

ALASKA PERMANENT FUND CORPORATION
Regular Meeting of the Board of Trustees
November 12 & 13, 2003

Location of Meeting
Alaska Permanent Fund Corporation
801 West 10th Street
Juneau, Alaska

SUMMARY MINUTES

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

Staff Present: Robert Storer
Robert Bartholomew
Richard Shafer
Christi Grussendorf
Maria Tsu
Chris Phillips
Jim Parise
Marshal Kendziorek
Laura Achee
Joyce Andrews

Advisors Present: Alan Bufferd
Robert Maynard

Invited Participants: Ron Lorensen, legal counsel
Michael O'Leary, Callan Associates
Bo Abesamis, Callan Associates
Mike Barnhill, Attorney General's Office
Bryan White & Larry Kohn of Quellos Capital
Management

Others Present: Cathy Porterfield, KPMG
Don Gotschall
Ryan Ballew (on teleconference)

CALL TO ORDER

CHAIR BRADY called the meeting to order at 1:37 p.m. on Wednesday,
November 12, 2003.

ROLL CALL

Trustees Brady, Frank, Corbus, Hudson, and Wohlforth were present at roll call to form a quorum. Trustee Renkes arrived at 1:50 p.m.

APPROVAL OF AGENDA

The agenda was approved as presented.

APPROVAL OF MINUTES

On a motion duly made and seconded, the minutes of both the September 5, 2003, meeting and the September 24-25, 2003, meeting were approved.

SCHEDULED APPEARANCES AND PUBLIC PARTICIPATION

There was no one who wished to address the Board.

EXECUTIVE DIRECTOR'S REPORTS

Corporate Operations

Pending Board Matters

Executive Director ROBERT STORER said staff is in the process of taking the input from the Board retreat and tailoring the report presentations to respond to this Board's needs. One suggestion was for the Board to have an informal discussion with the investment advisors, and a session has been scheduled for 9:00 a.m. on November 13.

MR. STORER stated that the Audit Committee meeting, rescheduled because of weather delays to follow recess of the Board meeting on November 12, will be the forum for a more expansive discussion about the issues regarding Putnam Investments. He encouraged all trustees to attend the Audit Committee meeting for that discussion, if possible.

MR. STORER reported that three firms have been identified as finalists for the gatekeeper/advisor for the new private equity program. Mr. Shafer will be visiting each firm (Pathway Capital Management, Hamilton Lane Advisors, and Abbott Capital Management) to do due diligence and will give a report at the December 4 board meeting. The three firms also will make finalist presentations to the Board at that meeting.

MR. STORER said that Maria Tsu was hired to fill one of two vacant investment officer positions. One project on hold until fully staffed is an evaluation of the growth equity portfolio structure.

Regarding the future agenda item "Review Bylaws," MR. STORER said that a report on Securities Lending is on this meeting's agenda. Part of the review is to re-evaluate the fixed income approach and possibly conduct a manager search in the spring, and to revisit the Disclosure Policy.

Disclosure Reports

MR. STORER stated that monthly financial disclosure reports for September and October were included in the Board packet.

Travel

MR. STORER said the report on Trustee and staff travel for the period September 6 through October 24, 2003 was included in the packet. He noted that he has been traveling around the state talking about the proposed constitutional amendment to restructure the way money would be paid out of the Fund.

Communications

Research & Communications Liaison, LAURA ACHEE, accompanied by Chief Operating Officer, ROBERT BARTHOLOMEW, reviewed the publications and outreach efforts completed since the September 24-25 annual meeting. Staff is modifying the APFC web page to make it more user-friendly and adding a section devoted to the Percent of Market Value (POMV) proposal. Three publications were produced in October: 2-1/2 pages for the Permanent Fund dividend application booklet distributed in January 2004; a four-page newspaper insert for November to annually publish the APFC financial statements; and a reformatted, shorter FY04 first quarter report that was mailed in early November. Staff is also checking the mailing list for the quarterly report to make sure people want to continue receiving it.

TRUSTEE WOHLFORTH asked that the Board consider abandoning the quarterly report if the response to the mailing list query is low.

MR. STORER said the ultimate goal is to eliminate paper reports and direct people to the APFC website for Fund financial information.

[Trustee Renkes arrived at 1:50 p.m.]

MS. ACHEE briefed the Board on the outreach efforts on the POMV proposal. She and Bob Bartholomew have worked with Debbie Reinwand of Bradley Reid to prepare a POMV communications plan for the Legislative Oversight Committee to review at its next meeting.

MR. STORER added that APFC's outside legal counsel met with the Attorney General's Office to evaluate an outline prepared for the Legislative Oversight Committee on how to address education. Staff is sensitive to following the applicable statutes and guidelines in communicating with legislators and the public regarding POMV.

Financial Report

The written report was included in the meeting packet. MR. STORER stated that all the asset classes are well within their target bands.

Investment Operations

Monthly Performance

Equity

MR. STORER drew attention to a list of 18 portfolio structure issues he and Mr. Shafer generated for review at board meetings over the next twelve months. He encouraged Trustees to add any issues they wished to evaluate.

TRUSTEE WOHLFORTH said he wanted another discussion on global mandates, which have been reviewed several times in the past. Also, the Board should look at whether the portfolio has too many sub asset classes, based on a statement from one of the investment advisors.

The Callan Associates preliminary performance report for periods ending October 31, 2003, was handed out for Trustees' information. MR. STORER observed that the total Fund return is 6.14% fiscal year to date. He added that Ms. Tsu has been given the task of improving internal monitoring of equity managers.

TRUSTEE WOHLFORTH suggested that UBS be one of the first managers scheduled to visit the Board so Trustees can get acquainted with the Fund's new client services representative there.

CHAIR BRADY disclosed that in May his firm, Brady & Company Insurance Brokerage in Anchorage, entered into a letter of intent to be purchased by Marsh Inc. Marsh & McLennan Company owns Putnam Investments, one of the APFC's investment managers. This week he completed a State ethics disclosure form and included a memorandum of explanation. He said he intended to abstain from voting on matters pertaining to Putnam and probably from any conversations or discussions, to avoid the appearance of conflict.

MR. STORER stated that he has had discussions with the Chair about the state of the mutual fund industry in general, but they have been broad in nature. The Chair has not given him any instructions regarding Putnam.

Real Estate

MR. STORER reported that in October real estate staff began working with the real estate advisors and the Fund's general consultant to develop a list of issues for reviewing the portfolio structure and management. The Real Estate Committee will be taking up this item in detail over the coming months. The product and recommendations developed from that committee work will be formally presented to the Board.

Real Estate Investment Officer, CHRISTI GRUSSENDORF, reviewed the pending sales in the real estate portfolio: Darien (retail in Chicago); Rice Lakes (retail in Chicago); Preston Village (apartments in Dallas); Island Club (apartments in Miami); Walnut (office in Cincinnati); and Southgate (industrial in Washington, DC). Another pending transaction is the refinance of Tysons Center, a large retail property in the Washington, D.C. area. The refinancing will increase the loan on the property from \$210 million to \$340 million, and \$130 million of it is earmarked for redeveloping and expanding the mall.

TRUSTEE WOHLFORTH asked if the Fund is intentionally reducing its real estate holdings. MS. GRUSSENDORF explained that staff holds an annual meeting with the real estate advisors to get recommendations. Staff then reviews those individual recommendations in light of the overall portfolio. The Fund has looked carefully at the properties that advisors identified for sale because acquisition activity is down, and the real estate allocation is under funded.

TRUSTEE HUDSON asked if staff had a plan for buying assets with the proceeds of sales. MS. GRUSSENDORF said that prior to 18 months ago the real estate portfolio was basically at its 10% asset allocation target, but now it is under the target. There are no purchases currently pending, but the Fund's real estate advisors are aware that there is quite a bit of money to invest and are on the lookout for good buying opportunities.

TRUSTEE HUDSON inquired about the process the Fund follows to purchase real estate assets. MR. O'LEARY explained that the APFC relies upon the real estate advisors to bring recommendations about good investments. The Fund staff reviews the recommendation independently and may engage a third party fiduciary to evaluate the individual transaction. If the asset is purchased, then the advisor who brought the deal to the APFC is paid for management responsibility of that property, which often entails hiring a local property manager.

TRUSTEE CORBUS asked what was the difference between gross and net proceeds of a property sale. MS. GRUSSENDORF said the cost to sell a property is typically 2%.

At the Trustees' request, MS. GRUSSENDORF briefly reviewed the history of the most recent Tysons Corner transaction. In September 2003, the APFC sold 6.5% of its ownership in Tysons to its partner, Wilmorite, for \$23.2 million. While both partners now own 50%, the Fund did not give up any control of the property.

TRUSTEE FRANK said a real estate report that shows the sales price of properties, the gain or loss on the sales, why it was sold, and if the returns were in line with expectations would be more useful to the Board.

CHAIR BRADY observed that the APFC has had essentially the same real estate advisors for a long time, and the advisors each have their own specialties. It is important to describe each advisor's role, and how and why the Fund is invested in each property type and geographical area. The Board needs to also understand the considerable fees involved in real estate, and what accounts for the gains and losses in the portfolio.

TRUSTEE RENKES said that at a Real Estate Committee meeting he would like to hear how other large public funds manage their real estate allocation.

CHAIR BRADY added that the Real Estate Committee should address the Fund's minority positions in properties. He preferred to have total control over assets where there are partners.

MR. STORER stated that the Fund has been evolving to 100% ownership of many properties, but it continues to have partners for very large assets like Tysons Center.

TRUSTEE WOHLFORTH requested a one-page summary of the entire Tysons Center transaction.

MR. STORER said that staff prepared an internal report in October that identified the managers and any issues, and he would provide that to the Trustees later in the day.

There was a brief exchange about scheduling the next Real Estate Committee meeting around the December 4, 2003 Board meeting in Anchorage. CHAIR BRADY requested that all Board members attend that committee meeting, if they are available. TRUSTEE RENKES indicated that he was previously scheduled to attend the National Association of Attorneys General annual meeting in Washington, D.C., that week.

Fixed Income

MR. SHAFER, Manager of Fixed Income Investments, stated that bonds continue to hang in there, and the BBB sector has produced an excess return over comparable duration Treasuries that is greater than expected from their duration alone (twice the excess return of anything in any other year on record). He added that BBBs are the least creditworthy within the investment-grade universe of bonds. Mortgage bonds have done about the same as the Treasury index for the quarter.

MR. SHAFER said there is a sense that interest rates are about as low as they can go, and most economic reports are supportive of a recovery. The bond market experienced a correction in late spring, when there was a hard sell-off of 10-year Treasuries, but they have been hovering in the range of a 4.6% interest rate since then.

TRUSTEE FRANK asked if the portfolio would experience a capital loss over the next year or two if interest rates rise. MR. SHAFER confirmed that the bond portfolio would decline from its present value, although there are some unrealized gains that would be absorbed first.

Further responding to TRUSTEE FRANK's question about holding bonds to maturity, MR. SHAFER said staff manages individual bond holdings in response to the opportunities (or lack thereof) that they see in the bond market. Each transaction triggers an income gain or loss in the portfolio, and sometimes it is neutral.

MR. STORER commented that until a few years ago there was never a negative return for the bond indices: even through the high inflation period the income stream was enough to offset against the loss in the bond portfolio. His assumption, absent something dramatic, is that there will be a more erosional approach to the pricing, and there will be some positive return based on the income stream.

MR. SHAFER said the hope is that what is bad for bonds will be good for the other asset classes in the overall portfolio, in much the same way that bonds have cushioned the decline in equity prices over the last three years. If stocks do well enough and increase in value, then rebalancing the portfolio would take advantage of buying bonds at a lower price.

Referring to the preliminary October 31 performance report, TRUSTEE WOHLFORTH noted that APFC's internally managed portfolio returned 8.49% for three years compared to the Lehman Aggregate Index at 8.36% and outperformed the two external fixed income managers.

TRUSTEE FRANK said he accepted that the Fund does not market time and, therefore, is not selling its bonds when interest rates are low, but he needed more education on the value of that policy. He acknowledged that market timers tend to have a terrible record, but he hoped a further explanation of this topic would be on a future agenda.

TRUSTEE WOHLFORTH remarked that staff's view of the market has been that interest rates are going to rise, and that economic view has, to some extent, driven the fixed income investment philosophy. In that regard, management of the in-house bond portfolio is not strictly neutral on market timing. MR. SHAFER said rising interest rates would help credit bonds and result in a flattening of the yield curve, so staff has positioned the portfolio to take advantage of that. However, sharply rising interest rates would hurt the bond portfolio, despite the defensive moves.

MR. STORER stated that the most successful funds have been the most disciplined and stayed the course. He suggested that Messrs. Bufferd and Maynard might share their views on market timing at the "Investment Advisors Observations" tomorrow morning. Further, the asset allocation work next spring will provide insight into how to adjust the Fund's portfolio, and the Board's exploration of hedge funds will explain another alternative to fixed income.

ALASKA CERTIFICATE OF DEPOSIT PROGRAM

MR. STORER said there are changes in the banking industry in Alaska, so it is a good time to review the Alaska Certificate of Deposit (CD) Program.

CHAIR BRADY disclosed that he was a director of the National Bank of Alaska for years and participated in the sale of that bank to Wells Fargo. He currently sits on a non-voting advisory board. MR. STORER clarified that staff initiated this review of the Alaska CD Program, not the chairman.

APFC Director of Finance, CHRIS PHILLIPS, reviewed staff's memorandum in the board packet, beginning with a history of the Alaska CD Program established in 1984. Simply explained, financial institutions can call APFC and ask the Fund to buy a CD from them. There have been several changes to the program over the years, the latest in early 2002 by Board resolution 02-01. She reviewed the purpose of the program to advance the Alaska economy, the financial institution eligibility criteria, collateral requirements, and CD rates.

MS. PHILLIPS reported that Wells Fargo Bank Alaska advised the APFC that it would be changing its charter in the next few months in a way that will make it ineligible to qualify for the CD Program under resolution 02-

01. Most recently, Northrim Bank and Wells Fargo Bank have been the primary participants of this program. This seemed a good opportunity to review several aspects of the CD Program again: (1) written confirmation from the Alaska financial institution senior management on the use of borrowed funds to further the Alaska economy; (2) eligibility requirement that Alaska financial institutions be headquartered in Alaska versus offices in Alaska; and (3) reporting requirements for the capitalization and financial ratio requirements.

TRUSTEE FRANK asked why the smaller banks did not participate in the CD Program. MS. PHILLIPS replied that it is currently cheaper for the banks to borrow funds from the Federal Home Loan Bank at any maturity without having to physically provide collateral. Also, banks have plenty of money on deposit to fund their customers' loan requests. MR. STORER added that the program was never designed to be the first source of funds for Alaska banks but to be an alternative source.

Responding to TRUSTEE RENKES, MS. PHILLIPS explained that all cash in investment managers' accounts sweeps into an internally managed short-term account. Part of this cash pool is used to fund the CD Program, which has a \$300 million allocation, although the loans to banks never approach that total. At October 31, 2003, the program had \$195 million in outstanding CDs.

TRUSTEE CORBUS asked if the financial community has been queried for suggestions on if, and how, the CD Program should continue. MR. STORER indicated that staff's evaluation will result in recommended changes they believe are appropriate, and the Alaska banks will be asked to comment on those proposed changes.

TRUSTEE WOHLFORTH commented that at times program participation is ho-hum, but when there is a money crunch the Alaska banks are happy the funds are available to borrow.

Referring to the abundance of capital available, TRUSTEE FRANK suggested raising the CD rates slightly so that banks only use the program when they really need it. TRUSTEE WOHLFORTH indicated he supported that idea.

MR. STORER said one question to ask financial institutions is what would be the impact of discontinuing the CD Program. TRUSTEE HUDSON agreed, saying he wanted to know if the program was helping Alaska businesses and the economy.

TRUSTEE RENKES commented that the new private equity program might potentially have a much greater economic impact in Alaska than the CD Program currently does.

MR. SHAFER recommended, if the program is terminated, that it be phased out over a six-month period so the \$200 million currently outstanding in CDs could be gradually reinvested into other fixed income assets.

MR. STORER stated that staff would contact Alaska financial institutions and report their comments at a future meeting.

TRUSTEE CORBUS disclosed that he owns stocks in most Alaska banks.

REPORTS OF STANDING AND AD HOC COMMITTEES

Audit Committee

Committee Chair WOHLFORTH stated that the August 29, 2003 minutes were included in the board packet. The next committee meeting has been rescheduled to immediately following recess of the Board meeting later today.

Private Equity Search Committee

Committee Chair CORBUS reported that the committee (Brady, Frank and Corbus), plus Trustee Wohlforth, met by teleconference about two weeks ago with Callan Associates, the consultant assigned to conduct the private equity manager search. Eighteen firms were invited to submit proposals, and Callan narrowed that list down to seven for the committee to consider. After reviewing Callan's analysis on each firm, the committee selected three finalists to make presentations at the December 4 Board meeting: Abbott Capital Management, Pathway Capital Management, and Hamilton Lane Advisors.

TRUSTEE RENKES asked if there was any committee discussion about the ability and willingness of the firms to provide Alaska investment proposals. He added that he is concerned about finding a gatekeeper firm that is highly sensitive to Alaska opportunities and that will give the proposals the time and attention they deserve.

TRUSTEE CORBUS replied that the Alaska ability was not one of the rating criteria in the Callan analysis, and the subject did not come up at the committee meeting. He anticipated that the question would be asked of the three finalists at the December 4 meeting.

MR. STORER stated that some of the finalists have implemented successful state programs for other public funds within the scope of fiduciary responsibility. Further, the emphasis of the private equity

program should be quality over quantity.

TRUSTEE FRANK inquired if there was any research on whether the demand for private equity investing is being met in Alaska. If no such data is available, he felt a professional analysis should be undertaken so the Fund would have a benchmark against which to assess the private equity manager that is selected. TRUSTEE WOHLFORTH indicated that there was a published economic and financial analysis of the Polaris fund, which was sponsored by AIDEA (Alaska Industrial Development & Export Authority).

MR. STORER said he would explore what data is available. He added that when he was chief investment officer at the Department of Revenue, and the Alaska State Pension Investment Board began a private equity program, he expected people to approach him about investments in Alaska but no one did. Part of the reason may have been that there was no shortage of capital during the 1998-1999 period.

MR. MAYNARD said that the State of Idaho has been trying with some success to implement a venture capital program in the state. A large element is educating potential entrepreneurs and potential capital sources about how institutional private equity programs work.

TRUSTEE WOHLFORTH agreed with Trustee Renkes that now is the time to look at the Alaska venture capital landscape and learn what has been done, what is currently available, and what role the APFC private equity manager could play in this area.

TRUSTEE RENKES asked the consultant if any private equity candidates expressed a willingness to put extra effort into managing an in-state portfolio. MR. O'LEARY said no, that the presumption was that the oversight manager would invest in partnerships, not in individual investments. Since there have been no Alaska-based partnerships, that was not a criteria. What was an important and related criterion was experience working with public funds, because every major public entity is confronted with the issue of investments in their state. All three candidates are very experienced with that issue. Some of what has been referred to today would be outside the scope of the proposals the firms provided, but it does not mean they couldn't do it.

MR. MAYNARD stated that while the gatekeeper will not be talking to individual business people, they could help put together general partnerships in the state to meet the institutional investment criteria.

TRUSTEE RENKES indicated he would like to see more information on the in-state aspect of the Idaho private equity program at a future meeting.

TRUSTEE HUDSON commented that the Fund's concentration should be on making money and not to get too deeply involved in trying to channel money to perform specific public purposes.

MR. STORER said the statutes specifically say that the Fund should invest in Alaska as long as the expected return and the risk profile are equal to alternative choices. Embedded in that is direction to heighten the interest of investment relationships so that they take the time to learn more about Alaska and find those opportunities.

MR. STORER added that when Mr. Shafer pays due diligence visits to the three finalist private equity firms he will inform them of the Alaska investment criteria so they can give informed responses at the December 4 interviews.

TRUSTEE WOHLFORTH suggested making available to the finalists any research that has been done on Alaska investing.

Brief recess from 3:47 to 3:55 p.m.

INVESTMENT ADVISOR CONTRACT RENEWAL

MR. BUFFERD excused himself while the Board took up this item.

MR. STORER stated that the investment advisors serve staggered three-year terms. The contract for seat three, held by Allan Bufferd, expires January 31, 2004. Staff recommends that Mr. Bufferd be reappointed for another three-year term.

TRUSTEE WOHLFORTH moved that the Board reappoint Allan Bufferd to another three-year term as an APFC investment advisor (to January 31, 2007).

TRUSTEE FRANK seconded.

TRUSTEE WOHLFORTH inquired about the pay and how often investment advisors are required to attend meetings. MR. STORER said that attendance is rotated so that at least one advisor attends every board meeting, and all three are at the February meeting for the asset allocation discussion. They may be invited to other meetings as necessary, to provide expertise on a particular topic. The pay and travel reimbursements total about \$25,000 a year.

TRUSTEE RENKES asked why there are three advisors. MR. STORER explained that by statute the Alaska State Pension Investment Board is required to have between three and five investment advisory members, and that board has historically had three. His experience is that three advisors provide adequate guidance, in addition to a general consultant. The point is for the advisors to attend meetings often enough to understand the board and the issues. One Fund advisor has expertise in academia and the endowment area, one is a practicing chief investment officer, and the third is a former principal of a money management firm.

TRUSTEE HUDSON asked if Mr. Bufferd served as an advisor to other funds. MR. STORER said Mr. Bufferd just relinquished his advisory position on the Massachusetts Public Retirement System, but he was not aware if he was currently advising any other public funds.

On a roll call vote, the motion passed unanimously, 6-0.

MR. BUFFERD rejoined the meeting.

ADOPT FY05 BUDGET

APFC Chief Operating Officer, BOB BARTHOLOMEW, stated that the Board reviewed details of the Corporation's FY05 draft budget at the September 5 meeting. Since that meeting, the Office of Management and Budget (OMB) has announced that there will be a significant increase in employer-borne costs for the retirement system -- unemployment insurance and terminal leave. The cost to the Permanent Fund's personal services budget to cover the increased employer costs is approximately \$151,000. OMB has tentatively approved that increment to the Fund's operating budget, but the final decision rests with the Board. The Board can either increase the overall operating budget for those fixed cost increases, or keep the budget the same and direct staff to make adjustments in other line items. Increasing the operating budget to \$6,994,900 will shrink the overall operations decrement to \$16,000 from the previous year.

TRUSTEE WOHLFORTH moved that the Board adopt a corporate operations budget request unit (BRU) of \$6,994,900 and adopt an investment manager and custody BRU of \$41,430,000.

TRUSTEE FRANK seconded.

There was a discussion about the \$203,500 in the proposed FY05 budget for the public information program and whether there will be enough to promote the POMV proposal if the legislature grants the authority to do advocacy. MR. BARTHOLOMEW said the committee would be coming up with an estimated cost for a statewide POMV educational effort over the next two board meetings. Late February or early March is the cutoff for making recommended changes to the proposed FY05 budget.

The roll was called, and the motion carried unanimously, 6-0.

RECESS

CHAIR BRADY recessed the meeting for the day at 4:18 p.m.

Thursday, November 13, 2003

RECONVENE

CHAIR BRADY called the meeting back to order at 10:53 a.m. on Thursday, November 13. Trustees Hudson, Frank, Wohlforth and Brady were present. Trustees Renkes and Corbus, both State commissioners, were absent and excused to attend a meeting in Anchorage.

HEDGE FUND PRESENTATION

BRYAN WHITE and LARRY KOHN of Quellos Capital Management gave an educational presentation on absolute return strategies, using their fund of funds as an example. Quellos does not invest in directional strategies because they believe absolute return strategies should provide a positive return in all market environments. Absolute return strategies should not be correlated to the stock market, the bond market or foreign currency markets.

MR. WHITE explained that hedge fund managers have very limited exposure to equity market risk and are relatively indifferent to whether the S&P 500 is going to go up or down. A large part of their risk comes from equity market volatility, credit spreads, the issuance of securities like convertible bonds, the installed base of distressed securities, and the amount of merger and acquisition activity in the capital markets. Hedge funds take the greatest portion of risk on whether merger and acquisition deals are approved, or whether a distressed debt company is going to be restructured. This risk structure is quite a bit different than it is for traditional equity and fixed income managers.

MR. WHITE illustrated how hedge funds have done during different periods of market stress since September 2002. While the S&P 500 Index monthly returns bounced up and down substantially between -10% and +10%, the hedge fund returns were very stable. MR. KOHN showed the

same pattern over a longer time period covering catastrophic events since the market crash in October 1987.

MR. KOHN stated that the spread between the best and the worst managers of absolute return strategies is enormous. So unlike the fixed income and equity asset classes, the manager selection decision in alternative investments is critical.

MR. WHITE reviewed three disciplines or investment philosophies of absolute return strategies: relative-value, event-driven, and hedged-directional. In relative value hedge fund managers are looking at the relative value between two securities: for example, United Airlines versus American Airlines, or a convertible bond versus the underlying stock. But generally the manager has little to no view as to the value of one specific security and is interested only in the value with respect to another security.

The event-driven area is where situational analysis is applied. Basically the history affecting a particular corporation or security is typically thrown out, and the current circumstances are analyzed further. That happens when companies go into bankruptcy, so their traditional earnings growth rate is less relevant. Another example is if a company is the subject of a merger proposal, friendly or unfriendly, their EPS growth rate tends to be less relevant. But whether the Department of Justice is going to grant anti-trust approval becomes a predominant causal factor in the price of that security.

The hedged-directional is the closest to traditional investing. This is where a manager would take a view as to the direction of a security. A hedge fund manager would hold a stock long if they thought that it was going to increase in value or sell a stock short if they felt it was going to decrease in value. Managers can do that in the equity markets and increasingly in the fixed income markets (credit long and short bets). In this general hedged-directional universe there are also macro managers who take a view as to the direction of a currency, or market-timing bet on the S&P, or interest rates. Dedicated short selling is also a directional strategy.

MR. WHITE said there are about 5,000 active hedge funds today. At least two-thirds are in the hedged-directional area, with much fewer being in the relative-value and event-driven area. The breakdown is less biased by capital, because some of the larger funds actually are in the relative-value and event-driven area, while many of the smaller hedge funds are in the hedged-directional area.

CHAIR BRADY asked if the hedge fund asset class is SEC (Securities and Exchange Commission) regulated. MR. WHITE said it always has been for

things like fraud and conflicts of interest, but the SEC is re-examining their regulations with respect to hedge fund activities. What has been outside the scope of the SEC is that hedge fund managers are not investment advisors according to the 1940 Investment Advisor Act. So there are record keeping issues and other things that hedge funds do not need to comply with. The staff of the SEC put forth some views a month ago recommending that hedge funds be required to register as investment advisors.

MR. WHITE agreed with MR. O'LEARY that over the last few years an increasing number of hedge fund advisors are registered. Quellos is a registered investment advisor, as are most fund of funds managers. Hedge funds have been primarily the purview of high-net-worth individuals, who were less concerned about registration. Today there is a commercial interest to have a hedge fund register because it allows them to take pension money in excess of 25% of their capital.

MR. O'LEARY observed that the way a hedge fund manager implements any of the absolute return strategies that Mr. White described could be on a risk continuum from very conservative to very aggressive.

MR. WHITE next delved into the details of strategies used in each of the three absolute return disciplines (relative-value, event-driven, and hedged-directional). He covered the risks and rewards of each strategy, examples of favorable or challenging market environments for each, and why inefficiencies exist in that particular investment vehicle. He noted that convertible bond arbitrage or convertible hedging is one of the oldest strategies in the hedge fund arena. Each strategy has its own acceptable or appropriate level of leverage that is commensurate with the risk of the asset.

Responding to a question from TRUSTEE FRANK about transaction costs, MR. WHITE stated that many hedge funds use commissions to pay for different aspects of their business. Hedge funds actually generate a lot of commission dollars, relative to traditional managers, and soft dollars can pay for research and systems. Those soft dollars tend to be generated predominantly in the hedged-directional area (stock-picking area where people are taking directional views on stock). The relative-value area is very sensitive to transaction costs, and people cannot afford to earn soft dollars to pay for research, etc. It is more straightforward and transparent in terms of how the investment operations work.

During MR. WHITE's description of distressed securities as a category of the event-driven discipline, MR. O'LEARY noted that this area appears to cross over into the private capital arena. He asked if there was a distinction between the types of things that are fair game for hedge funds

and those that attract private equity managers. MR. WHITE said that today both hedge fund managers and private equity managers will be playing in the same securities in the distressed arena. There has been an historical evolution of the distressed market: corporations used to have simplified capital structures, they went bankrupt, and private capital could buy the assets at a discount. It has become much more complex, and distressed corporate bonds are more liquid and trade easily. That is why there is much more hedge fund activity involved.

MR. O'LEARY asked how a fund of funds manages the concern that there is too much money going into strategies that are inherently limited in size. Further, he asked about confidentiality in a huge universe of strategies and little ability to see the underlying transactions.

Regarding capacity, MR. WHITE said the question is whether there is a cyclical trend in the returns to hedge funds, or are returns trending lower on a permanent basis. Last year was a poor year for returns, but this year is a good year. However, Quellos believes there is probably a very gradual erosion of returns that can be earned in the hedge fund area. But if a hedge fund manager consistently returns 8% over Treasury bills, and that outperformance gradually slips to 7%, it is still a significant accomplishment.

MR. KOHN stated that one risk as more money comes in is managers taking on more risk to get the returns that investors expect from hedge funds. All the absolute return strategies have to be overlaid with risk controls to make sure managers are not taking on risks they should not be taking.

MR. O'LEARY asked how public funds could determine whether firms like Quellos are reaching for returns, if the ability to get information is limited. MR. KOHN said they have been able to give clients enough information about the portfolio to satisfy them. What good fund of funds managers must do is give clients the output data of the risk management.

MR. O'LEARY stated that most times there is enough embedded trust in the relationship between the client and the intermediary that it works. It is the situation where the client wants to independently verify that is the challenge.

MR. WHITE replied that transparency is much greater than people initially believe. Information such as a list of hedge funds invested in can be given to public fund trustees but is not public information. Probably 80% of the information is not that sensitive, but it is the 20% that is in the clients' best interest to keep confidential.

CHAIR BRADY thanked Messrs. White and Kohn for their presentation and called a lunch recess at 12:12 p.m. The meeting came back to order at 1:37 p.m., and the chair reordered the agenda to hear a status report from the Attorney General's Office next.

UPDATE ON SECURITIES LITIGATION MONITORING

Assistant Attorney General MIKE BARNHILL stated that the Department of Law is almost finished centralizing the monitoring of securities litigation within the department on behalf of the whole state. The first step was to retain a securities monitoring consultant, Investor Responsibility Support Services. The consultant downloads all the state's transaction data, and whenever there is a securities class action lawsuit filed, they calculate the damages under different formulas. The state can then make decisions about whether to become actively involved in litigation. The AG's Office has calculated the losses on an aggregate basis for all of the state's funds in which there is exposure.

MR. BARNHILL said there are two formulas that are most important for evaluating involvement in securities litigation: the recognized damages formula, and the recognized losses formula. The recognized losses formula is used only for the purpose of determining who should be the lead plaintiff in a securities class action. This formula calculates the loss on the securities bought and sold during the class period, and ignores any securities held prior to the class period and sold during the class period.

MR. BARNHILL reported that the AG's Office has engaged in a request for proposal process to hire a law firm for the AOL Time Warner litigation. Three finalists were selected from the eight responses, and the interview process should be completed next week. The Attorney General would like to file litigation in Superior Court in Juneau in the near future.

Part of the memorandum of understanding the AG's Office entered into with the APFC and ASPIB is an agreement that the AG's Office will actively monitor any case in which the state's losses exceed a million dollars. Seventy letters were sent to the class lawyers in those cases about a month ago, asking them for an update, and there are 20 responses so far.

MR. BARNHILL said the final step in the process is to do a more critical evaluation of the bigger cases on the list to decide if there is any merit to actively engaging in litigation. The AG's Office may issue a solicitation for lawyers to give their advice on what they think the state's options are in these bigger cases.

MR. BARNHILL stated that studies have shown that the average settlement in a securities class action last year was something like 2.3% of losses. That is why there has been a more recent effort to increase the

recovery through creative litigation tactics. An example is the state opting out of the class action in an attempt to get a better recovery from AOL Time Warner.

TRUSTEE WOHLFORTH requested a separate calculation of the Fund's recognized damages, apart from ASPIB's. MR. BARNHILL agreed to provide that. He added that just because a case is filed does not mean it has merit.

TRUSTEE WOHLFORTH stated that if Mr. Barnhill thinks any of the cases might generate publicity for the APFC in the next month or two the Board should get another update report.

MR. MAYNARD said the securities litigation area is complex and can have unanticipated consequences, so it is important to do it right. He believes the Alaska AG's Office has set up a good system.

CONTEMPORARY HEDGE FUND ISSUES

MR. STORER stated that this is part of the trustee education on hedge funds. McKinley Capital has been invited to the December 4 board meeting to make a presentation on a long/short strategy that they run. After that, he will poll the Trustees to discern their comfort on the subject of hedge funds and if there is anything else to address. Then the Board can make a decision on how to proceed.

MR. O'LEARY distributed a copy of his slide presentation, entitled: "Hedge Funds: What Trustees Should Know." He indicated he would be discussing the return enhancing strategies of (1) separating alpha and beta, and (2) leverage.

He showed a graph of Callan's five-year projections for each asset class, where the projected return is higher as the risk increases. The intent of asset allocation is that because assets are not perfectly positively correlated there is some benefit, in terms of risk reduction, by combining assets. Hedge funds operate in the continuum of existing asset classes, and in the process of using leverage they create an opportunity to leverage alpha (return in excess of the risk accepted).

MR. MAYNARD said he did not agree that hedge funds are a separate asset class, that it is actually doubling down on active managers.

Spurred by CHAIR BRADY's questioning about Callan's five-year projection chart showing the median return for hedge funds at only 6%, MR. MAYNARD reminded Trustees that the Quellos representatives said that the premium return achieved from absolute return strategies comes in selecting upper quartile managers.

MR. O'LEARY reported that Callan's hedge fund of funds database shows a median return of 6.22% for the three years ended September 30, 2003. This illustrates that if you are going to participate in this area it is important to engage a manager that can identify and get you into top-flight hedge funds.

MR. MAYNARD suggested asking two separate questions: Would you do this if you only got the median return? Would you do it if you got the top quartile return? That turns the focus to, can you get top quartile type funds, and with a degree of confidence that overcomes the admitted potential problems in the area. Most people say that absolute return strategies are not worth doing for median returns. While there is a broader opportunity set to potentially make money, there is a broader opportunity set to lose money, too.

MR. O'LEARY said the big issue for the Board is what sort of return would it take to have this category of management be worthwhile to the Permanent Fund. If Trustees want a return greater than the public equity markets, then it means an approach that is very different from that offered by Quellos or Crestline. They are both top-flight firms that are striving for returns somewhere between stocks and bonds but at a very low risk level. Also, they strive for return patterns that are different from both stocks and bonds.

MR. O'LEARY explained that the Capital Asset Pricing Model indicates that by borrowing money at the risk-free rate one can augment returns at lower expected volatility than obtained from a portfolio with more equities. Extending that concept into absolute return strategies, occasionally there are arbitrage opportunities between owning the stocks that constitute the S&P 500 and the futures market for the S&P 500, which is highly liquid. So if the futures are undervalued relative to the stocks, somebody could sell the stocks and buy the futures, and that spread would be closed. So the enhanced return strategies are a combination of manager skill (alpha) and leveraging that alpha.

CHAIR BRADY commented that leverage is not a bad word, that a common example of leverage is debt in relation to equity in a house.

MR. BUFFERD remarked that all institutions have accepted leverage in their real estate portfolios, but it is less prevalent in the securities area. One thing to be explored regarding the use of leverage in hedge funds is the type of protection that may be provided by the legal structure of the management organization. Also, the alpha element, whatever the mispricing may be, is very, very small in general. Leverage is almost necessary in the hedge fund arena to get enough return that institutional

investors feel it is worthwhile after paying the transactional and manager costs of the process.

MR. MAYNARD stated that when leverage in a part of the portfolio is brought back to the entire portfolio it has the exact same impact as selling a bond. So an institution has to be careful about unintended consequences of leverage. For example, if a long/short manager buys GM and shorts Ford, and the portfolio has a long-only manager that is buying more Ford, it cross-cancels.

MR. O'LEARY said there are fine hedge fund organizations that have produced very attractive results. That has caused many institutional investors to seriously consider an area in which major endowments and foundations have been quite active for a long time.

MR. O'LEARY reviewed the uncertainties in the hedge fund world:

- Fraud - without custodian, abuse of investor faith possible.
- Opacity - poor transparency reduces ability to see danger.
- Illiquidity - significant exposure to poorly traded instruments.
- Leverage - magnified gains can lead to magnified losses.
- Evaluation - weak benchmarks for assessing hedge funds.
- Diminishing returns - effect of too much money chasing capacity-constrained opportunities. Investors in this area five years ago may have already used up the capacity for the people who produced the returns. So investors in a new fund being offered are betting that the managers will be able to identify other new firms that have capacity.

Regarding capacity, MR. BUFFERD said there is a lot of tension in the system about getting access to top quality managers. Further, if the active hedge fund manager is dealing with enormous demand for a particular arbitrage spread, a large amount of money pouring into that space has a way of collapsing the opportunity. So the dynamic at work is investors trying to get themselves positioned in the opportunity set but not necessarily sharing the nature of that position.

CHAIR BRADY asked if the Fund would be late in getting into this investment area, should the Board decide to go ahead next year. MR. O'LEARY said no, only relative to investors who have been doing it for years. If the Fund has a reasonable set of expectations there would be enough opportunity in the quality fund of funds oversight managers to implement a program.

MR. O'LEARY said there are public funds that have gotten into the hedge fund arena, but there are serious implications with a public fund participating. The Board needs to pre-experience the Monday-morning quarterbacking and the types of questions that will arise and be

comfortable with how to address them. One example is that Quellos, which made a presentation earlier, will not tell the Board officially for public disclosure what hedge funds they invest in. Trustees have to decide if that disclosure is a very important need, as well as disclosure of the performance of each of the funds and the underlying transactions of the funds.

MR. MAYNARD stated that disclosure is an issue he cannot get past for the Idaho Fund, but that fund does not have to reach for those extra returns. He would get fired for something bad happening that he did not know the details of, because of the potential headline risk, and the constituents have to believe the board and staff have control. Regarding timing, he said if APFC decides to invest in hedge funds next year it would not be too late in the game.

TRUSTEE FRANK asked how the Board knows if the reported returns are accurate. MR. O'LEARY replied that most of the leaders in this area have some form of limited partnership that is audited regularly, and the funds in which they invest have presumably been audited. In the end, it is whether the investors have realized the results that have been represented.

TRUSTEE FRANK commented that there is a lot of opportunity to report return information differently.

MR. MAYNARD said the problem of performance measurement is more difficult in the private equity area than in hedge funds, because absolute return strategies deal with marketable securities that are daily priced.

TRUSTEE WOHLFORTH suggested that if the Fund is going to invest in hedge funds through a reputable fund of funds manager it should educate the public in advance about the differences from traditional investments.

MR. O'LEARY said if he were responsible for managing a substantial amount of money he would feel comfortable investing in hedge funds. But the questions for this Board are, whose money is it, what are the pressures that are going to be brought to bear on the stewardship of that money, and are Trustees comfortable in addressing the questions.

Regarding the timing for entering the hedge fund arena, MR. STORER observed that the Fund would have no control over the amount of money entering the field following the Fund's entry. He wondered about oversight managers closing their fund of funds when they have reached capacity.

MR. O'LEARY stated that a good hedge fund manager has an incentive to

close at the optimal amount of capital: they make 20% of the profit in addition to the management fee. That incentive may not be at work at the fund of funds level because the oversight manager typically will be getting an asset-based fee.

MR. BUFFERD agreed there was an important distinction between capacity at the hedge fund level versus capacity at the fund of funds level. He added that fees are not trivial in this area because of the double layer of management. Running a hedge fund program directly raises a different set of issues, such as paying knowledgeable staff enough to keep them.

TRUSTEE HUDSON raised the question of whether the Fund has enough skills and resources to understand the fast-paced nature of hedge fund investing. MR. O'LEARY said that because enhanced return strategies cover such a broad array of different approaches, and because the Fund would operate under negotiated terms, the Board would need to understand how the program worked. He would not advise the Board to go near the hedge fund area without a skilled intermediary who is acting on the Fund's behalf.

MR. STORER indicated that staff agreed with that statement. Staff would have the skill set to evaluate and monitor a hedge fund program, but not in the foreseeable future would staff be able to manage a program internally.

TRUSTEE FRANK said he would find it instructive to learn more about what goes wrong in absolute return strategies. He noted that Mr. O'Leary has explained that the volatility in hedge funds is low, but it is common for the public to equate hedging with high speculation. He is concerned about communicating effectively with the public about what hedging would accomplish in the overall portfolio.

MR. BUFFERD cited the Canary hedge fund as an example of what could go wrong. That fund probably would not have discussed with anybody the strategy to purchase at closing price after the market had closed, so no amount of due diligence would have found that out. It raises the question of what level of transparency the Board requires.

TRUSTEE WOHLFORTH commented that it must take a high degree of integrity to operate honestly in the hedge fund business because managers have to seek every spread opportunity they can find, and there are some that are going to be marginal. A manager would need good solid institutional integrity to say no.

MR. O'LEARY said that many would argue that the major institutions are exactly the wrong people to be the vendors of these types of things because they are inherently conflicted.

The Chair called a brief break from 3:03 to 3:16 p.m.

INTERNALLY MANAGED FIXED INCOME

MR. SHAFER made a presentation on how the APFC fixed income staff manage the Fund's largest portfolio, valued at \$7.3 billion. He first covered the philosophy statement: Bonds will move with the overall market direction, but this is not a monolithic asset class. The range of investors and variety of issues is therefore large enough to permit investment staff to find low-risk opportunities to capture some excess return over time.

MR. SHAFER reviewed the resources and services available to help manage the fixed income portfolio.

MR. O'LEARY stated that the majority of fixed income firms in Callan's database have fewer assets under management than the APFC internally managed portfolio.

MR. SHAFER described the integral points in the investment process:

- (1) Deviate only modestly from the U.S. Lehman Aggregate benchmark but not be an index fund; take advantage of a simple sector approach.
- (2) Overweight intermediate non-treasuries for income, and get duration from treasuries.
- (3) Mitigate risk of non-treasuries through diversification, research, and proactive sells. The largest holdings tend to be in major (S&P 500) credits. Approach the mortgage-backed securities market generically and do not try to add a lot of extra alpha.
- (4) Overweight companies and sectors on bad news, sell for gains after turmoil subsides. Do the opposite on good news.

MR. MAYNARD reminded Trustees that they not only oversee the entire Permanent Fund, they act as the board of directors of the internally managed bond shop. He encouraged Trustees to look at future bond portfolio reports against each point in Mr. Shafer's description of the investment process to see if they are holding true.

TRUSTEE WOHLFORTH asked for the dollar amount held in corporates. MR. SHAFER said just over \$2 billion, and that dollar weighting is about 105% of the index.

MR. O'LEARY noted that within the credit index the largest issuer concentration is roughly 3%. He inquired about the maximum the internal

portfolio would be overweight an issue relative to the index. MR. SHAFER said it could be quite large because some issues are a very small percentage of the index. The policy is 3% of the entire portfolio, and the internal rule of thumb is to buy 1% of the corporate index. The corporate index is 26% of the portfolio, so this means one-quarter of one percent of the index, against a 3% policy limit. Dodge & Cox, which has a great record in bonds over the years, will put 3% of the entire portfolio in a corporate bond issue, but they do primary research on a company. Also, their equity analysts are the same as their fixed income analysts, and they like a company from both perspectives. The APFC does not take that kind of issue-specific risk. On no more than a dozen credits staff will do 2% of the corporate index, or half of one percent of the portfolio. A year ago when there were a lot of issue-specific problems in corporate bond land, one of the things that helped the in-house portfolio was this diversification approach. When other managers got in trouble with a single issue, it tended to be a much larger percentage of the portfolio.

MR. O'LEARY recalled that in the 4th quarter of 1999 Alaska Permanent Capital had a couple of percent in individual issues that were downgraded, and that accounted for a big underperformance in that quarter for them.

MR. STORER stated that the statutes require an investment-grade rating, and when credits fall below investment grade they must be sold from a portfolio. The Fund's "fallen angel" policy allows managers six months to liquidate a holding that has been downgraded below investment grade, giving a mitigating effect on price.

MR. MAYNARD asked if the basket clause would allow the Fund to hold a noninvestment-grade bond, thus relaxing the "fallen angel" policy and not penalizing a manager who otherwise would have to sell the bond. MR. STORER replied that he has thought about it but does not want to change the policy. The basket clause is limited so the Fund has to use it very carefully. The other reason is the complexity of using the basket clause to allow policy exceptions here and there.

TRUSTEE WOHLFORTH commented that some bond managers have really wanted to hang on to the downgraded credits. MR. STORER said that there is a penalty for soaring close to the sun. That is part of the manager contracts and the investment policy, and that risk should be embedded in the investment management decisions.

MR. O'LEARY said he has watched the internal bond portfolio closely for many years, and there have been changes in management approach. At one point the vast majority of the portfolio was a buy-and-hold portfolio with a small component that was traded. Then there was a period of much

more activity in the portfolio. He asked Mr. Shafer for his view on the amount of trading activity today.

MR. SHAFER stated that trading activity is down recently because the market has been directional. Investment staff did some selling around the time of the dividend funding, and they trade here and there as the risk/reward picture changes. Also, there are improving fundamentals in the economy that are making credit a safer bet. The in-house portfolio is starting to participate in mortgage-backed securities in the form of dollar rolls (TBAs: buy a mortgage and roll it over again before taking settlement on it). This creates turnover in the portfolio, but it does not change the risk profile.

TRUSTEE FRANK asked how many trades staff would normally do in a day. MR. SHAFER said one or two. Exceptions are when the Treasury holds quarterly auctions, at which time staff will often roll to the new benchmark issues. That could result in a trade of several hundred million dollars of a 5-year U.S. Treasury to buy the next Treasury issue.

Responding to TRUSTEE FRANK's question about the trading process, MR. STORER said staff watches how much activity is going to a single brokerage firm, in order to keep a number of trading relationships active.

MR. MAYNARD suggested reviewing mortgage TBAs at some point because that activity is an example of transportable alpha that Mr. O'Leary mentioned earlier. MR. SHAFER said the entire proceeds of dollar rolls are invested in 30- or 35-day U.S. Treasury bills.

Commenting that the U.S. may be going into a higher interest rate environment in the next couple years, TRUSTEE WOHLFORTH inquired if staff has considered buying TIPS (Treasury Inflation Protected Securities) again. MR. SHAFER responded that staff looks at TIPS regularly, and in retrospect, they missed a good opportunity to buy them. Having missed buying TIPS at the right time, staff is not inclined to chase the bonds and will wait for the next opportunity.

Referring to the point about overweighting on bad news and selling for gains when things improve, MR. MAYNARD said it could be seen as "trying to catch falling knives." He asked Mr. Shafer to talk about the risk controls in place to avoid holding too many WorldCom-type credits.

MR. SHAFER said that most of the bonds do not fail, and the internal portfolio deals with large companies -- it is rare that a large company goes broke quickly. While a small company may simply go broke, shareholders and investment firms will step in and demand management changes to a large company that is failing. New management opens up access to the

capital markets that are reassured by the changes, and the company can morph itself and move away from its risk.

MR. SHAFER explained for TRUSTEE FRANK the definition of investment grade as no lower than BBB- by S&P, at Baa3 by Moodys, and at BBB- by Fitch and the Dominion Bond Rating Agency. Ratings are lagging indicators: when a bond falls below investment grade it is often a recognition of events long past. But increasingly, rating agencies will act proactively and downgrade credits to send a message to corporations with weaknesses.

MR. SHAFER stated that the internal portfolio invests for income and not for price return. The portfolio produces \$500 million a year in coupon income. If interest rates go up, it is a good opportunity for reinvesting the \$500 million. Bonds are not exciting, but the market reprices itself in the reinvestment of risk, and over time bonds produce 3% real return.

Referring to the October 31 preliminary return numbers, TRUSTEE WOHLFORTH encouraged the APFC investment staff to keep up the good work.

SECURITIES LENDING

MR. STORER stated that the Fund operates a securities lending program through the Bank of New York. Mr. Bo Abesamis of Callan Associates, an expert in the area, was invited to provide some education on securities lending generically.

MR. ABESAMIS used a Callan slide presentation entitled "Securities Lending Primer" to illustrate his lesson. He said the Departments of Justice and Labor are trying to fix a 25-year-old Department of Labor ruling that allows securities lending for private pension funds subject to ERISA (Employee Retirement Income Security Act). Many public funds not required to follow ERISA use the spirit of ERISA as a guide for how to proceed with a securities lending program. The final comment letter from the Departments of Justice and Labor is due December 15, and he will forward it to the Fund.

MR. ABESAMIS said that securities lending is when an owner of a security agrees to lend the security to a borrower according to negotiated terms. Securities lending is a dynamic force in the industry. Lending is done to earn extra revenue, and there is always risk in securities lending, but there are ways to manage it. He noted that the only difference between hedge funds and securities lending is that everything is disclosed in securities lending, there is 100% collateral, and it is well regulated.

MR. ABESAMIS reviewed the regulatory issues, starting with the first securities lending transaction regulated by ERISA in 1981. He said that borrowers sometimes borrow in order to make delivery of securities they have sold but do not have yet, and the carrying cost in securities lending is a lot cheaper than going to the cash market.

MR. MAYNARD added that 80% of securities lending is for short selling: when people get the security they are shorting it, and they are financing the short by doing that. It is not legally a loan but rather a sale with a promise to resell back to the lender.

MR. ABESAMIS said that the lender no longer owns the security, the same as a sales transaction. But the difference is that the lender enjoys the economic benefits of ownership except for the right to vote proxies. The lender receives 102% collateral for the loaned domestic securities and 105% collateral for international.

MR. ABESAMIS reviewed the basic mechanics of borrowing securities to cover a settlement failure (5% of the market), to cover a short trading position (80%), and as part of an arbitrage transaction. The settlement category is expected to increase as the period to settle trades is shortened to T+1 in 2005.

MR. ABESAMIS said the biggest moneymaking securities lending portfolios are in international securities, using what is called tax dividend arbitrage in foreign markets. He reviewed who are the lenders and borrowers of securities and noted that the new U.S. tax act in May 2003 allowed institutional investors to compete with mutual funds and insurance companies in providing inventory for the marketplace. Because of reduced tax rates on dividends, public pension funds, ERISA plans and endowment/foundations suddenly had a 15% premium on what they could get for their securities, and mutual funds and insurance companies were basically taken out of the market. The biggest borrowers are broker/dealers and hedge funds.

MR. ABESAMIS discussed the reinvestment of the cash collateral. He said that because the APFC has a large inventory of securities the portfolio is highly lendable in a crowded marketplace.

MR. MAYNARD commented that the APFC's securities lending contract with its custodian, the Bank of New York, is unusual in that it guarantees the Fund protection against losses on the reinvestment of the cash collateral. MR. STORER added that because of the guarantee the Bank of New York operates the securities lending program very conservatively and is not aggressive in taking advantage of extended maturities with the collateral.

MR. ABESAMIS reviewed the four main types of risk in securities lending:

- (1) Borrower Default - the borrower fails to return the security on demand, due to financial difficulty or bankruptcy, Chapter 11, cannot find the security, or failure to deliver additional collateral after mark-to-market.
- (2) Operational Risk - if the lending agent fails to mark to market and collect the income, and risk from the T+1 straight-through processing environment.
- (3) Collateral Investment Risk - Failure to cover the rebate and the posted collateral furnished by the borrower. Exposure to rising interest rates in the cash collateral portfolios with a longer-weighted average maturity. The Bank of New York runs one of the shortest duration mismatches in the country - four days.
- (4) Currency Risk.

MR. ABESAMIS said that collateral can only be in U.S. cash, irrevocable letters of credit, and U.S. governments. The amendment under consideration would allow United Kingdom collateral, euros, non-U.S.-registered broker/dealers, and foreign subsidiaries of U.S. banks.

MR. ABESAMIS stated that Bank of New York has a \$500 billion lendable base and an average of \$200 billion out on loan on any single day. State Street Bank has \$1.6 trillion in lendable base and has between \$600-\$800 billion out on loan on any given day. The Bank of New York is the biggest government clearing agent of the Federal Reserve: it has an unbelievable utilization ratio because everybody comes to the BoNY or JP Morgan for U.S. government and U.S. corporate bonds. That is the underlying strength of the securities lending program.

MR. O'LEARY clarified that there is more supply of lendable securities than there is demand for loans. Part of the custodian's job is to get the securities out on loan.

TRUSTEE FRANK asked if that implies that the prices are too high. MR. O'LEARY said the demand is driven by other transactions, not by the cost of borrowing.

MS. PHILLIPS indicated that an average of \$4.5 billion of the Fund's

securities are on loan every day, of which roughly \$2 billion are Treasuries.

MR. ABESAMIS reviewed the historical 5-year average returns for securities lending by asset class. He noted that U.S. government bonds are highly lendable with a daily average of almost 90% on loan.

MR. STORER reported that the Fund's securities lending revenue was \$11 million two years ago, \$10.5 million a year ago, and then it dropped closer to \$7.5 million this year. There are years when certain types of securities have a greater value to lend, so the revenues go up and down from year to year.

In closing, MR. ABESAMIS stated that there is a lot of risk in securities lending, but the revenues are worthwhile if the program is set up right.

OTHER MATTERS

There were no other matters.

INVESTMENT ADVISOR COMMENTS

MR. BUFFERD said the investment advisors' ability to provide assistance to the Board can be enhanced by feedback. He encouraged the Trustees to pass on their comments and concerns to Mr. Storer.

TRUSTEE COMMENTS

There were none.

FUTURE AGENDA ITEMS

Items were mentioned during the meeting.

ADJOURNMENT

The Chair adjourned the meeting at 5:08 p.m. on November 13, 2003.

APPROVAL OF MINUTES

Carl Brady, Chair

Date