

Mr. Wohlforth, in his July 10, 2018 memo, puts forward an excellent set of topics and questions upon which the Fiscal Policy Group can build a better understanding of the Permanent Fund, particularly in the SB26 era. Outlined below are some of my initial thoughts re: the four issues found in the memo.

### **Forecasting**

- Mr. King's April commentary appears critical of the PFC for publishing a forecast that doesn't take into account draws against the ERA for the purpose of funding government operations. But, I don't think we should find the PFC approach to be surprising. I suspect they prefer to work with that which *is*, rather than that which *might be*. Now that SB26 is no longer a proposition, the PFC has likely studied the statute and assembled a revision to the earlier forecast (looking forward to hearing from the PFC on this).
- From this point forward, there may be value in the PFC presenting a low, mid and high case, as King does. This would also be in keeping with a similar practice found in DOR's annual Revenue Sources Book vis-à-vis oil price/production estimates. Since we are now looking to the PF to provide a significant source of operational funding, it seems reasonable that future forecasting models might follow this convention. We might also expect to see enhanced treatment of PF revenue in the next RSB.
- King states the projected real rate of return the PFC employs is significantly less than historic ROR (4% vs. 6%). But, it may not be unreasonable to error on the side of caution. Overestimating actual ROR could result in significant financial adversity whereas there is little-to-no harm done in favoring a relatively conservative target.
- In any event, with passage of SB26, it appears the expected real ROR target is now effectively set at a minimum of 5%, over the long run.
- Lastly, improved forecasting could infer dialing down the investment risk profile a bit in pursuit of greater certainty vis-à-vis annual returns.

### **Fund Mechanics**

- This is an excellent topic. The questions put forth are especially pertinent in advancing our understanding of how, as a practical matter, the PF functions (i.e. the manner in which cash flows, in and out, are handled; etc.). I'm looking forward to future presentations on this.
- With respect to the potential double counting of inflation, it might be interesting to hear from the Administration and/or relevant legislators to get their take on this. It seems legislative convention has been to make a discrete deposit *to principal* to account for inflation. SB26 carries that norm forward. In contrast, the delta between long-term ROR and the 5% payout cap (long-term) would be captured only in the ERA and therefore available, potentially, for 100% expenditure. So it seems the separate approach may be both conservative and prudent.
- Another topic we might explore under this heading concerns harvesting of PF assets. A well circulated legend has it that the BOT, at the behest of the executive branch, directed the PFC to liquidate investments, possibly prematurely, for the purpose of yielding a robust and politically timely dividend. It might be worth examining how the PFC determines when to liquidate an asset thereby converting unrealized gains to realized gains deposited into the ERA and available

for legislative expenditure. Of course, it would seem the prudent approach would be to harvest gains organically. But, now that the target is actually written in statute, it seems assets could be liquidated on a schedule more in tune with explicit expectations of the legislature and citizenry as opposed to prudent investment considerations alone.

### **Board Expansion and Anchorage Office**

- PFC office location is a puzzler. I agree that it might be worthwhile to hear what past BOT members have to say. On the surface, there seems to be no practical reason why the office needs to be in Juneau. There is no day-to-day interface between the PFC and the legislative and executive branches of government or other governmental agencies in Juneau. While PFC staff have proven, over the long-term, to be very capable it seems attracting qualified staff may be easier (possibly even cheaper) with HQ in Anchorage. This will make for interesting discussion.
- I'm looking forward to gaining a better understanding of CWN's position re: PFC board size and appointment procedure. There may be compelling arguments supporting changes. Or, maybe we leave it all alone. The best argument in support of the latter approach might be the PF's historical results.
- If increasing the size of the BOT is a favored approach, it seems plausible that any new seat(s) would be awarded to public members rather than those already serving in government. If so, I would think that statutory requirements regarding subject matter competence would remain a standard by which these new members must be measured.
- Interestingly, a recent study examined the efficiency of board decisions (quantified by firm value and operating performance) based on the odd-even structure of the board.<sup>1</sup> The study concludes that companies directed by boards made up of an odd number of members performed better than those directed by an even number of members. Supporting material indicates ideal board size as being five members. Furthermore, firm valuation is negatively impacted as board-size increases beyond five.<sup>2</sup> This might prove to be worthwhile information as we consider making a recommendation re: BOT size (maybe we drop a commissioner?).
- Regarding the appointment process itself, the current situation has the governor effectively appointing all six members (albeit two are subject to legislative confirmation by virtue of their commissioner role). While four of the six BOT members enjoy protection from a governor's capricious dismissal (public members can only be removed for cause), the appointment process still confers a modicum of perceived, if not real, loyalty to the State's chief executive (and, as we know, fully one third of the BOT is directly accountable to the governor).
- This raises an important question regarding independence. A couple years ago the Governor floated a proposal to use the PF as an investment vehicle for oil and gas tax credits. This was politely declined as being an unattractive opportunity, but it demonstrates the risk. A more persuasive or charismatic chief executive in combination with a pliable BOT may have produced a different result.

<sup>1</sup> *Voting Efficiency and the Even-Odd Effects of Corporate Board: Theory and Evidence*, Xin Deng, Huasheng Gao, Wei-Lin Liu, April 2012.

<sup>2</sup> Figure 1. Board Size and Tobin's Q, pg. 58 of study noted above.

- As for modifying the appointment method to emulate the AJC's process for judges, this may prove dissatisfying to the extent a candidate's success often seems unduly influenced by their popularity among peers rather than pure merit. If we felt it necessary to change the BOT appointment process, maybe we could look at some other approaches as well - such as the manner in which the redistricting board is assembled.

### **Socially Responsible Investing**

- Transitioning toward SRI and away from a strict market-based analysis of investment pros and cons may be in vogue, but it could invite opportunities for disappointment over the long run. To the extent SRI is largely based on subjective qualities, it is – and will likely continue to be – a constantly moving target predicated on contemporary society's whims of fascination and acceptability. This seems to be fundamentally inconsistent with investment strategies designed (obligated) to produce sustainable, long-term results.

Wrapping up, there is a related topic that might be worth some consideration. As the PFD has grown, the absolute dollar value lost in the form of federal taxes (paid by residents) has also grown into a significant chunk of change. So it seems the question of efficiency might become increasingly compelling. How much *real* value does the PFD have per capita? Is shrinkage, in the form of federal taxation, significant to Alaska's economy? Maybe, maybe not. But it might be interesting to consider.

I'm looking forward to learning more about these topics as we progress over the next weeks and months.

Respectfully,

Brian E. Hove

August 9, 2018