

HOUSE/SENATE FINANCE COMMITTEE MINUTES - 1967-1982 2609

JOINT FINANCE COMMITTEE MEETING

March 24, 1970

1:00 P. M.

Present

All members of the Senate Finance Committee were present for a joint meeting with the House Finance Committee and the Department of Education. Present for the Department of Education were Dr. Cliff R. Hartman, Commissioner; Robert L. Thomas, Director, Administrative Services; Donald Fridley, Assistant Superintendent, Anchorage School District; William Moran, School Board President, Anchorage; and representatives from district schools throughout Alaska. Interested members of both houses attended.

Chairman Vance Phillips called the meeting to order and introduced Mario F. Martini, Senate Fiscal Counsel, who spoke for the Senate Finance Committee. Mr. Fridley and Mr. Moran were introduced and spoke for the school districts.

SB 378

Section 1 through 3 of Senate Bill 378 were repealed and the discussion commenced with Section 4, 14.17.021, State Aid.

Mr. Fridley said the Governor's Advisory Committee recommended 90% state funding per instructional unit of \$14,500. \$14,500 is not an adequate amount of money for even the smallest unit, let alone the average, and the average unit in Anchorage is \$21,966. Senator Miller asked if there was any way to relate the instructional unit figures to this year's budget. Mr. Fridley

answered under the funding of the present budget the Anchorage district would be entitled to \$19,322,561. Under the unit of \$14,500 the Anchorage borough would receive \$23,138,100, and under the recommended increase to \$20,000 the school district would receive \$31,928,000.

Dr. Hartman distributed a booklet "District School Support Study Materials" to the Finance Committee chairmen which provided costs of the program per district.

Mr. Thomas summarized SB 378 as follows: The basic concept is that the state would support an average of 90% for each district, varied from 81% to 98+% for poor districts. An amendment has been proposed to put a floor of 90%, which would increase the cost. This would affect six districts - Bristol Bay, Juneau, Kenai, Ketchikan, Pelican and Skagway. A problem has been to determine what level of support the state considers as basic, and the recommendation of the Health, Welfare & Education Committee was \$20,000. The increase in teachers' salaries was not known at the time the Governor's Advisory Committee recommended \$14,500. The instructional unit figure includes all things that go into current operating costs of instruction and the Fairbanks District was the only district giving the breakdown of the supplemental programs. Dr. Taylor, Superintendent of Schools, Fairbanks, said the instructional unit estimate of \$22,400 includes supplemental programs totalling \$1,580. A discussion followed on what is

considered supplemental education and what is considered basic, and the resulting effects on the estimates and computations used in the formula.

Section
14.17.140

Mr. Martini referred to page 6, Section 14.17.140, Determination of Full and True Value by Local Affairs Agency, and questioned the provision for districts to go to court in case they didn't agree with the estimate by the assessor. If one district questions the assessment, it would delay the formula projection or produce an inaccurate projection for the entire state. Mr. Ray's opinion was that this variable would be so small that it would be easily adjusted.

Correspondence
Courses

Correspondence courses were questioned by Mr. Ray and Dr. Hartman said they would be included in the program since the costs are high if a teacher supervises the courses. Kenai, Kodiak, Mat-Su and Sitka have five or more correspondence students and are included in this program, and Mrs. Jackinsky from the Kenai peninsula explained some of the problems in supervision for a large geographical area and the costs involved. Senator Begich noted there are over 80,000 students projected for next year and only 86 correspondence students.

Amendment

Senator Phillips distributed copies of the Senate Journal which reflected the amendment to SB 378 by the Health, Welfare & Education committee providing that no district receive less than

90% funding from the state. Senator Begich stated the Governor's message requested 90% funding and the HWE committee amended the bill to provide just that. Senator Thomas said the instructional unit was revised to \$20,000 since the original figure of \$14,500 was estimated prior to the teacher salary increase.

Federal
Funds

Mr. Martini asked about Federally funded and self-supporting programs and how they are recognized in projecting costs.

Mr. Fridley said the receipts for special programs will be checked before a supplemental is requested.

Rural Schools

Senator Begich said a double standard issue had been noted by Senator Blodgett as to why rural education is not funded on a formula basis. Mr. Thomas said program budgeting might allow them to initiate this program and Senator Phillips stated program budgeting had been done by the University of Alaska. Dr. Hartman said the Department of Education expects to begin program budgeting but needs more money to fund the program.

Mrs. Jackinsky said she was representing the Alaska Association of School Boards, who believe 90% of state aid is equitable and \$20,000 is as low as any district can go. Mr. Fridley said the Superintendents Association is completely in agreement with Senator Blodgett's recommendation of aid to rural schools.

Teachers'
Salaries

Senator Phillips asked for opinions from the representatives on having a centralized board to negotiate teachers' salaries state-wide. Mr. Thomas said this would have a certain advantage to

relieve districts of time spent in salary negotiations; however, once established the local level would no doubt find other things to negotiate. Dr. Taylor said many fringe benefits and high standards in the teachers' programs are just as important to teachers as salary, and he would hate to think of negotiations only in salary. Senator Phillips said the districts are competing with one another and creating a whip-saw effect by raising salaries; therefore, a state-wide board should be investigated. Discussion continued on the comparison of teaching in rural schools as opposed to urban areas in salaries, location, fringe benefits, and teaching conditions.

The meeting recessed at 3:00 P.M. and resumed at 3:20 P.M.

SB 371

Senator Thomas stated SB 371 provides for state aid of 50% for retirement of school construction debt and Senator Phillips said something in this bill may be developed and incorporated in SB 378. Mr. Martini asked if there wasn't a danger of funding the school districts twice and referred to page 2 of SB 371 which would be construed as maintenance costs. Mr. Fridley stated this bill refers only to bonded indebtedness and normal maintenance would not apply.

Mr. Fridley explained the construction carried on throughout the state is of standard minimum construction. It meets the needs of the children and also meets the future economies of the taxpayer.

West High School in Anchorage has had almost 18 hours of use per day and has provided 17 years of service. Dr. Taylor stated the facilities are exceeded now by the number of students and enrollment will double in two years time. No construction is anticipated before one or one and a half years and portable classrooms have been purchased to meet the emergency.

Mr. Martini calculated the cost of the bill would run in excess of \$4 million and Senator Phillips suggested a sales tax to relieve the homeowner of any further taxes. Mr. Fridley had prepared a hypothetical case and if debt service were not funded at the rate of 50% the cost would be greater to the taxpayer.

Senator Begich said these bills had to be split between past and future - SB 371 covers the past and SB 545 covers the future - and will provide a greater savings in the future. Senator Phillips said we must project the amount of money these bills would cost and the impact they would have on the budget.

SB 546

Senator Thomas said an amendment had been introduced to SB 546 and Senator Begich said the amendment would encourage communities to raise their own money to fund their 50% portion of building construction.

Senator Thomas asked for comments on pre-elementary education and Dr. Hartman said the cost for the 13,700 three and four year olds would approximate \$13 million based on \$1,000 per student.

A half-day program would get by with half the amount and Senator Begich said the program was based on a half day. Dr. Hartman stated he would prefer to see the kindergarten go to a full day first, but it is up to the districts.

Senator Phillips asked the effect on the schools of the population growth in Anchorage and Mr. Fridley said they may have to consolidate classes or transport students due to over-crowding. Usable, available land without excessive cost is almost gone.

Adjournment

Meeting adjourned at 4:00 P. M.

SB

404

SENATE FINANCE COMMITTEE

March 26, 1970

3:00 P. M.

Present

All members of the Senate Finance Committee and Mario F. Martini, Senate Fiscal Counsel. T. K. Downes, Commissioner, Department of Administration; Walter L. Kubley, Commissioner, Department of Commerce; George A. Morrison, Commissioner, Department of Revenue; Charles Noble, Dr. John Arena, Loomis Sayles; Tom Phelps, Scudder, Stevens & Clark; Phillip Swan, Lionel Edie & Co.; A. Paul Haake, Continental Illinois National Bank; Wolfgang Falke; interested members of the Senate and members of the press.

SB 404

Chairman Phillips called the meeting to order for the purpose of hearing testimony on Senate Bill 404 and asked George Morrison to introduce the speakers. George Morrison said the different people were asked here today to discuss SB 404 and committee substitute for SB 404 because questions arose about provisions and expert testimony was requested. A brief presentation was given by each man, followed by a general discussion and questions.

Testimony by
Paul Haake

Mr. Morrison introduced Paul Haake, who has worked for 23 years in the Trust Department of the Continental Illinois National Bank in Chicago. Mr. Haake's comments were as follows: The two points to consider with regard to the bills in question are permanence and responsibility. Almost certainly this fund will be invested very heavily, if not entirely, in common stocks, and excellent investments could earn 9% over a period of years. Common stocks will continue to be safe investments if they can be long-term investments

but can be unsatisfactory for a short period of time. Therefore, the importance of permanence of the fund. Mr. Haake distributed a chart comparing \$1/2 billion fund invested for a ten-year period versus invested for tenure period showing the value of the amount on each June 30, deducting 1% of the market value as cost of administration. At time of stress in the market, such as the sharp break in 1962, stocks may have been sold and the money put into high yielding bonds. The \$1/2 billion invested in bonds in 1962 would be worth \$244 million as of the end of last year, and the average price of bonds would have been 61. This demonstrates the need for permanence, in order to protect the State of Alaska against the possibility of hasty action.

Permanent Fund

Senator Brad Phillips said with a permanent fund this might have happened, since even with fifteen constitutional amendments you could take it out of stocks and put it in bonds and still have the same loss. Mr. Haake agreed there is no way to guard against mistakes in the future. The point is in setting up a permanent fund with professional money managers, at some future legislature they may see the fund is temporarily down in value and the direction of the fund may be changed. This permanent fund must be protected. Mr. Haake has seen a Board of Directors change an investment policy because they thought they were preserving what they thought they had left. By taking money out of stock and putting it into bonds, money is lost when the stock market swings back.

Responsibility

Mr. Haake continued: The other major point is responsibility. In 23 years he has seen a variety of boards, committees, trustees, or

sharing of responsibility in investment process. His observation is the best investment results have been achieved where there is absolutely clear placing of responsibility and accountability in one person. Let him get the best help he can find, but make it clear he must account for the results. The worst investments are when the responsibility is given to a committee, especially a committee with a changing membership. In Mr. Haake's opinion, Alaska will be best served by embodying permanence of fund in the consideration and designating a Board of Treasury as suggested by the Governor.

Inflation

Senator Lewis asked about inflation. Mr. Haake replied it is unrealistic to think we will get rid of inflation. Hopefully we will get back to a livable rate of inflation - long term price inflation of about 1-3/4% per year. It is extremely unlikely that we will get under that. The important thing about inflation is that we can't stand the 5% or 6% rate of inflation occurring in the last year or two. Normal inflation from 1-3/4%, 2%, or 3% is overcome by common stock investment, but not with 5% or 6% inflation. Senator Lewis asked why Mr. Haake believes inflation will decrease, and Mr. Haake said monetary and fiscal powers in Washington recognize it is not acceptable to our country to allow this rate of inflation to continue. If the underlying factors that have caused the 5-6% rate of inflation are not corrected, the U. S. will get into something like they had in South America. He believes it is getting under control now, and hopes to see it under 4%.

Testimony by
Philip Swan

George Morrison introduced Philip Swan, Executive Vice President of Lionel Eide & Co. Mr. Swan said Lionel Eide is one of the leading firms in investments; corporate pension and profit-sharing funds, insurance funds, and private funds, and has considerable experience in funds comparable to the one considered here.

Permanent Fund

Mr. Swan stated Paul Haake made an excellent statement concerning permanence in this fund and he could only underline and emphasize its correctness. Very good programs have gone down the drain at a moment of adversity in the stock market. In 1962 market break, programs held were suspended or altered and this should be avoided. A constitutional amendment could be the way to avoid losing permanence.

Responsibility

Responsibility and accountability should be placed in the hands of one individual, which is better than having a committee of changing membership. Trouble can occur when personalities change and policies change.

Fund
Evaluator

The original bill wanted a fund evaluator and the new legislation doesn't provide for one. In a program where multiple counselors are used, a fund evaluator would be significant. Down the road the committee or treasurer might not want to have a fund evaluator make a report, and under the new legislation he wouldn't have to. Mr. Swan believed this is a desirable thing to have in the legislation. Senator Brad Phillips asked who invited the representatives to come and testify before the committee. Senator Vance Phillips said he asked Mr. Morrison for opinions from someone in the industry who didn't have anything to sell and George Morrison invited these men.

Purpose of
Meeting

Senator Brad Phillips asked if they had any briefing on what position to take. George Morrison answered he had talked to these gentlemen. Basically it was his concern that all sit down together, not in opposition but in conjunction with one another, and make the best financial plan for the state. The administration submitted what they considered the best financial plan originally, which was changed by committee substitute. The administration believed the changes are not the best financial legislation and has pointed out the major differences in the bills to the representatives testifying:

1. Permanence; 2. Executive Committee versus Treasury Department;
3. Maximum long-term total return versus long-term total return;
4. Concept of an independent fund evaluator.

The gentlemen testifying have not been briefed to the extent that they must be on this side or that side, but have been asked for independent evaluation. Senator Brad Phillips asked if all opinions would side with the administration, and Mr. Morrison said the financial representatives are free to select their view. We should be concerned with the broad overall view and not with what is one policy versus another.

Fees for Fund
Evaluator

Senator Blodgett asked Mr. Swan the fees charged by an independent fund evaluator. Mr. Swan said some firms add a percentage to the business generated and several firms do some good work in this area. They measure risk and give rates of return. Independent organizations, not connected with the brokerage aspect, would charge a nominal fee. The cost factor would not be significant.

Fees for Fund
Manager

Senator Blodgett asked the cost if the legislature employed a fund manager and Mr. Noble said if you hired one man and paid him a salary he would not have the research to back him up, as would be found in an investment firm. Just salary is not the total picture since by hiring counselors you are buying experience and research. Mr. Haake added a staff of people could be assembled to manage this fund and it would cost between \$1 million and \$1-1/2 million per year.

Miscellaneous

Senator Josephson asked Mr. Swan if he testified before the Senate Monetary Policy Committee and Mr. Swan said he had. He had commented on the prudent man rule, total return concept, 5% return, and on safeguards which are necessary. Mr. Swan believes it is unusual to find ground rules of this type in a public fund and it is a sound and forward program.

Senator Miller asked what are the size of portfolios handled by Lionel Edie & Co. Mr. Swan answered they vary in the public fund area - New York State has something like \$1/2 billion in stock and several billions in bonds. Funds range from a few million to hundreds of millions of dollars.

Testimony by
Tom Phelps

Mr. Morrison introduced Tom Phelps, general partner, Scudder, Stevens & Clark, now specializing in seeking special opportunities in investing. Mr. Phelps' reaction differed just a little to the points in question. His reason for emphasizing permanence of the fund is that any good investment advisor who knows the money may be required for non-investment reasons will protect himself by investing in short-term securities. This will hamper results that

could pay if the money was in permanently. Mr. Phelps read a memo from March 20 emphasizing the importance of a long-term investment program. How best to insure this is a political matter to be decided by the state.

Responsibility

Mr. Phelps said after 40 years experience he knows about investment principles where he knows nothing about law. One principle is the principle of differentiating clearly between those responsible for the job and those sitting in judgment on the job. Objectivity can be maintained in many ways, but for long-range welfare Alaska would do well to differentiate clearly. Obviously if a committee delegates to a manager what it wants done and let's him alone, the committee is not responsible. If a committee is going to manage the fund, let it manage the fund and take full responsibility, but Mr. Phelps strongly urged not to do this.

Maximum long-term return

A slight change in the committee substitute bill deletes the word "maximum" from the phrase "maximum long-term total return."

As an investment advisor, Mr. Phelps believes it wouldn't matter whether the law said maximum or left it out totally. Any good investment advisor will seek maximum long-term return.

Fund Evaluator

A fund evaluator is a good idea if you recognize the principle that when anything becomes a substitute for thinking it becomes useless. Fund evaluators are technical and a highly controversial matter. Any evaluator is going to present to you one point of view and you should use it as a background for your own consideration of the job and not as a substitute for thinking about who is doing a good job and who is not.

Constitutional
Amendment

Mr. Phelps stated with regard to a constitutional amendment, a sovereign in any state and a minor child have one thing in common. Neither can make a binding contract. It is impossible for a sovereign to make a binding contract because it can always be changed. Whether the objectives of building a growing source of income from non-tax sources would be better served if you make it difficult to end this or if you leave it simply to successive legislators is strictly up to the legislature to decide in light of conditions in the state.

Maximum long-
term return

Senator Miller said this was interesting testimony. The administration testified they expressed concern over the "maximum" long-term investment but this change seemed insignificant to Mr. Phelps. Mr. Phelps said if Scudder, Stevens & Clark were employed, it wouldn't make any difference because they would do the best they could to achieve maximum long-term return, whether spelled out in the bill or not. If someone bought nothing but U. S. government bonds, he would be quickly fired and probably not hired in the first place. That is why Mr. Phelps did not attach much importance to the term.

Conflict of
interest

The conflict of interest term within the bill was questioned by Senator Miller. If the committee concept is followed, members of the committee might not know what is being bought and sold. Mr. Phelps said the question of "conflict of interest" on the part of members of the committee would hardly arise if the committee had no active part in decision-making. If the committee was active in

making decisions, then it would definitely arise. Scudder, Stevens & Clark guards against it by requiring a monthly report of stock transactions from each employee, which is reviewed by top management. If a pension fund is buying thousands of shares of stock and a clerk bought it, he would benefit somewhat. It is absolutely forbidden at Scudder, Stevens & Clark to benefit from confidential information.

Responsibility

Senator Miller noted the utility in keeping those who review decisions separate from those who make decisions. The bills say the treasury "shall manage" and the executive committee "shall manage" and Mr. Phelps questioned this wording. Senator Brad Phillips said the intent was to set up a committee to hire professional managers and this language should be changed. Mr. Phelps said no one in Alaska could approach the expertise necessary to manage, and neither should they select a stock or tell the manager what he should buy. The language is incorrect and should be changed. He continued that on the basis of these evaluations he could see no difference in the fund being managed by the committee or by the treasury if, in fact, neither is going to manage but merely hire someone else. What he would urge Alaska to avoid is any professional involvement by the members of the committee having to defend what has been done rather than objectively appraise it.

The philosophy behind the investment program was questioned by Senator Miller. What will be the relationship between the person who hires and the money manager, since the person who hires the

money manager is ultimately responsible for what the money manager does. Mr. Phelps said objectivity must be maintained. So long as that attitude is maintained he didn't see much of a problem. Actually it is almost impossible to eliminate all bias in human relations. All we can do is try to minimize it, but it is a calculated risk. If it can be set up in such a way that the judges don't feel personally responsible and get defensive about what is being done, you are on the right track, Mr. Phelps added.

Evaluation of
Fund Managers

Senator Josephson told Mr. Phelps that one of the assumptions in his committee work was that the management committee would not be able to change investment counselors very often. Too frequent change-overs would deprive us of the right to evaluate on a long-term basis. Mr. Phelps said he assumed a selection would be from among the most reputable, outstanding firms, which would receive wide publicity. The firm would certainly put forth any effort to achieve a good record, and it would be madness to change abruptly. To change anywhere short of three years would be a great disservice. Senator Vance Phillips asked if a member of the committee would be able to secure a loan easier from a bank handling state funds. Mr. Haake answered they would not loan money unless it is a good loan and the Continental Illinois Bank wouldn't make a bad loan to keep any other relationship.

Treasury vs.
Committee

Senator Lewis asked Mr. Phelps if he expressed a preference for either the treasury or the committee system and Mr. Phelps said no. He merely suggested the objectives you should seek to achieve and

leave it up to your judgment as to how to do it. If you gave Scudder, Stevens & Clark the job and didn't interfere, it wouldn't make any difference whether the treasurer or a committee was involved.

Inflation

The rate of inflation was questioned by Senator Lewis. Mr. Phelps said basically inflation is cheating. It results from attempts to get something for nothing. If we stop cheating we can stop inflation but inflation gets into the system. All nations in history have had it and we will never get rid of inflation because it has been going on as far back as records go. A little larceny is enjoyable and we are probably going to continue it, but there is a point where it ceases to be enjoyable. Where it inhibits future planning it becomes a depressant rather than a stimulant, and it must be checked. Mr. Phelps is betting it will be reduced to 3% per year, but not betting it will be eliminated.

Permanent Fund

Senator Brad Phillips said there has been much discussion about the "permanent" fund and the inference is if we go the committee route it will not be permanent. He feels if it is done by law rather than constitutional amendment it will be a permanent fund. The Public Employees Retirement Fund and Teachers Retirement Fund are secure and permanent since the performance has been good. Mr. Phelps said this is a very valuable precedent and should be reassuring to investment managers if you declare this to be permanent by the legislature. Senator Brad Phillips added our whole concept is in terms of a permanent fund. We understand it has to be permanent and we believe our route is as permanent as the administration's.

Mr. Martini asked if it wouldn't be more difficult to control a committee. If the policy established by the committee and coordinated by the money managers is not sound, how do you get rid of the committee? Mr. Phelps answered he is very anxious not to get into political problems because he couldn't pass on them. However, it would be more difficult for legislators to discipline their own members. Senator Begich said the Teachers Retirement Fund and the Employees Retirement Fund have had no interference and have an excellent record. They are under a constitutional amendment, operated through the administration and are well invested. Mr. Morrison said these funds are permanent, but they are not subject to appropriation by legislative action as this fund is. That is what makes this fund non-permanent. Senator Brad Phillips did not agree. Money will be appropriated to the care of the investment committee to manage. Mr. Morrison said it would only be for one year.

Testimony by
John Arena

Charles Noble and Dr. John Arena of Loomis, Sayles were introduced by Mr. Morrison. Dr. Arena said the Ford Foundation report is an objective view of how a fund should be run and it must be a long-term investment. In an economic report in 1966, it became quite apparent the U. S. had to have a tax increase. President Johnson didn't go along with the recommendations and caused inflation since political pressure was against raising taxes. As many safe-guards as possible must be made to insure permanency. In the question of treasury or committee, Dr. Arena said if this meant advising your manager to put X number of dollars in blue chips and Y number of

dollars in bonds, the fund managers are handicapped. Loomis Sayles has two clients, one in which the company is free to invest and the other where they have to go to a committee. Where a committee is involved, accounts have 1% to 2% lower rate of annual return. On \$500 million you place quite a constraint on this fund by checking with a committee. The problems of inflation and business forecast will be covered tomorrow with a slide presentation by Dr. Arena and Mr. Noble.

Tax Increase

Senator Lewis noted a tax increase was recommended to fight inflation, and asked Dr. Arena if he recommended a tax increase in Alaska. Dr. Arena said he was not familiar with Alaska's fiscal situation, but inflation is subsiding slightly now.

Testimony by
Wolfgang Falke

Wolfgang Falke was introduced and explained he did not have a copy of his proposal for each member due to the mail delay in New York. He distributed a chart which listed a nine-member committee. Mr. Falke recommended setting up different funds, each fund having its own Board of Directors. The fund managers would compete with one another and an evaluation could be determined by the results of each manager.

Division of
Fund

Senator Bradshaw asked what is an ideal fund value to each manager - \$100 million - \$150 million? Mr. Haake said you would probably get better results with five managers, each responsible for \$100 million. It would be possible to monitor them more frequently. Mr. Noble agreed that too many fund managers would run up costs and create problems in monitoring. An original issue of \$100 to \$150 million was recommended by Mr. Falke, and each manager would attempt to

double and triple that money. Mr. Falke stated money should be invested with two objectives: to have an increase in income and an increase in capital. Whether in mutual funds, real estate, common stocks or bonds, a small portion of the money should be invested in Alaskan industry which has a good future.

Senator Blodgett noted bonuses are given to good employees for excellent performance and the spirit of competition creates interest. This could be done with fund managers. Mr. Noble said a bonus factor would encourage risks by the fund managers, and safeguards would be practiced merely by judging performance. A firm which is doing poorly would be eliminated. Mr. Haake agreed that there is sufficient incentive in the fact that comparative performance of the managers will be judged.

Adjournment

The meeting adjourned at 5:10 P.M., to resume at 8:00 A. M. in the Governor's Conference Room on March 27.

SENATE FINANCE COMMITTEE

March 27, 1970

8:10 A. M.

Present

All members of the Senate Finance Committee and Mario F. Martini, Senate Fiscal Counsel. T. K. Downes, Commissioner, Department of Administration; Walter L. Kubley, Commissioner, Department of Commerce; George A. Morrison, Commissioner, Department of Revenue; Charles Noble, Dr. John Arena, Loomis, Sayles & Co.; Tom Phelps, Scudder, Stevens & Clark; Phillip Swan, Lionel Edie & Co.; A. Paul Haake, Continental Illinois National Bank; Wolfgang Falke; interested members of the Senate and members of the press.

Testimony by
Dr. John Arena

Testimony on Senate Bill 404 was presented by Dr. John Arena, who is a Vice President and Economist for Loomis, Sayles & Co. After receiving a PhD in Economics, Dr. Arena worked for the Federal Reserve Bank in Boston and was on the Economic Advisory Board for President Johnson.

The three important points of difference between SB 404 and the committee substitute are as follows:

Permanent Fund

Dr. Arena urged a permanent fund. Looking at the economy, the most rapidly growing area is in state and local governments. People want more service. The legislature will be under considerable pressure, since spending is rising by 12% a year, to find additional sources of revenue. Political pressures and economic realities will tempt you to touch this fund and he urged not to do it.

Maximum long-
term return

The second issue is deletion of the word "maximum" in the committee substitute. It is too unclear what the long term return is going

to be and you could buy a bond and sit on it forever. Return "maximum" to the bill as pointed out in the Ford Foundation report.

Responsibility

Finally, whether the fund is handled by a committee or treasury, Dr. Arena considers to be the problem of the legislature. The constraints placed on the fund managers will have to be minimal.

Income from Fund

Dr. Arena noted the return which can be expected from the fund. This can best be judged by what the economy will look like in the next ten years. A copy of the slides presented is attached and Dr. Arena's comments on each slide follow:

Unemployment Rate

Unemployment Rate - presents the economic constraints you must work with. The unemployment rate varied as high as 7% in 1958 and as low as 3-1/2%, which has been average for the last couple of years. When the unemployment rate rises to 7%, people are unemployed in large amounts and very little corporate profits are achieved. President Nixon has stated he lost the 1960 election because we happened to be in a recession at that time and there is pressure to keep the unemployment rate low.

Employment & Inflation

Employment & Inflation - in 1966 President Johnson drove the unemployment rate lower but inflation grew. In order to keep unemployment rate low, the rate of inflation will increase. Inflation can't get to zero unless you tolerate an unemployment rate of 9% and the political decision made in the '70's will try to control unemployment to 4-5% to keep inflation to 2%.

Households & Labor Force

Households & Labor Force - 1970's labor force is increasing due to the high birth rate in 1942. Every effort is being made by the

administration to employ these people, as 102 million people are projected in the total labor force by 1980.

Total Income and Gross Saving

Total Income and Gross Saving - The increase is due to the high rate of growth in the labor force. Gross National Product of \$2 trillion is projected for 1980, twice as big as we have today due to inflation and the growth of the economy.

Corporate Profits

Corporate Profits as Percent of Gross National Product - Corporate profits have averaged about 11.2% of total GNP. Due to the Federal government asking for more services, the profits after taxes will drop to 5 or 5-1/2%.

Earnings & After-tax Profits

S & P Earnings & After-tax Profits - \$50 billion corporate earnings in 1969. 1980 projection - \$110-120 billion. Profits will share in the growth of the total dollar budget. Earnings per share last year averaged \$5.80 per share, and earnings per share of \$12.14 are projected by the year 1980.

P/E Ratio

S & P 500, P/E Ratio - tends to reflect the value the market is putting on the securities and shows an unusually depressed period after World War II. 1980 multiple will be at about the 17 level and the S & P index price tag will be between 230-250.

Rate of Return

Projected Annual Rate of Return on Common Stock - growth appreciation will be about 11% per year plus dividends yielding 3%. We now have a greatly oversold market, an unusually good buying market. The stock market is low today because we are in the midst of an economic recession and there is no question that within a couple of years it will materially hurt profits. Secondly, we have had the most prolonged decline in the stock market since 1939. If you invest \$500 million, you could expect 10-11% on growth.

Basically this would generate a transfer to the General Fund of \$25 million and \$50 million by 1980 (based on a 5% withdrawal). This will provide for the long-term growth in the State of Alaska. It will provide attractiveness for industry and clearly improve the credit rating of the state. These are trend projections and you should expect the stock market to go up and down. When you have stock market corrections is the time you tend to lose faith in the market, which is exactly the time you should be buying. Unless you put the fund in a permanent fund, you tend to lose your nerve when the market is down. This is exactly the time you should not sell but pay attention to long-term values.

Maximum Return

To achieve maximum return you must put your managers under pressure to achieve maximum return under the prudent man rule. The managers will be working against each other and the market and if they don't beat the market they haven't done a good job. If they all do significantly better than average, retain them all.

Committee vs. Treasury

On the committee versus treasury question, it makes no difference whether the managers answer to a committee or treasurer. The key aspect is the relationship of the committee to the fund managers. You should take a full arm's length relationship with your advisors and give them authority.

Market Condition

Finally, Dr. Arena said he tried to make the case that the market is at a truly over-sold position today and is very close to rock bottom. The market is in advance of the general economy, so this will put a great premium on time. If you defer the action for one year, these rates of return would not apply. The Federal Reserve Board has shifted policy and the stock market is bound to benefit.

A decision should be made reasonably soon because delay could be costly.

Summary

Dr. Arena summarized his recommendations as follows:

1. Set up a permanent fund;
2. Put "maximum" back into the bill for maximum long-term return;
3. Do it quickly.

Economy of
U. S.

Senator Lewis asked why Dr. Arena was so sure the stock market was at the bottom. Dr. Arena answered based on historical patterns. The typical post-war depression lasts nine months and we have already gone seven months. President Nixon will take steps to push the economy upward and already the monetary policy is changing, becoming looser and more liberal. Senator Lewis asked what Pres. Nixon's steps would be and Dr. Arena said a Federal pay hike and a general loosening of a number of other expenditures. He has both monetary and fiscal devices at his power.

Federal Reserve
Board

The loosening of the economy by the Federal Reserve Board was questioned by Senator Lewis. Dr. Arena said the last eight weeks show definite signs of growth where there was no growth in the prior seven months. Mr. Noble added it has been a stronger stock market in the last week than it has been in a number of months. Senator Lewis asked who controls the Federal Reserve Board. Dr. Arena said it was set up in 1913 and technically power is with the U. S. Congress. Congress delegated authority to the Federal Reserve System, which is technically a private organization but is

actually a government organization. The Board submits a report to Congress and has annual hearings. They are also called for command performances before Congress. Seven governors are appointed for fourteen year terms and twelve other members are presidents of regional Federal Reserve banks for a total of nineteen. The twelve presidents from the Federal Reserve banks are appointed by directors of the banks. Senator Lewis asked if Congress audits the Federal Reserve and Dr. Arena answered they have internal auditors and independent auditors. Everyone in Congress can look at the report. He added all paper money is actually in the form of Federal Reserve Notes.

Interest Rates

Senator Phillips said some people believe the ceiling should be taken off interest rates and they will seek their own level.

Senator Phillips asked Dr. Arena if he had any advice. Dr. Arena said interest rates will drift lower over the next six months and as interest rates go lower you are going to earn less. As a matter of philosophy, he believes the market should seek its own level.

Fund Evaluator

The question of a fund evaluator was again discussed. Dr. Arena stated everyone has different opinions and the fund evaluator should set down the guidelines for the fund manager and give an independent opinion on how well he feels the fund manager is doing. It would not be his job to advise which stock to buy but to judge how well the managers are doing.

Collateral

Senator Phillips asked for opinions on how much money should be put in Alaska banks and what type of collateral should be required. Dr. Arena said the value of deposits is only as good as the

collateral there. There are no hard and fast rules. A bank as a member of the Federal Reserve System could not make a loan in excess of 10% of capital. Because Alaska could deposit in a bank pretty heavily, it would have a major interest in that bank. The real issue is how well the bank is run.

Interest Rates

Senator Blodgett said the legislature is giving serious consideration to bank collateral on deposits. A banker told Senator Blodgett he wanted to raise interest rates upward. Dr. Arena said a banker may be willing to pay more than 7-1/2% because he has some fairly attractive investments to make. A banker may want to raise rates because he can't get the amount of deposits he wants.

Collateral

Mr. Haake spoke on the general question of whether state's deposits should be collateralized. Speaking as an investment person, he would have a strong feeling that whoever is responsible would want deposits collateralized. The approach of the two bills clearly indicates that you want to take into account the economic needs of the State of Alaska and not simply put the funds out to earn the highest rate of interest for a short period of time. Considering the amount of money that you have, you must consider the inflationary effect of what you do with this money. Mr. Haake said he is not qualified to tell what percent of collateral should be in various instruments.

Senator Phillips said the main objective is protection of the money. Mr. Phelps noted it is extremely important to decide at the time money is put out whether it is a grant or a loan and not

Risk Capital

make a bad loan which should have been called a grant. He has seen many people kid themselves by what they call loans to worthy projects which no banker would have made. In effect, Alaska would be setting up a super-bank. The state is undertaking to perform a banking function by doing it indirectly, by putting deposits around in banks. Mr. Phelps did not think any real risk should be taken with these deposits. If stimulating the economy is the purpose, you could set up a fund and recognize that this was not really banking money but risk capital that the state was making available for that purpose. It wouldn't be good banking if you didn't follow good banking processes. Mr. Phelps said when you start telling a banker or an investment man how to invest, you are increasing the problem. You are really responsible for results, but you intend to hold the banker responsible which causes nothing but trouble. When you put money in a bank as a deposit, you leave it to the banker to decide what to do with it. If you make it available as a subsidized source of risk capital, it should be ear-marked accordingly. If the money doesn't come back, you accept the responsibility. In setting up a risk-type of banking, there is no reason why you shouldn't do it directly. It may be more convenient to do it through existing banks, but these funds should be clearly ear-marked as something different from ordinary bank deposits if that is what you are trying to accomplish. Senator Blodgett said when funds are deposited they lose their identity, and he was reluctant to be too lenient on collateralization. Mr. Haake added there was no question but that funds in a pool

of money being used for all sorts of purposes can readily lose their identity. The question of collateral is not necessarily related to the uses for which the banks lend out money except the bearing that collateral has on your responsibilities as trustees of this money. Looking at it as a trustee, you would want to be protected against mistakes in judgment made by bankers. Mr. Haake personally felt strongly that deposits ought to be collateralized. Mr. Kubley said the money wouldn't lose its identity if \$10 million was put in a bank and it was spelled out where the money should go. Senator Phillips noted the possibility of oil income not materializing. In three or four years the money would be used to support the budget.

Short-term and
long-term loans

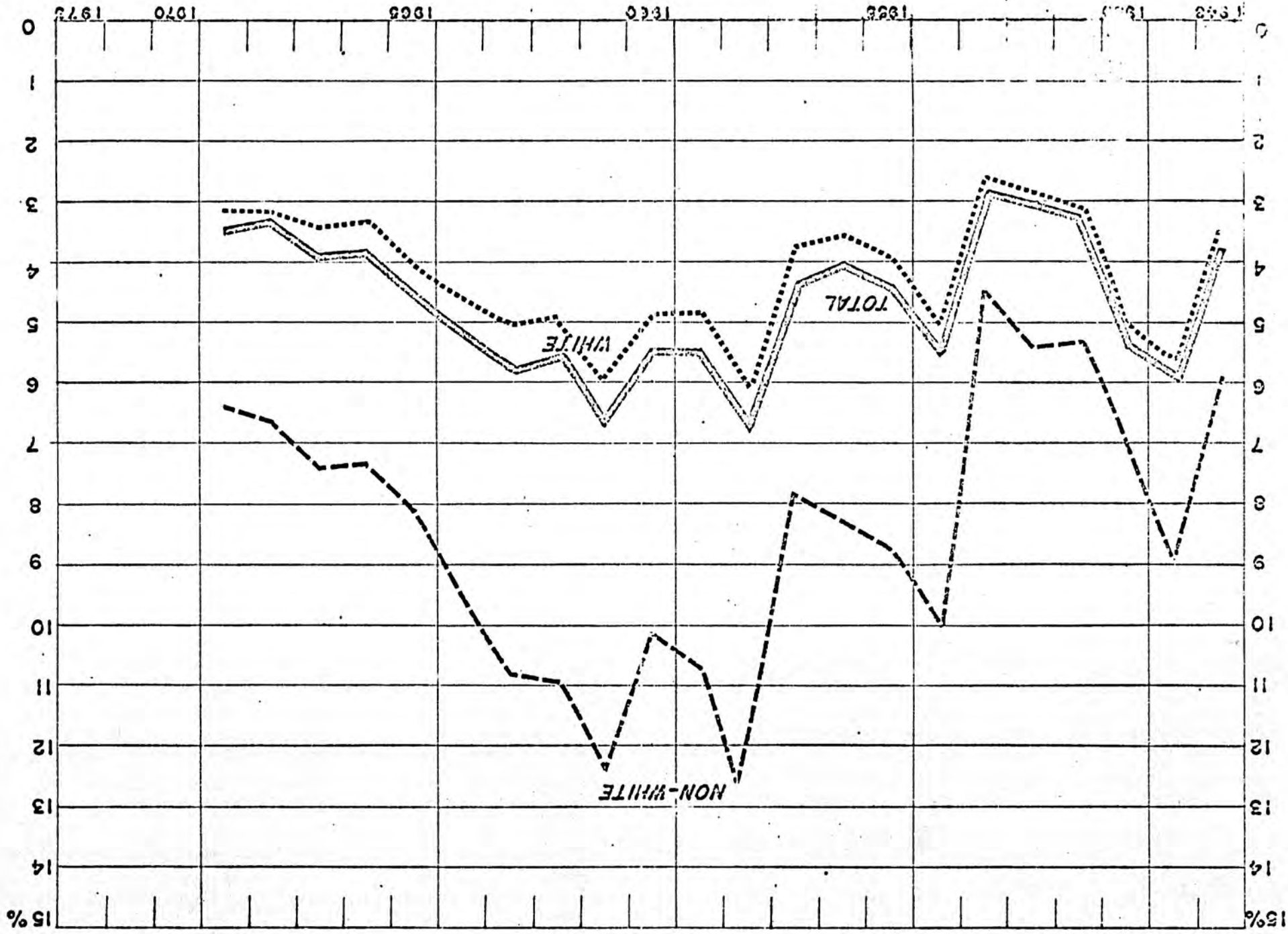
The time difference between short-term and long-term loans was questioned by Senator Bradshaw. Mr. Haake answered it depends on the type of loan. If talking about financing houses, short-term is a lot longer than short-term if talking about financing a crop. It is impossible to draw a sharp line and say short-term ends here and long-term starts here. Senator Bradshaw said two years is called a long-term loan at Alaskan banks.

Senator Phillips said hopefully deposits in Alaska would be loaned to Alaskans and Dr. Arena said this could be included in the bill but you will be in the banking business.

Adjournment

Senator Phillips thanked the financial representatives for attending and expressed the appreciation of the Senate Finance Committee for their testimony. The meeting adjourned at 9:30 A. M.

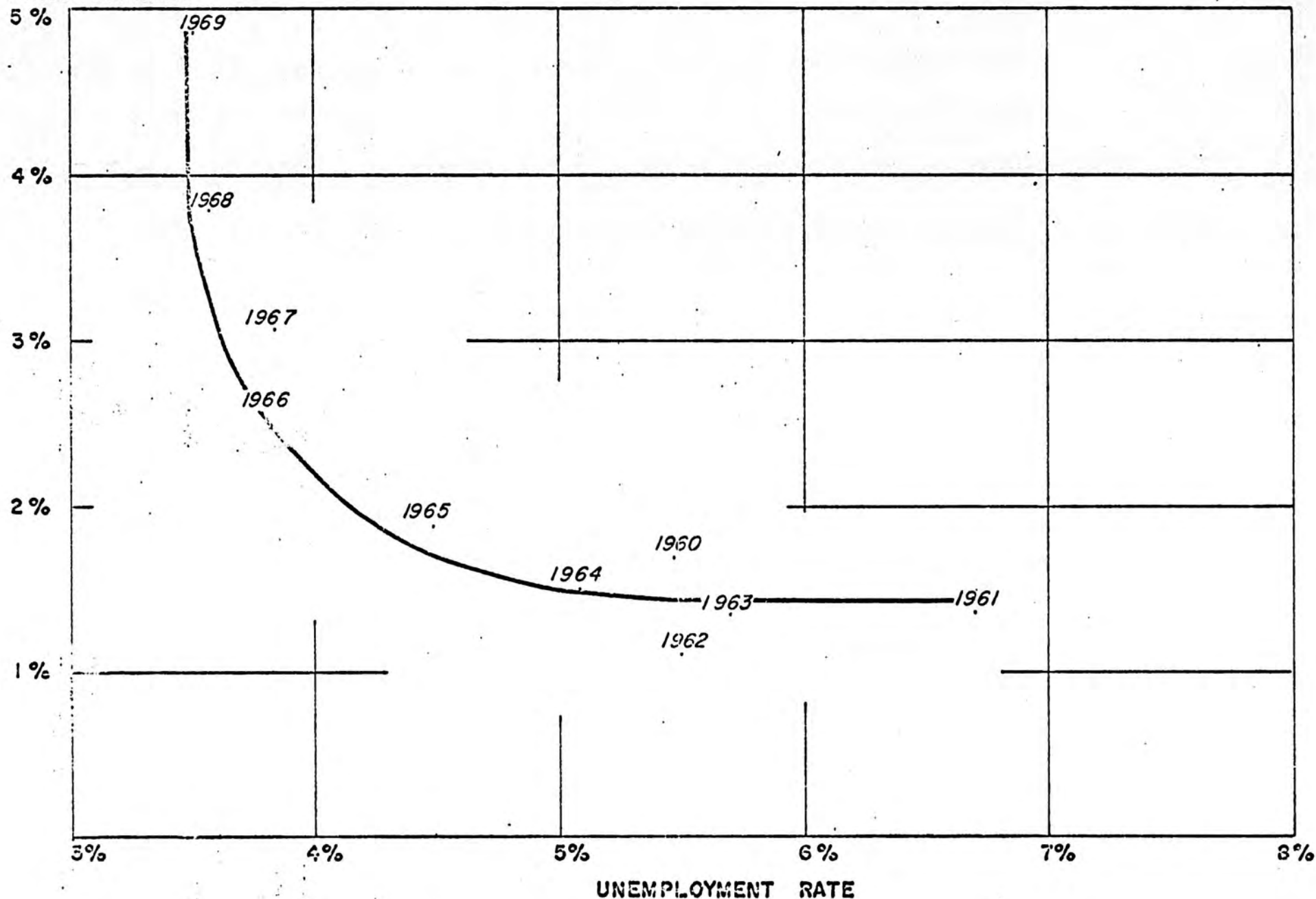
UNEMPLOYMENT RATE - BY COLOR



EMPLOYMENT AND INFLATION

2

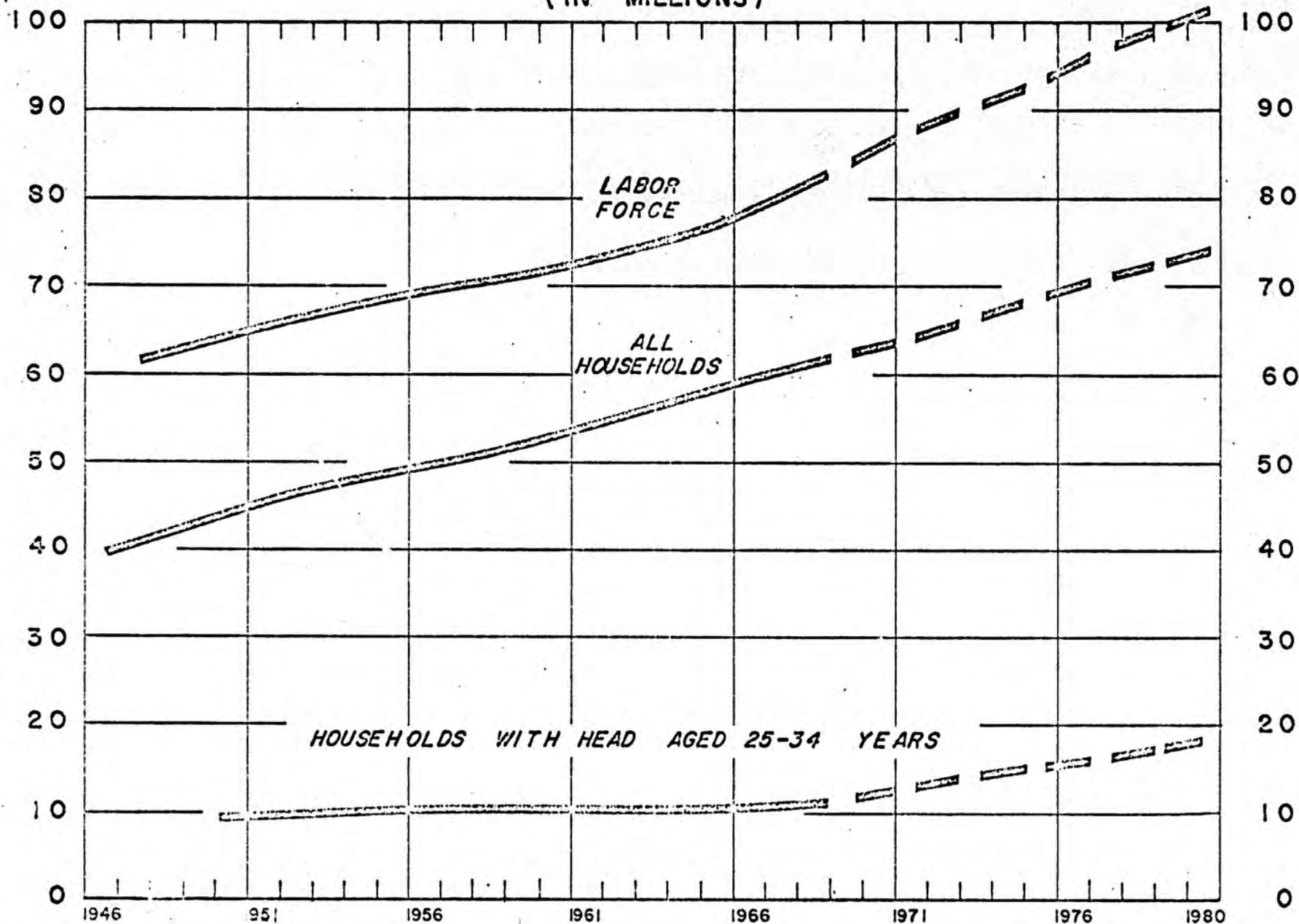
PRICE CHANGES



HOUSEHOLDS AND LABOR FORCE

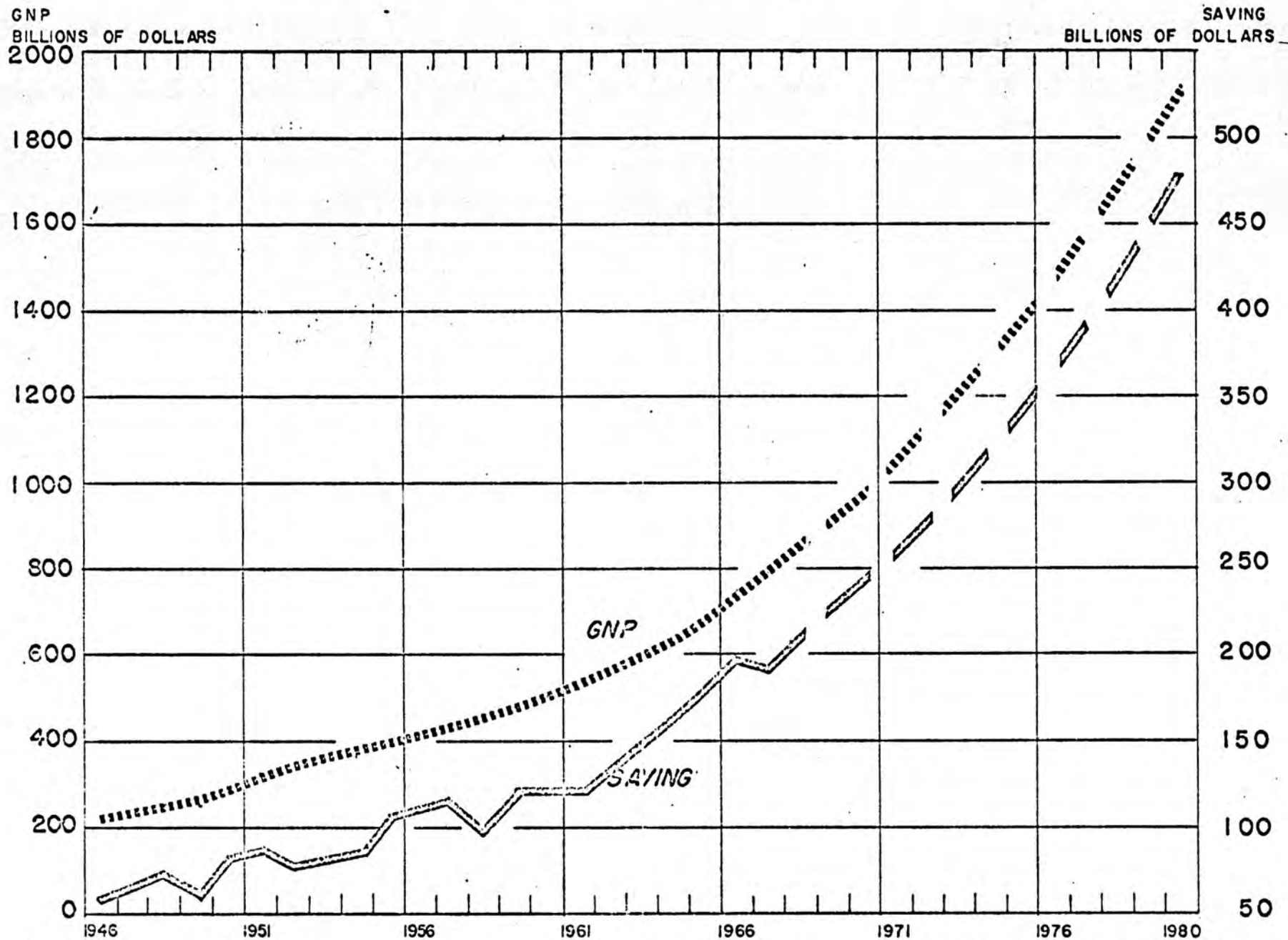
3

(IN MILLIONS)



LOOMIS, SAYLES & CO.

TOTAL INCOME AND GROSS SAVING

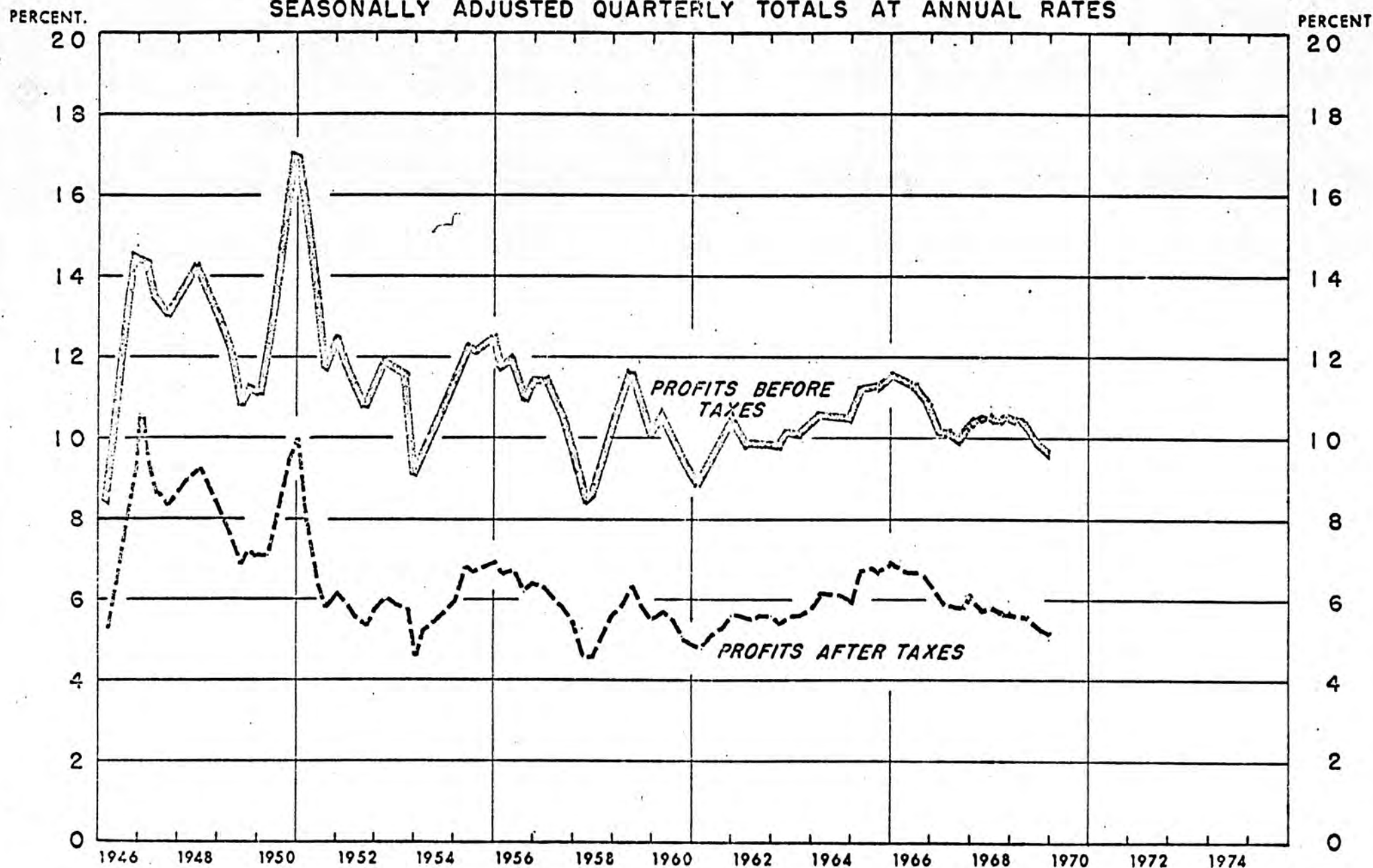


LOOMIS, SAYLES & CO.

CORPORATE PROFITS AS PERCENT OF GROSS NATIONAL PRODUCT

5

SEASONALLY ADJUSTED QUARTERLY TOTALS AT ANNUAL RATES



DEPT. OF COMMERCE

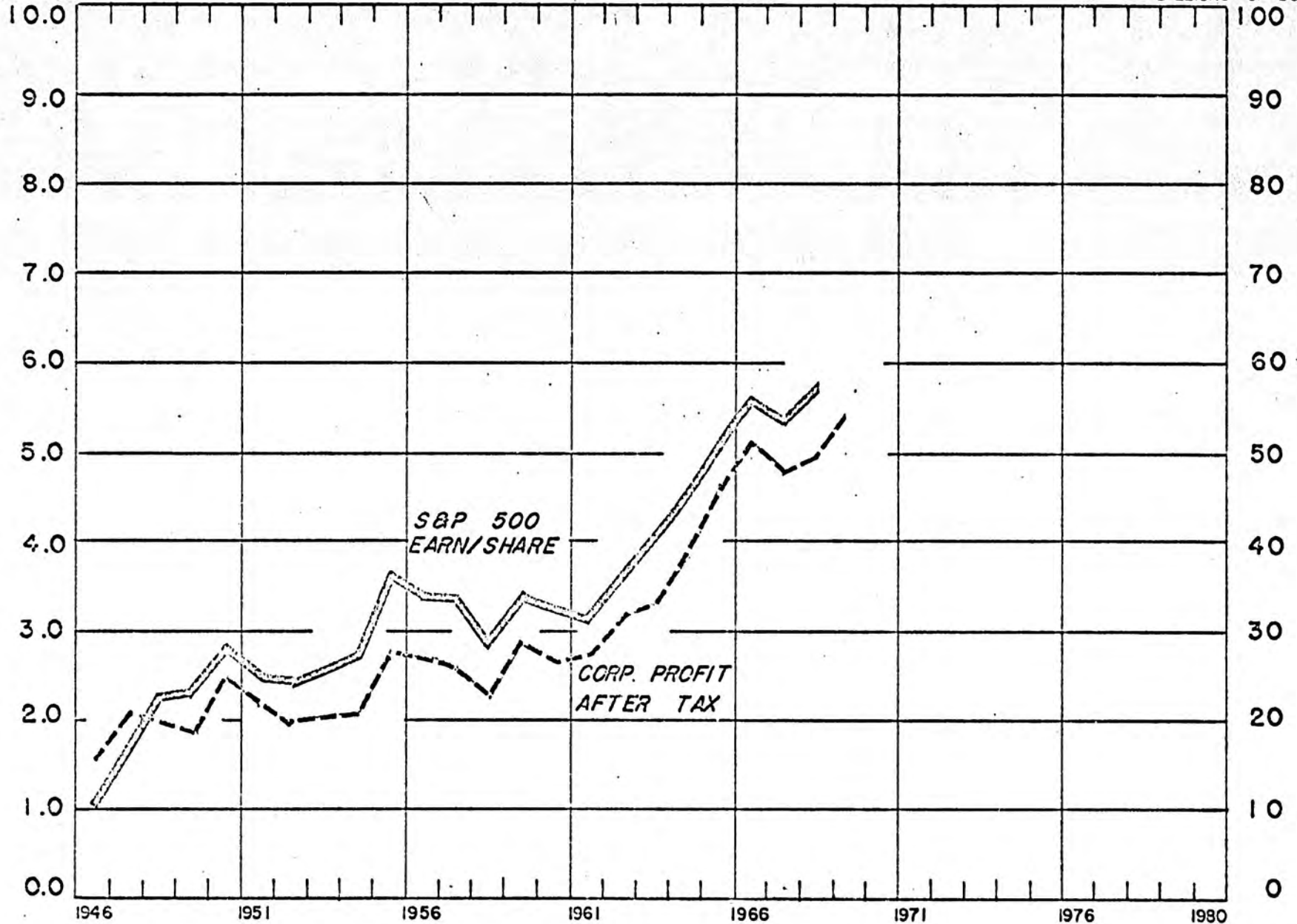
LOOMIS, SAYLES & CO.

S&P EARNINGS & AFTER-TAX PROFITS

6

S&P EARNINGS
DOLLARS

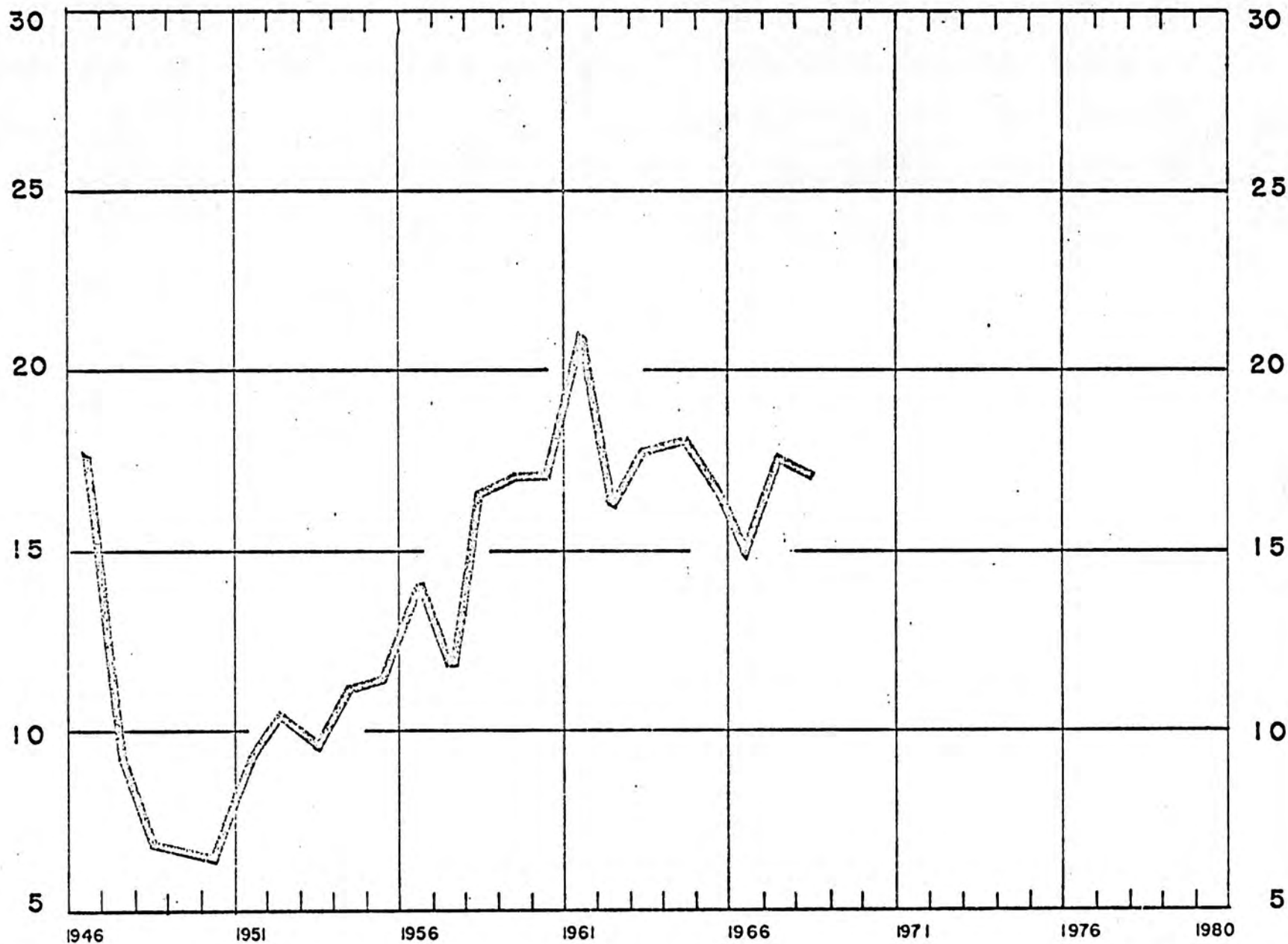
PROFITS AFTER TAX
BILLIONS OF DOLLARS



LOOMIS, SAYLES & CO.

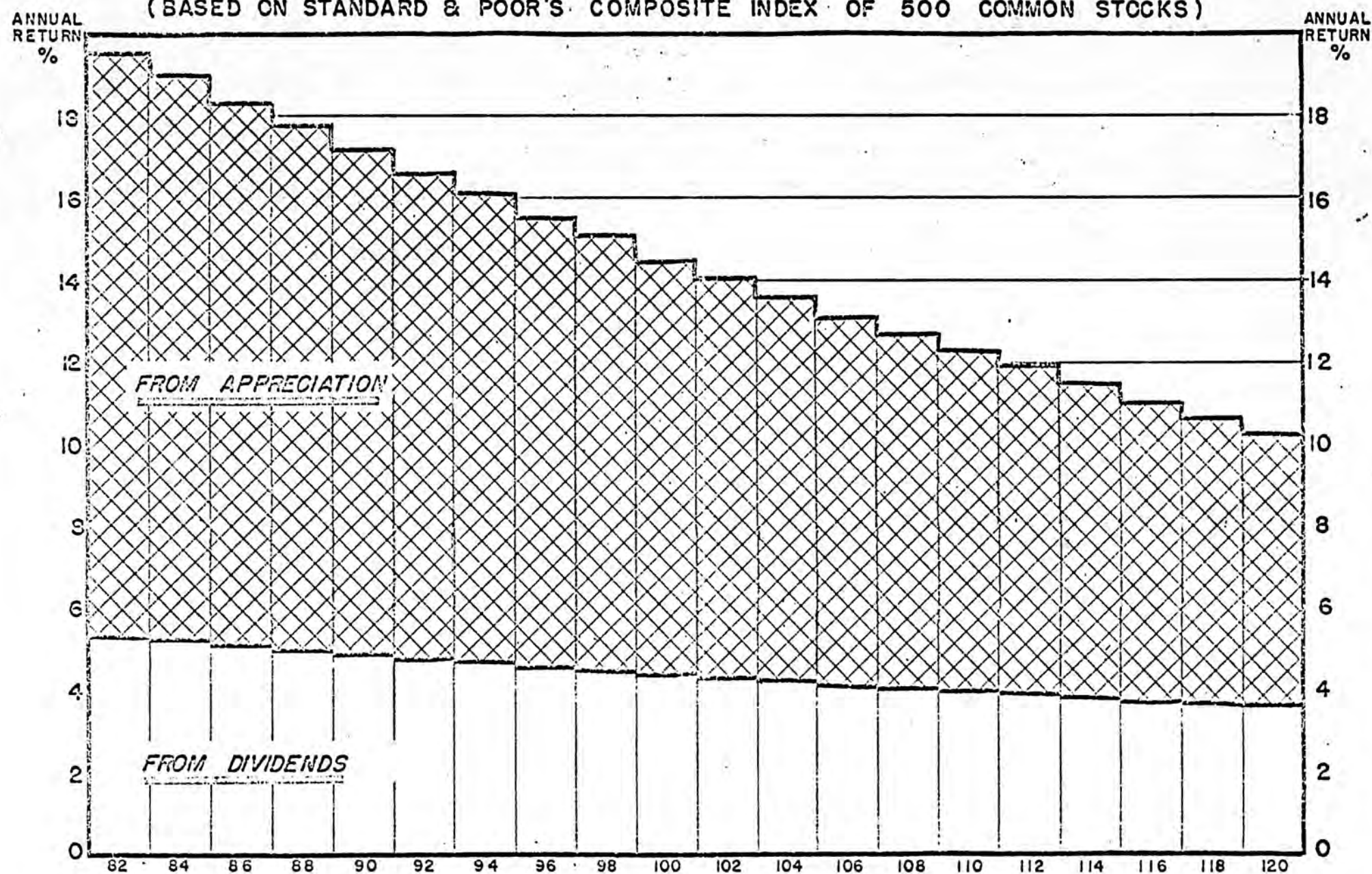
S&P 500, P/E RATIO

7



PROJECTED ANNUAL RATE OF RETURN ON COMMON STOCKS

(BASED ON STANDARD & POOR'S COMPOSITE INDEX OF 500 COMMON STOCKS)
1970-75



1969 PURCHASE PRICE - S. & P. 500 STOCKS

LOOMIS, SAYLES & CO.

PROJECTIONS

THE UNITED STATES ECONOMY 1975 AND 1980

AND

THE RATE OF RETURN ON COMMON STOCK INVESTMENT

February 17, 1970

Table 1.

THE ECONOMY IN 1975 AND 1980

	<u>1969</u> <u>(Actual)</u>	<u>1975</u> <u>(Projected)</u>	<u>1980</u> <u>(Projected)</u>
Civilian Labor Force (millions)	80.7	89.5	97.5
Unemployment Rate (%)	3.5	4.5	4.5
Civilian Employment (millions)	77.9	85.5	93.2
Total Employment (millions)	81.4	88.2	96.0
Average Work Week (hours)	37.7	37.0	36.5
Output per Man-hour - 1969 Dollars	5.84	6.97	8.08
GNP - 1969 Dollars (billions)	932.1	1,185.	1,465.
GNP - Deflator (1969 = 100)	100.0	119.4	135.1
GNP - Current Dollars (billions)	932.1	1,410.	1,980.

Table 2.

IMPLIED AVERAGE ANNUAL GROWTH RATESWITH HISTORICAL COMPARISONS

	<u>Next 6 Years 1969-75</u>	<u>Last 6 Years 1963-69</u>	<u>Next 11 Years 1969-80</u>	<u>Last 11 Years 1958-69</u>	<u>Last 21 Years 1948-69</u>
GNP - Current Dollars	7.2	7.9	7.1	6.9	6.3
GNP - Constant Dollars	4.0	4.7	4.2	4.5	3.9
GNP Deflator	3.0	3.0	2.7	2.3	2.3
DPI - Current Dollars	7.3	7.6	7.1	6.4	5.9
Industrial Production	4.4	5.6	4.6	5.6	4.5
Population	1.5	1.3	1.6	1.4	1.6
Total Labor Force	1.5	2.0	1.6	1.7	1.5
Total Employment	1.3	2.4	1.5	2.0	1.5
Average Weekly Hours	-0.3	-0.5	-0.3	-0.2	-0.3
Man-hours	1.0	1.9	1.2	1.8	1.2
Real Output per Man-hour	3.0	2.8	3.0	2.7	2.7
Gross Corporate Profits as Share of GNP	10.5%	10.6%	10.5%	10.3%	11.1%

POPULATION OF THE UNITED STATES

1965 estimated, and 1969, 1970, 1975 and 1980 projected

Age Group	Population (in millions)					Absolute Change (in millions)				Percentage Change (%)			
	1965	1969	1970	1975	1980	1965-70	1970-75	1975-80	1970-80	1965-70	1970-75	1975-80	1970-80
Under 14 years	56.3	56.8	57.3	60.9	69.1	+0.9	+3.7	+8.1	+11.8	+ 1.6	+ 6.5	+13.3	+20.6
14 to 19 years	20.6	22.6	23.1	25.1	24.6	+2.5	+2.0	-0.5	+ 1.5	+12.1	+ 8.6	- 2.0	+ 6.5
20 to 24 years	13.7	16.5	17.3	19.3	21.0	+3.6	+2.0	+1.7	+ 3.7	+26.3	+11.8	+ 8.8	+21.6
25 to 34 years	22.4	24.6	25.3	31.4	37.0	+3.0	+6.1	+5.6	+11.7	+13.2	+24.1	+17.7	+46.1
35 to 44 years	24.4	23.3	23.0	22.5	25.4	-1.5	-0.5	+2.9	+ 2.4	- 6.0	- 2.2	+13.0	+10.5
45 to 54 years	22.0	23.1	23.3	23.5	22.1	+1.3	+0.2	-1.4	- 1.2	+ 5.8	+ 0.9	- 5.9	- 5.1
55 to 64 years	17.0	18.2	18.5	19.8	21.0	+1.5	+1.3	+1.2	+ 2.5	+ 9.0	+ 7.2	+ 6.1	+13.7
65 years and over	<u>18.2</u>	<u>19.3</u>	<u>19.6</u>	<u>21.2</u>	<u>23.1</u>	<u>+1.4</u>	<u>+1.6</u>	<u>+1.9</u>	<u>+ 3.5</u>	<u>+ 7.9</u>	<u>+ 8.0</u>	<u>+ 9.0</u>	<u>+17.8</u>
Total	194.6	204.4	207.3	223.8	243.3	+12.7	+16.5	+19.5	+36.0	+ 6.5	+ 7.9	+ 8.7	+17.3

Note: Computations are based on figures in thousands

Source: Current Population Reports, Series p. 25, No. 381, December 18, 1967, Table 8 Series B