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Letter from the Chair

Jim Sampson

July 29, 2002

Dear Alaskans:

It is with great pleasure that I present Volume VII of The Trustees' Papers: "Making the case for complete and protected inflation-proofing."

Inflation-proofing has been – and will continue to be – a key component of the Fund's success. It is a topic deserving of special attention.

Under the Trustees' proposal, the Fund can be expected to produce more than $40 billion in income available for appropriation over the next 25 years. Oil revenues, the state's second largest revenue source, are projected to total less than half that amount. If the Fund is inflation-proofed over the next 25 years, the $40 billion of appropriable Fund income will be there. If the Fund is not inflation-proofed, that income stream will be cut in half in real terms and Alaska's ever-growing Permanent Fund will have become Alaska's ever-declining temporary fund.

To accomplish the desired results – and avoid the continuing diminishment of the Fund's purchasing power – it is only necessary to make sure that the Fund retains income sufficient to permanently offset inflation. With inflation projected to average 3 percent annually, and investments projected to earn 8 percent compounded over the long term, that means that each year's payout of Permanent Fund earnings must be limited to the "real" income, i.e., Fund income earned in excess of inflation.

In simple terms:

8 percent long-term return
- 3 percent average inflation

= 5 percent sustainable payout.

Alaskans are proud of how their Fund has grown over its first quarter century. It is a great success story. From an initial deposit of $734,000 twenty-five years ago, the Fund has become one of the 100 largest savings accounts in the world. The challenge facing us now is no longer how to build a public trust, but how to keep it secure.

It was the people of this state who made the momentous decision in 1976 to begin saving a portion of our one-time oil wealth and that decision

has proven visionary. Now, 25 years later, oil revenues are in decline and Fund income promises to become Alaska's dominant source of income for all of the future.

Now, in the Trustees' view, is the time for the people of Alaska to make another far-sighted decision if we want assurance that the Fund will realize its promised income. Although there are differing points of view about how Fund income ought to be used – whether for dividends or public services – there is general agreement that protecting the real value of that income stream is paramount. The best way to accomplish that is to approve the constitutional amendment proposed by the Trustees.

In addition to the 5 percent limit on annual payout, the proposal is based on the Fund's market value rather than income and includes a five-year averaging mechanism to smooth annual distributions. This is a modern, proven mechanism used by most endowment funds designed to provide benefits for generations.

The basic concept, as applied to Alaska, is that a 5 percent payout from a $25 billion Permanent Fund is $1.250 billion. This is how much can be appropriated from a fully inflation-proofed Fund each year on a sustainable basis for all public purposes including dividends. The amount will grow over time at the rate of inflation plus a little extra due to income earned on new constitutionally or statutorily dedicated mineral revenues added to principal. If the current dividend formula is maintained, an additional $175 - $300 million would be available annually to help fill the fiscal gap.

This Trustees' Paper makes the case for inflation-proofing. It provides simple, illustrative examples to prove the soundness of the underlying economic theory. It educates about the importance of managing volatility. It includes statements of support from a wide cross-section of Alaskans and explains why 5 percent is the right payout in terms of balancing Permanent Fund benefits between current and future generations of Alaskans.

Alaskans interested in receiving additional information regarding the Permanent Fund or this proposal are encouraged to visit the Corporation's web site at www.apfc.org

Thank you for your interest in the Permanent Fund.

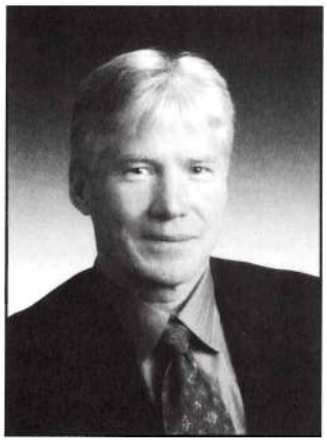
Sincerely,

Jim Sampson

Chair, Board of Trustees

A proposal by the Board of Trustees

Testimony before House Judiciary Committee
Trustee Clark S. Gruening October 19, 2001



Clark S. Gruening

Chairman Rokeberg, thank you. In February of this year, HJR 15 and SJR 13, a proposed constitutional amendment for inflation-proofing the Alaska Permanent Fund, were introduced in both houses of the legislature at the request of the Board of Trustees.

For 21 of the Fund's 25 years of existence, the APFC has been governed by a six-member Board of Trustees. Protecting the Fund against inflation has been the highest public policy priority of the Trustees since the original Board was appointed in 1980. The first Board testified to the legislature that the greatest threat to the permanence of the Fund is inflation. In response, the legislature adopted statutory inflation-proofing in 1982.

In more recent years, the Board has examined the use by various large endowments and public funds of a formula approach to determine the method and size of payouts from these funds while still providing protection against inflation. This approach is generally referred to as "percentage of market value" payouts, or "POMV" for short.

POMV – A new approach for the Permanent Fund

The purpose of this formula is to protect the long-term viability of the Fund and to provide consistent distributions for the beneficiaries. It also provides a spending limit on what can be currently spent or, in legislative parlance, appropriated. Existing law prohibits the appropriation of principal. In other words, anything but "principal" is income and can be spent. Principal does not vary or move up or down with the market. Instead, principal is a notional number that simply equals the sum of the constitutionally mandated 25 percent of mineral deposits and the non-mandated (or voluntary) deposits the legislature has chosen to make.

It is no surprise to you, but perhaps to the public in general, that two-thirds of that $21 billion deposited to the principal of the Fund was made voluntarily by the legislature as inflation-proofing and as extra deposits to principal. The remaining one-third came from the mandated 25 percent of mineral proceeds.

In the past year, Alaska has lost three former Trustees who had a great deal

to do with the formation and success of the Permanent Fund: Elmer Rasmuson, Hugh Malone and Oral Freeman. Two of them, Oral Freeman and Hugh Malone were legislators and like the Fund's first Chair, Elmer Rasmuson, were totally committed to inflation-proofing the Fund.

Complete inflation-proofing protects the entire Fund, not just the principal

What Elmer Rasmuson said about inflation is as true today as it was when he was chair of the Board of Trustees 21 years ago: "Inflation is like a thief in the night." What has changed is that principal is now a much smaller percentage of the Fund than it was in 1982, when inflation-proofing was first adopted.

In fact, if we count all the years from the first deposit in 1977 through 1995, income (or the Fund's earnings reserve) averaged only eight percent of the Fund. Despite the recent stock market retreat, the earnings reserve still makes up some 15 percent of the market value of the total Fund. Assuming no significant appropriations out of the Fund, except for dividends, the earnings reserve is projected to grow larger in proportion to the principal.

Unlike the present statutory provision for inflation-proofing, HJR 15 provides for inflation-proofing of the entire Fund. But clearly, one of the most important reasons to support the proposal is that it would maximize distributions over the long term.

This is significant because since 1982, Alaska's fiscal picture has changed dramatically. The Alaska Permanent Fund has produced, and will again in the future produce, more state revenue than any single Alaska resource – more than oil, more than fishing, more than tourism and more than a natural gas pipeline.

Similar to the concept of sustainable yield

The Board's proposal for inflation-proofing doesn't require any changes in statute, including the dividend statue. Whatever future decisions are made by the legislature or the voters regarding the use of Fund earnings, the five percent payout of market value limit will assure complete and protected inflation-proofing while providing a maximum sustainable payout over the long term.

In managing fishery stocks, the only sensible choice is to avoid taking too

Testimony before House
Judiciary Committee
Clark S. Gruening
October 19, 2001

much of any stock so that, over the long term, the harvest is maximized. Of course, over-harvesting can reap short-term rewards of more fish, more money, but the inevitable result is, at best, fewer fish, less money and, at worst, permanent impairment or destruction of a fisheries stock. The same is true for managing distributions from a large investment fund like the Alaska Permanent Fund.

I want to close with two key points. The first point is that if Alaska is going to have a Fund that is truly permanent, we must take those steps necessary to ensure permanence. This will require commitment to basic principles of long-term investing.

What is long term? The long-term is more than a "business" or "political" cycle. The long-term should include, at a minimum, the time in which our children, grandchildren and our grandchildren's children grow into adulthood. The critical flip side of a sound long-term investment strategy is a sound and sustainable distribution plan – a plan that will sustain and maximize the benefits to each generation of Alaskans. The form in which those benefits should flow is going to be the subject of much debate in the years ahead.

The second and last point I want to leave you with is a fact of life that I hope has become obvious – and that is that the Permanent Fund cannot do it all. Certainly, the Fund can and probably will play a role in any fiscal plan this or a subsequent legislature may pass, but it cannot do it all.

What we want to avoid, at all costs, is defaulting to the position where the Constitutional Budget Reserve (CBR) is today. Within the next few years, the CBR is destined for extinction. As the investment horizon of the CBR steadily shortens, it will be necessary to keep the assets of the CBR in very short-term and less-profitable investments.

I am concerned that in the event of the demise of the CBR, the trustees may have to adopt a shorter investment horizon for a significant portion of the Fund.

Whether we liken the Alaska Permanent Fund to a whole resource industry like Alaska's fisheries or to some kind of perpetual money machine, one thing is clear: the Alaska Permanent Fund imports big money into our state year after year. Legislative passage and voter approval of the Board's proposed amendment would protect the ability of the Fund to be managed for the long-term and to continue to pour money into the Alaska economy for the long-term.

Succeeding generations will rightly view this proposed amendment with the same degree of appreciation and admiration as the original one Alaskans overwhelmingly approved 25 years ago. The Trustees believe that this proposal for complete and protected inflation-proofing makes ultimate good sense for Alaska's Permanent Fund and for Alaska's future.

APFC analysis of SJR 13 dated May 5, 2001

The proposal

The Board of Trustees of the Alaska Permanent Fund Corporation (APFC) unanimously recommends that the legislature approve Senate Joint Resolution 13 or House Joint Resolution 15 which would place before the voters a constitutional amendment to permanently inflation-proof the Fund.

SJR 13/HJR 15 (hereinafter referred to as SJR 13) accomplishes inflation-proofing by limiting the annual payout of Fund income to no more than 5 percent of the Fund's five-year average market value. This methodology protects the purchasing power of the entire Fund and provides the maximum amount of sustainable income to benefit current and future generations.

It also conforms with the Board's asset allocation which is designed to earn a total rate of return 5 percent in excess of inflation.

The benefits

1. Provides constitutional protection against inflation for the total Permanent Fund, thereby more effectively safeguarding the Fund and increasing the amount protected.

2. Maximizes the total amount of Fund income which can be paid out in the future, at least as compared to higher payout rates, and does so in a way that balances the Fund's benefits fairly between the current generation and future generations.

3. Increases the likelihood that both the Fund's principal and its income will continue to grow in perpetuity in both nominal and real, inflation-adjusted dollars.

4. Makes available, beginning in 2003, $175-$300 million per year, depending on the Fund's market value, for purposes other than inflation-proofing and dividends. This amount will grow over time as the Fund grows.

5. Uses the percent of market value (POMV) payout methodology which smoothes volatility, treats realized and unrealized income equally as investment return, and is consistent with generally accepted accounting principles and modern endowment practice.

6. Lets lawmakers know in advance, within a relatively narrow range, how much Fund income will be available for appropriation each year.

The analysis

Principal and inflation-proofing. Under SJR 13, both the Fund's principal and the earnings reserve account would be inflation-proofed by constitutional mandate. In addition, there would be two constitutional limits on Permanent Fund spending: (1) principal would continue to be unavailable for appropriation; and (2) appropriations from the earnings reserve account in the future would be limit-

ed to no more than 5 percent of the Fund's average market value for the past five years.

Earnings reserve. All income not appropriated under the 5 percent payout limit would be retained in the earnings reserve account to offset inflation over the long term and to provide a cushion for future payouts in periods of extended down markets.

5 percent payout. The 5 percent limit is chosen for three reasons: (1) 5 percent is on the high end of sustainable payout rate that still maintains the Fund's real value; (2) 5 percent allows greater distributions over time than a higher payout; and (3) 5 percent is what the majority of endowments pay out; e.g., 85 percent of all public endowment funds pay out 5 percent or less, and the median payout of endowments, according to a 1999 Greenwich Associates study, is 4.9 percent.

Five-year averaging. Under SJR 13, the annual payout may not exceed 5 percent of the Fund's market value averaged over the prior five years, including the fiscal year just ended. This methodology is chosen to dampen volatility in annual payouts.

Dividends. This proposal does not affect the existing dividend program. It should be noted, however, that any future public policy decision to use an additional portion of Fund income for any purpose will affect the dividend, as will market volatility, but under SJR 13, these impacts would either be equal or diminished compared to the status quo.

Residual income available for appropriation. Except in the case of extraordinarily good financial markets, the 5 percent limit set by SJR 13 is above what is required to pay dividends per current law, leaving a residual amount available for appropriation. If the entire 5 percent were paid out, the residual amount is expected to range from $175-$300 million per year in a median case, growing over time as the Fund grows. Because of the mechanics of the existing statutory dividend formula, however, if the dividend in any year is extraordinarily high, the amount of the residual could be reduced to zero.

SENATE JOINT RESOLUTION NO. 13

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-SECOND LEGISLATURE - FIRST SESSION

BY THE SENATE RULES COMMITTEE BY REQUEST OF THE LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Introduced: 2/14/01
Referred: State Affairs, Judiciary, Finance

A RESOLUTION

Proposing amendments to the Constitution of the State of Alaska relating to inflation-proofing the permanent fund.

BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* **Section 1.** Article IX, sec. 15, Constitution of the State of Alaska, is amended to read:

Section 15. Alaska Permanent Fund. (a) At least twenty-five per cent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the **permanent** [GENERAL] fund [UNLESS OTHERWISE PROVIDED BY LAW].

(b) For any fiscal year, appropriations from the permanent fund shall be limited to five percent of the average of the year-end market values of the permanent fund for the last five fiscal years, including the fiscal year just ended. No other appropriations from the permanent fund may be made.

* **Sec. 2.** The amendments proposed by this resolution shall be placed before the voters of the state at the next general election in conformity with art. XIII, sec. 1, Constitution of the State of Alaska, and the election laws of the state.

Inflation-proofing the Alaska Permanent Fund

Juneau Empire
Editorial
May 6, 2001

The trustees of the Alaska Permanent Fund are proposing a constitutional change for the purpose of protecting the fund against inflation. Any time there is discussion about changes to the fund, Alaskans wonder about their dividends - the relationship between the size of recent dividends vs. the size of future dividends. And when they hear certain words or phrases, such as "limit the annual payout," they may become wary of the proposed changes.

Thus, it is critically important to the future of the fund and to Alaska's current and future residents to understand the proposed changes, which the Empire supports.

The proposal is built on the premise that less can be more. That's not doubletalk nor the latest example of fuzzy math. If the payout from the fund is limited to 5 percent of its average year-end market value over a five-year period. And if the fund's investments continue, on average, to outpace inflation, as they have for the past 17 years. And if all income from the fund's investments are constitutionally required to be deposited in the permanent fund, rather than the general fund. And if no other appropriations beyond the 5 percent of the fund's average year-end market value over a five-year period can be made. Then the principal of the fund should continue to grow and 5 percent of an ever-larger fund becomes an ever-larger amount of money.

Bottom line: 5 percent of a $30 billion fund is more than 5 percent of a $20 billion fund.

Five percent is not a figure the trustees pulled out of the air. It is a figure that, when combined with five-year averaging, offers the best chance for inflation-proofing.

The Legislature, not the trustees, will decide on the formula to be applied to the payouts permitted within the proposed 5 percent cap. They cannot spend more - for dividends or for any other purpose - than the 5 percent. And neither the trustees nor the legislators will do anything at all without the approval of a majority of Alaskans. That is why the trustees of the fund have asked the members of the Legislature to approve a constitutional amendment for the 2002 ballot.

The Empire supports the request because we believe the trustees of the permanent fund are acting in the best interest of current and future generations of Alaskans. Their proposal deserves the approval of the required two-thirds majorities of each house of the Legislature. Then it will be up to the voters of the state. The fund is a complex financial organism. The proposed changes can be simplified only to a point. But the trustees are not saying: "Just trust us." Their information and education efforts have begun. It will be in the interest of all Alaskans to pay attention. When the information is understood widely, when questions have been asked and answered, then doubts can be dismissed and the people of our state can take this historically important step to protect our very special savings account.

Questions and answers about the constitutional amendment (SJR 13) to inflation-proof the Permanent Fund

#1. What is the purpose of the proposed constitutional amendment?

The Board is supporting an amendment to the Alaska Constitution to provide constitutional – not just statutory – assurance that a portion of Fund income will always be retained each year to offset the effects of inflation. As Trustee Clark Gruening points out, this proposal puts emphasis on the word 'permanent.' The amendment would accomplish this by providing that annual payouts from the Fund can be up to but no more than 5 percent of the five-year average market value of the Fund.

#2. How does a payout of no more than 5 percent inflation-proof the Fund?

The Board's best estimate is that, over the long term, the Fund will earn an inflation-adjusted, "real" rate of return of 5 percent. For example, the Board's current 5-year target asset allocation is designed to earn an average, annual rate of return of 8 percent with an expected inflation rate of 3 percent. This proposal sets the maximum payout at 5 percent – the difference between what the Fund earns and what it loses to inflation – to ensure that the Fund's growth will at least keep up with inflation.

#3. Why is the Board taking this action now?

After many years of study and analysis, the Board is convinced that a constitutional amendment is the best way to protect the Fund against the effects of inflation. It is also fitting that this debate should take place during the time while Alaskans will be celebrating the 25th anniversary of the Alaska Permanent Fund's creation in 1976.

#4. Does the legislature have to approve this?

Yes. Before any constitutional amendment can be voted on by the people, it first has to win the support of a super majority, that is, two-thirds of the legislature.

#5. Do the people get to vote on this issue?

Yes. Once the legislature gives its two-thirds approval, the proposed constitutional amendment would be placed before the voters at the next general election.

#6. Why 5 percent?

The Board has been studying percent of market value (POMV) payout limits diligently since 1996 and has found that the majority of large foundations and endowments set payouts of no more than 5 percent of their funds' market value. The Board also reached two important and related conclusions. First, 5 percent is the maximum that a fund can pay out and still maximize its long-term distributions; and second, 5 percent is the maximum sustainable payout rate, beyond which the real value of the Fund would begin to erode.

#7. How does SJR 13 differ from the status quo?

The major difference is that this amendment provides constitutional inflation protection for the entire Fund whereas the status quo provides statutory inflation protection only for the principal. It also limits withdrawals from the Fund by the legislature – currently all of the earnings reserve is available for appropriation.

#8. Does SJR 13 change the way principal is treated?

No. Principal cannot be spent under existing constitutional and statutory law. It would continue to be unavailable for appropriation under SJR 13. In addition, a portion of the earnings reserve account would also become unavailable for appropriation: that amount in any given year which is in excess of that required under the 5 percent of average market value limit. So, for example, if the principal in the future were $22 billion and the earnings reserve were $10 billion, and the five-year average market value of the Fund were $30 billion, only $1.5 billion

of the money in the earnings reserve account would be available for appropriation that year (5 percent x $30 billion = $1.5 billion.)

#9. How does SJR 13 affect the dividend program?

It doesn't. The Board has modeled this proposal and come to two fundamental conclusions: (1) the constitutional amendment will have no impact on the dividend program vis-à-vis the status quo; and (2) volatility in the financial markets may impact the dividend program, but the impact will be the same under either the status quo or SJR 13.

#10. Is the Board sure that 5 percent is the right number?

The Board's best estimate is that, over the long term, the Fund will earn an inflation-adjusted, "real" rate of return of 5 percent – which can be safely paid out without the Fund losing ground to inflation. There will be short-term periods when earnings are too low and inflation too high and the Fund will not be protected against inflation. However, over the long term, such periods should be offset by periods of strong asset growth.

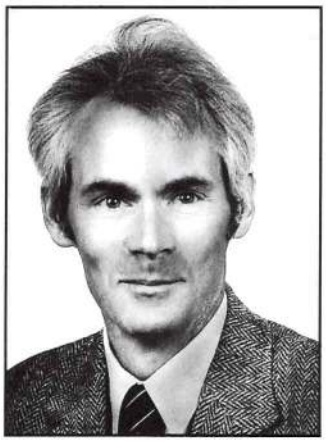
2002 APFC
Board of Trustees

(Back, left to right)
Wilson L. Condon
Chair Jim Sampson
Bruce M. Botelho
(Front, left to right)
Vice Chair Eric E. Wohlforth
Janie Leask
Clark S. Gruening

Why complete and protected inflation-proofing is a good idea

Arguments in support of a percent of market value (POMV) distribution of Fund income

First recommended by Trustee Hugh Malone in the late 1980s, recommended for further study by the Commission on the Future of the Permanent Fund in 1990, recommended by the Long-Range Financial Planning Commission in 1995, recommended by the Board of Trustees in 1996, approved by the House of Representatives in 1999, this is a well-considered idea which has been thoroughly studied and enjoys wide support. What follows are ***excerpts*** *from papers written on the subject over the past 11 years.*



Hugh Malone

"A Payout Rule for the Alaska Permanent Fund," Commissioner of Revenue Hugh Malone, December 8, 1989

The problem to be solved is how to (1) preserve the real value of the assets under your care; (2) pay out good, consistent earnings, and (3) not disrupt or distort investment decisions in order to achieve (1) and (2).

One solution, much discussed, is a payout rule – developed at Harvard in the 1960s and since adapted in one form or another by other endowments. A payout rule involves spending each year a fixed percent of the market value of assets; market value is averaged over a number of years, commonly five, to bring stability in the amount of spending.

The fixed percent should be no more than the long-term real income of the Fund on a total return basis, i.e., adding interest, stock dividends and any other cash receipts to net capital gains in equities, real estate and bonds. The capital gains do not have to be realized in order to be counted.

In order to win public confidence in this long-term approach, and more to remove the temptation to increase the payout rate unwisely, the number should not be in a bare statute. It should be set in a constitutional amendment and placed before the public who, in truth if not in law, are the owners of the Permanent Fund. The following language, for instance, replacing the present wording on the disposition of income, could serve the purpose:

ART. IX, Sec. 15. All income from the permanent fund shall be retained in the permanent fund, except that the legislature may each year appro-

Arguments in support of a percent of market value (POMV) distribution of Fund income

priate no more than five percent of the average market value of the permanent fund over the past five years.

Advantages of the new rule:

- Gives the Fund's managers five years to meet or exceed inflation, rather than asking them to do it each year.
- The new approach will, over time, keep payouts within the real income of the Permanent Fund.
- As for its impact on investment decisions, the payout rule is a valuable aid and safeguard.
- This new approach allows the Fund to hold more investments, chiefly equities, which need more time.
- Most importantly, a long-term payout will help teach the public to look at the Fund's performance long term – not year to year or, worse, quarter to quarter. This is key to having a public of sufficiently patient investors.

Long-Range Financial Planning Commission's Recommended Plan, October 1995

The Commission believes the best method for preserving current capital wealth for current and future generations of Alaskans is to follow traditional endowment principles. For our Permanent Fund those principles include preservation of the Fund, the best possible level of performance for the Fund, and the preservation of Alaska's oil wealth for future generations of Alaskans.

Our plan calls for the Permanent Fund to grow as an endowment for the State.

- The plan establishes the Permanent Fund as an endowment (by amendment to the Constitution) that pays up to four percent of the Fund's five-year average market value to the general fund for the dividend program and State service. The Commission recommends a four percent payout based on the experience of other endowment funds in the United States, and takes into account the Permanent Fund's earning experience, asset allocation and need to protect the principal.
- Earnings of the Permanent Fund in excess of this four percent payout rate are retained in the Fund. Years with good investment performance will, over the long run, balance years with poor investment performance to more than fully inflation-proof the Fund.

"A Primer on Endowment Management," Callan Associates, November 27, 1995

The goal of the Permanent Fund's Board of Trustees is to (1) preserve the purchasing power of principal and (2) produce a stable flow of

Michael O'Leary

Arguments in support of a percent of market value (POMV) distribution of Fund income

income available for appropriation. These two basic goals inherently conflict. Most institutions achieve the balance by determining a sensible long-term target rate of spending and applying that rate to a moving average of endowment market value.

Letter from Michael O'Leary, Callan Associates, August 6, 1996

Shifting to this endowment type model, in my view, would better enable the Board to focus investment policy on the long term and not be as concerned with consistency in the shorter term. This longer-term focus, combined with greater flexibility arising from the prudent expert standard, should result in higher earnings.

"Discussion Paper," Investment Policy Options Subcommittee of the Board of Trustees, Chair, Eric Wohlforth September 10, 1996

The subcommittee strongly urges full consideration of a statutory change to provide for a modified annual payment provision for the Fund: based upon a percentage of a moving average of the market value of the Fund. The primary considerations favoring this recommended change:

Shifting to a market value distribution formula will permit focus on a long-term investment policy and recognize that a dollar of realized gains and a dollar of unrealized gains each have the same value.

Continuing the present realized return formula may lead to distortions of good investment policy if gains are taken or asset allocation decisions are made, primarily to maintain annual dividends.

Employing a market value distribution formula and setting a real rate of return target above the amount produced by that formula will give inflation-proofing of the Fund first priority and assure that the principal of the Fund is protected.

A market value distribution formula will allow the legislature, as it presently does, to set the dividend level in statute.

A percent of average of market value policy should permit a more level distribution program consistent with accepted methods of measuring Fund performance and with the market value accounting requirement now mandated by the Governmental Accounting Standards Board (GASB).

At the heart of APFC investment planning for the future will be the attempt to mediate among these conflicting objectives:

1. Maximize long-term total return.
2. Maximize annual spending distributions.
3. Preserve the *real* (i.e. inflation-adjusted) value of the Fund and the distributions.
4. Maximize the stability and predictability of spending distributions.

"Comments regarding Discussion Paper," Callan Associates, August 8, 1996

Major endowments have a primary goal of supporting current operations to the maximum extent possible provided that such distributions are consistent with making the same relative contribution over the long term. In other words, distribute as much as currently possible provided that the future distributions reasonably can be expected to grow with inflation.

In order for this objective to be achieved, distributions must be limited to 4-5 percent of average market value. Over the long term, diversified investment pools can expect to earn a 4-5 percent real return. By limiting distributions to this amount, the purchasing power of the corpus can be maintained.

Alaska's existing statutes and practices (combination of inflation-proofing, earnings reserve account, averaging for determination of earnings, etc.) strive to achieve the same objective (i.e., preservation of purchasing power and an equitable distribution policy). The current approach, in my judgment, is potentially more complex than it need be.

The concept of "realized earnings" as opposed to total return affects decision-making. A dollar of income or realized gains is more valuable than a dollar of unrealized gains. In fact, both have the same value. The need to realize gains results in costs (both explicit and implicit) that need not be incurred.

Even with a five-year averaging period, limiting distributions to a function of earnings (whether realized or unrealized) will result in distribution volatility that need not occur. Attention is shifted from long-term earnings maximization toward greater consistency in shorter-run earnings.

Minutes, Board of Trustees Meeting, September 25-26, 1996

Mr. Wohlforth: We recognize the primacy of the legislature and the people of the state of Alaska in identifying and enacting into law those programs deemed appropriate for Permanent Fund earnings. However, when proposals are advanced, as they have been and increasingly will be, that would affect the investment goals or portfolio of the Fund, we think the Permanent Fund is well suited, if not legally obligated, to bring to the attention of public officials, elected officials, all significant Fund investment and management issues that arise from fiscal proposals.

"Issues related to establishment of an endowment/market value distribution model for the Permanent Fund," Ron Lorensen, APFC legal counsel, November 8, 1996

The payout rate for an endowment is typically set at or slightly below the fund's expected real rate of return over the longer term. In looking to a fund's real rate of return, the distribution formula automatically provides for preservation of the fund's purchasing power by leaving the inflationary component of its nominal rate of return untouched.

Under present AS 37.13.145(c), an amount is transferred annually from the earnings reserve account to the Fund's principal "to offset the effects of inflation on principal." The operation of this provision is commonly referred to as "inflation-proofing." However, to permit an endowment concept to operate fully and predictably, the regular transfer of Fund income to principal would almost certainly have to be discontinued. This is particularly so in the early years when it will be necessary to allow the amount available for distribution to grow large enough to cover distributions during periods when asset values may have declined substantially due to general weaknesses in the markets.

In considering moving the Fund to an endowment model, it is important to assure that the endowment is structured adequately to assure its ability to "weather" periods of market decline. With respect to the Permanent Fund, because of the constitutional proscription against "invading" principal, this primarily means assuring that sufficient

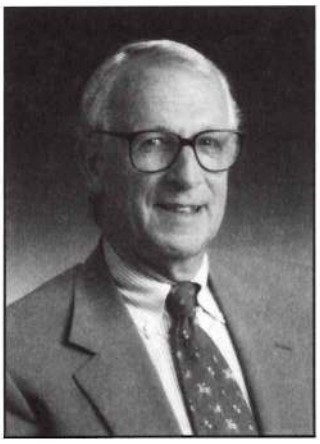
Arguments in support of a percent of market value (POMV) distribution of Fund income

assets are retained in the Fund's non-principal account to satisfy distributions during markets downturns.

A presentation to the "Principles and Interests Conference," Chair of the Board of Trustees Eric Wohlforth, November 21, 1997

It is hard to imagine any major spending decision of the state in the future which will not involve some consideration of the use of Fund income. The very first action, therefore that should be taken is adoption of a modern and rational means of determining what distributable Permanent Fund income is on an annual basis. Only then can intelligent and rational decisions be made on the use of income.

The legislature can take this action without amendment of the Alaska Constitution so long as the payout does not exceed actual income. On a longer-term basis, we should consider a constitutional amendment to achieve this goal.



Eric Wohlforth

Legislative action would amount to an affirmation of the Fund's asset allocation model and acceptance of an appropriate level of risk and volatility. It would give stability and certainty to annual permitted payouts. It would recognize that capital gains, at least in part, are real additions to income. It would put the Fund in sync with the new GASB rules.

"Alaska Permanent Fund Long-Term Investment Considerations," An APFC presentation to Senate Finance, March 31, 1999

In the Trustees' view, it is not likely that the existing investment and distribution structures will work as well for Alaska in the next 20 years...and here's why: (1) increased volatility in capital markets; (2) GASB 31, the new financial accounting standard, changes the way the APFC reports income in the earnings reserve account...and that causes an inconsistency between current Generally Accepted Accounting Practices and state law, according to Morrison & Foerster and KPMG; (3) the crossing of Fund income and state oil revenues lines in 1998.

At the heart of APFC investment planning for the future will be the attempt to mediate among these conflicting objectives:

- Maximize long-term total return;
- Maximize annual spending distributions;
- Preserve the real (i.e., inflation-adjusted) value of the Fund and the distribution; and
- Maximize the stability and predictability of spending distributions.

Arguments in support of a percent of market value (POMV) distribution of Fund income

Advantage of POMV:

- Provides more predictability and stability in annual distributions.
- Disconnects investment decisions from short-term spending considerations.
- Spending provision becomes part of long-term investment strategy rather than tactical response to market cycles.

"Questions and Answers About the September 14 Ballot Proposition," APFC Position Paper, June 14, 1999

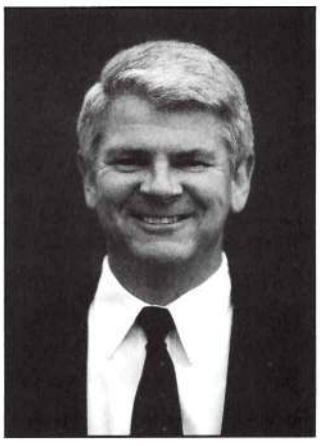
The Plan adopts a new payout methodology based on a percentage of market value distribution of Fund income. This methodology, which is used by most endowments and foundations – and which is supported in principle by the Board of Trustees – is designed to preserve the purchasing power of the corpus by limiting the annual distributions to a rate lower than the expected long-term rate of return minus the rate of inflation. The income not distributed remains in the fund to offset the effect of inflation.

As the percentage of Fund assets invested in equities is increased, there will be increased short-term volatility (risk) as well as increased long-term returns. One of the reasons why the Trustees favor a percentage of market value distribution methodology is to moderate the effects of that increased volatility. For Alaskans, it highlights the need to very carefully balance the three conflicting objectives of preserving purchasing power, maximizing income, and providing stable, reliable and predictable annual payouts.

Q. *How much can be distributed while still preserving the real (i.e., inflation-adjusted) value of the Fund?* A. If you want to preserve the real value of the Fund, you must not spend more than the real rate of return on your investments over the long term.

Q. *Isn't a payout based on a percentage of market value going to be more volatile than one based on income?* A. No, distributions under the Plan will be more stable, reliable and predictable than the status quo distribution which is based solely on realized income. This is one of the features of the Plan which is a clear improvement. Calculating annual distributions on market value rather than income means that a dollar of unrealized income will be treated no differently than a dollar of realized income. This will bring the Fund completely into conformity with generally accepted accounting principles.

Compiled by Jim Kelly
APFC Director of Communications
January 11, 2000



Jim Kelly

Importance of managing volatility

Managing volatility: A key element in Alaska's public finances, — Excerpt from Fall 2001 Revenue Sources

Investment Revenue Volatility

The lesson that many people have relearned recently is that investments can lose money. Although the state manages many of its funds to avoid volatility, the state also manages some funds, such as the Permanent Fund, for the purpose of making money over the long term. To meet this long-term goal requires taking risk; taking risk means that at times the Fund will make money and at times it will lose money.

Does this volatility cause a problem? Potentially, it does. If the state is relying on a steady stream of income from an endowment to fund a program, the volatility of investment returns can wreak havoc with the program's budget.

It's easy to find examples of this. Section VII of this forecast describes Alaska's endowment funds, all of which invest money in order to live off the investment income. One example is the Alaska Science and Technology Fund. This fund makes grants from the income of its investments, and also provides funding for certain other programs. The fund has existed since 1988. Although the fund would occasionally stockpile some earnings, it had no formal earnings reserve account.

As long as the Science and Technology Fund made money, it could deal with volatility simply by making fewer grants in lean years. Between FY 1992 and FY 2000, its realized income ranged from a low of $7.3 million to a high of $14 million; its spending ranged from $1.5 million to $25.7 million . . .With the large losses experienced by fund managers in 2002, however, the fund now faces a dilemma. Unless the legislature spends some of the principal of the fund, not only will the fund be unable to meet its obligations in this year, but it must face the question of whether future earnings will have to first restore losses before any additional spending can take place. This situation is made even more complex for the fund because it has unrealized losses, which, with no shock absorber, eat further into its value.

The Permanent Fund, on the other hand, has avoided this problem because it does have an earnings reserve in which excess revenue is deposited. In years such as this one, in which the Permanent Fund loses money, it can still pay out dividends from the reserve fund.

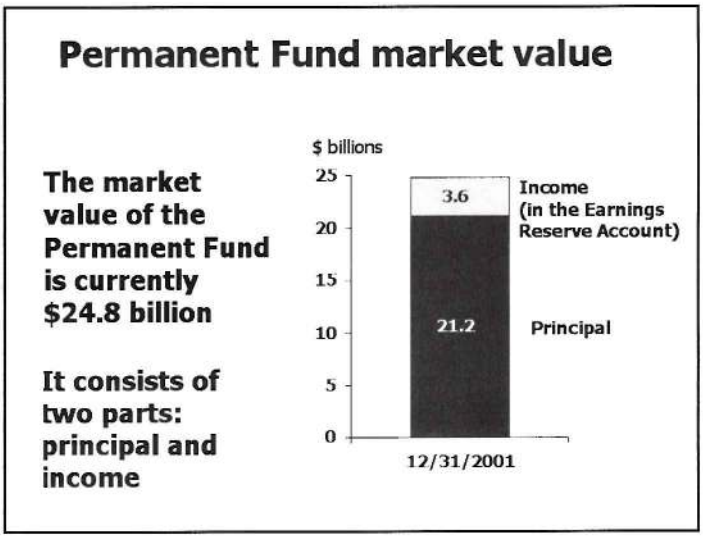
As with the CBRF (the Constitutional Budget Reserve Fund), over the years people have proposed various ideas regarding the Permanent Fund's earning reserve. One of the most common is the suggestion that the earnings reserve — or a large portion of it — be appropriated back into principal, where it could not be spent without a vote of the people. If this were to happen, however, the Permanent Fund would be in the same shoes as the Science and Technology Fund. It would be at the mercy of the volatile financial

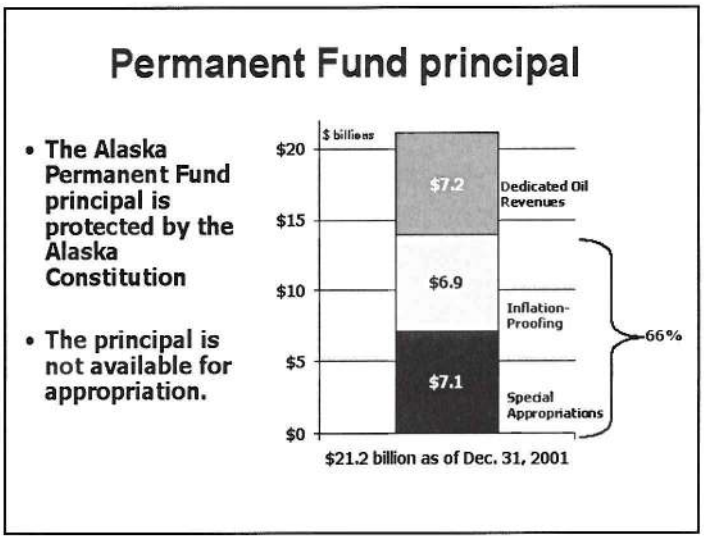
markets, and, if it had no reserves, unable to meet its obligations — currently, dividend payments and inflation proofing — in years when it did not make money. Indeed, if the Permanent Fund lost money, it would show a negative balance in its earnings reserve, and would have to wait for that balance to return to a positive number before it could pay out any amount at all . . .

The most prevalent payout structure for most modern university and hospital endowments allows a yearly payout based on a percent of the market value of the entire fund. If the payout is set at the right number — usually around 5 percent per year — the endowment can provide a relatively steady source of revenue for its programs, while still growing enough to offset the effects of inflation. Year-to-year volatility can be dampened even further if the payout is based on a rolling average of the fund's market value over three to five years.

One interesting aspect of endowments with payouts based on a percent of market value is that they do not usually distinguish between principal and income. Instead, they treat the fund as a whole. Therefore, these endowments do not need an earnings reserve account. The endowment managers are comfortable with the idea that the fund as a whole will grow or retain its value over time. If in a period of low or negative earnings the fund eats into what would be traditionally considered "principal," the managers do not panic because they know that, over time, financial markets will make money and that the fund will return to the black.

It is possible, however, to hybrid the "percent-of-market-value" concept with the traditional notion of protecting the principal of an endowment fund. For example, the Permanent Fund has recently proposed using the percent-of-market-value methodology, while keeping intact the constitutional restriction on spending principal. When these two approaches are combined, the Fund must retain a healthy earnings reserve account. An account with a ban on spending of principal would have no way to make any payout — that is no dividends — during lean years if it had no earnings reserve.





Volatility 101: Using simple examples to demonstrate how volatility affects returns

DONNA COVENEY / MIT

Allan S. Bufferd, Ph.D.

At the February 15, 2001 Board of Trustees meeting, one of the Alaska Permanent Fund Corporation's (APFC's) investment advisors – Allan S. Bufferd, Ph.D., Treasurer of the Massachusetts Institute of Technology – gave a demonstration using a series of four examples to illustrate the math of volatility. The APFC's Executive Director Robert D. Storer later added four examples of his own to further illustrate the point.

The first four examples, A, B, C and D all assume that you begin with a $100 investment and at the end of each year you pay out 5 percent of the ending market value (no smoothing by averaging). You do this for three years. All four examples have identical one-year returns – 10 percent, -10 percent and 20 percent. The only difference between them is when that return is earned.

	Year 1	Year 2	Year 3
A	20 %	-10 %	10 %
B	-10 %	10 %	20 %
C	10 %	-10 %	20 %
D	20 %	10 %	-10 %

In all four examples, the arithmetic and geometric mean returns are identical: 6.67 percent and 5.91 percent respectively. But, the combined three-year payout varies in each case, from a low of $14.56 to $15.56 to $16.49 to $17.63.

Looking only at examples A and B for illustration, here's how to read the tables. In A, the fund goes up 20 percent in the first year, then goes

The sequence in which returns are earned matters.

5% payout – End-of-year market value

	Year 1	Year 2	Year 3
Annual return	20%	-10%	10%
	Arithmetic mean		6.67%
	Geometric return		5.91%

	Value	Price Appreciation	5% payout
Year 1	100.00	120.00	6.00
Year 2	114.00	102.60	5.13
Year 3	94.47	107.22	5.36
Final Value	101.86		**16.49**

A

5% payout – End-of-year market value

	Year 1	Year 2	Year 3
Annual return	-10%	10%	20%
	Arithmetic mean		6.67%
	Geometric return		5.91%

	Value	Price Appreciation	5% payout
Year 1	100.00	90.00	4.50
Year 2	85.50	94.05	4.70
Year 3	89.35	107.22	5.36
Final Value	101.86		**14.56**

B

Examples by Allan S. Bufferd, Ph.D

down 10 percent, and then goes up 10 percent. In B, it goes down 10 percent, up 10 percent, and then up 20 percent. In an arithmetic sense, it turns out pretty simple, plus 20 and plus 10 is 30, minus 10 is 20, divided by 3, equals approximately 7 percent arithmetic mean – the same for both examples.

To do the calculation for the geometric or the average annual compound return, in A , you multiply 1.2 (20 percent) times 0.9 (-10 percent) times 1.1 (10 percent), take the cube root of that, and it comes out to 5.9 percent. You do the calculation on B, it also comes out to 5.9 percent. So notice the situation. You have the same arithmetic mean, you have the same geometric mean, albeit lower.

But, look at the different payouts these identical arithmetic and geometric mean returns produce. In example A, you start out with 100 units, it goes to 120. It went up 20 percent. You pay out 5 percent of that equals minus 6. You then start at 114 (120-6), it then goes down 10 and goes to 106. Your ending point after a three-year distribution is 101.86. But, look at the income produced: example A has produced 16.49, example B 14.56. That is the effect of volatility.

This series perfectly illustrates how sensitive a fund is to the sequence in which returns are earned. The lesson: in successive years of up and down performance, it is much better to have the up years first, more income will be produced.

5% payout – End-of-year market value

	Year 1	Year 2	Year 3
Annual return	10%	-10%	20%
	Arithmetic mean		6.67%
	Geometric return		5.91%

	Value	Price Appreciation	5% payout
Year 1	100.00	110.00	5.50
Year 2	104.50	94.05	4.70
Year 3	89.35	107.22	5.36
Final Value	101.86		**15.56**

C

5% payout – End-of-year market value

	Year 1	Year 2	Year 3
Annual return	20%	10%	-10%
	Arithmetic mean		6.67%
	Geometric return		5.91%

	Value	Price Appreciation	5% payout
Year 1	100.00	120.00	6.00
Year 2	114.00	125.40	6.27
Year 3	119.13	107.22	5.36
Final Value	101.86		**17.63**

D

Examples by Robert D. Storer

Volatility 101: Using simple examples to demonstrate how volatility affects returns

The second series of examples, E, F, G, H, shows a more dramatic impact using actual NASDAQ and S&P 500 data for the two years, 1999 and 2000.

In 1999, the NASDAQ was up plus 86 percent and then in 2000, minus 39 percent. The S&P 500 had a 21 percent return, and then a minus 9 percent. If you do the arithmetic average between those two years, the S&P 500 was up an average 5.97 percent per year. The NASDAQ, on the other side was 86 percent minus 39 percent, or 47 divided by 2, or 23 percent per year on average.

The average annual compound return, the geometric return, calculates out to 4.89 percent for the S&P 500 and 6.39 percent for the NASDAQ.

Notice in example E, what happens if you have that same 5 percent payout rule. Again, with no smoothing, so taking the full impact of the volatility, 100 goes to 121, you take out the 5 percent, and you're left with 115, etc., and you end up with 99.30. So even though you are reporting a 4.89 percent annual return, the fund actually has depreciated in value. Forgetting about the inflation adjustment. It has just depreciated in value.

Volitility in annual payouts can be dramatic; smoothing matters.

S & P 500	Year 1	Year 2	
Annual return	21%	-9%	
	Arithmetic mean		5.97%
	Geometric return		4.89%

	Value	Price Appreciation	5% payout
Year 1	100.00	121.04	6.05
Year 2	114.99	104.52	5.23
Final Value	99.30		**11.28**

E

NASDAQ	Year 1	Year 2	
Annual return	86%	-39%	
	Arithmetic mean		23.46%
	Geometric return		6.39%

	Value	Price Appreciation	5% payout
Year 1	100.00	186.10	9.31
Year 2	176.80	107.53	5.38
Final Value	102.15		**14.68**

F

Examples by Allan S. Bufferd, Ph.D

Now, on the other side, the NASDAQ side, where the volatility was enormous, you have paid out 14.68 and you end up with 102.15, but you have had big swings in annual income. These examples show why an averaging methodology to smooth out volatility makes sense.

One last observation. In all cases in which there is actual, observed volatility, the geometric mean return is always lower than the arithmetic mean return – and the greater the volatility, the wider the spread.

Robert D. Storer

S & P 500	Year 1	Year 2	
Annual return	-9%	21%	
	Arithmetic mean		6.00%
	Geometric return		4.93%

	Value	Price Appreciation	5% payout
Year 1	100.00	91.00	4.55
Year 2	86.45	104.60	5.23
Final Value	99.37		**9.78**

G

NASDAQ	Year 1	Year 2	
Annual return	-39%	86%	
	Arithmetic mean		23.50%
	Geometric return		6.52%

	Value	Price Appreciation	5% payout
Year 1	100.00	61.00	3.05
Year 2	57.95	107.79	5.39
Final Value	102.40		**8.44**

H

Examples by Robert D. Storer

Endowment Distribution Background by Callan Associates

The Board of Trustees held a workshop in Anchorage on June 9, 1999 to learn more about how other large endowments manage their spending policies.

As part of that workshop, Michael O'Leary, Executive Vice President for Callan Associates, Inc., made a presentation on the then-most current study of endowments which was released by the National Association of College and University Business Officers (NACUBO) in 1997.

Mr. O'Leary's PowerPoint presentation (herein included provides an at-a-glance comparison of how other funds, like the Alaska Permanent Fund, make their pay outs each year.

Specifically, his presentation:

- reviewed actual distributions as reported by the endowments;
- summarized spending policies for the top 25; and
- reproduced, by institution, the reported spending policies.

Actual Distributions As Percent of Market Value

Note that these numbers reflect distributions not the basis for spending
They were taken directly from the 1997 NACUBO Study

The following table represents the average withdrawals made by the endowments on an annual basis. Withdrawals are expressed as a percentage of of the average of beginning and ending endowment market values.

Responding Institutions	Endowment Payout	Investment Expenses	Other	Total
In aggregate				
Dollar Weighted Mean	3.9%	0.5%	0.6%	5.0%
Equal-weighted Mean	4.2%	0.6%	0.9%	5.7%
By endowment size				
$25 million and under	4.6%	0.7%	1.1%	6.3%
$25 - $100 million	4.2%	0.7%	1.1%	6.0%
$100 - $400 million	4.1%	0.6%	0.8%	5.5%
Over $400 million	4.0%	0.5%	0.4%	4.9%

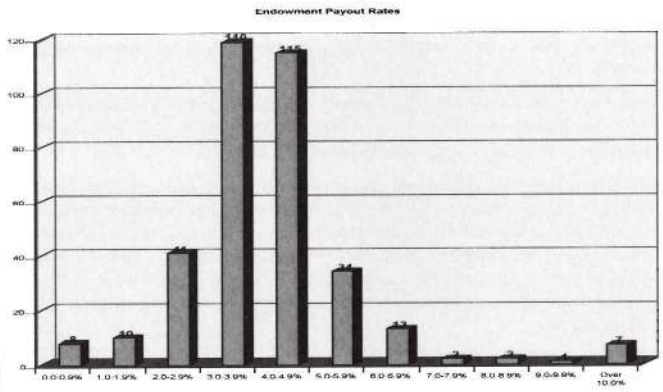
CAI

Slide 1

Endowment Distribution Background by Callan Associates

Actual Distributions As % Of Average Market Value

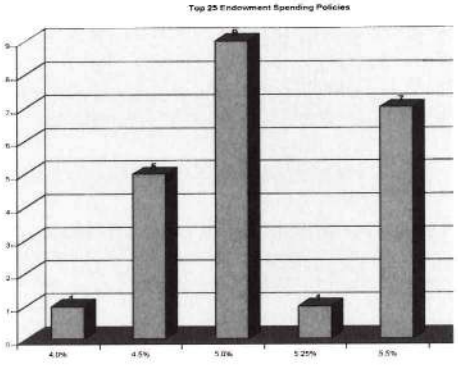
This chart illustrates the breakdown of the various percentages that the institutions pay-out on an annual basis. Note: this graph excludes investment expenses and other distributions



Slide 2

Summary of Top 25 Endowments With A Spending Policy Linked To Market Value

We wanted to isolate the specific spending policies of the top endowments in terms of asset size. While the study done by NACUBO did not specifically address this issue, they provided the necessary data to complete the analysis. The following data examines the spending limit policies of the top 25 endowments by asset size. Those endowments who did not list a specific percentage were not included. For those endowments listing a range of spending guidelines, we used the upper limit.



Slide 3

Top 25 Endowment Spending Polices

• **Harvard University** - An appropriate rate is determined on an annual basis to provide current income and long-term protection against inflation.

• **University of Texas** - The Board of Regents has adopted a policy to hold payout constant until the distribution stream reaches a base payout equal to 4.5% of the fund's average market value. At that point, the payout rate will be adjusted each year by the consumer price index subject to a maximum payout of 5.5% and a minimum of 3.5% of the fund's average market value.

• **Yale University** - A long-term spending rate of 5% is used with a smoothing rule which reduces the volatility of spending levels. Spending for a given year is equal to 30% of the long-term spending rate of 5% applied to the endowment's current market value, plus 70% of spending in the previous year, adjusted for inflation.

• **Princeton University** - Spend a portion of investment income earned by the primary pool in the previous fiscal year. Net income available per unit is increased by 5.5% over the previous year. Income earned in excess of spending is reinvested quarterly in principal.

• **Stanford University** - Stanford's endowment payout policy uses a smoothed payout rate applied to the endowment's beginning year market value. Fluctuations in market performance are managed by smoothing the payout rate, rather than the fund's market value. This is accomplished by multiplying the projected beginning year fund market value by the smoother payout rate which is a weighted average of (1) the target payout rate (currently 5.25%) and (2) the actual endowment payout rate used in the prior fiscal year. The weights used are 40% of the target payout rate and 60% of the prior year's actual payout rate.

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This summary identifies the top funds by size regardless of spending policy

Slide 4

Top 25 Endowment Spending Polices

• **Emory University** - Spend percentage of a three-year moving average of market values, with a floor of 4% and a ceiling of 6%; the increase over the previous year's spending is not to exceed the University's expected long-term inflation rate of 4.5%.

• **University of California** - Spend all current income coupled with a goal to produce a growing level of annual income that matches or exceeds inflation.

• **Massachusetts Institute of Technology** - Spend an amount equal to real investment returns over time relative to inflation. This amount should be determined in a manner that will meet the need for minimum fluctuations in distribution growth relative to both the rate of inflation and past distributions.

• **Columbia University** - Spend the lesser of (a) 4.5% of the average market value of the merged pooled funds for the previous three-year period or; (b) a 5% to 7% increase over the previous year's spending.

• **Texas A&M University** - Income distribution will be, excluding fees, no more than 5% of the last 12 quarter rolling average of market values.

• **Washington University** - Spending must fall within 3% to 5.5% of the unit value of the pooled endowment based on a five-year moving average of market values. Within this parameter, the spending rate will increase at the rate of the CPI plus 0.5% calculated on a three-year moving average.

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Slide 5

Top 25 Endowment Spending Polices

• **University of Pennsylvania** - Spend 4.7% of a three-year moving average of market values for investment pool.

• **Rice University** - For planning purposes, increase endowment distribution by 5% for fiscal year 1996; 4.9% for fiscal year 1997; 4.95% for fiscal year 1998. Projected distribution should fall within a band defined by minimum of 4% and a maximum of 7% of a three-year moving average of beginning market values. The long-term target is to distribute 5% to 5.5% of the three-year moving average endowment market value.

• **Cornell University** – Spending is limited to the difference between the total return on investments and the Higher Education Price Index average over a five-year period.

• **University of Chicago** - Spend 5% of a 12-quarter moving average of unit market values, on a two-year lag, with declines limited to 4% below the prior year's payout.

• **University of Michigan** - Spend 5% of the one-quarter lagged 12-quarter average share value, provided that distributions do not exceed 5.3% of current share value.

• **Northwestern University** – Allocate on a per unit basis last year's amount increased by the CPI, unless the total is more than 6% or less than 3.5% of a three-year moving average of the Long-Term Balanced Pool 750 market value per unit (lagged by one year).

• **Notre Dame** - The University has a constant growth rate rule where spending per unit is increased annually by 4%. A collar (4% to 6%) is also in place to ensure that spending keeps pace with investment results.

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Slide 6

Top 25 Endowment Spending Polices

• **Vanderbilt University** - Spend 5.2% of a five-year moving average of market values.

• **Dartmouth College** – Increase per unit spending by an inflation increment approved by the trustees, providing that the resulting distribution is between 4.25% and 6.5% of a 12-quarter moving average of market values.

• **University of Southern California** - Increase spending up to 5% each year. Spending must range between 4% and 6% of a 12-quarter moving average of market values as of December 31 of the previous year.

• **Case Western Reserve** - Spend no more than 5.5% of a four-year moving average of market values.

• **Johns Hopkins University** - Objective is to spend only 4.5% to 5% by the year 2002 by reducing the rate of increase in the payment to 1.5% per year.

• **Duke University** - A decreasing rate is applied to a three-year moving average of market values, converging to a 5.5% net spending rate.

• **University of Virginia** – The Pooled Endowment Fund is divided into two classes of shares according to the applicable spending rate. Distributable income per share should represent approximately 4% for Class A shares and 6% for Class B shares of the previous June 30 market value and grow at a rate of 4% per year. If in October of any given year the projected distribution is greater than 5.5% or less than 3.5% for Class A shares and greater than 6.5% or less than 5.5% for Class B shares of the previous June 30 market value, the distribution may be adjusted.

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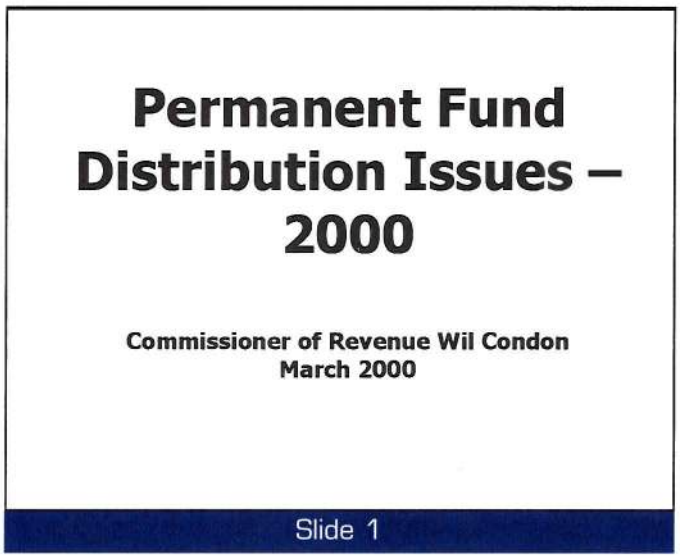
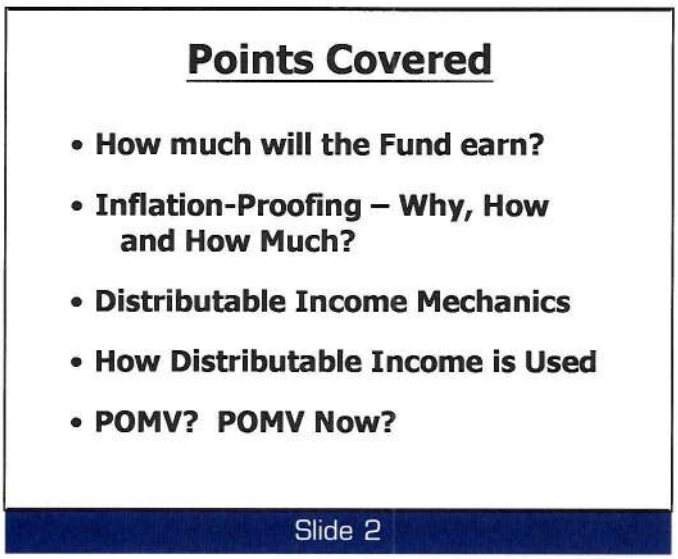
Slide 7

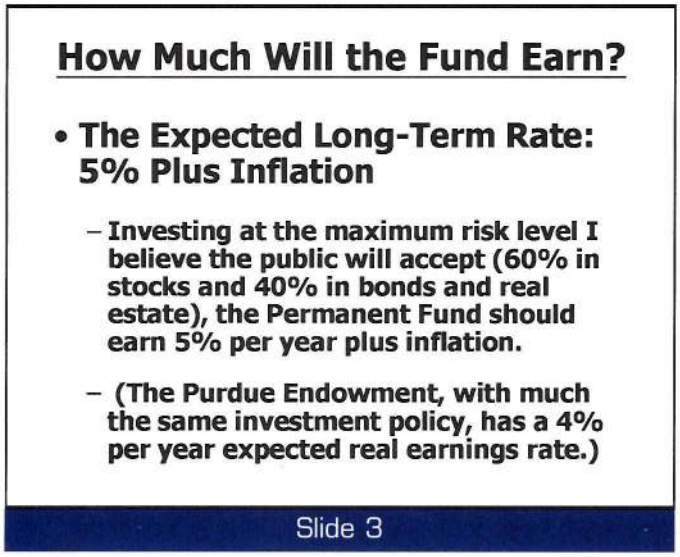
Why a 5 percent payout rate

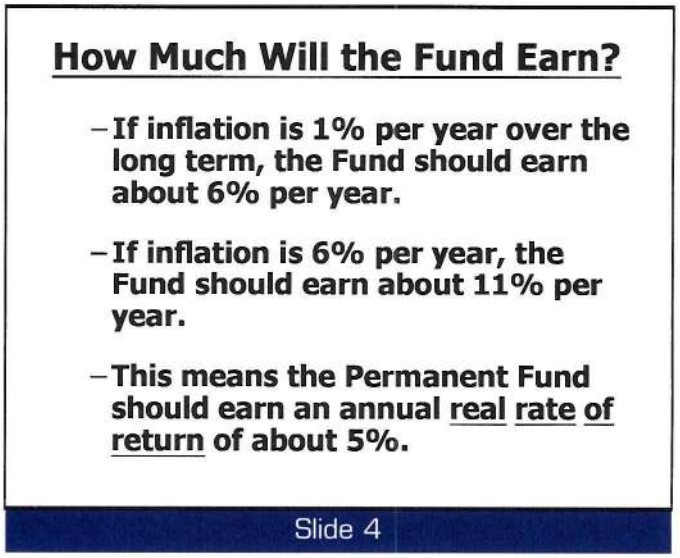
Permanent Fund distribution issues by Wilson L. Condon

In March of 2000, the Board of Trustees debated the advisability of seeking legislation to create a percent of market value (POMV) distribution policy for the Permanent Fund. As part of the educational process, Commissioner of Revenue Wilson Condon developed a PowerPoint presentation to provide his colleagues with his perspective on the issues as they relate to the annual distribution of Permanent Fund income. That presentation, which is duplicated in this section, is an excellent summary of the major issues, from a mechanical as well as philosophical viewpoint.

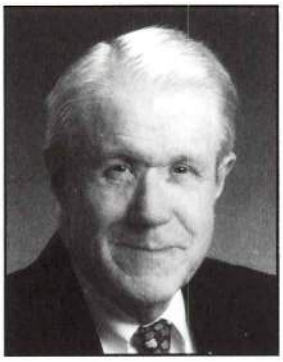








Permanent Fund distribution issues by Wilson L. Condon



Wilson L. Condon

Why Inflation-Proof?

- If you don't, both the real earning power of the Fund and the purchasing power of the Fund's earnings will decline.
- With inflation at 3% per year and Fund earnings at 8% per year (the real return – 5% – plus inflation), why not spend the whole 8%? Because while you'll have more to spend now, you'll have lots less to spend in the future.
- If you spend only the "real" annual earnings – 5% – you'll preserve both the purchasing power of the Fund's annual earnings as well as the real earning power of the Fund itself.

Slide 5

Inflation-Proofing – How?

- Two ways to do it -- Explicitly and Implicitly

– Explicit Inflation-Proofing

1) Measure the inflation in the economy each year.

2) Multiply that rate times the Fund balance and make sure you don't spend the resulting amount.

Slide 6

Inflation-Proofing – How?

– Implicit Inflation-Proofing

1) Set a spending rate at or below the "real" earnings rate.

2) The residual rate of annual earnings should equal the average inflation rate over time.

The "real" annual earnings of the Fund should average 5%; that should be the maximum spending rate. Earnings in excess of that amount should be retained for inflation-proofing rather than spent if you want to preserve the real value of the Fund over the long run.

Slide 7

Inflation-Proofing and the Permanent Fund Today

- Provided by Formula In Statute
  - Formula explicitly inflation proofs
    - Expressly inflation-proofs only the principal – a policy choice to preserve the purchasing power of only the constitutionally protected portion of the Fund
    - On average, the Fund has consisted of about 85% principal and 15% earnings reserve; it is 70% principal and 30% earnings reserve today

Slide 8

Permanent Fund
distribution issues
by Wilson L. Condon

Inflation-Proofing and the Permanent Fund Today

- Has the Fund been over- or under-inflation-proofed?
  - Under if you only consider the results of applying the statutory formula.
  - Over if you count the earnings in excess of the statutory amount that have been appropriated into the principal or left in the earnings reserve.

Slide 9

Inflation-Proofing and the Permanent Fund Today

- A Dilemma and a Lurking Unpleasant Surprise are the Product of requiring the appropriation of inflation-proofing into the principal.
  - Some believe the requirement is absolutely necessary; if it's not constitutionally protected, they argue, the Legislature will spend it.
  - But appropriating inflation-proofing to principal instead of leaving it in the earnings reserve makes it much more likely there will be years when little or no money is available for distributions/dividends.

Slide 10

Distributable Income Mechanics

Earnings Distribution – Dealing with Year-to-Year Variability

- Some years the Fund will earn a lot more than the expected 5% real return and some years it will earn a lot less. Some years it will have negative earnings.
- It makes sense to find some way to smooth the earnings distribution to avoid the boom and bust that would otherwise occur.
- An average of either the Fund's earnings or the total Fund value for the current year and the two, three, or four previous years (called a three-, four- or five-year moving average) would provide a basis for averaging the distribution rate to substantially reduce volatility. The longer the period, the more it will reduce the volatility.

Slide 11

Distributable Income Mechanics

Moving Average of What?

- A moving average of "Realized Earnings" or "Total Return" or a "Percentage of Market Value," if correctly calibrated, should all yield the same amount of earnings for distribution over the long term.
- However, each of the moving averages would differ in any one year.
- Distributions calculated on a moving average of "Percentage of Market Value" would be the least volatile from year to year.

Slide 12

Distributable Income Mechanics

How Used?

- Some of the earnings are used each year to pay the Permanent Fund Dividend.
- Some of the earnings are used each year to inflation-proof the Fund.
- Some of the earnings are available – but so far have never been used – to help pay for public services.

Slide 13

POMV (Percent of Market Value) Distribution – Is it Time?

- Earnings distribution based on POMV would establish an earnings target for the Fund and consequently clarify the guidelines for prudently investing the Fund.
  - Whether an investment policy is prudent or not depends on the earnings requirement and risk tolerance for a fund.
  - You would not invest 100% in stocks unless you needed an average annual 6% real return with the possibility of many bad years in a row.
  - If you need 5% real, something like 60% in stocks and 40% in bonds and real estate would be prudent.
  - If you only need 4% real, you might consider investing all your funds in TIPS (Treasury-Inflation-Protected Securities).

Slide 14

POMV (Percent of Market Value) Distribution – Is it Time?

- How much should the Trustees try to earn? The Legislature has not established an explicit earnings target for the Permanent Fund. By implication they may have established a 5% annual real return goal.
  - The statute governing the Permanent Fund tells the Trustees "to maintain safety of principal while maximizing total return..."
  - By authorizing the investment of up to 60% of the Fund in stocks, the Legislature may be suggesting an annual earnings goal of 5% real.
  - Explicit directions from the policy makers about what they want from the Fund would be preferable. Prudent Trustees would then have the job of figuring out how to get there.

Slide 15

POMV – Other Reasons to Do it

- Besides assisting the Fund's investment policy by establishing a specific return goal, what are the other advantages of POMV?
  - POMV more effectively smoothes the year-to-year volatility in earnings distributions than do distribution procedures based on realized or total return. This would be very important if earnings were used to pay for public services.
  - POMV simplifies the inflation-proofing procedure. However, because inflation-proofing is implicit rather than explicit, it is much less visible.

Slide 16

Two independent studies on optimal endowment payout rates

At the June 8, 2001 meeting of the Fiscal Policy Caucus, APFC staff testified that a 5 percent payout is on the high end of doable for the Permanent Fund in terms of a sustainable payout rate that still maintains the Fund's real value. This is the policy reason that the Board of Trustees is seeking to limit future payouts of Fund income to no more than five percent of the Fund's market value, averaged over the prior five years.

Essentially, 5 percent is the most the Fund can pay out each year and still accomplish full inflation-proofing over time, given the statutory management framework and asset allocation limits established by the legislature.

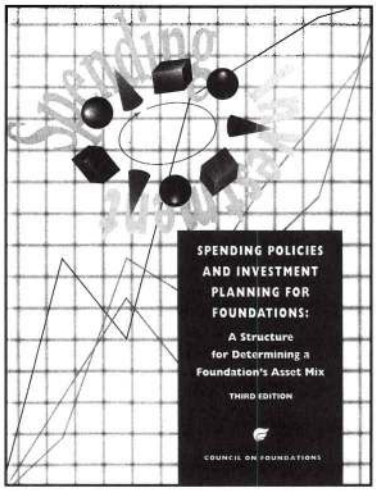
The Alaska Permanent Fund Corporation (APFC) has reviewed two independent studies which support this position: in the long term, lower initial spending results in higher aggregate spending over time. Thus, a 5 percent payout would allow greater distributions over time than a 6 percent payout rate and a 4 percent payout rate would allow a greater distribution over time than a 5 percent payout.

In both cases, it would take approximately 17-19 years for the lower payout rate to begin to produce higher annual distributions than the higher payout rate. Eventually, the cumulative distributions of the lower payout rates become larger than those of the higher payout rates.

Setting the level of the payout rate is clearly a legislative prerogative. As the following excerpts from the two studies indicate, the payout rate acts as a balancing device between current and future spending. Making that determination is the public policy responsibility of the legislature.

The Board of Trustees has a fiduciary responsibility, however, to point out that a payout rate that is overly high will initially produce high levels of distributions, but will, over time, erode the value of both the Fund and the absolute level of dollars being paid out.

Two independent studies on optimal endowment payout rates



SPENDING POLICIES AND INVESTMENT PLANNING FOR FOUNDATIONS, Third Edition

This excerpt is reprinted with permission from Spending Policies and Investment Planning for Foundations - A Structure for Determining a Foundations's Asset Mix, by the Council on Foundations. For further information, please visit www.cof.org

Table E-1 examines three different spending policies. Each of the three scenarios starts with an initial portfolio of $1 million in 1950. To determine the investment returns for each policy, we have used representative asset allocations for foundations as determined by Greenwich Associates surveys. We have made five adjustments in the

Table E-1 Summary Analysis of Different Spending Policies

Spending Level* (in Thousands of Dollars)

	5.5%	6.5%	7.5%
1950 Asset value	1,000	1,000	1,000
1998 Nominal asset value	13,756	8,604	5,357
1998 Real (inflation-adjusted) asset value	1,982	1,239	772
1950-1998 percentage growth (loss)	98.2%	23.9%	-22.8%
1950 Total spending	55	65	75
1998 Total spending	684	510	370
1950-1998 Total spending	9,698	8,392	7,202

* Spending is defined as (1) qualifying distributions; plus (2) taxes paid (excise tax and any unrelated business income tax); plus (3) 0.5 percent for investment management expenses.

Two independent studies on optimal endowment payout rates

portfolio over time. First, we looked at the period from 1950 to 1970, then from 1970 through 1972, 1973 through 1989, 1990 through 1994, and finally 1995 through 1998.

The results of the analysis are dramatic. For example, Table E-1 shows that over the 49-year period from 1950 to 1998, a foundation spending 5.5 percent every year distributes $1,306,000 more than it would have if it had been spending 6.5 percent per annum and $2,496,000 more than if it had been spending 7.5 percent. This analysis confirms the study done by Alicia Meckstroth, "Private Foundations and Charitable Trusts 1990," published by the Internal Revenue Service in the Statistics of Income Bulletin. Both studies suggest that in the long term, lower initial spending results in higher aggregate spending over time. More specifically, our analysis indicates that by 1968 (19 years), a foundation spending 5.5 percent begins spending more each year than if it had been spending 6.5 percent. The 5.5 percent policy overtakes the 7.5 percent policy in 1967, or in a total of 18 years.

One can also determine the impact of different spending policies by comparing the total dollars paid out today under each policy. For example, under a 5.5-percent spending policy, $684,000 was spent during 1998 (Table E-1). Under the 6.5 percent spending policy, on the other hand, $510,000 was spent. Thus, the 5.5 percent policy results in 34.1 percent more spending than the 6.5 percent policy. Compared with the 7.5-percent spending policy, 84.9 percent more is spent under the 5.5 percent policy.

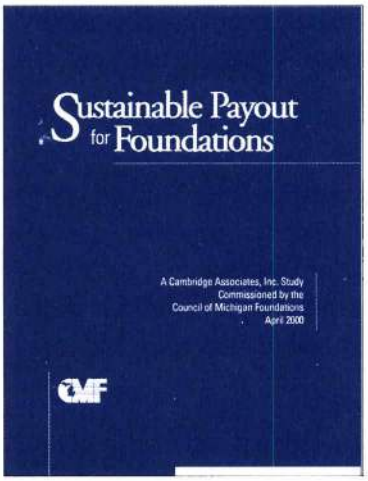
. . .This study yields several observations. First and foremost, a foundation's asset allocation and spending policies are interrelated. Spending policy set at a level greater than the real returns a portfolio is capable of producing suggests that the foundation will effectively undergo a liquidation.

Second, the asset allocation policy, usually set by the foundation's governing board, is critical to long-term portfolio performance. Therefore, each board has a responsibility to consider its asset mix decisions carefully in a structured, disciplined manner, together with the implications these decisions have on spending policy.

Third, based on the analysis of historical asset class returns used in this study, foundations cannot maintain current spending rates at 7.5 percent or above if they also wish to maintain their portfolio's purchasing power. Foundations will require fairly aggressive asset mixes to achieve real returns that will even support 5.5 percent spending.

Fourth, over a long period, a more aggressive spending policy today will lead to lower nominal dollars available for spending in the future. Organizations must balance short-term needs against long-term goals.

Finally, one should be cognizant of near-term returns and the potential impact on conclusions reached when developing an asset mix policy. Financial markets experiencing abnormally high or abnormally low returns for a fairly extended period (15 years) can have a significant impact on the conclusions. Therefore, foundations should focus on "normal" term (25+ years) return assumptions when developing an asset mix strategy.



SUSTAINABLE PAYOUT FOR FOUNDATIONS

Excerpted from Section II

Past returns using passive allocations: effects of changes in payout rate

In this section we first posit a simple portfolio invested 65 percent in the S&P 500 Index and 35 percent in the Lehman Brothers Government/Corporate Index. We then show the effects of changes in the spending rate over the past 30 years on this simple, passively-invested portfolio. This 65/35 allocation approximates the average asset allocation for diversified Michigan foundations during the study's 1973-97 time frame.

As a simplifying assumption, spending was assumed to occur at a constant percentage of a four-quarter moving market value. In this model, cash disbursements (at the rate of one quarter of the constant percentage of a four-quarter moving average) are also recognized and accounted for.

Results of 4 percent, 5 percent, 6 percent, and 7 percent payout rates over time

Exhibit 1 models the level of real spending and real market values after spending for the 65/35 hypothetical portfolio described above for the 30-year period 1969 - 98. This 30-year period was selected because it includes both unfavorable and favorable market conditions. In each case, a beginning market value of $100 million was assumed.

- Real fund market value increased under a 4 percent spending rule, with the corpus of the hypothetical endowment growing from $100 million in 1969 to $160.43 million by the end of 1998. Real spending was also enhanced, and grew from $4 million in 1969 to $5.07 million in 1998.
- Under a 5 percent spending rule, the purchasing power of the foundation grew from $100 million in 1969 to $119.52 million at the end of 1998. The purchasing power of the distributions declined to $4.78 million at the end of the period (from $5 million at the beginning of the period).
- A 6 percent spending rule would have eroded the purchasing power of the foundation's endowment, with the real ending market value dropping to $88.58 million at the end of the period. Spending also dropped from an initial level of $6 million at the beginning of the period to $4.30 million by its end. This represents a decline of more than 25 percent in terms of the real purchasing power of the foundation's payout.
- Under a 7 percent spending rule, the declines in real fund market value and levels of spending are more dramatic, with the level of real spending dropping nearly in half over the 30-year period, and fund market value declining over a third in real terms.

Two independent studies on optimal endowment payout rates

- Real payout and real market value of the portfolios declined steeply in the early years of this period irrespective of the payout rate being modeled. At the 4 percent and 5 percent levels, real ending market values only regained their initial value by virtue of the extraordinarily strong financial markets of the 1990s. Only the 4 percent payout rate ever fully regained the inflation-adjusted level of the initial amount of payout in 1968.

Why the reliance on real values (for both payout and fund market value) instead of a calculation reporting nominal values? Some donors may anticipate, or even encourage, the foundations they endow to spend themselves out of existence over time by disproportionately benefiting current programming at the expense of future programming. Such donor intent, when it exists, is compatible with the current federal rule which mandates a minimum level of payout and permits a foundation to set itself on a course where its future role will be less than its present role. Many donors, however, establish foundations to provide for both current and future needs and maintain comparable levels of programming. That objective can only be achieved by maintaining the real value of the payout.

Exhibit 1A illustrates the way in which the level of prescribed payout acts as a balancing device between current and future spending. A spending rate that preserves purchasing power of both the fund market value and payout stream holds constant the scope of programming that a foundation can fund over time. Put another way, a payout rate that is too low allows a foundation to accumulate assets and provide greater resources in the future at the expense of current programming, while a payout rate that is too high has the opposite result.

Exhibit 1B graphically illustrates that the lowest initial level of payout rises to the highest future real payout, while the highest initial level of payout results in the lowest future real payout. A payout rate that is overly high will initially produce high levels of payout, but will, over time erode the

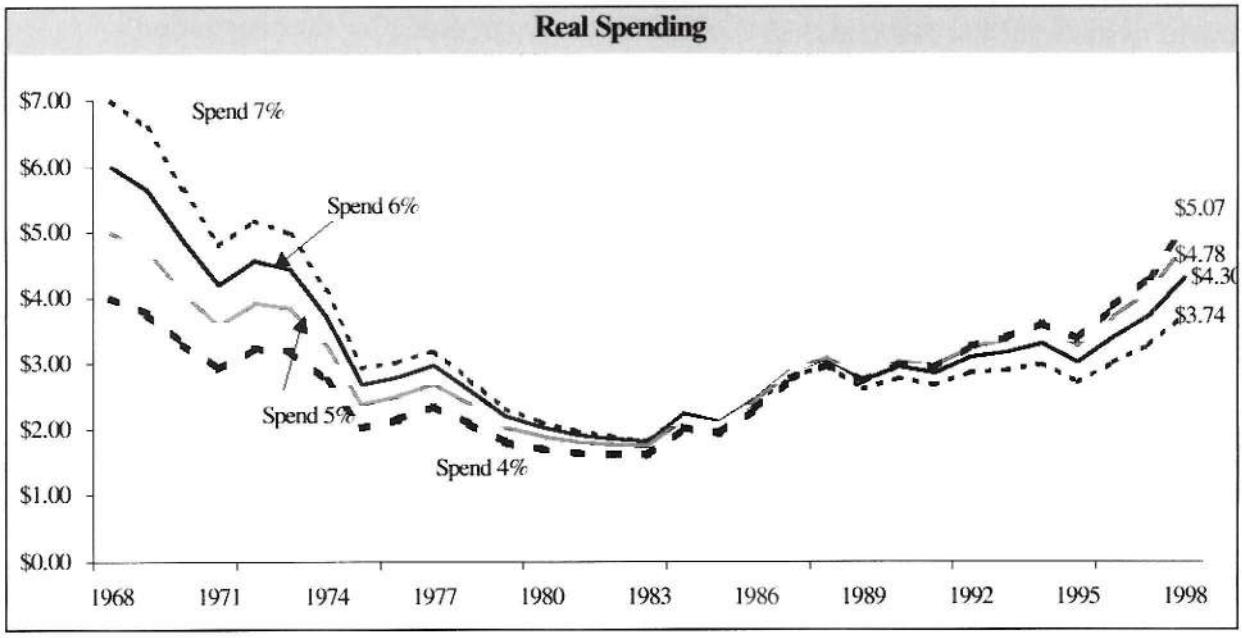


Exhibit 1A

value of both the fund and the absolute level of dollars being paid out from that fund. A lower payout rate will enable the fund to accumulate value and will result in higher absolute levels of real payout in the future. Only the 5 percent payout rule comes closest to preserving purchasing power and level of payout for the hypothetical portfolios in this period.

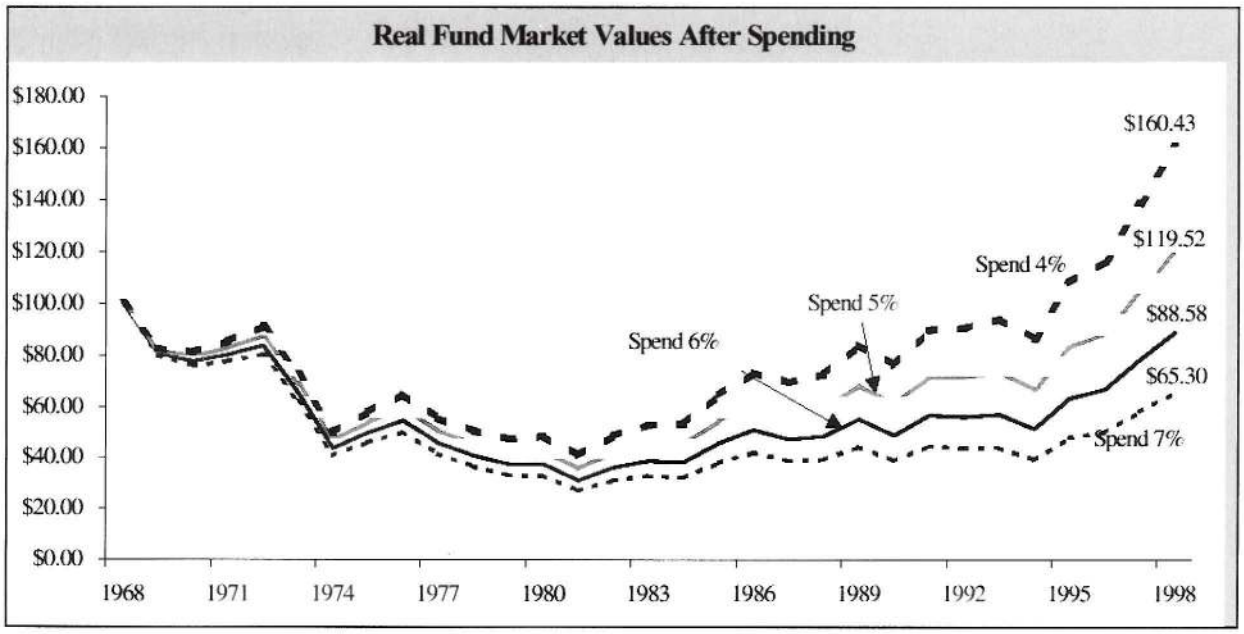
The period shown here begins towards the end of the great bull market of the 1950s and 1960s. By 1968, the diversified Michigan foundations we surveyed had over 50 percent of their assets allocated to equities, virtually all invested in U.S. stocks. In the decade of the 1970s that followed, stocks posted anemic nominal returns and had a negative real return.

Whatever the period, however, the following holds true: the more you spend today, the less you will be able to spend tomorrow because a higher rate of spending eats more rapidly into the market value of the fund. Note that by the end of 1998, real spending (i.e., after inflation) for each of these funds remains below the 1969 level, with the sole exception of the fund spending 4 percent.

In addition, only the funds spending 4 percent and 5 percent have succeeded in preserving their real value over this period. Those spending 6 percent and 7 percent remain substantially poorer than they were in 1969.

Finally, these illustrations pre-suppose a disciplined, long-term investor that rebalances to the target asset allocations each year. Any investor that failed to rebalance, or bailed out of stocks after the 1973-74 decline, or employed active managers that underperformed the market indexes, would have had worse results than those shown here.

Exhibit 1B



Proposal for fund is important step

Anchorage Daily News
January 8, 2001
Arliss Sturgulewski

The state has been wrestling with the fiscal issue big time since the first oil hit the pipeline in the late 1970s. Solutions will be complex and controversial. Progress won't always come in one universally accepted approach. As someone who believes the beginning of a journey is important, I offer some thoughts on one proposal to deal with what must be a cornerstone of any fiscal plan: the Alaska Permanent Fund.

Arliss Sturgulewski

Alaskans have spoken with a very loud, clear voice that they want the Alaska Permanent Fund to be just that, permanent. A whole lot of Alaskans who had or are having a hand in the establishment and continuing protection of the fund have worked and are working to make that clear message a reality.

Kudos to the board of trustees for its wise proposal to make the fund permanent. On Dec. 8, after four years of study, the board recommended that the Alaska Legislature, in consultation with the governor and the board, consider and approve a constitutional amendment that would provide for permanent inflation-proofing of the fund. The amendment would state that the annual payout from the fund would be no more than 5 percent of the average fiscal year-end market value of the fund over the immediately preceding five fiscal years. Currently, we have statutory protection for inflation-proofing. According to the board, providing for inflation-proofing in a constitutional amendment as proposed would strengthen and extend the existing statutory provision for inflation-proofing the principal of the fund by putting inflation-proofing into the constitution and apply it to total fund assets, including principal.

The late Elmer Rasmuson, the first chairman of the board, was a great student of the fund. During devastating national inflation, 13.5 percent in 1980, he became concerned that in order to protect the fund it was absolutely imperative that inflation-proofing be provided.

Elmer convinced those of us in the Legislature of this wisdom, and in 1982 we passed a statutory amendment to inflation-proof. Lest you think this wasn't such a big deal, take a look at the slip of paper that accompanied your 2000 dividend of $1,963.86. You will see that $620.37 (32 percent) of the payout was due to inflation-proofing.

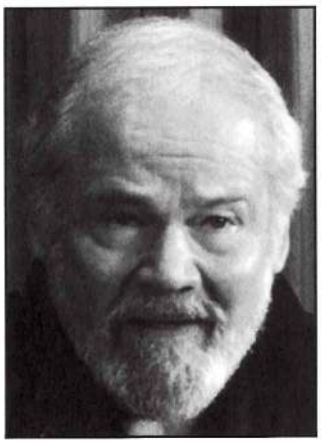
Alaskans are fiercely protective of the dividend. No doubt the first question they will ask is "How does this proposal affect my dividend?" The board's response is, "It doesn't." In modeling of the proposal, it came to two fundamental conclusions: "(1) The constitutional amendment will have no impact on the dividend program vis-á-vis the status quo; and (2) Volatility in the financial markets may impact the dividend program but the impact will be the same under either the status quo or the proposal."

What do other large public endowment funds do? I personally am connected with three endowment programs that use the University of Alaska Foundation, the Presbyterian Church (USA) Foundation or the YMCA of the USA Fund as managers of the funds. All use payout plans very similar to the board's recommendation. The latest report from the National Association of Colleges and University Business Offices shows that some 72 percent of the respondents, 320-plus institutions, used a pre-specified percentage of a moving average of market values. Good company to keep.

Our fund will have a 25th birthday in November, and we can truly say, "You've come a long way, baby." With a constitutional mandate to inflation-proof the fund, we can do even better.

Arliss Sturgulewski is a former state senator and candidate for governor of Alaska.

Public statements of support from Alaskans around the state



Jay Hammond

Governor Hammond supports Board's proposal

Anchorage Daily News
Excerpt from an Editorial
January 19, 2001
Jay Hammond

Two proposals from Juneau could do much to protect the Permanent Fund and its dividend program.

The first came from the Permanent Fund Board proposing a constitutional amendment requiring inflation proofing. Currently there is statutorily mandated inflation proofing, but this could be abolished at the whim of the Legislature, which then could spend all fund earnings, including those required for inflation proofing and dividends, without voter approval. I strongly support the board's proposal for the same reason I insisted the fund itself be enshrined in our constitution and its invasion permitted only with voter consent.

While a constitutional amendment would protect the fund, it alone does not necessarily prevent devastation of dividends. However, hand in hand with the second proposal (that of the governor to set a target level beneath which our Constitutional Budget Reserve may not be depleted without automatically imposing a tax) it would erect a formidable barrier to those who'd like to get their hands on your dividends. While such a barrier may not have been either proponent's major objective, I commend both for proposals that could provide the "dividend insurance" coverage I believe absolutely necessary if the program is to remain viable.

Jay Hammond served as governor of Alaska from 1974 to 1982.

Marc Langland

Fiscal Policy Council of Alaska

March 28, 2001
Excerpt from a letter by
Marc Langland

Dear Legislator:

The Fiscal Policy Council of Alaska, Inc. is dedicated to promoting the state's long-term fiscal certainty through research and providing objective information about Alaska's finances. This has involved advancing Alaskans' understanding of the state's finances and the long-term implications of the choices our elected officials make-and don't make. We believe the state's economic future rests on stable state spending and revenue policies

To that end, we urge the Legislature to take action this legislative session that will bring fiscal certainty a step closer. This includes support for the

passage of HJR 15/SJR 13, the constitutional amendment that will provide for permanent inflation proofing of the Permanent Fund.

Three shortcomings in the present management of the Permanent Fund could be overcome with simple technical changes in the state law covering the method for determining earnings available for distribution each year. These shortcomings are:

1. Conflicting Management Objectives. Management of the portfolio of the Fund to maximize long term earnings may come into conflict with the need to generate realized income to fund payment of the Dividend.

2. Unstable Flow of Income. Permanent Fund realized income, which becomes available for appropriation each year, might be unstable from year to year since it depends upon portfolio management decisions.

3. Uncertain Inflation Proofing. Since inflation proofing is paid out of fund income after the Dividend, there is no guarantee that enough money will be left over in any year to fully inflation proof the Fund.

These problems would be eliminated by converting from the current method of determining annual income to the method used by most large managed funds.

That method is to make available for distribution each year a fixed percentage — typically 5 percent — of the market value of the fund averaged over a long interval — typically the last 5 years.

A fixed percentage distribution would free Permanent Fund managers from the need to cash out investments in order to fund the Dividend at a time when holding the investments would maximize long term earnings. A fixed percentage distribution would stabilize the annual income available for distribution by severing its tie to the realized income of the Fund and by dampening its connection to fluctuations in the stock and bond markets. The longer the time period over which the market value of the Fund is averaged, the greater the stability in the annual distribution.

A fixed percentage distribution would automatically inflation proof the Fund and guarantee its value over time. A fixed percentage distribution of 5 percent, used by many large funds, reflects the expectation that the Fund can, over time, earn a real rate of return of 5 percent, over and above inflation.

We believe the "5 x 5 Rule" will maximize the growth of the Permanent Fund, stabilize its annual earnings, and guarantee inflation proofing of its principal.

We urge prompt action of this legislation and look forward to working with the Legislature as it faces the critical decisions that will chart the course of Alaska's fiscal future.

Sincerely,
Marc Langland
President
Fiscal Policy Council
of Alaska

Public statements of support from Alaskans around the state

Permanent Fund Earnings Phase II — A Cornerstone for Fiscal Certainty

Excerpt from Commonwealth North's Permanent Fund Report May 1999

Inflation proofing is a crucial aspect of the health of the Permanent Fund. Inflation transforms part of Permanent Fund principal each year so that it appears to be income. Spending some or all of this inflation-created "income" would, in effect, constitute a withdrawal from the Fund's real principal. Returning the inflation-created "income" to the Fund corpus (i.e. inflation-proofing) is necessary to keep the corpus whole. Redefining the principal as the original corpus plus earnings reserve and unrealized gains yields a larger basis for investment allocation and calculation of the 5% earnings. Sound long-term investment policy will be the main engine of earnings as fund managers strive to achieve a return greater than the defined endowment rate of 5%.

Asset allocation should be the foundation of the investment process. Commonwealth North urges use of a real total return concept in defining Permanent Fund earnings. Earnings above the anticipated long-term level of inflation can be available for distribution. Most large college endowments and foundations use this concept. The earnings available for all uses would be defined as 5.0 % of the average total value of the Permanent Fund for the last five years. While investment returns will vary from year-to-year, under this endowment concept historical perspective indicates that in the long run the real earnings of the Permanent Fund will be sufficient to make the 5% payout and also inflation-proof the Fund.

Keep it permanent — 5 percent limit protects Alaska Permanent Fund

Anchorage Daily News
Excerpt from an Editorial
April 17, 2001

Trustee Clark Gruening said the 5 percent-limit is the "best way to ensure the Permanent Fund is permanent."

The 5 percent rule has another advantage. Without affecting the current dividend formula, and while strengthening the fund against inflation with the force of the state constitution, the limit would leave a projected $175 million-$300 million in earnings available for state spending. This amount could be used to help cover the state's spending shortfalls. That residual amount is projected, not guaranteed — the proposed constitutional amendment puts inflation-proofing and dividends first — but the soundest proposals for ways to square state spending and revenue have included some use of Permanent Fund earnings along with other revenue and economies.

Whether or not the Legislature would decide to use leftover earnings that way, the proposed constitutional amendment would be as close as Alaskans can come to having the fund's protection written in stone. That would guarantee a growing fund to serve Alaskans yet to be born, as well as those of us alive now.

Time to use Permanent Fund

Anchorage Daily News
Editorial
April 12, 2002

It's time to see the Alaska Permanent Fund for what it is: A blessing of riches to use, not worship, for the public good of Alaskans today and generations to come. It's time to use some of its earnings to pay for public services and make the principal as permanent as we can.

Alaska voters created the Permanent Fund in 1976; beginning in 1982, Alaskans have received a Permanent Fund dividend check. Over 20 years, we've built the fund into a machine churning out bigger and bigger dividends that topped out at almost $2,000 in 2000.

The Permanent Fund has earned $25 billion since the first deposit in February 1977, according to Deputy Revenue Commissioner Larry Persily. We've saved $14 billion and paid out $11 billion in dividends.

Is that all the Permanent Fund is for?

No.

In 1999, Department of Revenue Commissioner Wilson Condon made a short speech announcing that year's dividend. He reminded Alaskans of Article 1, Section 1 of the Alaska Constitution. There we affirm our natural rights to life, liberty, the pursuit of happiness and the enjoyment of the rewards of our own industry. But Mr. Condon pointed out that the Declaration of Inherent Rights includes responsibilities:

"All persons have corresponding obligations to the people and to the state."

Good stewardship of the $25 billion Permanent Fund is a vital part of meeting those obligations to one another and to our children. To that end, Alaskans need to see the fund as more than a dividend machine.

First, we should guarantee the fund's permanence by approving a constitutional amendment that would make the fund an endowment, paying out no more than 5 percent of a five-year market value average each year.

Second, we should devote some of those earnings to public services.

THE UPSIDE

Clark Gruening, one of the Permanent Fund's trustees, has said the endowment plan is the best way to guarantee the fund's permanence. Historically, lawmakers have been scrupulous in not only inflation-proofing the fund, but in loading it with extra deposits to speed its growth. Inflation-proofing is protected only in statute, however, and that would be easy for a future Legislature to change.

Embodied in the Constitution, the 5 percent payout limit would be as close as we can get to written in stone. Given an average annual return of about 8 percent and an inflation rate likely to average about 3 percent, the amendment would protect the fund from inflation for keeps. It would continue to benefit Alaskans long after this generation was gone.

If we spend some of the earnings of the Permanent Fund to provide state services, to maintain and enhance our roads, schools, public safety and university, we'd be investing in a society that doesn't blunt free enterprise and the private sector but provides the foundation for it. As Mr. Condon said, we must recognize "the need to spend money as a community to protect our freedom as individuals."

THE DOWNSIDE

There's no getting around it: We'd all see a dip in dividends and the joys they bring — not only individual spending or saving, but also less cash circulating in the economy. Those costs are real, and use of fund earnings is a regressive tax that takes a bite from Alaskans too young to crawl and too old to walk. But that regressiveness can be tempered with a graduated income tax.

THE UNCERTAINTIES

The endowment principle is sound — provided averages calculated over 75 years of investment history continue to hold true. We can't know that for sure.

We can't know for sure what other income sources Alaska may have in future years. Will we continue to need a share of Permanent Fund earnings in the hundreds of millions of dollars, or more?

We can't completely chart the future, nor should we try to handcuff Alaskans who will make future decisions. We can act based on what we know, anticipate variables as best we can and share the burden of risk fairly.

THE BOTTOM LINE

Make the Permanent Fund an endowment, and we make it permanent. Spend some of the earnings on state government to fill the fiscal gap, and we draw from all Alaskans to build and maintain a better Alaska. Coupled with a progressive income tax, use of Permanent Fund earnings asks everyone to give, but asks more from those who have more.

Yes, this use of earnings breaks the spell of the fund as untouchable. It's time. That spell is a crippling illusion that weakens us in the long run. The Permanent Fund is not an end in itself, but a powerful means to the end of a more prosperous, stable Alaska. Together, an endowment and wise spending give us the means to provide for ourselves, our children and their children. We'll still have dividends, a benefit no other state in the Union enjoys. And we'll keep Alaska's economy sound. That's no illusion. That's good sense and good stewardship.