Commonwealth North Fiscal Policy Group
Proposed Permanent Fund Study Plan

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INTRODUCTION

It is now clear that the Alaska legislature plans to use Permanent Fund income in substantial amounts to finance government. The legislature has, over several sessions, declined to increase existing taxes or to impose any kind of state income or sales tax. The Permanent Fund has, therefore, moved into a more central place in the state's fiscal future. This memo outlines some Fund issues the Study Group can tackle.

A) Forecasting Methodology. The public needs to better understand how the fund works as it becomes a main-stay in paying state operating expenses. It needs access to the best forecasting methodology for future income as we look down the road of the next ten years. A King Economics post of April 27, 2018 points out the defects in the Fund's own forecast and says it is not ". . .an accurate starting place for a discussion" because it does not assume any use of earnings for operating expenses.

B) Fund Mechanics. Besides forecasting methodology, the issue of Fund mechanics is not well understood. The Fund's constitutional amendment permits only actual realized income to be paid out. Modern endowment funds permit a pay out of a percent of market value. Last year the legislature capped annual payouts at 5 ¼ percent of market value. This a cap, actual payouts again are limited to actual income. The annual payout of actual income must be annually appropriated by the legislature and is subject to line item veto by the governor, which he exercised to reduce the dividend last year.

The 5 ¼ percent payout cap is based on long-term estimates of future income in the 7 ½ percent range. The difference between 7 ½ percent and 5 or 5 ¼ percent is an estimate of long-term inflation. Thus, even though inflation is accounted for in the 5 ¼ percent payout limitation, the legislation passed this year additionally requires deposit in the principal account of an estimate of inflation. Without perhaps intending to, the legislature has double counted inflation.

In Permanent Fund material as of June 30, 2015, provided by Ralph Townsend of UAA, the Fund explains that the Earnings Reserve Account contains a pro rata share of main fund assets. Each investment purchased by the Fund is allocated to principal and earnings reserve based on the relative percentages of the entire Fund each component represents.

Thus, there are no separate investments in the Earnings Reserve but only a percentage of each investment in the Fund. A portion of the Earnings Reserve Account is *perforce* illiquid. These questions arise:

Do we know what this portion is?

Is there an alternative way to account for the Earnings Reserve by assigning liquid investments to it?

Further in these 2015 materials, the Fund discloses that when a principal investment is sold at a loss, the earnings reserve makes up the loss of principal. Does this fact argue for a more conventional investment policy for the Fund? Should it be more risk averse?

C) Board Expansion and Anchorage Office. Previous reports of the Fiscal Policy Group have argued for expansion of Board membership and a new method of appointing Board members much as our judges are appointed. With the Earnings Reserve Fund increasing in importance in the state's fiscal future this expansion and improvement in quality of Board membership becomes all the more urgent.

In its 2015 materials, the Fund lists as a challenge "Business Travel to financial centers." Our prior reports have urged an Anchorage office to alleviate this problem and to enhance and strengthen the nascent investment firms in Anchorage.

D) Socially Responsible Investing. Other issues presented to the Fund at Board meetings include the need for thorough investigation of socially responsible investing. Recent analysis of returns of funds in this field indicate returns equal or better than returns from conventional funds. Assets using SRI policies totaled nearing nearly $7 trillion in 2014, a 76 percent jump in just two years. Yet newspaper accounts reveal little Board discussion after a major presentation to the Board. Why?

How can the Study Group proceed with this agenda?

As to (A) Forecasting Methodology, I suggest a presentation from King Economics. We should have a presentation as well from the Fund and its consultants Callan and Company.

As to (B) Fund Mechanics, We should ask the Fund whether our understanding is correct. Is another method of defining the Earnings Reserve and/or desirable?

As to (C) Board Expansion and Anchorage Office, query of former Board members at a meeting might be helpful.

As to (D) Socially Responsible Investing, the Group could study the materials presented to the Board to see if they are persuasive and seek any contrary views.