

ALASKA PERMANENT FUND CORPORATION
Regular Meeting of the Board of Trustees
September 8, 2004

Location of Meeting
Alaska Permanent Fund Corporation
Hugh Malone Board Room
801 West 10th Street
Juneau, Alaska

SUMMARY MINUTES

Trustees Present: Steve Frank, Vice Chair
William Corbus
William Hudson
Gregg Renkes
Eric Wohlforth

Trustee Absent: Carl Brady, Chair

Staff Present: Mike Burns
Richard Shafer
Maria Tsu
Chris Phillips
Sandra Firestack
Freda Westman
Laura Achee
Kathy Thatcher
Marshal Kendziorek
Joan Cahill

Consultants Present: Michael O'Leary, Callan Associates (teleconference)

Others Present: Theresa Nangle Obermeyer (teleconference)

CALL TO ORDER

VICE CHAIR FRANK assumed the chair duties. He called the meeting to order at 9:07 a.m. on Wednesday, September 8, 2004, in Juneau, Alaska.

ROLL CALL

Four trustees were present at roll call to form a quorum. Vice Chair Frank and Trustees Corbus participated by teleconference. Trustee Wohlforth joined the meeting by telephone at 9:48 a.m.

APPROVAL OF AGENDA

The agenda was approved as presented, on a motion made by TRUSTEE CORBUS and seconded by TRUSTEE RENKES.

APPROVAL OF MINUTES

TRUSTEE CORBUS moved that the Board adopt the minutes of the June 16-17, 2004 meeting and the July 13, 2004 meeting.
TRUSTEE HUDSON seconded.

The motion to approve the minutes passed unanimously.

SCHEDULED APPEARANCES AND PUBLIC PARTICIPATION

There was no one who wished to address the Board.

FY06 BUDGETS

KATHY THATCHER, APFC Administrative Officer, presented the initial draft budgets for FY2006 for corporate operations, investment management and custody fees, and capital improvement projects. She said this is an opportunity for the Board to review the budget and make changes prior to the November Board meeting, when the final budget will be presented for approval. The FY2006 budget will then be submitted to the Office of Management and Budget (OMB) and eventually to the Legislature.

Operations

MS. THATCHER referred to the corporate operations chart that showed the authorizations, actual expenditures and lapses for fiscal years 1997 through 2004. Over the past four fiscal years the Corporation has reduced its authorization by about one million dollars. Those lapses stay in the Fund. She noted that FY2004 actuals do not provide a good representation of the Corporation's actual costs. It was an unusual year for personal services because of high staff vacancy — about 11%, or equal to roughly \$360,000 if those positions had been fully staffed during the year. The vacancies in the investment department also affected travel expenditures. There was minimal to no acquisition activity in the real estate asset class in FY2004, so real estate consulting and legal fees and other administrative costs associated with due diligence were only \$38,000. Staff's conclusion is that had more positions been filled the actual expenditures for FY2004 would have been at least \$500,000 higher.

CHAIR FRANK inquired about the projected vacancy rate for the FY2006 budget. MS. THATCHER said the FY2005 budget was built on a 4.9% vacancy rate, and the FY2006 budget uses about the same rate.

TRUSTEE HUDSON asked if the APFC has authority to carry over funds or if all unexpended money lapses. MS. THATCHER said all money lapses but remains in the fund.

MS. THATCHER said the APFC is requesting a \$7,154,000 operations budget that reflects an overall increment of about \$220,000. The increment includes \$56,000 for increased personal services costs, \$54,000 in travel, and \$119,000 in contractual monies. The personal services proposed budget of \$3,356,000 has an increment of about \$160,000 increased cost in personal services, \$98,000 of which is attributed to performance-based increases for staff and \$62,000 for the executive director's salary adjustment that happened in FY2005. Staff believes they can find the \$104,000 difference between the increment and the increased costs from other money within the proposed authorization, if needed.

MS. THATCHER stated that the travel budget request is \$272,000, which is \$54,000 higher than the FY2005 authorized. The extra funds are for additional investment staff to travel to board meetings, for investment due diligence travel, and for specialized staff training. The increment also is needed to keep the travel for the executive director, the chief operating officer and operations staff at the same level as FY2004. Last fiscal year saw more travel for outreach related to the percent-of-market-value proposal.

The contractual services budget is proposed at \$3.3 million, \$119,000 higher than FY2005. Contractual services has 13 account categories, and the largest increment is in professional services, which is about \$212,000 higher than FY2005. This increase is largely related to the anticipated boost in real estate acquisition activity that will mean higher real estate consulting and legal fees.

MS. THATCHER noted that the \$53,000 for Callan is not really an increase. Callan Associates has renegotiated a flat rate contract, and the cost of asset allocation (\$20,000) and of the PEP software product is now incorporated in the \$275,000 flat fee. Those costs will be reduced in other account lines.

TRUSTEE CORBUS recalled that the Department of Law was looking at the legal fees in the real estate area where the fees presumably are \$1 million a year. He said there must be other legal fees that do not show up on APFC's budget.

Chief Investment Officer RICK SHAFER replied that the fees are capitalized, that is, charged directly to the properties and not overtly in the Fund's budget.

TRUSTEE RENKES confirmed that his department is developing a policy, and the issue of how outside legal counsel is hired and how to reduce costs will be raised at a later meeting.

MR. BURNS mentioned that in the first nine days of the new real estate procedures the managers have brought \$177 million in potential new deals. So giving the real estate managers more discretion has already resulted in increased activity.

TRUSTEE RENKES asked how staff came up with the 25% increase in travel. MS. THATCHER explained that staff builds the travel budget from the bottom up by calculating how many trips will be needed for property visits, investment manager visits, training, board meetings, etc.

CHAIR FRANK inquired if the travel budget reflected the Board's desire to meet less often in person and hold more teleconferences. MS. THATCHER said the FY2006 budget was built on the same board meeting schedule as last year's budget.

TRUSTEE RENKES asked if the increase in travel expenses for staff is related to the Board's wish to have investment staff out with the money managers more often. MR. BURNS said absolutely. TRUSTEE RENKES observed that the dollar amount does not seem like much of an increase.

MR. SHAFER agreed but said there was a draw down in travel in FY2004 because the investment area was understaffed. Now investment staff is required to become a CFA (certified financial analyst), which means travel for special training. Besides the due diligence trips for real estate, Ms. Tsu has been in her job less than a year and needs to visit the equity managers and become more familiar with their operations.

TRUSTEE RENKES asked what percentage of the Fund's managers staff would visit in the budget year. MR. SHAFER guessed it would be much less than one hundred percent on the equity manager side. Staff is developing a property visit policy on the real estate side that contemplates site visits every 18-24 months.

TRUSTEE RENKES said that, as part of the travel budget development, staff must have had some estimate of how many trips staff would make to managers in the year. MR. SHAFER said they start with the obligation to attend conferences because that is more predictable, and then try to build in manager or property visits on the same trips.

TRUSTEE RENKES indicated his inquiries and comments were on Trustee Wohlforth's behalf in his absence. He said Trustee Wohlforth has spoken in the past about staff having a budget and schedule for visiting investment managers, and doing that routinely, not as an incidental side trip when staff is on other business. There should be a goal to visit a certain number of managers over the course of a year.

MR. SHAFER stated that he could work with the executive director to formalize a list of manager visits. There has been a recent move to have the investment managers appear at regular Board meetings more often. So there has been a conscious attempt to address the Trustees' concerns about making sure the managers are scrutinized.

Mentioning another of Trustee Wohlforth's suggestions, MR. BURNS said that staff is working on an outreach program for the managers as they come to Alaska to visit the Board to also be available to the university or to business groups in the communities where meetings are held.

TRUSTEE CORBUS asked if the increase in personal services for salaries included a component that would bring the Corporation closer to its goal for staff salaries, particularly for the investment people.

MS. THATCHER replied that the \$160,000 increase assumes only annual performance-based raises and does not include any market adjustments for investment staff salary ranges. She said staff proposes going to the Legislature with a \$56,000 increment in personal services. If the vacancy rate built into the FY2006 budget does not happen, and there is a need to fund the entire increase anticipated in personal services, staff would have to come to the Board and ask for funds from another line item.

Responding to TRUSTEE HUDSON's question about the Fund's salary ranges, MS. THATCHER said the APFC has its own written salary program, and people understand the salary steps for higher performance and qualifications.

MS. THATCHER explained further that there has been a significant increase from FY2004, not only to fund what were vacant positions, but for increased employer contributions to the Public Employees' Retirement System and for higher health insurance premiums.

TRUSTEE CORBUS asked what the Compensation Committee's recommendation was when it last reviewed the salary policy. He recalled that the Committee wanted to make the salaries for its investment positions more competitive in the marketplace.

APFC Administrative Officer FREDA WESTMAN stated that the Compensation Committee discussed the personnel management program and reviewing salaries on a periodic basis using a market salary survey to upgrade the compensation structure as needed. In the most recent past, the Corporation has upgraded the compensation structure using a market salary survey. Before that, the Corporation looked at what other state agencies were doing and upgraded the compensation structure with a cost-of-living-allowance (COLA) increase that other state agencies were using.

TRUSTEE CORBUS said he wanted the compensation structure upgraded regularly through the use of market surveys so APFC investment position salaries are brought in line every budget season. He did not see any effort in that area for the FY2006 budget.

MS. WESTMAN and MS. THATCHER both indicated that staff was waiting for action from the Compensation Committee, which next meets on December 1. Once the Committee's recommendation is approved by the full Board, any salary increments would become part of the FY2007 budget process. It takes about two months to get the results of a market salary survey.

TRUSTEE RENKES commented that if the Board wanted to act on the results of the market survey and the Compensation Committee's recommendation this year it would be good to have the work done while there was still an opportunity to submit an amended budget to the State Legislature (the middle of March).

MR. BURNS stated that there is always the option of accessing other funds within the budget that have not been fully expended. He stressed that staff is working to bring investment position salaries more into line with the marketplace, but it is not reflected in the salary line of the FY2006 budget.

TRUSTEE CORBUS observed that trying to get a salary adjustment in a supplemental budget request is much harder than it would be to include it in the regular budget process.

There was a brief discussion about the timeline for submitting the FY2006 proposed budget to OMB and whether staff could have new salary survey information available for the Board to look at in November.

MR. BURNS reiterated that the FY2006 budget has \$160,000 planned for salary increases but only an increment of \$56,000. MS. THATCHER confirmed that staff believed it would be easier to get a \$56,000 increment approved for salaries than the higher figure of \$160,000.

TRUSTEE RENKES suggested that when staff has its meeting with OMB to flag the personal services line, explain that the Compensation Committee has a meeting scheduled in December, and that the APFC may have a proposal for the Governor's amended budget in March 2005, based on data from the market survey results. He said to convey there is interest by the Trustees in having the salaries be more market based.

TRUSTEE HUDSON asked if there was a feeling that the Corporation's compensation package is below market rates. MR. BURNS said yes.

TRUSTEE HUDSON said he agreed with Trustee Renkes that the Board can produce justification in the form of market survey results for requesting more money in the budget for the salary structure. It is important to the Board to pay competitive salaries to safeguard against having its best investment people recruited by other companies, and to be able to attract good candidates to Alaska for any future vacancies. Finally, the Fund is getting into more aggressive investment strategies to earn more money.

MR. BURNS mentioned that Fund management will be interviewing a candidate for the senior fixed income position and will get some indication there whether the salary is adequate or not.

TRUSTEE CORBUS stated that he felt the Board already has the Fox Lawson survey results, and it would have been better if staff could have a proposal to make at OMB now rather than count on the Governor's amended budget in March.

MR. BURNS asked Trustees if they wished to raise the increment for personal services to the full \$160,000 instead of the \$56,000 that staff has proposed. It would change the total request from a 3% increase from FY2005 to about 4%. He felt confident staff could put together the justification for the increment based on the salary surveys that have already been done and what management has experienced in the recruiting process.

TRUSTEE RENKES said he supported putting in \$160,000 now, or whatever increment staff has justification for. He added that it is possible the Compensation Committee may look at the latest salary survey results and recommend even more than that, and it would make any second increase less significant.

[Trustee Wohlforth joined the meeting at 9:48 a.m.]

CHAIR FRANK agreed, saying the Fund may not need the additional funds, in light of vacancies and any opportunity to shift money from other line items.

TRUSTEE HUDSON said he fully agreed with that, adding that the APFC is looking for authorization to spend money on salaries if it needs to. If the market survey results show the need is less than \$160,000, then the Fund does not have to spend it.

TRUSTEE CORBUS stated that he felt good about that solution.

TRUSTEE HUDSON moved that the APFC Board direct staff to submit an increment of \$160,000 for personal services in the FY2006 budget, instead of the proposed \$56,000.

TRUSTEE RENKES seconded.

The motion passed without objection, 5-0.

TRUSTEE RENKES noted that the public information program has no increase from FY2005 to FY2006, and that the actual expenditures in FY2004 were larger than the 2005 authorization. He said the POMV proposal passed in the House but not in the Senate last legislative session. There was acknowledgement at the end of that process that there is still a significant information gap between what the public understands about the POMV issue and the Board's desire to change the way money would be paid out of the Fund. That recognition was instructive and suggested that maybe the Permanent Fund has not done as good a job as it could over the previous ten years in laying an information foundation with the Alaska public about the regulatory and statutory environment the Fund operates in. He would like to see a budget that reflects that communications challenge and a plan to address it. To have no increase in the communications effort from FY2005 to FY2006 strikes him as a policy decision not to pursue a more aggressive information program to inform the public about the long-standing Trustee objective to reform the management and payout mechanism of the Fund. This is probably the biggest and most important thing that the Trustees could do for the Fund for the future, and the Corporation does not have a program or expenditures in the budget to reflect it. He asked for the thinking behind that budget decision. He favored putting a substantial amount of additional support toward some program that can be designed over the next several months and implemented in the next year.

MS. THATCHER agreed that the FY2006 was a hold-the-line budget for the public information program. If the Board's policy is to continue the public outreach of the past fiscal year then that budget will have to be increased. The proposed budget basically covers the communications contractor and the current program of regular publications.

MR. BURNS explained that the Corporation does not plan to spend as much on publications as it has in the past. So staff is looking at how to spend those dollars differently.

TRUSTEE RENKES commented that with significantly less in the public information program for FY2005 and then holding the line at that for FY2006 suggests to him that the APFC has completely backed off the POMV information effort just at the time when the feedback indicates there is a significant information gap. The Trustees have a role to promote public education in this area if they want to see this reform happen.

APFC Research and Communications Liaison, LAURA ACHEE, explained that the Fund spent an extra \$150,000 in the public information program for a proposed ballot initiative last fiscal year that is not planned for in FY2005. Bradley Reid has a three-year contract for a maximum of \$1 million, with two renewals. So the Fund has the leeway to spend up to about \$210,000 with Bradley Reid in FY2006. But staff would have to get a contract amendment through the

State of Alaska procurement system to go any higher than \$210,000. She said if the Board wants a greater communications effort on POMV staff can work with the contractor to plan the best course of action. The Fund was relying on the Legislature to pass a potential ballot initiative, and the Legislature took great offense to the Corporation's extra efforts with the \$150,000 used for a newspaper insert, two advertisements, and radio spots. Right now the budget is built around a public relations budget, not an advertising budget.

TRUSTEE RENKES said his concern is that the Fund's information strategy has been driven by the legislative effort, and that is fundamentally flawed. The Fund has waited to see what the Legislature is going to do and then tried to build a communications strategy to support it when it looks like there is going to be some momentum. It appears that if the Fund does not think there will be some legislative momentum then very little education is done. When it gets to crunch time in the Legislature it becomes evident that the information program has been inadequate over time. He said he would like to see an information program that is completely independent of any legislative activity whatsoever. Then the Legislature cannot take offense, and the Board is not responding to their business or supporting one political measure over another.

TRUSTEE RENKES said the Fund should be educating the public about the basic principles that the Trustees have supported in proposing modernization of the statutes that guide the management of the Fund. The education needs to convey that the Fund is not just a dividend program, explain the types of investments and how they are managed, and define the relationship to Alaskan investments (the proposed gas line, for example). Then when it came time for legislative activity the Board would be in a much better position than it is now. He said he was not advocating for an enhanced communication program that is focused on a legislative goal but an information program that is focused on bringing the Alaskan public along on the basic concepts for the reform that the Trustees have proposed and supported over the last ten years.

TRUSTEE RENKES said he would like this part of the Fund's activities enhanced with more information available to the public and more discussion and debate about the Fund and its future to promote greater understanding than currently exists in the public. The FY2006 budget ought to reflect some action plan for addressing that.

MR. BURNS explained that, although not reflected in the dollars, staff is trying to provide less information and more education. The public has probably been overwhelmed with performance information that means nothing to most people. An example is several pages of information in the dividend application package about the Permanent Fund, but it is really useless when somebody is filling out the application. That is being dropped at a savings of \$16,000. Staff is working on realigning that effort into an education program, but maybe the total dollars in the budget are not enough.

TRUSTEE WOHLFORTH indicated he agreed with Trustee Renkes about the need for an enhanced education program. He also supported using the best professionals to find out how to educate most effectively and not doing it ad hoc. He would support additional money in the budget, if it were necessary, to find out what needs to be done and to design and implement an education program.

When queried by the executive director, MS. ACHEE said she did not know how much it would cost to hire professional advice on effective methods for educating the public. Referring to Trustee Renkes' comments about past efforts, she said the Corporation has done a very good job of exploring and using every public relations outlet, which means low cost. Staff has not received direction from the Board to start looking at the other side — advertising on radio, television and newspapers — which costs money. Also, direction from the Governor's Office and OMB last year was for state departments and agencies to cut their budgets. She said she would be happy to begin instituting the Board's direction if the desire is to reach out to the public more directly, even if it costs more money.

TRUSTEE RENKES stated that he would like an enhanced education program that provides the resources to directly communicate with the public about Fund management and investments that are important to the Trustees. Things that were done in the past, such as occasional editorials and speaking engagements, are just talking to largely the same group of people over and over again. There is a lot of public interest in the Permanent Fund because of the dividend, and people would be receptive to more information if it were presented in a way that was more accessible — but this costs money. It has to be education and not advocacy, and building a foundation of understanding is a slow-drip process that takes dedication. The Board has to start a more direct outreach with the public so that over time that foundation of knowledge will develop and make reforms and modernization to protect the Fund for future generations of Alaskan more achievable.

TRUSTEE HUDSON said this Board thought it was very important the last several years to move to the POMV, not because of any policy orientation, but for results. Public education has to demonstrate what the Fund is doing at the present time and what potential positive results could accrue if POMV were adopted. He agreed with Trustee Renkes about not waiting to tie the education effort to some action in the political arena because any political stance has adversaries, so it is hard to educate someone while constantly trying to fight somebody else's politics. The Board is looking for results — increasing returns from the public's invested dollars — not policies on how the money is spent. No tie to the Legislature is the best way to avoid POMV being tied to politics. It would be worth spending some monies to educate people about the positive change POMV could provide to the public's best interest.

CHAIR FRANK expressed his preference for the APFC's annual report taking

more the form of a newsletter from Trustees, as opposed to doing radio, television or newspaper type advertising. He felt the Board would gain more support for the Fund's educational efforts from the Legislature and it would not be as offensive to those that do not support the POMV or do not want the Corporation spending money on advertising. A newsletter format might not be as effective as advertising, but it might appeal to those who are really interested in the management of the Fund.

TRUSTEE RENKES agreed that there is a range of options for achieving direct public education.

TRUSTEE WOHLFORTH said that if all the public efforts were aligned with the notion of education in mind it could be very effective. An example is two or three months ago there could have been an effort to include some discussion of POMV with the economic survey reports scheduled in conjunction with the APFC annual meeting. The Corporation needs to be more proactively engaging the public, and there are a number of venues for doing that. Another example is that the economic presentations will not be telecast or available outside of Fairbanks, and a good question is, why. First-class educational presentations should be broadly available.

TRUSTEE RENKES moved that the Board increase the FY2006 communications contractor line (public information program) to the FY2004 level, back to \$210,000 (from \$123,500).

TRUSTEE WOHLFORTH seconded.

TRUSTEE RENKES said this would be an interim conservative measure; understanding that the Board wants to do more but is not sure exactly what form that will take until the communications contractor helps develop a plan. But this will give the Fund authority to proceed with a public information program at least at the FY2005 level. If more money is needed, the Board can address that in an amended budget or supplemental later, once there is a specific education program.

MS. ACHEE clarified that the Fund spent closer to \$300,000 with Bradley Reid in FY2004. MS. THATCHER said some of those costs were allocated to the advertising/printing/binding line.

MR. BURNS said that \$210,000 would have an even larger impact; based on how staff is realigning some of the money the Fund has historically spent on communications. However, new money is also part of the answer.

MS. ACHEE recalled that some of the criticism from legislators was that the Fund did not have its ducks in a row when it requested funding last fiscal year for an advertising campaign.

CHAIR FRANK brought up the possibility of increasing the communications mailing service line to the FY2004 level so there was enough money to implement a modest expansion of the education effort.

As an amendment to his motion, TRUSTEE RENKES said he supported the in-house publication information program going from \$15,000 to \$30,000, and the communications mailing service increasing from \$15,000 to \$40,000. That would reflect basically where the Fund was in FY2004 with the mailings and provide a little more for some in-house planning and production. Increasing the communications contractor line to \$210,000 gives more flexibility but does not mean it has to be all spent.

TRUSTEE RENKES asked about the increase to print Trustee papers. MS. ACHEE said there have been seven Trustee papers, and they are printed on an as-needed basis. For FY2005 staff is considering updating and re-issuing "The Alaskan's Guide," which has not been reprinted for about three years. The FY2006 budget includes funding to print another Trustee paper, however, that money could be shifted to something else if the Board wishes to reach more people.

CHAIR FRANK asked if there was any objection to the motion. There was none. He asked staff to make those changes to the FY2006 draft budget.

TRUSTEE RENKES said he supported funding to republish Trustee papers recommended, under the advertising/printing/binding budget. He added that the Alaskan's Guide is a good education tool, and he would like to see it printed annually.

MR. BURNS said the Alaskan's Guide has a good shelf life.

TRUSTEE HUDSON recommended changing the title of "public information program" to "public information/education program," to reflect the Fund's new emphasis on education. It is important for the public to recognize that the Fund is not simply informing them but is trying to provide education as well. MS. THATCHER said she would make that title change.

Continuing with the FY2006 budget review, MS. THATCHER said information technology services is being reduced by \$82,000. Much of that decrease comes from moving the Yardi real estate system cost of \$40,000 from the IT category and putting it in financial networks to better reflect the source of the cost. The other line items were reduced to better reflect FY2004 actuals.

MS. THATCHER said the state support services category is higher by \$32,000. The majority of this increase is coming from the Department of Administration cost allocation to support the centralized human resources function. There is also about \$7,000 to help support staff at the Commissioner of Revenue's office in Anchorage, where the Fund now operates a satellite office.

TRUSTEE RENKES remarked that centralization of human resources was supposed to save money. MS. THATCHER clarified that about \$20,000 of the increase is for centralization. The remaining \$12,000 is for increases in support costs from the Commissioner's Office, some administrative services the Fund gets from the Department of Revenue, as well as other pass-through costs for ADA and EEO.

MS. THATCHER said the financial networks line item request is for an additional \$27,000 over FY2005. Some services have been dropped and replaced, and there are increased annual costs associated with these systems. Also, another investment staff position has added to the fixed income services.

TRUSTEE RENKES inquired about the level of service from the Administration Department's human resources compared to when HR services were internal. MS. THATCHER replied that new employee orientation is being done over the phone or through the web, instead of in person, and that does not seem quite as personal or efficient.

MS. WESTMAN added that the response time for classification or hire information has been pretty good, but there have been delays associated with HR staff and offices relocating and getting set up. The biggest complaint from employees has been the slow response to payroll questions.

TRUSTEE RENKES stated that the agencies are going to be putting service contracts for HR services in place with the Department of Administration so there are clear expectations about the services delivered. There are also issues about increased costs from when HR services were provided within each department. Another reform is that each department is supposed to have an HR advocate to deal with the Department of Administration on its performance of the HR service agreement. Because that reform has not been put in place yet, the FY2006 budget does not reflect that addition. But staff should look into whether the personal services category will have to be amended to reflect the potential hiring of an HR person to be the liaison with the Department of Administration.

TRUSTEE HUDSON asked if there are any offsetting savings in human resources at the Fund to offset the higher cost of paying a pro rata share of centralized human resource services to the Department of Administration.

MS. THATCHER said she understood that the Department of Revenue was fairly efficient with its human resources positions and expenditures. When the State

centralized all the HR costs and reallocated them back to the departments, the Department of Revenue (and the APFC) started to share some of the higher costs of departments that were not as efficient.

TRUSTEE HUDSON said the centralization was supposed to save the State money, and he hoped the Department of Administration was going to take a hard look at the costs of the centralized HR function. He added that he has been through centralizations and decentralizations during his career in state government, and it always winds up costing money.

TRUSTEE RENKES stated that there is currently a six-month evaluation of the centralized HR function to see if the goals were achieved or if adjustments are needed.

Concluding the operations budget, MS. THATCHER said the commodities request line and the equipment line are basically at the same level as the FY2005 authorized.

Investment Manager and Custody Fees

MS. THATCHER said the proposed FY2006 budget for investment manager and custody fees is \$42.9 million, up \$1.5 million from the FY2005 budget. This increment basically reverses the \$1.7 million reduction in FY2004. The budget is based on the median case of Callan's capital market assumptions for equities and fixed income. The Fund is also expecting a budgetary impact from adding an emerging markets manager and a fixed income manager in FY2005.

MS. THATCHER stated that the real estate line item is for REIT (real estate investment trust) management fees, and the request is for a \$500,000 increment due to extraordinary growth in the asset value that occurred in FY2004 and a corresponding under-budgeting for this asset class in FY2005. Fees for the new hedge fund investment class are going to be paid directly from the investment versus writing checks from corporate receipts. This is an accounting industry standard, similar to what is done with real estate private investments.

MS. THATCHER said the custody fee budget of \$1.8 million is the same as FY2005.

TRUSTEE RENKES asked how the ratio of passive to active management of equities impacts the \$41 million of investment manager fees budgeted for FY2006.

MR. SHAFER replied that at the margin a change would have less impact than one might think because most likely the Board would choose to add to passive or take away from passive in those parts of the equity asset class that are most efficient. Those are the ones for which the active fees tend to be lowest. If the

Board chose to make a much bigger change in the equity structure then the impact on fees would be much larger.

TRUSTEE HUDSON asked if staff felt they were in control of costs when fees are paid directly from the hedge fund investments. MR. SHAFER said yes, that the fee is set in the manager contract and remains the same even if it is subtracted from the pool of money that is being invested by the manager.

Capital Budget

MS. THATCHER stated that the Fund is not requesting any capital budget appropriations for FY2006. However, the Corporation expects to pay \$200,000 for a new phone system due to the age and the ongoing problems following a lightning strike to the telephone system this summer.

TRUSTEE HUDSON asked if there were any new capital budget costs for APFC because of security.

MARSHAL KENDZIOREK, Director of Information Technology, said nothing specifically in the capital budget, that most security measures have been taken care of through the normal operating budget.

TRUSTEE HUDSON said he assumed if there was a specified need that staff would bring that forward to the Board. MR. KENDZIOREK said yes.

TRUSTEE CORBUS asked for an explanation of the MIS consolidated reporting and data warehouse.

MR. KENDZIOREK explained that staff has postponed utilizing that money. The main intent is to unify some of the data systems the Fund uses, predominantly in the fixed income area, so there is a single place for staff to look for information. Staff issued a request for information about two years ago to evaluate the options, and there was a bit of sticker shock when it was found that systems cost \$200,000 to more than \$500,000. The other part is an intranet project underway that will support a way of looking into the different "islands" of data at the Corporation from one screen and allow better access by remote users.

TRUSTEE WOHLFORTH recommended having a full array of publications available at the Anchorage satellite office, including things like meeting minutes. He said there should be a place in Anchorage where an interested person can go besides the web site.

TRUSTEE RENKES commented that he thought the Anchorage satellite office was going to be more than just a place where staff or the Trustees could work from in Anchorage, that the public could go there to get information about the Fund.

MR. BURNS said he was not aware of that intent, but staff could follow up and probably be able to provide the public access the Trustees suggested.

PUTNAM ADVISORY COMPANY - STAFF RECOMMENDATION & DISCUSSION

MR. SHAFER reviewed the staff report in the packet. The report covered the Fund's investment history with Putnam Advisory Company since 1998, the regulatory action against Putnam in 2003 related to some investment people there engaging in market timing of mutual funds managed by the firm, and the Board's exhaustive review starting last year and leading up to action at the June 2004 meeting to extend Putnam's contract through January 31, 2006. At the June meeting, the Board requested that staff continue to monitor Putnam closely.

MR. SHAFER referred to staff's recommendation to: (1) Terminate Putnam Advisory Company, LLC as an APFC equity manager; (2) Initiate a manager search through the general consultant, Callan Associates, Inc., for a replacement U.S. large cap core growth equity manager. Direct Callan to consider managers with a broad range of large cap growth styles, excluding very aggressive growth styles); and (3) Transition the Putnam portfolio to Mellon Capital Management for the interim period and instruct Mellon Capital to manage the annualized tracking risk of the portfolio to a level ranging from 1.5% to 2.5% to a blended style benchmark of 60% S&P 500 Index and 40% Russell 1000 Growth Index.

MR. SHAFER said that staff has worked hard to keep Putnam in the line-up and did everything reasonable to save expenses and time. Things did not happen the way staff had hoped. Putnam's performance has been acceptable and not a reason to take action. Maria Tsu, APFC's Manager of Equity Investments, has worked out a comprehensive and low-cost transition program for the assets at Putnam, and used the technical analysis and support of Callan Associates to verify the numbers. Staff estimates the upfront transaction costs to be \$50,000 to \$100,000 to transition the Putnam account to Mellon Capital for an interim period and have Mellon do some modest rebalancing to control risk in that portfolio.

TRUSTEE RENKES asked about the alternatives staff considered that led to the recommendation to place the Putnam portfolio with Mellon Capital for an interim period.

MS. TSU outlined the following alternatives:

- Divide the \$526 million Putnam portfolio among some of the existing managers. Staff felt it was important to keep the money in the large cap growth space to maintain the equity style exposure. RCM already has \$1.2 billion of the Fund's assets. McKinley Capital was recently allocated another \$150 million, plus their strategy is more aggressive growth and a less liquid portfolio. Alliance Capital also has an aggressive growth strategy and remains under close watch for performance problems. Tukman was hired as a large cap value manager, although their style is hard to categorize.

- Move the money to the S&P 500 Index fund for a temporary period. This would result in losing the style exposure to the large cap growth space, and one-way transaction costs would range around \$2 million.
- Three variations on a common theme: (1) move the money to some kind of large cap growth index product; (2) move the money to an assortment of Mellon Capital commingled funds that would provide the desired mix of S&P 500 and Russell 1000 Growth Index exposure; (3) use exchange traded securities as well as a basket of futures to replicate the desired style exposure. All three variations have the benefit of maintaining the large cap core growth style the Fund is looking for. But, for the three- to four-month period of a manager search, these alternatives would cost about \$3 million in transaction fees and be more complicated.

MR. SHAFER said staff discussed all the alternatives with the executive director, who agreed with staff's conclusion to place the money with Mellon Capital for the interim.

TRUSTEE WOHLFORTH asked if the interim Mellon transaction would prejudice or remain neutral to the Board possibly deciding in a couple of months to go to one of the index combinations Ms. Tsu just outlined.

MS. TSU said Mellon Capital fully understands that this is a temporary mandate. She did not think it would in any way prejudice whatever the Board should decide to do following the temporary period of time.

TRUSTEE HUDSON asked if the bottom line for terminating Putnam was that the people managing the Fund's account left the firm.

MS. TSU explained that when the Board acted in June to keep Putnam as an APFC equity manager for the time being it was based heavily on the stability of the portfolio management team — Richard England and Mike Nance — and the stability of the investment process. In the space of a month, both the portfolio managers left Putnam and were replaced by Putnam's director of research and a new hire. Then the chief investment officer, Josh Brooks, indicated a desire to make a meaningful change to the investment process in an effort to enhance performance. While better performance may be the eventual outcome, there is no guarantee, and it is a clear departure from the investment process Putnam had in place since early 2002, which has been yielding positive results. Staff feels a lack of confidence at this point in Putnam's ability to provide a stable investment team and a stable process.

TRUSTEE HUDSON inquired if there was any financial risk to APFC in terminating Putnam. MR. SHAFER said no, that all the manager contracts contain language that allows the Fund to terminate a manager at any time for whatever reason.

MR. BURNS added that two of Putnam's portfolio managers on APFC's account leaving and the firm's intention to change the investment process were just the final reasons for staff to recommend termination, but there were other issues leading up to this point.

TRUSTEE RENKES commented that he was an advocate for terminating Putnam in June. He asked why the Fund has to have an interim option for the Putnam portfolio: why not go straight to the permanent solution.

MS. TSU said staff is recommending a search for a new large cap growth manager, which will take Callan and the Board three to four months to complete. Leaving the portfolio at Putnam until a new manager is hired is an option, but that is not staff's recommendation.

MR. SHAFER continued that thought by pointing out that if staff believes Putnam is not suitable for the Fund going forward, then it would be inconsistent to leave the portfolio at Putnam in the interim.

MR. BURNS stated that Callan has already started the manager search process on their own cost, in anticipation of the Board's action at this meeting and knowing the urgency on this.

TRUSTEE RENKES asked if the three-month interim period during the manager search was too long to leave the portfolio at Putnam. Both MR. SHAFER and MR. BURNS said yes.

MR. BURNS raised another of staff's concerns, that being that poor morale at the Putnam organization makes the firm a prime candidate for every headhunter. In fact, another person left Putnam just last week but not on the Fund's account. So things could change at Putnam even over as short a period as the next three months.

TRUSTEE WOHLFORTH remarked that he could not think of a less opportune time for Putnam to announce a change in investment strategy, and he found their entire management approach disturbing. He said he had no problem moving out of Putnam, but he was not convinced that initiating a search for a new large cap manager was the way he would like the Board to go. He preferred fuller consideration of some kind of large cap index, an option staff presented but did not recommend as the best interim measure.

TRUSTEE RENKES said he agreed with Trustee Wohlforth, to look at that option rather than as an interim measure.

MR. BURNS indicated the two courses of action were not mutually exclusive.

MS. TSU said staff is recommending a low-cost, low-turnover interim strategy — having Mellon Capital step in and assume responsibility for the existing Putnam portfolio and do some modest rebalancing to manage the risk of that portfolio. This option gives the Board a lot of flexibility to determine what the end point will be. The Putnam portfolio currently has about 85 stocks. If the portfolio were placed in a large cap growth index fund the number of stocks would increase to 800. Then if the Board were to decide four months later to hire a large cap manager they would have to take the portfolio back down to something like 85 stocks again. The question is why churn the portfolio and incur the transaction costs for a temporary solution.

TRUSTEE WOHLFORTH said he was not arguing against a temporary solution; he simply wanted more time and information on the permanent option possibly being a large cap index structure that staff mentioned earlier. He clarified that he wanted the manager search to go ahead but to have further analysis of the pros and cons of indexing at the same time.

TRUSTEE RENKES expressed support for that direction.

MR. BURNS indicated that staff could do that.

TRUSTEE CORBUS moved that, for the time being, the Board accept staff's recommendation, which is to terminate Putnam Advisory Company, LLC, to initiate a large cap core growth manager search, and in the interim instruct Mellon Capital to manage the Putnam portfolio.

TRUSTEE HUDSON seconded.

TRUSTEE WOHLFORTH indicated he supported the motion, as long as it was understood that the large cap manager search would include an analysis of the indexing possibility.

CHAIR FRANK asked if there was an objection to including the analysis for the indexing option.

TRUSTEE CORBUS said he took that as a friendly amendment.

MS. TSU requested some comment from Mr. O'Leary on whether it would be sending mixed signals to potential manager candidates if the Fund were also exploring a growth index option at the same time as the manager search.

Seeking to clarify the motion on the floor, MR. O'LEARY said staff's recommendation was that Mellon Capital assume responsibility for the Putnam portfolio and not that the assets would be moved into an existing Mellon portfolio.

Responding to Ms. Tsu, MR. O'LEARY stated that it would be challenging but entirely possible to identify prospective large cap growth candidates and also revisit the alternative structure issue for large cap simultaneously. The Board can decide to stop the manager search at any point. Also, the Board may decide that before interviewing the managers it may want to follow up with some additional questions in response to the initial analysis of the active-versus-passive combination that is currently the Fund's policy. The choice to proceed with the manager search will maximize the Board's future flexibility.

CHAIR FRANK queried staff if they were comfortable with the motion. MR. SHAFER said yes.

The motion passed without objection, 5-0.

OTHER MATTERS

Emerging Markets Manager Search Process

MS. TSU reported that the semi-finalists have been selected in the search for an emerging markets equity manager. She asked if the search committee wished to set a date to review and select the finalists for interviews. She also indicated this might be a good time to address creating a search committee for the large cap manager search to replace Putnam.

TRUSTEE CORBUS stated that, if he was not already on the emerging markets manager search committee, he definitely wanted to participate.

MR. BURNS recalled that at the August retreat Trustees indicated they did not want to participate in the manager interview process, except for Trustee Corbus, who wanted to take part on an ongoing basis. Staff will work with Trustee Corbus's schedule to set a date for the emerging markets finalist interviews.

There was an exchange among staff, Trustees and Mr. O'Leary to clarify how the Board wished to conduct manager searches on a trial basis for the next six months to a year. Trustees wanted to have information on the candidate managers and a comparative analysis so they could provide input on winnowing the list down to semi-finalists and then to finalists. Trustees could choose to participate in these manager search meetings and interviews by teleconference or in person if they were interested and their schedules allowed. Following the manager interviews conducted by staff and any Trustees who wished to attend, staff would present their recommendation and supporting analysis to hire a manager to the Board for final approval. The Board then wished to meet with the manager selected in person before a contract was put in place.

TRUSTEE COMMENTS

TRUSTEE WOHLFORTH expressed hope that staff could find a way to have the economic presentations and roundtables scheduled in Fairbanks in September well publicized in Fairbanks and available by phone connection in Anchorage.

MR. BURNS said he would follow up on that suggestion.

ADJOURNMENT

There being no objection and no further business to come before the Board, the Chair adjourned the meeting at 11:34 a.m.

APPROVAL OF MINUTES

/s/ Steve Frank, Vice Chair

November 22, 2004