in real estate; the Trustees, meanwhile, have instructed staff to invest 10% of the Fund in real estate.

The primary reasons your Fund managers are seeking changes to the existing real estate statute are: (1) to gain increased management control over the Fund's real estate investments; and (2) to help the Board of Trustees reach their real estate asset allocation target. We have been trying to reach that 10% target for about five years and have never come much closer than we are today. It is our view that the Fund will be unable to reach its desired real estate asset allocation unless there is some relief provided from the 40% ownership rule.

PFD STATEMENT

Representative Al Vezey
March 4, 1994
Page 2

For the information of the members of the House State Affairs Committee, I have attached a number of supporting documents which thoroughly describe the rationale for this legislation.

Attachment #1 is the Board of Trustees resolution dated December 6, 1993 in support of this proposed change. The Trustees adopted this resolution unanimously.

Attachment #2 is a memorandum dated November 18, 1993 addressed to the Board of Trustees from our Real Estate Investment Officer, Pete Jeans. It describes the specific proposed change in the Permanent Fund statutes and explains the need for the change from an historical perspective.

Attachment #3 is a letter dated November 9, 1993 addressed to Mr. Jeans from the Corporation's outside real estate consultant, Paul Saylor. This letter provides the consultant's fiduciary opinion in support of the proposed change.

Attachment # 4 is a letter dated November 16 addressed to Mr. Jeans from the Corporation's outside law firm, Morrison & Foerster, which also provides a fiduciary opinion in support of the proposed change.

Finally, Attachment # 5 is a copy of an article which appeared in the July 1993 issue of *The Institutional Real Estate Letter*. The article, I think, makes a compelling case from an uninterested but expert third-party perspective that the concept of co-investing as currently practiced by the Alaska Permanent Fund Corporation is not necessarily in the Fund's best long-term interest.

The Fund invests in real estate to maximize the risk and return benefits of diversification. There is nothing in the bill which would hinder that, and much that would enhance it. On behalf of the Board of Trustees, I request that you give their concerns serious consideration.

Thanks very much for scheduling this bill. My staff and I look forward to discussing this issue with you at the upcoming State Affairs meeting on Saturday, March 5.



1

Alaska Permanent Fund Corporation

P.O. Box 25500 Juneau, Alaska 99802-5500
(907) 465-2047

**RESOLUTION OF THE BOARD OF TRUSTEES
OF THE ALASKA PERMANENT FUND CORPORATION
PERTAINING TO LEGISLATIVE CHANGES IN THE ALASKA STATUTES
RELATING TO REAL ESTATE INVESTMENTS BY THE
ALASKA PERMANENT FUND CORPORATION**

RESOLUTION 93-11

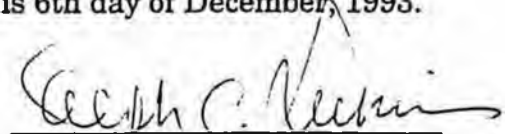
WHEREAS, the Fund is limited in directing business decisions on real estate investments as a 40% participant; and

WHEREAS, the Alaska Permanent Fund Corporation is impaired in its ability to reach its targeted real estate asset allocation within current parameters; and

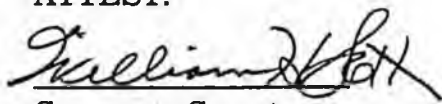
WHEREAS, the Alaska Permanent Fund Corporation has lost opportunities to acquire high return, low risk real estate investments;

NOW, THEREFORE, BE IT RESOLVED, THAT the Board of Trustees unanimously directs staff to seek legislative changes to provide for up to 100% ownership in real estate investments.

PASSED AND APPROVED by the Board of Trustees of the Alaska Permanent Fund Corporation, this 6th day of December, 1993.


Chairman, Board of Trustees
Alaska Permanent Fund Corporation

ATTEST:


Corporate Secretary

2

Alaska Permanent Fund Corporation
P.O. Box 25500 Juneau, Alaska 99802-5500
(907) 465-2047

MEMORANDUM

DATE: November 18, 1993

TO: Board of Trustees
Alaska Permanent Fund Corporation

FROM: Pete Jeans *PJ*
Real Estate Investment Officer

THROUGH: William H. Scott
Executive Director

SUBJECT: Recommended Legislative Changes, Real Estate

I am recommending a change to Title 37, Chapter 13, Section 37.13.120, the Alaska statute that authorizes the Fund's investments in real estate. The reference to real estate investment responsibilities of the Board of Trustees will be changed to read:

- (g)(16) equity interest in, and debt obligations secured by mortgages granting a first lien on, real estate located in the United States.
- (16)(A) deleted
- (16)(B) deleted
- (16)(B)(i) deleted
- (16)(B)(ii) deleted
- (16)(B)(iii) deleted

This change removes the 40% restriction on real estate acquisitions. The real estate "investment list" is stricken from the Statute and transfers to the Board of Trustees, the responsibility for establishing prudent investment standards and guidelines through the annual real estate resolution.

In order to justify this recommendation it is necessary to give a brief description of the Fund's real estate experience over the past ten years, along with my views on the changes that are taking place in the industry.

In 1983, the year the Alaska Permanent Fund Corporation made its first investment in real property, the Board of Trustees had allocated 6% of the \$3 billion Fund to real estate. The Board of Trustees hired a real estate consultant to assist

11-18-93 MEMO PFD

in selecting three real estate advisors. From 1983 through 1987, the Fund took a passive role in real estate investing and relied almost exclusively on the recommendations of the consultant and advisors. Additionally, the 40% co-investment requirement created a high comfort level for the Trustees. By co-investing with larger, more sophisticated pension funds and endowments, the Permanent Fund took advantage of their expertise and leadership in real estate investing. During this period, control and involvement in property decisions were not priorities for the APFC.

In the later part of the 80's, there was a turnover in Permanent Fund real estate staff. Soon after, the Fund employed new real estate consultants and attorneys, all of which resulted in a more directive approach to real estate investing. The Fund has become more involved in the real estate investment process, from requiring certain controls and buy-sell arrangements on each real estate transaction to initiating disposition activities. Even as a 40% player, the Fund has been able to negotiate either equal or favorable terms and receive coequal treatment from larger investors.

Historically, market conditions played an important role in negotiations for favorable terms. During the recent market decline in the industry, many pension funds sat on the side lines, offering little competition for deals. Now that the market has shown signs of recovery, pension funds are re-entering the markets. Like the APFC, our institutional partners are gaining knowledge and confidence in their abilities to control investments and they no longer allow us to participate as an equal partner in a 40/60 deal. The only way to secure the same level of control that the Fund historically obtained with past investments is to acquire an equal or majority interest.

~~Control is by far the greatest benefit of holding a majority position in an investment.~~ Timing of major capital events, such as a property sale or the funding of a mall redevelopment designed to head off new competition, is often crucial to enhancing returns on a property. The inertia of some institutional partners has caused numerous missed opportunities for the Permanent Fund in the past.

~~Other advantages also exist.~~ The real estate asset allocation set by the Board of Trustees ~~will be more easily attainable!~~ Unless a single deal is exceptionally large, the acquisition of a single property will not materially affect the diversification strategy. Through resolution, the Board of Trustees will continue to maintain control over the diversification goals.

~~Legal costs will be reduced substantially by eliminating or decreasing the negotiations over control issues in partnership agreements.~~ Complications in replacing investment advisors are directly correlated with the number of partners in a deal. The replacement process is simplified in a 50/50 to 100% investment.

Board of Trustees
November 18, 1993
Page 3

By ~~having the option to take 100%~~ of an investment, we anticipate an increase in ~~deal flow~~. With only one or two investors involved, advisors will be more likely to propose acquisitions to us, particularly those with short closing time frames.

This proposed change to the Statute will give the Board of Trustees the flexibility to direct the real estate staff by board resolution. Attached is a letter from our legal counsel and real estate consultant recommending these changes.

RECEIVED #3

DEC 6 1993

ALASKA PERMANENT
FUND CORPORATION

SAYLOR PROPERTY CAPITAL, INC.

EIGHT PIEDMONT CENTER
SUITE 320
ATLANTA, GEORGIA 30305

TEL: (404) 261-8049
FAX: (404) 261-0271

NEW YORK OFFICE
437 MADISON AVENUE, 40TH FLOOR
NEW YORK, NEW YORK 10022-7380
TEL: (212) 754-6260
FAX: (212) 754-6264

PAUL H. SAYLOR

November 9, 1993

Mr. Pete Jeans
Investment Officer
The Alaska Permanent Fund Corporation
801 West Tenth Street
Suite 302
Juneau, AK 99801

RE: Proposed Legislation

Dear Pete:

You have asked that I give a few thoughts why I am in favor of a legislative change to allow you to take up to a 100% interest in an investment.

1) *Control*

Although co-investment documentation is evolving to the point where a minority investor will not necessarily be disadvantaged as to influence or control, there is no such thing as a 40% gorilla. In other words, it would be preferable for the APFC to invest on a basis that would allow it to control major investment, management and divestment decisions in its own best economic interests, rather than be influenced by one or more investors which may, at least over time, have differing objectives.

While I believe the APFC has been advantaged by retaining discretion over major investment, management and divestment issues, it is currently required to be totally aligned with one or more partners in order for activities which best serve it to occur. Examples include the inability to close recent transactions because of (what I consider) minor differences with a 60% partner, and your lack of influence in matters associated with Boston Real Estate Counsel assets in a situation where at least one of your partners was lethargic and bureaucratically hamstrung from acting in all partners' best interests.

2) *Maximum New Opportunities*

As property markets turn back in favor of sellers, the APFC will receive

11-9-93 SAYLOR PROPERTY CAPITAL

increasingly fewer high quality investment opportunities, as investment managers will be less in need of the APFC's capital and wish to conclude transactions with either one investor or a commingled format over which they have discretion. Currently, it is relatively complicated for a transaction originator to identify an asset for the APFC with the condition the APFC will only pursue due diligence or the consummation of a transaction once a compatible investment partner has been identified. Recently, transactions have gone elsewhere to avoid this process.

Additionally, there are increasing concerns regarding potential incompatibility of APFC requirements with those of certain other active investors. Although the multi-asset co-investment opportunity which we have collectively pursued for the last several months will go a long way to establish levels of overall compatibility among several investors and standardized processes, sellers or transaction originators generally attempt to avoid the unknowns associated with due diligence and documentation requirements of multiple investors.

3) *Management Changes*

Since the APFC appropriately exercises rights of management oversight, it is more likely to recognize management program weaknesses and to move to correct them than most other institutional investors. Existing assets and portfolios need to be intensively managed in order to improve their performance and occasionally to position assets for sale. Managers who are ineffective should be replaced, and manager replacement is most difficult to accomplish for the APFC as a minority investor especially since most partners of the APFC are required to live with an "approved list" of investment managers.

I do not at all advocate that the APFC should only pursue acquisition of full interests in individual assets and portfolios, but I believe a change of legislation to allow you to do so is most important. It is my view that the immediate effect of such change will not be termination of your co-investment programs, but rather a gearing up of the process contemplated by your co-investor conference this past April. Your ability to be a major partner, rather than (always) a minor partner is most important to the achievement of your objectives set forth for the asset class of real estate and to your competitiveness in the marketplace.

Yours very truly,



Paul H. Saylor

CC: Llewellyn Lutchansky

#4

MORRISON & FOERSTER

LOS ANGELES
SACRAMENTO
ORANGE COUNTY
PALO ALTO
WALNUT CREEK
SEATTLE

ATTORNEYS AT LAW
345 CALIFORNIA STREET
SAN FRANCISCO, CA 94104-2675
TELEPHONE (415) 677-7000
TELEFACSIMILE (415) 677-7522
TELEX 36-0154 MORSN FOERS SFO

NEW YORK
WASHINGTON, D.C.
DENVER
LONDON
BRUSSELS
HONG KONG
TOKYO

November 16, 1993

DIRECT DIAL NUMBER
(415) 677-7048

VIA FACSIMILE

Mr. Pete Jeans
Real Estate Investment Officer
Alaska Permanent Fund Corporation
P.O. Box 25500
Juneau, Alaska 99802-5500

Dear Pete:

You have asked us to review the proposed legislative amendments to Section 37.13.120(g) of the Alaska Statutes in the context of our experience as investment counsel for the Alaska Permanent Fund Corporation (the "APFC"). We understand that the legislative amendment to be reviewed by the Board would modify subsection (g)(16) of Section 37.13.120 to provide:

(g) Subject to the limitations contained in this section, the board may invest fund assets at the competitive national market rates or prices that are applicable to each investment only in

...

(16) Equity interests in, and debt obligations secured by mortgages granted a first lien on, real estate located in the United States.

We believe that this proposed amendment would be beneficial in carrying out the investment policies of the APFC for several reasons. First, it would allow the APFC to effect real estate investments that fulfill its investment objectives without imposing legal constraints that may not be relevant to ensuring that the investments are prudent. Second, the existing provisions of Section 37.13.120 that would remain unchanged by this legislative proposal ensure that sufficient fiduciary safeguards are present in connection with the acquisition of real estate by the APFC. Third, and perhaps most significantly, the proposed

140638(14507/1)

MORRISON & FOERSTER

Pete Jeans
November 16, 1993
Page Two

amendment would allow the APFC to invest in real estate on terms that are comparable to the terms available to ERISA-regulated corporate and Taft-Hartley (union) retirement plans and a majority of governmental retirement systems. By adopting the standards utilized by most tax-exempt institutional investors, the APFC will be poised to compete more effectively with such investors for real estate opportunities and to exert the degree of control that many of such investors have viewed as conducive to maximizing return and minimizing risk in their real estate portfolio investments.

The current provisions of Section 37.13.120(g)(16) include specific limitations that mandate, among other requirements, that the APFC not hold greater than a 40 percent beneficial ownership interest in a real estate investment at the time of acquisition, that the real estate investment is improved by completed buildings and that such buildings are substantially leased. These types of restrictions are typically referred to as "legal list" statutes and were commonly used in state statutes applicable to public and private retirement plan investments prior to 1974.

The enactment of the federal ERISA statute in 1974 eliminated the applicability of these legal list statutes to private corporate and union retirement plans. ERISA imposed general fiduciary standards applicable to all types of investments. The foundation of these fiduciary standards is the prudence and diversification rules of Section 404 of ERISA. These rules are incorporated into Sections 37.13.120(a) and (c) of the Alaska Statutes and are fully applicable to the APFC's real estate investments.

The drafters of ERISA abandoned the legal list statutes in favor of general rules of prudence and diversification for two reasons. First, to the extent that a restriction found in a legal list is a restriction appropriate to effecting a prudent and diversified investment, the legal list restriction is merely duplicative with the general fiduciary standards. Moreover, to the extent that the restriction was unnecessary to ensuring that appropriate fiduciary caution was exercised in effecting an investment, the legal list restriction was viewed as impeding the plan's ability to pursue prudent acquisition opportunities.

MORRISON & FOERSTER

Pete Jeans
November 16, 1993
Page Three

Since the enactment of ERISA, a majority of public retirement systems have adopted legislative changes that substitute general fiduciary standards for legal list statutory restrictions. The rationale underlying these changes has been similar to the legislative intent of Congress in enacting ERISA, that the legal list restrictions are either duplicative with the general standards of prudence and diversification, are obsolete interpretations of such standards or are general examples of such standards that may not be appropriate in specialized investment contexts.

It would be beneficial to the APFC to pursue investment opportunities in real estate under standards similar to the fiduciary standards applicable to the majority of institutional investors competing for these investment opportunities. Because the APFC will be fully obligated to pursue real estate investments that satisfy the prudence, diversification and other standards applicable under Section 37.13.120, to the extent that the legal list restrictions of current subsection (g)(16) are appropriate to ensure prudence or diversification, these restrictions will still apply to real estate investments of the APFC. Thus, for example, if a purchase of more than forty percent of the beneficial ownership of a particular real estate investment would not be consistent with the standard of maintaining a reasonable diversification among investments, the "forty percent rule" would continue to apply. If, however, it was not only prudent and consistent with diversification standards to invest in a larger percentage of a particular real estate investment, but would allow greater controls with respect to operating budgets, leasing decisions and other control features determined relevant to enhance the APFC's investment return, the forty percent rule would operate to limit potential investment returns in the APFC real estate portfolio.

In summary, the legal list restrictions of subsection (g)(16) are generally redundant with the prudence and diversification standards of sections (a) and (c) of Section 37.13.120. In those instances where these restrictions do not duplicate the general standards, but provide more onerous restrictions, it is difficult to justify rules that do not further the standards of prudent real estate acquisitions or may impede such acquisitions.

It is widely recognized that the current real estate acquisitions market demands a greater scrutiny of

MORRISON & FOERSTER

Pete Jeans
November 16, 1993
Page Four

current income opportunities than was the case in years where capital appreciation in real estate could be more easily projected. It is significant to note that the APFC's ability to control decisions that are economically relevant to both income and potential capital appreciation is limited by its current inability to acquire a majority interest in its real estate investments. By allowing the board and, to the extent delegated by the board, the APFC staff, the ability to balance the economic benefits of control against the costs of such a percentage acquisition, the APFC will be able to maximize its investment objectives in a context relevant to each particular investment opportunity it reviews for potential acquisition.

Please contact me if we can be of further assistance in this matter.

Very truly yours,

Rachel Markun pmd

Rachel Markun

RM:pmd

THE INSTITUTIONAL REAL ESTATE LETTER

The Information Source For Industry Insiders

Volume 5, Number 7

ISSN 1044-1662

July 1993

PROSPECTUS

Securitization — REITs have outperformed everything lately. Can it last? (It didn't the last time REITs were hot.)

Page 1

Co-Investment — Does it really improve investment manager performance and investor control?

Page 1

Editorial — An investment manager's non-responsiveness may be an indicator.

Page 2

People — Steven Wheeler joins Copley; changes at Utah State Retirement, Rhode Island and District of Columbia.

Page 7

Legal — Acquisition and performance fees: new Department of Labor ruling.

Page 8

Debut — Freedom Home Equity Partners are bringing back reverse annuity mortgages for institutional investors.

Page 11

Investment News — Updates on pension plans and others in the real estate investment community.

Page 18

Portfolio Management — Tailoring the risk/reward profile for an asset.

Page 20

Securitization — Martin Cohen explains common myths of REITs.

Page 24

Mortgages — Commercial rates are cheap and supplies are adequate.

Page 25

Advisor Fees — Frank Russell Company reports on its "Fairness" study.

Page 29

Trends — Dr. Gruen on the price of tulip bulbs, the merger mania of the Eighties and other speculative bubbles.

Page 32

SECURITIZATION

by Steve Bergsman

REITs On a Tear

Déjà Vu—Have We Been Here Before?

Real estate investment trusts have been on a tear. For the first quarter of 1993, REITs posted returns of 19.1 percent, easily outdistancing the S&P 500 which only managed a 4.3 percent return. This was an even faster start than in 1992 when REITs

blistered the market for a 20.7 percent return, again showing up the S&P 500 which only notched a decent 7.7 percent return.

It's not just the market performance of REITs that has caught the eye of the investor—last year, the REIT market raised \$6.6 billion, nearly \$2 billion greater than the previous record year of \$4.8 billion. More than half of that \$6.6 billion was raised by existing REITs which were extremely active in the real estate market, acquiring \$2 billion worth of properties. REITs suddenly became the Japanese of the Nineties. The paradox is, after mugging the U.S. real estate market with a seemingly inexhaustible supply of capital, the Japanese have disappeared. Will the same thing happen

Continued, Page 5

CO-INVESTMENT

by Steve Bergsman

The Dark Side

Co-Investment May Be Trendy, But It's Not All Wine and Roses

The concept of co-investing has been around for decades, but recently, it seems to have become the "in" thing to do.

Increasingly, over the past three years, investors and investment managers alike have been dressing their portfolios up with co-investments—the institutional investment community's analog of the "grunge" look.

The "grunge look"—ripped jeans and flannel shirts—may be popular in some circles today, but it certainly isn't for everyone. Neither is co-investment. Even if co-investment is particularly well-suited to the needs of your fund, there are numerous issues which must be considered to make sure your beneficiaries don't end up in rags and tags.

Like the grunge look, the trendsetter for co-investment came out of the Pacific Northwest. Since the mid-1980s, the **Alaska Permanent Fund**—a \$15 billion endowment organized for the benefit for

Continued, Page 15

COVER STORY

Co-Investment

*Trendy, But It's Not All Wine and Roses**Continued from page 1*

all the citizens of Alaska and funded by taxes on mineral extraction revenues—has been the leader in the U.S. co-investment movement.

The reason? As always, necessity is the mother of invention. By statute, the maximum interest the Permanent Fund can hold in any single property is 40%. This means that, in order to make separate account investments work—and the Alaska Permanent Fund's Real Estate Investment Officer, **Pete Jeans**, very much wants his fund to be a separate account investor—the Fund has no choice but to co-invest (join with other tax-exempt funds to make a purchase).

As a result, for the last eight years, Jeans has made co-investment after co-investment, bringing into his real estate plays more than 100 pension fund investment partners. The approach has worked well for the Alaska Permanent Fund, and now Jeans has come south to spread his gospel throughout the "Lower 48." (More than 40 pension, foundation and endowment funds recently attended a private conference on co-investment in Dallas, sponsored by the Alaska Permanent Fund and its advisors.)

Obviously, Jeans is having some success spreading the word. He credits this success to the discontent so many pension plans have been feeling over the real estate investment programs in which they invested during the early to mid-1980s. During those formative years, Jeans explains, the institutional investor community enthusiastically embraced the concept of blind pool commingled fund investing. With this approach, a group of tax-exempt investors would invest their capital in a specified group trust, insurance company separate account or limited partnership organized and managed by an investment manager in order to enable those investors to acquire a diversified portfolio of real estate assets. The problem with these funds, says Jeans, is that investment decisions and management responsi-

bilities were left in the hands of a third party who had ultimate discretion over the funds—and who almost always had significant conflicts of interest. To make matters worse, when the real estate market collapsed, funds trying to escape the calamity discovered they were blocked by poorly-conceived exit strategies.

Today, pension plans, still tangled in the webs of commingled funds but anxious to get in on the buying opportunity of a lifetime, are looking for new paradigms—alternative forms of real estate investment that can offer greater control and liquidity. Of course, the ultimate control results when a pension fund acquires properties directly with no partners. Some funds are unable or disinclined to go that route, however, which, according to Jeans, is what makes co-investment so appealing today.

If one considers investment structures on a continuum, notes **Allen Andersen**, a Principal with the Dallas office of **Arthur Andersen Real Estate Service Group**, they will fall somewhere between sole ownership and commingled funds. Where on the continuum co-investment lies—especially in regards to the control issue—is still subject to debate. Andersen, for one, says he would place co-investment closer to commingled funds on the spectrum, rather than placing it squarely in the middle.

Of the many forms of co-investment, the least popular have been those which require advisors, operating partners or developers to put their own capital at risk alongside the investors. While some investors now require such arrangements, others shy away because of the obvious inherent conflicts of interest. (As **Bob Burke**, a Principal of **AMB Institutional Realty Advisors** likes to point

out, the investment management industry appears to have come full circle. The real estate investment management industry really took off, explains Burke, when the Employee Retirement Income Security Act of 1974 (remember ERISA?) mandated that pension funds interject a fiduciary between pension plan assets and deal promoters. Today, notes Burke, pension funds requiring their advisors to co-invest effectively are requiring them to become promoters—creating, once again, precisely the kinds of conflicts the provisions of ERISA sought to eliminate.)

An examination of many of these structures also will reveal that the advisor/developer/operator often stands to receive back in fees during the first few years of the investment, an amount equal to or exceeding the capital it generally committed to the partnership. In such cases, the pension fund's coinvestment "partner" may have little or no capital at risk after the first few years.

To make matters worse, warns **Allen Andersen**, when the other partner is not a tax-exempt fund there usually is a disproportionate level of investment. The tax-exempt investor typically funds something akin to 90-95% of the investment and the advisor, 5-10%. Those kinds of splits don't

Of the many forms of co-investment, the least popular have been those which require advisors, operating partners or developers to put their own capital at risk alongside the investors.

really do what the pension fund wants them to do.

When pension funds do require their investment managers to put their own capital at risk in the deal, adds **Jim Curtis**, a Principal with San Francisco-based workout specialist **The Bristol Group**, they typically are seeking to align the interests of their partners with their own. The hope, explains Curtis, is that, by having their capital at risk alongside the pension fund's capital, the operating partner will be more attentive to the management of the pension fund's investments. "That's the hope,"

Continued, Next Page

Continued from previous page

notes Curtis. "We've learned, however, that people can make equally as bad investment decisions with their own money as with somebody else's." Clearly, therefore, having capital at risk is no guarantee that things will go well.

Curtis also cautions that frequently the partner doesn't even have its own capital at risk. "They raise it from other sources or they borrow it. The problem is, when the capital contributed is non-recourse, the investment manager or promoter really isn't at risk at all. In such cases," warns Curtis, "all that these co-investment requirements really create is the *illusion* of comfort."

In addition, an incompatibility of incentives often exists in these types

of investments, according to **Ron Karp** of the Summit, NJ-based consulting firm **Ronald A. Karp & Associates**. Karp notes that there is a mismatch in the long-term stability and financial staying power of the pension plan versus the investment advisor or operating partner. "If the investment gets into trouble, who is going to fund the losses? Obviously, it's going to be the pension plan. And that is going to create a problem when it comes to decision-making."

of investments, according to **Ron Karp** of the Summit, NJ-based consulting firm **Ronald A. Karp & Associates**. Karp notes that there is a mismatch in the long-term stability and financial staying power of the pension plan versus the investment advisor or operating partner. "If the investment gets into trouble, who is going to fund the losses? Obviously, it's going to be the pension plan. And that is going to create a problem when it comes to decision-making."

The most popular form of co-investment, however, is between similar investors with similar objectives and resources, such as two or more pension plans. Even here, however, there are variations and concerns. One type of co-investment, for example, relies on an advisor who brings together investors with a common investment strategy. The advisor then executes transactions accordingly. A second type of co-investment occurs when investors unite under their own initiative—when the co-investment is investor-driven, rather than manager-driven.

The principal feature of every co-investment, however, is that it in-

volves more than one investor (the typical co-investment involved between three to five investors). Therein lies co-investment's strength—and its weakness.

For a smaller pension plan, co-investment offers the opportunity to participate in transactions larger than those the plan otherwise would be able to execute on its own. "Small funds may not be able to invest in large projects simply because their allocation is insufficient," explains **Terry Ahern**, a Principal with the Cleveland-based **Townsend Group**. It also enables a larger investor to achieve more diversification than otherwise would be possible by investing directly. According to its Chief Real Estate Investment Officer, Grayson Sanders, for example, the Ameritech Pension Trust has assembled a roughly \$1.2 billion real estate portfolio over the past ten years. Sanders notes, however, that because it has acquired much of that

portfolio by co-investing with other tax-exempt funds, Ameritech's \$1.2 billion position is covered by a portfolio of more than \$14 billion in real estate assets.

Investors who have done co-investments often say they like being involved with other participants with similar goals because there is a comfort with being associated with other entities that have the same investment strategy. Or, as **Andy Smith**, President of **L&B Real Estate Counsel Inc.** says, "There is a warm and cozy feeling about doing a large investment with others." Why? For one thing, there is a lot more due diligence, explains Smith. Each partner gets to scrutinize the deal; there are more checks and balances so it's less likely there will be any surprises.

Despite the lack of surprises, there also is going to be a lot more work—and fiduciary liability—for the co-investors. By co-investing rather than commingling, for example, tax-exempt investors not only have to review the potential investments, but also must participate in the decision to acquire. In addition, they must be

involved in decisions concerning the ongoing management of the property, and when and how eventually to divest. The problem is, without a third party fiduciary to share the risks, a pension fund subject to ERISA provisions must shoulder the fiduciary liability associated with making these decisions alone.

Despite the extra work and liabilities, however, this is precisely the kind of control that was lacking in the commingled funds, and precisely the kind of control that many tax-exempt investors now want. When investors were passively investing in commingled funds, advisors and managers made those decisions. When advisors became promoters, and began structuring funds as partnerships to avoid being subjected to fiduciary liability under ERISA, they still made the decisions, but investors no longer enjoyed any insulation from fiduciary liability. When investors realized they weren't going to receive any fiduciary insulation, they started questioning why they should give up control. This issue, and this issue alone, is the primary driving force behind the co-investment trend. "Investors were very concerned about the lack of control in commingled funds," explains Alaska's **Pete Jeans**. "They wanted to be part of the process. Co-investment gives the investor more control."

Or does it?

LESSONS LEARNED

The old axiom of real estate used to be "location, location, location." But, counters **Tim Getz**, Investment Officer with the **Ohio Public Employees Retirement System**, the axiom really should be "control, control, control. You're not going to get that control," warns Getz, "by sharing your decision-making power." Getz speaks from experience—his fund was a pioneer in both the early commingled fund and co-investment movements. "One of the lessons that we learned from commingled funds was that the investor didn't make portfolio decisions. The decisions were always being made by someone else. When things got difficult, it was impossible to achieve consensus." Getz warns that the problem is no different with co-investments, which he says are

"nothing more than a commingled fund warmed over."

As noted before, one of the strengths of co-investment is the added layer of scrutiny. This also is a weakness, however, because it often can be difficult if not impossible to get multiple parties to come to a decision. And, since co-investors don't always have equal shares, by definition, someone is bound to end up with a minority interest. Obviously, that can be a real problem if the majority investors have a different point of view than the minority investors.

"Co-investment complicates every single aspect of a transaction," says **Susan Hudson-Wilson**, Director of Portfolio Strategy for Boston-based **Aldrich, Eastman and Waltch**. "All of a sudden there are two or more parties—very interested parties—that need and ought to be satisfied on every single aspect of the investment." As Hudson-Wilson points out, however, a hot button for one co-investor may not be so hot for another. This can make it extremely difficult to structure a transaction.

Once a co-investment has been completed, however, there essentially are five decisions upon which co-investors have to agree: leasing; capital improvement; budget; sale; and an exit strategy. In a co-investment, the way for the investors to feel their way through those processes, says L&B's Smith (who has been putting together co-investment deals since the 1970s) is to make sure that one participant never has more than 50 percent of the vote. To make a co-investment program work, explains Smith, a reasonable level of democracy must be established.

Michael Evans, National Director with **Ernst & Young's** Real Estate Advisory Services in San Francisco, counters that co-investment adds another, unneeded level to problem solving over the life of the asset. "When there are decisions to be made by different investors who have changing objectives and strategies, there is always going to be the potential for conflicts of interest."

Hudson-Wilson concedes that co-investment may be a great way for a small pension plan to participate in larger investments, but reiterates that, "there is true lack of control when you need it most." At the point when you

most need and want to do something big—like invest more or reduce the size of your investment—you discover that your options aren't much different than if you had invested in a commingled fund.

A FORMULA FOR SUCCESS

Co-investors typically try to avoid the problem of potential conflicts of interest by finding other investors with similar investment objectives. "The big key to success in co-investment is picking your partners," admits Jeans. "It does little good to find a partner who wants to hold properties for the long term, if you want to sell after three years."

Cab Grayson, Managing Director of **CB Commercial Realty Advisors**, feels that establishing a pre-existing association for co-investment can greatly enhance the success of the co-investment. "These associations of like-minded investors agree in advance to a defined real estate investment strategy, acquisition process, standardized contracts covering the decision-making powers of investors and transferability of interests, and pre-negotiated investment management fees that are performance-based and aligned with the investors' interests. The associations and the predefined process allow the investment manager to move quickly and to better negotiate with the seller." CB completed its first co-investment in 1981 and has created an active co-investment association of like-minded investors. **Scott Tracy**, Grayson's partner at CB Commercial, adds that, "The association prompts the co-investors to address most of the issues beforehand, and minimizes the difficulties in gaining consensus. Investors agree that, once the initial acquisition decision has been made, the advisor is given a defined level of discretion on operating decisions, thereby reducing disputes.

When constructing the co-investment, it is critical that the rights of the co-investors be stated clearly and definitively. "You must have a mechanism for resolving disputes among the participants," warns **Jim Snyder**, President of **Kennedy Associates Real Estate Counsel**, a Seattle-based advisor that has been putting together co-investments for the past 15 years.

Snyder explains that the problem-solving process among the co-investors should be formalized as a general part of the co-investment agreement. Sometimes the process could be as simple as a majority vote among the co-investors, but it also should include a way to allow an unhappy investor to exit the co-investment. As noted, liquidity is one reason why pension plans are looking at co-investment. Investors, therefore, need to be assured that there is an easy out if they want to leave.

"Our experience," says Jeans, "has been that, if we're having a problem or disagreement with a partner, we call a meeting and sit down together face-to-face. Ninety-nine percent of the time we can solve the problem. In those few instances where it absolutely doesn't work out, the partner can leave." According to Jeans, that usually means the other partners will buy out the disgruntled party.

The New York State Teachers Retirement System also has been involved in co-investment transactions in the past, but none recently. "We're not saying we won't do any more, but when we have a choice, we prefer to invest on our own," notes **Jim Campbell**, Assistant Real Estate Officer at NYSTRS. The Fund wants to control its own destiny, Campbell explains, and it is tougher to do that when hooked into other investors. "It can be frustrating to be in a deal with an investor who has a shorter term horizon or is handicapped by political decision-making processes."

The bottom line is, co-investment is a little like "the Force"—that wonderful source of power that Luke Skywalker discovers in George Lucas' *Star Wars*. Like the Force, co-investment can be either of great benefit, or great harm to the user—depending on how you approach it. And, as with all sources of power, investors must not forget that co-investment has its dark side. ♦

Steve Bergsman is a freelance real estate writer in Mesa, Arizona.

375

HB

8-LS1524E
Cook
4/14/94

CS FOR HOUSE BILL NO. 375(STA)
IN THE LEGISLATURE OF THE STATE OF ALASKA
EIGHTEENTH LEGISLATURE - SECOND SESSION

BY THE HOUSE STATE AFFAIRS COMMITTEE

Offered:
Referred:

Sponsor(s): HOUSE RULES COMMITTEE BY REQUEST OF THE LEGISLATIVE BUDGET AND
AUDIT COMMITTEE

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to equity investments of the permanent fund; and providing for
2 an effective date."

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

4 * Section 1. AS 37.13.120(g) is amended by adding a new paragraph to read:

5 (21) notwithstanding (i) of this section, equity investments may
6 comprise more than five percent of the stock of a corporation if the investments in
7 excess of five percent consist of an interest in a partnership or ownership in a
8 collective investment vehicle, and only under the following conditions:

9 (A) the fund may not own more than a 60 percent interest in a
10 partnership or collective investment vehicle;

11 (B) the aggregate investment of the fund under this paragraph
12 may not exceed five percent of the total investments of the fund;

13 (C) appropriate policies and procedures for investments under
14 this paragraph shall be reviewed and approved annually by the board.

1

* Sec. 2. This Act takes effect immediately under AS 01.10.070(c).

FISCAL NOTE

STATE OF ALASKA
1994 LEGISLATIVE SESSION

BILL NO. House Bill No. 375

Revision Date:

Dept. Affected: Department of Revenue

Title: "An Act relating to investments of the permanent fund in certain limited partnerships each of who principal purpose is investment in securities of public or private companies; and providing for an effective date."

BRU: APFC

Component: APFC

Sponsor: House Rules Committee by Request.

Requestor: House State Affairs.

COMPONENT SERIAL NO. 109

Expenditures/Revenues:

(Thousands of Dollars)

OPERATING	FY95	FY96	FY97	FY98	FY99	FY00
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL	200.0	206.0	215.0	223.0	232.0	240.0
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	200.0	206.0	215.0	223.0	232.0	240.0

CAPITAL						
---------	--	--	--	--	--	--

REVENUE FUND SOURCE:						
----------------------	--	--	--	--	--	--

FUNDING:

(Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1006 GF/MHTIA						
Other (Corporation Receipts - 1022)	200.0	206.0	215.0	223.0	232.0	240.0
TOTAL	200.0	206.0	215.0	223.0	232.0	240.0

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

Estimate of current year (FY94) Impact: \$ -0-

ANALYSIS: (Attach a separate page if necessary) The Corporation intends to begin expending money for due diligence relating to these investments on July 1, 1994. These costs will include a "gatekeeper" fee similar to current real estate advisory fees; and will increase annually at the 3.75% inflation rate.

Prepared by: William H. Scott, Executive Director
 Division: Alaska Permanent Fund Corporation
 Approved by: Darrel J. Rexwinkel, Commissioner
 Commissioner:
 Agency: Department of Revenue

Phone: (907) 465-2047
 Date: April 12, 1994
 Date:

PREPARER TO PROVIDE ALL DISTRIBUTION COPIES TO GOVERNOR'S LEGISLATIVE OFFICE
 For further distribution information call the Governor's Legislative Office



Alaska Permanent Fund Corporation

P.O. Box 25500 Juneau, Alaska 99802-5500

(907) 465-2047

MEMORANDUM

DATE: April 12, 1994

TO: Representative Al Vezey
Chairman, House State Affairs Committee

FROM: William H. Scott *WHS*
Executive Director

SUBJECT: **House Bill 375**

House Bill 375, introduced at the request by the Board of Trustees, would amend current law with respect to equity investing. Specifically, it would allow the Permanent Fund to purchase – under certain conditions – more than five percent of the stock of a corporation.

The bill sets out general policies and guidelines for alternative asset investing. The purpose of the alternative asset investment program is to prudently employ a modest percentage of Permanent Fund assets to alternative investments to produce a well-diversified, profitable portfolio which will enhance the Fund's total return. The goals of the program are: (1) to achieve superior total returns compared to traditional asset classes; and (2) to diversify away from traditional capital market risks.

Even though alternative investments as an asset class are employed by hundreds of public and private corporations and institutions around the country, including universities and state retirement systems, they would represent a new type of investment for the Permanent Fund. As such, it is understood that a significant amount of education will be required both within the Corporation and within the legislature before such investments would be initiated, even on a limited basis.

Representative Al Vezey
April 12, 1994
Page 2

To begin the educational process, I am enclosing the following six attachments:

Attachment #1 is draft language for a proposed committee substitute for HB 375. This language, rather than focusing on the transaction mechanics of the new investments, more properly addresses alternative investments as simply a new asset class to be made available to your Fund managers for investment under the very stringent guidelines set forth by the Prudent Investor Rule. It is important to recognize that the particular selection criteria for each of these investments will most likely evolve and be adjusted over time as a result of the interaction between the staff, the Board and our consultants.

Attachment #2 is the Board of Trustees resolution dated December 6, 1993 in support of the original legislation. The Trustees adopted this resolution by a vote of five to one.

Attachment #3 contains excerpts from the minutes of the December 6 Board meeting in which Trustee Brady made the case for the proposed change.

Attachment #4 is the Executive Summary from the "1992 Survey of Alternative Investments by Pension Funds, Endowments and Foundations." This document indicates that investment by our peers in the asset class of alternative investments is widespread, significant and growing. For example, the top 200 funds in the U.S. and Canada currently have \$36 billion invested; this represents 3.6 percent of the assets of those funds that allocate dollars to alternative investments.

Attachment #5 is a reprint from the Spring 1994 issue of *The Journal of Investing*. The headline of the featured article is "Alternative Investments Grow Rapidly at Tax-Exempt Funds." Interestingly, this article indicates that it is the largest funds which are most the active in alternative investing. In fact, of the 33 \$10 billion-plus funds surveyed, more than 80 percent participate in at least one alternative investment asset.

Attachment #6 is a copy of a letter from Dave Rose, the Fund's previous executive director, stating his support for the legislation and his reasoning, as well as some thoughts about the specific prohibitions included in the proposed committee substitute.

Representative Al Vezey

April 12, 1994

Page 3

The bottom line is that the Board wishes to have the authority contained in this amendment because we are convinced it will help us to do a better job protecting and enhancing the Permanent Fund. I would ask for your support and stand ready to provide additional information at any time.

Be it enacted by the Legislature of the State of Alaska:

*Sec 1.AS.13.120.(g) is amended by adding a new paragraph to read:

(21) Notwithstanding 37.13.120(i), equity investments may comprise more than five percent of the stock of a corporation only through an interest in a partnership, or ownership in a collective investment vehicle, under the following conditions:

(A) the Fund shall not own more than a 60% interest in a partnership or collective investment vehicle;

(B) the aggregate investment of the Fund under this paragraph may not exceed five percent of the total investments of the Fund:

(C) at no time may the Fund own directly or indirectly, through a corporation, partnership or collective investment vehicle, more than 5% of any entity which has substantial oil and gas operations in the State of Alaska;

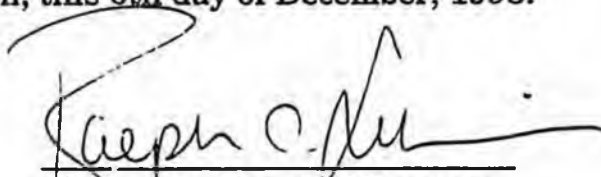
(D) appropriate policies and procedures for investments under this section shall be reviewed and approved annually by the Board of Trustees.

RESOLUTION OF THE BOARD OF TRUSTEES
OF THE ALASKA PERMANENT FUND CORPORATION
PERTAINING TO LEGISLATIVE CHANGES IN THE ALASKA STATUTES
RELATING TO ALTERNATIVE INVESTMENTS BY THE
ALASKA PERMANENT FUND CORPORATION

RESOLUTION 93-12

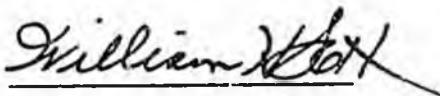
BE IT RESOLVED, THAT the Board of Trustees directs staff to seek legislative changes to provide that, notwithstanding any other provision of law, but subject to the prudent investor provisions, the Alaska Permanent Fund Corporation may invest in the category of "Alternative Investment Strategies."

PASSED AND APPROVED by the Board of Trustees of the Alaska Permanent Fund Corporation, this 6th day of December, 1993.



Chairman, Board of Trustees
Alaska Permanent Fund Corporation

ATTEST:



Corporate Secretary

CHAIR SEEKINS: Yes, Mr. Brady.

MR. BRADY: I'm going to follow our senior Trustee's example of trying take the floor for a while and stand up here and talk to you about this subject. No offense, Mr. Freeman. I think Mr. Surz's presentation highlighted an opportunity here that wasn't presented necessarily by his presentation, but presented to you in the fashion of understanding of something that sounds to be very complicated and possibly even beyond the grasp of most of the activities we do, in your mind.

I probably am the one responsible for all of this today and it has to do with a number of things. Firstly, we've all concluded one way or another, I believe, that the strategy of diversification through asset allocation is the primary key to our success. As a matter of fact, I don't know how many of you saw this article in Forbes Magazine recently, with which I don't agree, but which basically asks why spend a lot of money with money managers because, if you just bought into S&Ps and saved all that money, you'd end up with approximately the same results? I don't concur that, over a long period of time, this is true.

If we're going to continue to grow in profit in the style and manner at which we've set our objectives, this horizontal development of asset allocation, I think, is very important to all of us. If we don't, that pyramid in the middle, our bonds, keeps getting bigger and bigger and we have a shallower horizontal allocation. I think that, to continue to diversify, we've got to continue to do this. We're in alternative investment strategy right now. That's all real estate is. We're betting on Pete and Llewellyn and others to find the deals that make the most sense. That's an alternative investment strategy. I don't want to confuse this with venture capital or with the other investment funds that the State of Alaska does. This is not building a water pipeline to California or buying into a gold mine. I think we're looking at here a strategy that would allow us to do some of the things that we're currently prohibited from doing.

For example, we're limited to the extent of 5% on any publicly traded equity. This summer, when all this started, I met some very bright fellows. We've heard over and over and over that the key to a lot of this is the people you find for your partners. I think that's true in any successful entrepreneurial enterprise. These guys and gals have rates of return that are phenomenal. They're doing partnerships with people like ourselves. If we had an alternative investment strategy of 5%, whether we fund it or not, by resolution we can restrict it however we wish. Let's say we don't want to do timber, although that's been very successful recently, we don't want to do dairy farms, we don't want to do gold mining, and we don't want to even get into

some of the IPOs or some of the other things that are happening. But, let's say that we wanted to partnership with some people who buy what they feel are undervalued small-cap, publicly traded companies, for whatever reasons. They can either influence the board or put themselves on the board or do things to maximize their rates of return that otherwise aren't happening. It may be that there's one senior shareholder that's got a large percentage of it and you can recapitalize, do all the things that need to be done to fix the company, and get the rates of return that company is likely to get being fixed, if you will.

Bill Scott and I met with these folks. These kinds of people are real interesting. I think this is something we ought to do. I don't think we should take 1% and throw it out there for a home run, but I think we should take some percentage as we broaden our diversification and look at opportunities with people and companies that are successful at making a lot of money.

By the way, although I know this doesn't carry a lot of weight with you, Mr. Freeman, almost everybody else is doing this. It is not just the swingers, the universities, and the colleges, but the public entities, the states, and the corporations are in this category. I got a sampling of this myself and over 100 entities similar to ourselves have an alternative investment strategy. That doesn't mean we take 5% of our money and throw it at the wall and say, "Do deals, whatever they are, and we just trust you." That's not the suggestion I have here. The suggestion I have here is that we pass a resolution that allows us to incorporate, in our legislative package, the ability to invest in alternative categories. Then, through our own means and devices, such as limitations as we talked about with real estate, we control through resolutions what it is we want and wish to do. I don't have anybody in mind. There's not many Duracell deals floating around. Those come around once in a while. There are, however, a lot of small-cap companies and other situations that come along that are good. The rates of return some of these people are generating are really good. As our oil revenues go down and other things take place, you could create a scenario that we ought to have other opportunities and ways to make money around here.

Having said that, the example that I tried to lay out here to do this is prohibited because, in many instances, we may find ourselves in a partnership wherein we would own more than 5% of a specific stock. We can't do that. But, if we had an alternative investment category and we invested with partners and it was understood that these investments, made from time to time, in most cases, we would find ourselves in a situation where we would have 20% to 30% of this partnership that would own 30% to 50% of a publicly traded company.

We just flipped over the edge. What I want to do is convince you, as best I can, that through our asset allocation and diversification, we should have this category. Once we have this category and the authority to do these sorts of things, then we come back and we look at the opportunities through presentations to learn the history, the track records, the benchmarks, and all the things we talked about earlier that we need and want to have to feel comfortable about this. Then, if we choose to do this, we can do it. Mr. Surz said it and Mr. Stone said it. Not just because everybody else is doing it. I do believe it's a missed opportunity, if we don't have ourselves positioned so that we can take advantage of these kinds of opportunities as they continue to come along.

With \$80 million to \$120 million a month coming in, the pyramid keeps getting bigger and we're shallower on our diversification. That's why I feel, after having learned a little bit about this from reading stacks of information and discussing those with Commissioner Rexwinkel, it's something we should be doing. The other board Commissioner Rexwinkel sits on is going to do it. We're not throwing something at the wall, closing our eyes, and looking out the corner to see what's going to happen. This is something that's got some premeditated thought to it and some pre-examination. I feel very strongly that this is something we should have in a resolution to be able to incorporate. I've got a copy of the New York statute, if anybody wants to see what they did. They just authorized up to "X" percent of their allocation for that category.

That doesn't force us into any position to have to do anything. It would just allow, if the timing is such that we can convince the Legislature we're right about this, the passage of legislation to authorize us to engage in these different opportunities, as they come along. Thank you.

CHAIR SEEKINS: Are there any comments? Mr. Freeman.

MR. FREEMAN: I would assume from your remarks, Mr. Brady, that a change in legislative authorization would be necessary for what you want to do?

MR. BRADY: I think so, only as respects, from what I understand, the potential of intentionally going out and having an indirect, but real, ownership in more than 5% of a publicly traded company. That's where the Legislature would have to come into play.

MR. SCOTT: If you can't do that, then you can't accomplish the types of private buy-outs involved here. If you can't own more than 5%, then you can't effectively operate in this arena.

It's interesting to me, and it may be just of incidental help, that it's been demonstrated over the years that higher tax rates dry up entrepreneurial capital. The only reason I make that point is that we're going into a period of higher tax rates, unless Congress and Clinton change their minds, and we're going to see a drying up of entrepreneurial capital and it may very well be that also demonstrates an opportunity for the institutional investor to take the place of some of that.

CHAIR SEEKINS: Commissioner Usera.

COMMISSIONER USERA: I'm wondering what is your experience in terms of the necessity of having staff involved. Did you feel that the Washington and Oregon funds felt it was necessary to staff up to do oversight of this process?

MR. STONE: It was interesting that, at the time we got involved, staff did it all. There was no outside expertise. To be honest with you, I don't think they increased their staff at all with respect to what they were doing. That's not true. In Washington, they added one person who was specifically involved in alternative investments.

COMMISSIONER USERA: The impression I get is that you do have to know what you're doing. You have to be tuned into it and not, like with passive investments, say that you'll check back in six months or a couple of years. Certainly, it requires close monitoring and having a sound communication system between the funds, as well as the gatekeeper and the company that's going to be a parent. If I'm hearing you right, what they're doing is saying they're in agreement and they collectively, as partners, are going to insure the success of this company by using these very best and brightest people who are going to go in and add value to the investment.

MR. STONE: That is true, to a certain degree. Let me add this. John was mentioning Paul Saylor earlier with respect to real estate. He is very well know and very good. Surprisingly, in this area there are some very good people. We found some excellent, if you will, Paul Saylor types who could monitor this and have done a very good job for Washington and Oregon.

COMMISSIONER USERA: They were on a contract basis?

MR. STONE: Yes. I'm not recommending adding staff. This guy talked earlier about smart people. There is some real talent out there in terms of companies who are overseeing this as consultants and advisors who do a wonderful job.

COMMISSIONER USERA: Mr. Chairman, could I ask just one other question? What is the competition for the good deals?

MR. STONE: What we found to happen is, in the 1980s, this asset category got flooded with money. I think that is one of the reasons you've got so many problems. What has happened now is a lot of that money has pulled back. That's in the form of insurance companies. Banks can't do it any more because the regulations have changed and they can no longer be involved in this type of asset category. So, the number of good deals have increased dramatically with the available dollar that's out there. The funds are having potential deals go across their table that are very attractive.

COMMISSIONER USERA: Do the deals come to you or do you go out and look for the deals?

MR. STONE: They come to the fund.

COMMISSIONER REXWINKEL: Mr. Chairman, I have a question. Do we have legislative authority to do some of these that Mr. Surz pointed out on page 2 of his presentation, which include hedged funds, market neutral, and managed futures?

MR. BRADY: No.

COMMISSIONER REXWINKEL: None of them?

MR. SCOTT: We can hedge individual positions, but not on a speculative basis.

CHAIR SEEKINS: Mr. Freeman.

MR. FREEMAN: I suspect that my feelings and position on this and my lack of enthusiasm doesn't come as a surprise to Mr. Brady. I don't want to make a long-winded pitch on the merits of it. I'll be a little more practical than that. I asked the question whether you thought this was going to require legislative approval and a change in the statute and I'm sure that it will. From a practical standpoint, how do I put that? One of the lessons I learned in politics is, once in a while, you try to do something you think should be done, but it's very unpopular politically. Even though something is unpopular, if you can get it done, it's a lose/win situation, as far as politics is concerned. But anytime you tackle something that's very unpopular and don't get the job done, all you've done is diminish your credibility, harmed your reputation politically, and haven't accomplished anything other than that.

From a practical standpoint, 1994 is an election year and you know, as well as I do, the concern that our politicians have for reaction from the public as far as tampering with the Permanent Fund. The chances of accomplishing the changes in the law that you need are just about nil. If you're not going to accomplish that and can't get the job done, I think it's harmful to the Permanent Fund with regard to the feelings of the public as far as the Permanent Fund Board of Trustees is concerned to attempt it, if you can't get the job done. You can do as you wish, but whether this is good or bad, there are a lot of people in the Legislature today that I served with years ago and were there when the Permanent Fund was created. They are well aware of the background, the history, and the philosophy all along the line and most of those people have enough seniority that they're in positions of reasonable influence today. When I have serious thoughts about the Permanent Fund, I don't hesitate to talk to them and I have a pretty good idea what are some of their feelings. Regardless of the merit of what you're trying to do, it's not going to happen. My suggestion would be to discuss it and whatever you want to do, but I wouldn't put my foot on the line to get it done. That's just my opinion.

MR. BRADY: Mr. Chairman.

CHAIR SEEKINS: Mr. Brady.

MR. BRADY: Mr. Freeman, I respectfully disagree. You know better than I the evolution of the investment strategy of this Fund. At one time, we didn't have a real estate portfolio. At one time, we didn't invest in stocks. We simply started with some bonds and some cash. I think that the Fund was late in making the proper decisions in those investment strategies. The results will bear that out.

Having said that, I don't think this is an attempt to hoodwink the Legislature. I'm attempting to, as convincing as I can be, go back to our asset allocation strategy and I think we can make awfully good sense to all of our legislators that the success in our Fund has been largely due to that, to date. I think we need to continue to broaden that. I don't know what's going to be coming next. You said \$10 billion and I think it's more than that. Whatever it is, there are hedging opportunities through diversification that we're foolish to ignore. I believe this is one we should give very serious consideration and we should move forward in a continued asset allocation through diversification, if you will. What we end up purchasing, at the end of the day, remains to be seen. The fact is, the timing is here. As I spoke at the last Fund meeting when I said I wanted to bring this up, I said I wanted to bring in somebody who could try to explain that

this isn't something that is novel, new, or unique to one or two private investors, but this is something that's going on in lots of ways with lots of funds with lots of money.

The interesting thing is that this concentration of money is not in the traditional risk-takers. I say traditional risk-takers are typically colleges and universities. I guess they figure, if they lose some money, they can go back and get some more and have it replaced. They do swing more than the state retirement funds. Having said that, it's not just the colleges and universities, it's universal. I'm sorry that maybe we haven't had a work session prior to this to go through and exemplify some of the activities with proven results. I've had the opportunity of having done that and have seen those results. I see the future here and it's very clear to me that we're amiss, if we don't do this. If it's a gamble at this point in time because of politicians going off and being re-elected, I'm prepared to take that gamble because I feel that it's important to this Fund to be able to have this diversification. Then we can sit down and decide where it makes the most sense to go forward.

CHAIR SEEKINS: Mr. Brady, if you perhaps want to bring some action, you might want to do that during New Business.

MR. BRADY: I intend to do so.

CHAIR SEEKINS: Thank you very much. We are one-half hour behind on our agenda.

MR. SCOTT: Mr. Chairman, because we are one-half hour behind, could I intercede here? I have checked with Mr. O'Leary and he could switch to a point later on in the agenda. We do have Capital Guardian here to address you and one part of their presentation is going to be a conference telephone hook-up. Those people are ready and waiting and, if it's all right with you, I think we should go on to that one next.

CHAIR SEEKINS: We would like to then go ahead with **Capital Guardian**, who is right on time.

MS. YORBA: They had to go out and place a quick telephone call.

CHAIR SEEKINS: So, we will have two new items under New Business. One will be a real estate resolution and one will be dealing with alternative investments.

Mr. Scott, would you introduce the next presenters on the agenda, please?

P.3

#4

Attachment #4

1992 SURVEY OF ALTERNATIVE INVESTMENTS

By PENSION FUNDS, ENDOWMENTS AND FOUNDATIONS



Goldman, Sachs & Co. and Frank Russell Company
 October 1992

SEP 08 '93 11:35 RHH OF AIC MGMT
 04/23
 10/22/93
 10/22/93
 10/22/93

1992 SURVEY OF ALTERNATIVE INVESTMENTS 2921

Executive Summary

The 200 largest pension funds, endowments and foundations in the United States and Canada currently have \$36 billion invested in alternative investments

Pension funds, endowments and foundations have invested significant assets in alternative investments⁽¹⁾ -- the top 200 funds in the United States and Canada⁽²⁾ have invested \$36 billion. This represents 3.6% of the assets of those funds that allocate dollars to alternative investments.

Alternative investments have, until recently, been the province of a small group of investors; participation is broadening significantly:

- 54% of all respondents participate in alternative investments
- Over 80% of funds with greater than \$10 billion in assets participate in alternative investments

Buyout funds and venture capital have been the predominant investment strategies.

Limited partnerships are the most common investment vehicle; 80% of all alternative investment dollars are channelled through them.

There is a strong appetite for alternative investments *going forward*:

- 71% of all respondents plan to increase commitments to alternative investments
- Venture capital continues to dominate investor interest

(1) "Alternative investments" are defined as non-traditional investments that are illiquid and have a substantial equity component. See p.22 for a more complete definition.

(2) See p. 2 for a breakdown of institutions surveyed. A smaller survey of 72 of the top 100 pension funds in the U.S. and Canada was performed by Goldman Sachs in 1991.

#5

THE JOURNAL OF INVESTING

A PUBLICATION OF INSTITUTIONAL INVESTOR, INC.

VOLUME 3 NUMBER 1

SPRING 1994

ALTERNATIVE INVESTMENTS GROW RAPIDLY AT TAX- EXEMPT FUNDS

Reprinted from the Spring 1994 issue of *The Journal of Investing*
488 Madison Avenue, New York, NY 10022

SPRING '94 JOURNAL OF INVESTING

ALTERNATIVE INVESTMENTS GROW RAPIDLY AT TAX- EXEMPT FUNDS

THOMAS J. HEALEY

is head of the Pension Services Group at Goldman, Sachs & Co. in New York. He joined Goldman in 1985 in charge of real estate capital markets and became a partner in 1988. Mr. Healey was previously the assistant secretary for domestic finance at the U.S. Treasury Department in Washington. He holds an A.B. degree from Georgetown University and an M.B.A. from Harvard.

DONALD J. HARDY

is the director of Private Investment Services at the Frank Russell Company in Tacoma, Washington. He has been with Frank Russell since 1977. Mr. Hardy has more than twenty-five years of investment experience, and has previously been a fund manager, a securities analyst, and a trust officer. He holds a B.S. from Boston University and an M.B.A. from the University of San Francisco.

When interest rates on U.S. Treasury bills dipped below 3% last summer to their lowest level in thirty years, investors and the public alike were caught by surprise.

But no one was more alert to this drop than pension fund managers. These specialists knew that the continuation of this trend could make it difficult to match the high investment returns of the 1980s.

One look at the figures illustrates the problem: between the end of 1991 and the end of 1992, total returns on equities dropped from 33.0% to 9.0%; on cash, from 5.75% to 3.61%; and on fixed-income investments, from 16.1% to 7.6%.¹

NEW ASSET CLASSES IN SPOTLIGHT

Tax-exempt funds, appropriately, are exploring new ways to increase returns. One result is greater interest in categories like alternative investments, which have a strong potential for higher returns.

A number of studies have shown that private

U.S. equities produced returns of 18% or 19% during the latter part of the 1980s, while some leveraged buyout funds did considerably better.

Of course, the illiquidity of these private investments makes them subject to greater due diligence and oversight. But the results can be worth it, especially when other potentially high-yielding asset classes like real estate are still under water.

Additionally, with traditional sources of capital like insurance companies and banks facing major constraints, tax-exempt funds find themselves in a new role — providing a much more active source of capital. They are offered a much wider range of private investment opportunities at extremely attractive returns.

Yet this asset category still suffers from one major problem, along with its potential cyclicity and relative youth: Very little systematic data are available. Funds traditionally have been secretive about their most successful alternative investments, and the variety of strategies involved has made it hard to develop useful benchmarks.

To start building a more accurate picture,

Goldman, Sachs & Co. and the Frank Russell Company joined forces last summer to launch the first truly comprehensive study of this investment category. The study requested data on alternative investment participation from the 228 largest tax-exempt funds in the U.S. and Canada (assets ranging from \$500 million to \$68 billion).

194 (85%) of the 228 funds contacted responded, a remarkably high response rate (Exhibit 1). The results of the study, entitled "1992 Survey of Alternative Investments by Pension Funds, Endowments and Foundations," were released in the fall of 1992.

STRONG PARTICIPATION IN ALTERNATIVE INVESTMENTS

This article discusses the findings of the survey, using the terms tax-exempt fund and investor interchangeably to refer to respondents. Percentages are rounded in the text and shown to the nearest tenth of a percentage point in the exhibits.

The survey defines alternative investments (AI) as illiquid private investments that have not been registered with the Securities and Exchange Commission. It focuses on eight different types of strategies within the asset class, strategies typically grouped together under the rubric of "alternative investments."²

These strategies are buyout funds, venture capital, mezzanine financing, oil and gas programs, distressed companies, targeted investments, timberland (and/or farmland), and other. All strategies involve an equity or equity-like component (Exhibit 2).

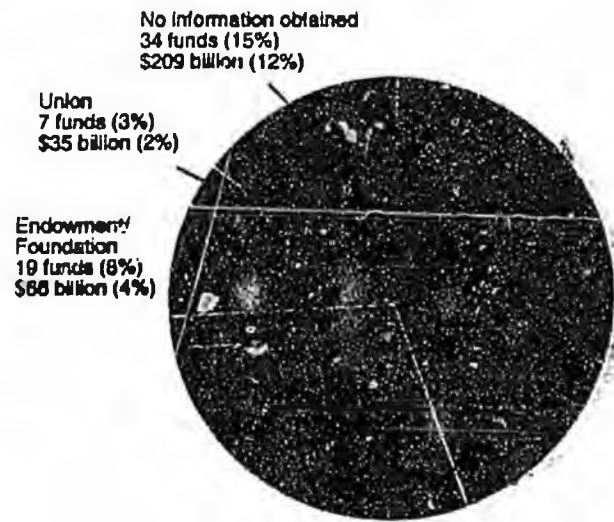
LARGEST FUNDS MOST ACTIVE IN THIS MARKET

One of the most impressive findings of the survey is the fast growth rate of this asset class. The assets held by tax-exempt funds have tripled over the past six years.

More specifically, in 1986 about one-third of the respondents in the survey held \$12 billion in this investment category (Exhibit 3). Today over half (54%) have invested a total of \$36 billion in alternative investments. This is a compound annual growth rate of 20%.

The survey reveals that the largest funds are most active in alternative investing (Exhibit 4). These investors dominate the asset category. By and large, they are the ones that have committed professional staff and developed consistent strategies within this

EXHIBIT 1 SURVEY PARTICIPATION: BREAKDOWN OF FUNDS SURVEYED



Total Funds Surveyed = 228, representing \$1.7 trillion assets
Total Funds Responding = 194, representing \$1.5 trillion assets

investment category.

Over 80% of investors with assets of \$10 billion or more participate in at least one alternative investment asset. Put another way, thirty-three funds with assets of \$10 billion or more account for 69%, or \$24.6 billion of all alternative investment assets.

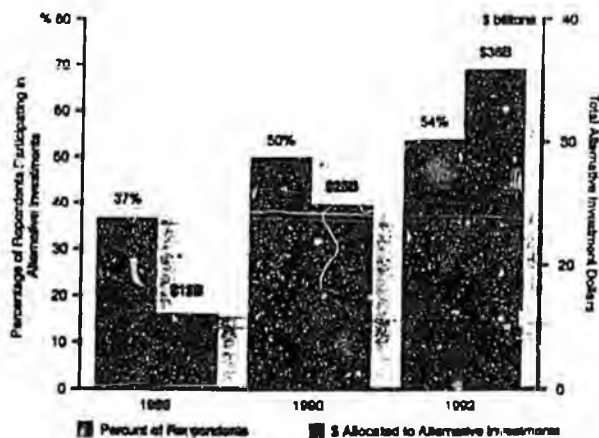
Among the remaining funds, those with assets from \$5 billion to \$9.9 billion account for only

EXHIBIT 2 ASSET ALLOCATION



Sources: *Pensions & Investments*, Goldman Sachs/Frank Russell 1992 Survey.

**EXHIBIT 3
ESTIMATED GROWTH OF ALTERNATIVE
INVESTMENTS**

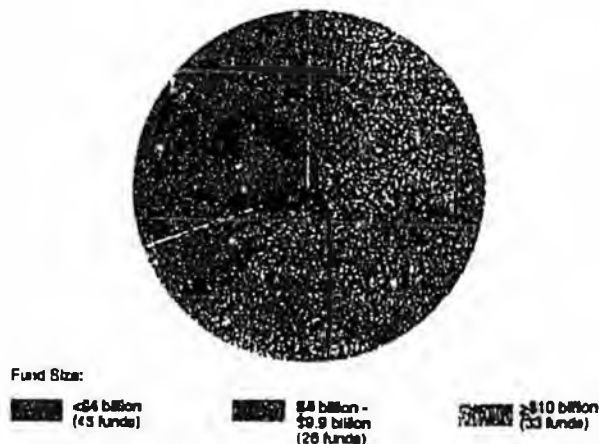


17.9%, or \$6.4 billion, while funds with under \$5 billion have 13%, or \$4.8 billion, in AI assets.

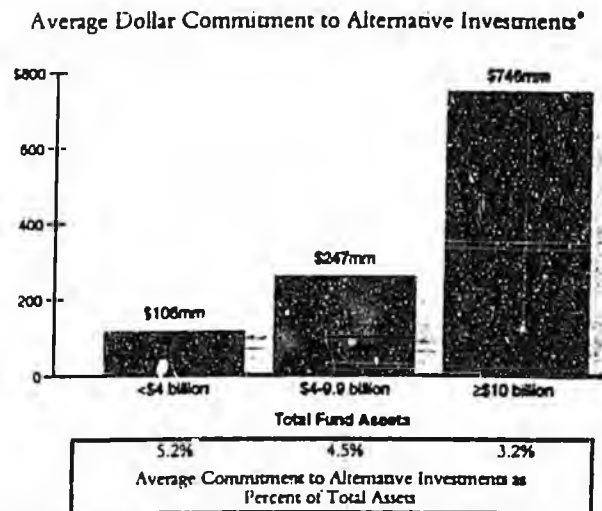
The largest funds certainly have significantly greater resources to investigate opportunities in this market. They also have the potential to obtain better returns and gain more control than smaller players. Furthermore, large funds can make significant investments in private equity without exceeding their asset allocation guidelines.

For example, funds with over \$10 billion in assets commit, on average, \$750 million to AI assets, versus a mere \$106 million for funds under \$4 billion (Exhibit 5). Yet alternative investments comprise only 3% of total assets for these giants, compared to 5% for the funds with under \$4 billion in assets.

**EXHIBIT 4
PARTICIPATION IN ALTERNATIVE
INVESTMENTS BY FUND SIZE**



**EXHIBIT 5
AVERAGE ALLOCATION TO ALTERNATIVE
INVESTMENTS BY FUND SIZE**



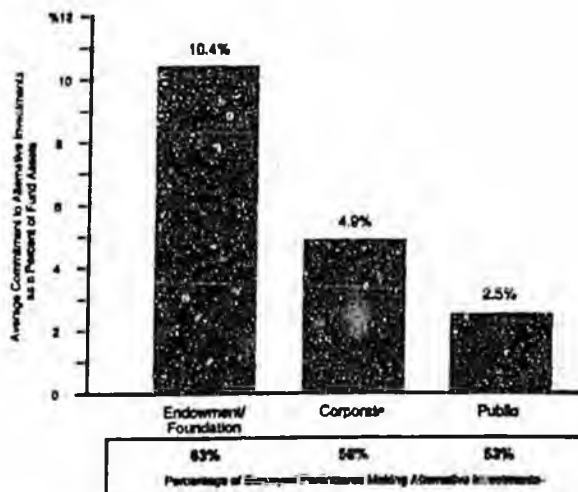
*Includes all funds committed whether drawn down or not.

This does not mean that smaller funds cannot invest efficiently in alternative investments. It just means that when they do, the investment usually involves a larger portion of their asset allocation. And it usually means that they invest more heavily in certain types of AI investment than do their larger peers.

BEHAVIOR DIFFERS BY FUND TYPE

The historical behavior of tax-exempt funds differs not only by fund size, but also by fund type (Exhibit 6). Endowments and foundations were the

**EXHIBIT 6
ALTERNATIVE INVESTMENTS BY FUND TYPE**



first to enter this market, investing steadily in the 1970s and 1980s. This early involvement probably stemmed from the long-range thinking of their boards, as well as a shorter chain of command. Even today, these funds are the most committed to alternative investing, keeping 10% of their assets in AI funds versus only 5% for corporate funds and 3% for public funds. Despite their smaller size, endowments and foundations continue to commit a greater portion of their assets to alternative investments than corporate or public funds.

Corporate and public funds did not start participating heavily in this market until 1982. Today their total investment in this asset class far surpasses the others. This fact is probably more a function of their size than a greater commitment.

In fact, corporate funds today lead their public fund peers, although the public funds appear to be catching up. With the possible exception of targeted investments (assets with a special component such as a social or geographic imperative), union pension funds that flirted briefly with the idea of alternative investing seem to be sitting on the sidelines. This may be the result of membership constraints.

THE EIGHT MAJOR INVESTMENT STRATEGIES

Our study breaks alternative investments into eight different investment strategies (Exhibit 2). Some of these, like venture capital and oil and gas programs, have been around for years, and thus have solid track records.

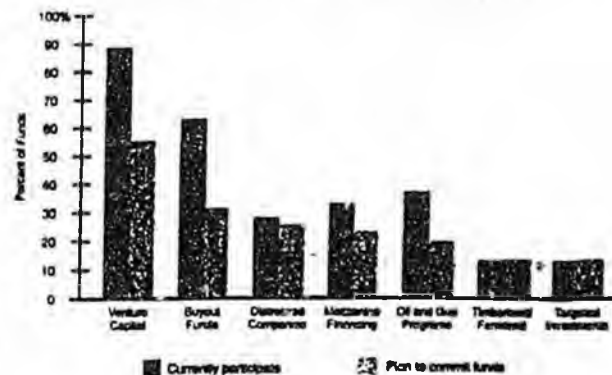
But others came of age in the 1980s. These include several corporate finance-related strategies such as leveraged buyout equity funds (LBOs), mezzanine financing (subordinated debt), and distressed companies (restructuring or bankruptcy funds). The remaining strategies include farmland and/or timberland and "targeted investments."

The alternative investment assets of respondents that did not provide a detailed breakdown were assigned to the "other" category. Coinvestments and project financings are likely to be among the investments in this category.

Inclusion of these newer strategies dramatically expands the AI category. This expansion has given AI assets more importance in the overall asset mix and is probably the reason why alternative assets are considered such an important, newly recognized asset class today.

EXHIBIT 7 FUND PARTICIPATION BY INVESTMENT STRATEGY

Percent of Funds that Participate in Each Investment Strategy and Plan to Commit Initial/Additional Funds



FUNDS DIFFER IN THEIR INVESTMENT MIX

When tax-exempt funds first consider AI investing, they usually start with venture capital, complementing it with one or two other strategies. Within this structure, most investors do not seem to have one preferred plan for AI asset allocation.

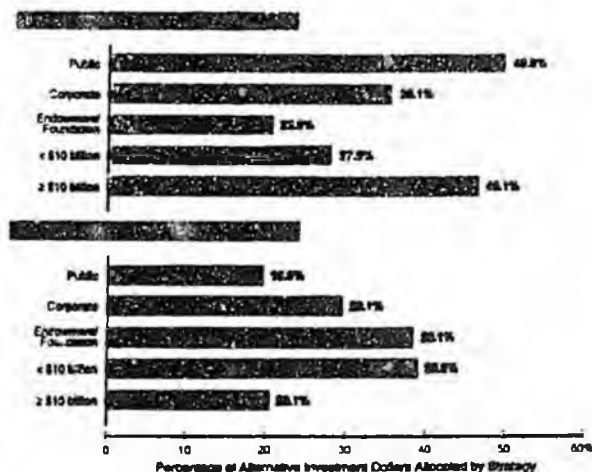
Given this pattern, it is no surprise that venture capital is the most popular asset on a participation basis (Exhibit 7). Almost 90% of the funds with alternative investments have allocated some dollars to this strategy. Investors also report that they are more interested in investing in venture capital in the future than in any other investment strategy.

Even though venture capital attracts more participants, however, it attracts far fewer dollars than leveraged buyouts (Exhibit 2). Investors have invested \$9 billion in venture capital versus \$14 billion in buyout funds.

LBOs represent 41% of all AI assets, which makes them the largest AI investment component (Exhibit 2). Venture capital comprises 26% of all AI assets, while mezzanine financing accounts for 10%. These top three strategies represent 77% of all AI assets. Of the remaining 23%, investors have put 7% in oil and gas programs, perhaps because these have been around the longest, 4% in distressed companies, 3% in targeted investments, 2% in timberland or farmland, and 6% in "other."

The popularity of LBOs is related to the size of each investment. Despite the attraction of venture capital, it is difficult for investors to commit large amounts of assets to these deals because of the small

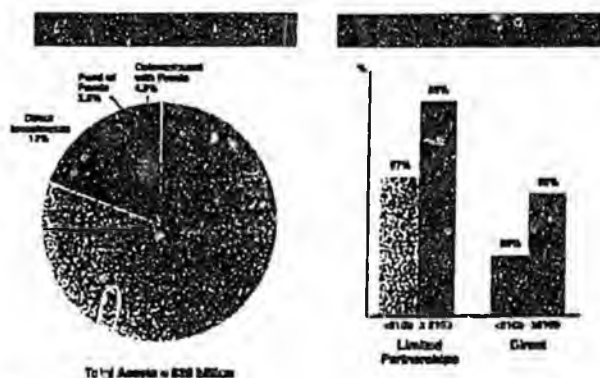
**EXHIBIT 8
LEADING STRATEGIES: INVESTOR PROFILES**



size of individual venture investments.

Leveraged buyouts, however, give equity investors an opportunity to commit large dollar amounts in far fewer deals. In doing this, the investor usually purchases significant control of a company. Given the asymmetry between the two most popular AI strategies, it is not surprising that large investors and public funds, in particular, gravitate toward buyout funds, while smaller investors, endowments, and foundations focus on venture capital (Exhibit 8).

**EXHIBIT 9
INVESTMENT PROCESS — VEHICLES***



*Limited partnerships and other commingled vehicles.

Coinvestment/Add-on Investment with Funds: The investor invests in parallel with or in different securities from the Limited Partnership.

Fund of Funds: A multiple-manager vehicle with investments in more than one fund.

Direct Investments: The investor does not use an intermediary such as a Limited Partnership or Fund of Funds.

The largest funds keep 46% of their AI assets in buyout funds, while public funds keep 50%. On the other hand, smaller funds have 39% of their assets in venture capital, while the largest invest only 20% in that strategy.

REASONS FOR INVESTING IN THIS ASSET CLASS

The study examines the main reasons funds invest in alternative investments. Predictably, 63% said they were looking for superior returns. But another 33% said their main motive was diversification. This is understandable because the volatility of this asset class has a low correlation with other asset classes. Of the remaining participants, 2% said they are looking for an inflation hedge, while 2% believe these assets enhance their reputation.

The lack of information about alternative investing has made it difficult to understand the investment process itself. To clarify this, the study looks at three different aspects of the process: the choice of investment vehicle; organization and decision-making; and monitoring and measurement.

THE POPULARITY OF LIMITED PARTNERSHIPS

Limited partnerships are by far the most popular investment vehicle, accounting for 80% of all alternative investment dollars (Exhibit 9). Direct investment accounts for 13%, while coinvestment with funds represents 4% and fund of funds are 3%.

With limited partnerships, investors can rely on outside experts for assistance in making their investment decisions. This is particularly helpful for smaller investors with limited staff.

Although many investors reported seeking out coinvestment opportunities with general partners, only the largest funds have been able to do this on a consistent basis. To date, coinvestment attracts approximately \$1.6 billion.

The study shows that limited partnerships have been, and will likely continue to be, the primary vehicle for alternative investing (Exhibit 9). But it also reveals that certain pressures are changing the typical partnership structure. As pension funds gain more experience in alternative investing, they want to take a more active role.

For instance, investors rank negotiating terms and conditions as the most important contractual issue. Additionally, investors are putting pressure on

partnerships to establish priority returns and to reduce the carry from the traditional 20%.

While some investors do not emphasize these cost issues, they do search for general partners that put their own capital at risk rather than relying solely on investors' capital. Overall, the bottom line seems to be a trend toward selecting a general partner with whom the investor can forge long-term partnerships.

Although direct investment is the second favorite investment vehicle, with 13% of alternative investment dollars, it is difficult to gauge whether more funds are going to move toward this vehicle in the future. There is no consensus on the subject.

Clearly, the largest and most experienced funds are those that do the most direct investing. They are also the ones that plan to do the most direct investing in the future (Exhibit 9). For example, 50% of the investors with over \$10 billion in assets plan to commit additional funds through direct investing, compared to only 25% of the smaller funds.

Direct investing allows the larger funds to avoid the fees charged by general partners. Many smaller funds say they would like to do more direct investing, but they simply do not have the resources, time, or staff to do the necessary groundwork.

DECISION-MAKING

Participation in alternative investments brings with it a unique set of risks and rewards. As private investments, these assets are much less liquid than traditional stocks and bonds. Thus the due diligence process is different, more complex, subjective, and more judgmental. In addition, investments must be held longer than many others to yield the expected results.

To determine whether investors handle this category differently, the study looks at who is responsible for the decision-making process, including the initial decision to participate in alternative investments; allocation by strategy; and, finally, selection of individual investments.

The study shows that top-level management exercises unusually strong control over this entire three-tier process. The investment committee or board of directors maintains total control over the first two decisions virtually 100% of the time. They maintain control over the selection of individual investments about two-thirds of the time. When they do give up control, the board or investment committee delegate the third tier of decisions to the chief investment officer or other professional staff

29% of the time and to an outside consultant 6% of the time.

Nearly half (49%) of the investors use outside consultants to help evaluate or manage this asset category. The study defines consultants as external advisors who provide either non-discretionary advice or handle selection and oversight of investments on a discretionary basis.

Looking at the specific functions performed by these advisors, survey respondents said they use consultants in an advisory capacity (22%), to handle due diligence (18%), to take on the entire decision-making process (6%), and as Qualified Plan Asset Managers (QPAMs) (3%).

MONITORING AND MEASUREMENT

There is no consensus among respondents about how to measure performance in this asset category. Although 52% report using a benchmark, there appears to be little consistency. Many funds consider their benchmarks to be proprietary information.

When it comes to measuring actual performance, most investors report turning this task over to the internal staff or the trustee bank. The respondents are split on measurement methods. 53% use internal rate of return as their primary method; 48% use time-weighted rate of return; and 16% use cash on cash.

A large majority of respondents (84%) say they would welcome development of generally accepted performance measurement standards for this asset class.

THE FUTURE OF ALTERNATIVE INVESTMENTS

Looking toward the future, 71% of the funds say they intend to expand their alternative investment assets in the future. This answer suggests a strong appetite for these investments. More specifically, the funds selected four strategies as most popular going forward: venture capital, buyout funds, distressed companies, and mezzanine financing.

Investors were also asked which *single* investment strategy they would favor if they were just starting out. The three top choices were venture capital (39%), buyout funds (16%), and mezzanine financing (8%), in that order.

However, when asked to select *three* investment strategies, investors still rank venture capital first (81%), but mezzanine financing is second

(56%) and buyout funds third (52%). This suggests that venture capital and mezzanine financing may be the leading alternative investment strategies in the future.

GREATER OPPORTUNITIES FOR INVESTORS

The timing seems right. Today, the economy has started to expand. Yet many traditional lenders are still relegated to the sidelines until they solve their own capital adequacy and loan problems.

In the meantime, pension funds, endowments, and foundations are filling this gap. These tax-exempt investors have suddenly become a much more important source of capital to the economy as a whole. Thus, they receive a much larger flow of more sophisticated transactions to evaluate and select from. And many of these transactions fall into the alternative investment categories.

To evaluate and track these transactions may take more expertise than other investments. But with the potential for double-digit returns, clearly the rewards justify the extra effort.

It is clear today that alternative investments offer investors an unusual opportunity. By investing in these strategies, tax-exempt funds may achieve both the higher returns and the diversification they will need in the 1990s to succeed in the new, lower-return investment environment.

ENDNOTES

The authors wish to thank for their assistance with the research and preparation of this article: W. Blair Garff, Matthew A. Bernstein, and Jill Byatt of Goldman, Sachs & Co.; Sharon L. Hammel, Holly F. D'Annunzio, Heide L. Botger, and Sandra M. Sullivan of The Frank Russell Company; and April W. Klimley of Klimley Communications.

¹Sources for these figures: equities, the Russell 1000 index; cash, ninety-day Treasury bills; fixed-income, the Lehman Brothers Long-Term High Quality Government/Corporate Bond Index.

²Following is how the study defines the eight strategies commonly considered alternative investments:

Venture capital: Equity investments in companies that have undeveloped or developing products or revenue.

Buyout funds: Equity investments in public or private companies that result in the purchase of a significant portion or majority control of the company.

Distressed companies: Investments made through the purchase of debt or trade claims in companies that are in financial distress, restructuring, or bankruptcy.

Mezzanine financing: Investment in the subordinated debt of privately owned companies. The debtholder participates in equity appreciation through conversion features such as rights, warrants, or options.

Oil and gas programs: Investment in the exploration for oil and/or gas reserves or in the development of proven reserves.

Timberland or farmland: Investment in land to harvest lumber or farm commodities.

Targeted investments: Investments that have a special component, usually related to geographical, economic, or social issues. These investments are sometimes referred to as "ETIs," or "economically targeted investments," and include investment in minority-owned businesses and state-financed housing.

Other: This category is a catchall that includes assets that respondents did not break down into individual strategies. Coinvestments and project financings may be among the investments in this category.

#6

Alaska Permanent Capital Management Company

900 West Fifth Avenue, Suite 701
Anchorage, Alaska, 99501

Phone: (907) 272-7575

Fax: (907) 272-7574

February 2, 1994

Mr. Carl Brady, Jr.
Board Member
Alaska Permanent Fund Corporation

VIA COURIER

Dear Carl:

Thank you for providing a copy of the Permanent Fund Trustees' Resolution 93-12 which sets in motion a legislative request to authorize Alternative Investment Strategies. Thank you, also, for a copy of the proposed legislation and the analysis thereof.

At the outset, allow me to comment that this proposal appears to have been well thought out. The Trustees started with the broad concept of Alternative Investments (which could have involved everything from investments in timber, agricultural land, and venture capital) and quickly narrowed it down to investments in corporate stock.

Having established that focus, certain important investment parameters were wisely established:

1. **Other institutional co-investors are required** This insures that additional participants—institutional investor peers—scrutinize each transaction.
2. **A significant level of other institutional participation is established.** When the Fund started real estate investing, it used the same approach and it provided for the important useful exchange of information between large funds. It also provided a needed comfort and confidence level and "eased" us into investments and relationships over time. This gave us an opportunity to expand our knowledge, increase our returns and revise and establish policy over a long protracted period.
3. **A cap is placed on the amount of such investment.** This is wise as it controls the amount of non-diversification which could occur and restricts the Fund to activity in the small and medium capitalization company field. You won't be able to join in the Paramount takeover under this legislation; and you shouldn't!

Registered with the U.S. Securities and Exchange Commission

LETTER FROM DAVE ROSE

Hickel Investment Company

BOX 101700
ANCHORAGE, ALASKA 99510-1700

EXECUTIVE OFFICES
PHONE (907) 276-7400
FAX (907) 258-4857

FAX TRANSMITTAL

DATE: April 5, 1994
TO: Representative Vezey
Fax #465-3258
Number of Pages Including this Page: 1
FROM; Hickel Investment Company
SUBJECT: House Bill 375

Dear Representative Vezey:

I urge your support of House Bill 375 that would allow the Permanent Fund Corporation to diversify its assets, reduce its risks and increase its returns. These minor changes in the investment guidelines of the Permanent Fund would enable the Fund to take advantage of investment opportunities currently not available to it. The restrictions to the proposed modifications are more than adequate to assure prudent investments, (though certainly not risk free), while enabling the fund to achieve higher returns. This bill deserves your support.

Sincerely,



Robert J. Hickel
President

File HB-375

Alaska Permanent Capital Management Company

900 West Fifth Avenue, Suite 701
Anchorage, Alaska, 99501

Phone: (907) 272-7575

Fax: (907) 272-7574

April 11, 1994

Representative Al Vezcy
State Capitol
Juneau, Alaska 99801-1182

Dear Representative Vezcy:

This letter pertains to HB 375/SB 245 which proposes to authorize the Trustees of the Alaska Permanent Fund to broaden the scope of Fund investments.

I have had several discussions with individual Trustees regarding this legislation. We have discussed several approaches and a new, amended version of the bill(s) will be offered in committee testimony this week.

Throughout our discussions, the goals and aspirations of the Trustees are very clear. There is strong focus on preserving principal and increasing investment yield.

To protect principal, diversification is important. This will be accomplished by the new legislation which will authorize specialized investment in domestic corporations. This expansion of the equities portfolios will enable the Fund to make larger investments in corporations which are undervalued, corporations which may be takeover candidates, corporations whose parts may be worth more than the whole and thus may have spin-off opportunities, and corporations who have strong potential which may not be recognized until or unless major changes are made in its management.

Generally, a well-conceived and well-executed investment program which involves the above should be beneficial to the Fund through the realization of higher investment yields.

As you may have noted, financial markets have become more sophisticated, global in scope and more volatile than ever. As markets change, entities like the Permanent Fund must have the flexibility to meet market challenges. They must have a whole toolbox full of choices in order to get the job done and to do it well. The proposed legislation simply provides another tool.

In Alaska, we treat investments in two ways. One way is to broadly authorize any investment which comports to the Prudent Investor Rule. Another method is to construct a "legal list" of investments which describes each investment instrument which may be held within the portfolio. The PERS/TRS system has the flexibility of the former while

the Permanent Fund is constrained by the latter. Since the Permanent Fund is a "legal list" fund, it is essential that those who construct the list keep it current in a fast changing market environment.

It is incumbent upon Trustees of "legal list" funds, in exercising their fiduciary responsibility, to bring proposals for list expansion to the attention of the list makers. That is what they have done in proposing HB 375/SB 245.

The legislation includes some important checks and balances which tend to reduce the risk of moving forward with poor investments. The legislation requires that there be co-investors. This insures that every investment is scrutinized by another fund. If funds have problems, questions or are uneasy with the investment, they discuss it and compare notes. The limit on oil and gas investments in an oil and gas state make sense. Alaska's wealth should be diversified and this stricture is a prudent one.

I commend this legislation to you and recommend its passage. It will take the better part of a year for the Trustees to construct specific policies, firm managers to help execute that policy and devise a method for reviewing performance. The lead time involved to do the job right argues for passage this session.

If you have questions and concerns regarding this legislation and wish to contact me, I would be pleased to respond.

Best wishes in all your endeavors.

Sincerely,



David A. Rose
Chairman