

Should Permanent Fund managers stick to philosophy?

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COMMENT

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In late August, Sarah Palin flew off on her nine-week campaign for the nation's second-highest office. During those nine weeks the Alaska Permanent Fund lost \$8 billion, including more than \$1 billion from the supposedly untouchable principal.

Palin's absence played no role in the fund's meltdown. The fund's managers lost the state's money because of the world financial collapse. But Palin's preoccupations -- with gas pipeline issues, Troopergate and the national campaign -- may be implicated in the paralysis that has gripped managers in responding to the fund's hemorrhaging value.

The decline in fund investments has not occurred across the board. Stocks and real estate have declined most dramatically, while bonds have done relatively well. As a result, percentages of assets in several of the fund's nine asset categories have drifted far from the board's allocation targets. So far, managers have taken no steps to bring them back to where they belong. Domestic bond holdings, for instance, account for 27 percent of fund assets, way above the 19 percent target and well beyond the permissible percentage variation the board established in a July resolution. Real estate holdings are also outside the limits, though in the opposite direction.

Maintaining allocation discipline is the Holy Grail that has guided managers at the fund since the theory was first adopted there in 1983. Innovative then, the notion that diversified asset allocation is the key to successful investing is now a core tenet of investment theory as taught in finance and investment courses at graduate schools around the world.

Why have Permanent Fund managers abandoned this long-held discipline?

Author and investment manager Peter Lynch writes that when it comes to investing, "The key organ in the body is the stomach, not the brain." The way to maintain the allocation percentages is to sell assets that have done well and use the proceeds to buy more of the assets that have done poorly. Following through on that discipline in today's market requires the courage of one's convictions.

That kind of courage appears to be in short supply at Permanent Fund headquarters. Fund managers have the responsibility to maintain that discipline; they don't need to wait for the board of trustees' blessing. In an interview last month with reporters for the Alaska Budget Report (see the newsletter's Oct. 31 issue), Michael Burns, the fund's executive director, was asked repeatedly why the oft-touted discipline appears to have been abandoned.

"We're working through it," was his most direct response.

Permanent Fund managers also worry about the political implications of continuing to draw money from the fund to cover its expenses when doing so eats into the constitutionally protected principal. The principal is the sum of the state's contributions to the Permanent Fund since its inception, whether from oil royalties, special state appropriations or inflation-proofing. As the chart shows, on Nov. 18 the fund's

market value was \$1.6 billion less than the principal, putting the fund "under water." Money drawn to pay Burns' monthly \$21,416 salary or any other outlay submerges it even deeper.

If the fund is under water in June when it's time to transfer more than a billion dollars to the Department of Revenue for Permanent Fund dividends, someone could ask the courts to block the payments on grounds they would invade the principal.

Former Attorney General Gregg Renkes, in a 2003 legal opinion, wrote that the problem can be eliminated by adopting a new legal definition of "principal," but Burns is uncertain where Palin -- who styles herself as a fund protector -- might come down on that. On Oct. 23 he wrote an official memo to Palin's budget chief, Karen Rehfeld, requesting the administration's views.

So far, we see little indication that Palin or her top officials have paid much attention. In an interview late last month, Rehfeld, noting the implications for next year's Permanent Fund dividend, said Burns shouldn't expect a substantive response to come quickly.

"We have to look at that question, we have to look at inflation-proofing, all of those pieces. We're researching it now," Rehfeld said.

Patrick Galvin, Palin's revenue commissioner and one of her two representatives on the Permanent Fund's six-person board of trustees, was unaware of Burns' memo to Rehfeld until I asked him about it a week after it was sent.

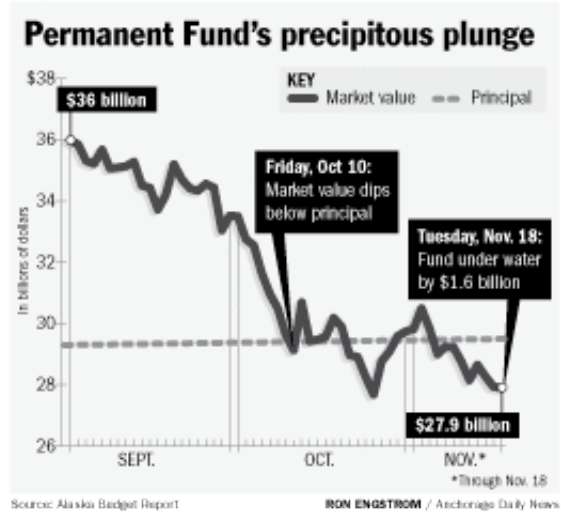
The trustees have a meeting scheduled Tuesday and Wednesday in Anchorage. That's their chance to ask Burns whether managers have the courage to stick to their allocation discipline, and how he proposes to deal with a potential dividend challenge. Let's hope the trustees do ask those questions. And let's hope they get coherent answers.

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