

ALASKA PERMANENT FUND CORPORATION
Regular Meeting of the Board of Trustees
February 5, 2004

Location of Meeting
Anchorage Marriott Downtown Hotel
820 West 7th Avenue
Anchorage, Alaska

SUMMARY MINUTES
Thursday, February 5, 2004

Trustees Present: Trustee Brady, Chair
Trustee Wohlforth, Chair
Trustee Frank, Vice Chair
Trustee Corbus
Trustee Hudson
Trustee Renkes (via telephone)

Staff Present: Robert Storer
Rick Shafer
Joyce Andrews
Laura Achee

Invited Participants Present: Michael O'Leary, Callan Associates
Kathy Porterfield, KPMG
Mike Barnhill, Attorney General's Office (via telephone)

Others Present: Theresa Nangle Obermeyer
Mike Burns

CALL TO ORDER

CHAIR BRADY called the meeting to order at 1:30 p.m.

ROLL CALL

All members were present at the time of roll call with the exception of Trustee Renkes who joined the meeting telephonically at 2:23 p.m.

APPROVAL OF AGENDA

TRUSTEE FRANK moved to approve the agenda. TRUSTEE HUDSON seconded.

There being no objection, the motion passed unanimously.

SCHEDULED APPEARANCES AND PUBLIC PARTICIPATION – None

CAPITAL MARKETS PRESENTATION

BOB STORER explained this is an opportunity to review Callan Associates Inc.'s capital market projections. This review occurs in February of each year in anticipation of a recommended asset allocation being brought to the Board in March.

MICHAEL O'LEARY with Callan Associates Inc. (CAI) stated there have been some minor adjustments from last year's capital market assumptions. Consideration will be given to determine what issues the Trustees believe are important to address before the asset allocation meeting in March.

The process begins with an evaluation of the current environment and economic outlook and whether CAI has a different stand than the consensus. This year there is no difference between CAI's outlook and that of the consensus. When the specific capital market projections are developed, CAI goes through a median number for each asset class, but actually forecasts a range of returns for each asset class and the interaction of each asset class with other asset classes.

The projections are formulated through a series of steps. CAI has a quantitative research group that prepares background material beginning in October/November. CAI also has an internal Client Policy Review Committee that looks at the quantitative information, asks that group to look at specific questions, argue with the group about the outcome of their analysis, and ultimately decide on a set of projections. This is an analysis of long-range projections. CAI always expects, at the median, stocks to return more than bonds and bonds to return more than cash. CAI is not simply extrapolating past relationships, but looks at a range of returns in each asset class and decides what is a comfortable return within that range. CAI considers what is the spread between stocks and bonds, what is the five-year inflation figure, and whether things have changed, such as the character of markets and the character of statistical relationships between one asset category and another. If it were possible, CAI would focus on major asset classes, but also does forecasts for emerging markets, absolute return strategies, private equity, and real estate. CAI has much less confidence in the projections in those other asset categories, with the exception of real estate, because the data is much more limited than for the major asset classes.

The objective for CAI's work is to develop a realistic forecast for each asset category so that, looking back in five years' time, the actual return for each asset category would have fallen within the predicted range. More importantly, CAI wants the combination of asset classes to produce a return that is accurate to the predicted range. CAI has been doing capital market projections for 14 years and in almost every case the results have been within the range. The ranges are big, for example, if 9% is expected from stocks but there is a 17% deviation, two-thirds of the time stocks would return 9% plus or minus 17%.

TRUSTEE WOHLFORTH understood this is a one-year segment of a five-year analysis. He remarked that stock prognosticators say it is likely in 2004 that large cap stocks will have higher returns and small cap stocks will not. He understood that kind of analysis would not influence CAI's projection. MR. O'LEARY replied that it would at the margin, but just as stocks would not be expected to return less than bonds in a five-year period, within stocks large cap stocks are expected to return more than small cap stocks because they are more volatile. He noted that the spread between small and large cap stocks could be wider or narrower. This year, CAI narrowed that spread because for the last five years small cap stocks have done so much better than large cap stocks and also because dollar weakness might be more beneficial to large cap, global companies.

MR. O'LEARY presented a comparison of calendar year returns in each asset category (broad market, large cap stocks, small cap stocks, international, domestic bonds, and non-domestic bonds), as well as a five-year average. He noted that 2003 pulled several of the stock indices into positive returns. He noted that this was the first time in a long time that international stocks meaningfully outperformed domestic stocks, which was largely attributable to the weakness of the dollar, which added approximately 10% to international stock returns. There was a large difference in performance between small cap stocks and large cap stocks during 2003.

MR. O'LEARY commented that CAI believes the U.S. recession was in fact an investment-led global recession; there was too much capital spending in several major sectors that was fueled by the ease of money to fund much of that activity and then the subsequent collapse of that activity.

TRUSTEE HUDSON asked how this would relate to an individual's personal activities. MR. O'LEARY stated that either the threat of job loss or actual job loss weakened people's confidence. There were significant

effects on typical families. The middle class manufacturing jobs were hit the hardest and are not likely to rebound significantly because of the global competitive advantage of other economies. MR. O'LEARY noted that deflation has not been a serious worry until this recession. Decreases in prices could have a cascading effect, given the amount of debt in the economy. A small amount of inflation is not bad in terms of the economy; it helps make changes in relative compensation easier to accept. The extent of monetary and fiscal stimulus was enormous and that contributed to preventing deflation and fueling the beginning of a recovery. The terrorist attacks of 9/11, corporate governance scandal, the war in Iraq, and the SARS scare all happened during a fragile time for the economy. Policy makers erred on the side of ensuring the economy did not spiral downward.

MR. O'LEARY stated the recession appears to be over and the economy is growing, but employment has not rebounded. Employment, in many cases, is a lagging indicator. As the economy begins to turn, the workweek typically lengthens, then the use of temporary help might increase, and there are ultimately employment gains. Business investment is still comparatively weak, although this was an area of optimism in 4th quarter 2003 and it seems that is changing. Inflation has been extraordinarily low at 1.9%. Interest rates are also extraordinarily low, in part because so much liquidity has been put into the economy and in part because investors were afraid of the stock market and transferred their money to less risky assets. Even with inflation at a low level, there is a negative real return on money that is invested in a money market fund. CAI has examined all periods where short-term rates were below inflation and, based on that analysis, CAI does not believe this will persist. CAI expects inflation of 2.6% over five years and short-term interest rates should average slightly more.

MR. O'LEARY stated that below investment quality bonds out performed most stocks in the 12 months from October 2002 to October 2003. This is an illustration of how investor attitude changed. Prior to that time there was fear of owning bonds of some major companies, particularly those that were rated below investment grade. As the economy began to show signs of recovery, people were willing to buy these bonds at a good price. Now the spread between below investment grade bonds and investment grade bonds has narrowed and the spread within the investment grade arena has narrowed. Throughout the recession consumers kept spending, in part by refinancing their mortgages.

From February 2001 to July 2003, 2.7 million jobs were lost in the U.S. In the third quarter of last year real GNP growth was up over 8% and was at 4% in the fourth quarter. TRUSTEE CORBUS asked if 2.7 million jobs would ultimately come back into the economy as the recovery cycle continues. MR. O'LEARY believed unemployment rates would decrease and jobs would be created. The challenge for the economy is the nature of the jobs that are created. Many manufacturing jobs that produced good incomes might not come back and they will have to be replaced by higher quality service industry jobs in order for those employees to feel as comfortable as they felt before. He remarked on the burgeoning manufacturing industry in China and the fact that those jobs are replacing manufacturing jobs in the United States. He noted this trend is expanding into technology as well. He noted it is difficult to have the same quality control when work is contracted out as when the company does it, so he did not expect the same sort of displacement in the technology arena.

CHAIR BRADY suspected that domestic help and illegal alien jobs are not counted in the job market statistics. Alaska felt this scenario when higher paying energy related jobs were replaced with retail and service industry jobs. He suspected there are people working who are not on the federal job roles.

TRUSTEE HUDSON asked if the job loss measurement is consistent, that is, does it reflect those who apply for unemployment benefits or is there some other measure. MR. O'LEARY responded there are a number of different indicators. He noted he is always struck by how often these measurements of the economy are revised. He stated he personally views the data by seeing if there seems to be a trend and if other things support the trend. He stated there does seem to be a trend toward some improvement in employment. MR. SHAFER felt there was no question that certain factories have closed and jobs have gone overseas. However, when the American consumer buys products made in China that were previously made in America, those dollars go to China but eventually those dollars have to come back to the United States, redeemed for either a good or service the consumer wants or needs. Having those dollars overseas lowers interest rates in the United States, which is good for investments in the United States. MR. O'LEARY remarked that the individual who lost their manufacturing job is in a different situation in terms of being able to apply their skills and earn the same income. At the same time, the individual who develops a software program that enhances productivity is being handsomely rewarded.

MR. O'LEARY indicated that manufacturing capacity utilization remains low, reinforcing the notion that much of the capacity that exists is in areas where capacity is not needed. Corporate profits are increasing significantly. TRUSTEE FRANK asked if this increase in profits is the result of cost controls, increase in price, consolidations, or some other factors. MR. O'LEARY felt it was a combination of all these factors. There was tremendous cost cutting through labor reduction and consolidation of facilities, movement toward lower cost locations, interest rates reducing, and taxes being lower. There were also a number of write-offs that contributed to a recovery. In the last several months there has been an increase in mergers and acquisitions, as well as some new stock issuance.

MR. O'LEARY indicated that new homes and existing home sales, as measured in units, has been on the rise and contributed significantly to the economic recovery. MR. STORER asked if this is an issue of demographics or lower interest rates. MR. O'LEARY replied that the interest component of housing cost is a huge factor and the decline in interest rates has made homeownership more accessible. It could be argued that demographics run counter to this.

MR. O'LEARY stated an analyst at CAI believes that the change in how the Federal Reserve operates has contributed to less cyclical in home building. Non-residential construction has rebounded, but it is still not a positive factor in the economy. Due to financial constraints, spending at the state and local government level has been curtailed, while spending at the federal level has increased markedly. TRUSTEE HUDSON asked if federal spending is replacing some of the local spending or is that increase primarily related to funding the Iraq war and such things. MR. O'LEARY felt that both were occurring. Federal spending has increased due to the war in Iraq and creation of the Department of Homeland Security, as well as transfer payments such as the extension of unemployment insurance. The deficit has clearly been affected by the reduction in capital gains tax revenue and a reduction in income tax because of lower incomes.

MR. O'LEARY stated the United States has a widening current account deficit. The largest change has been an increase in imports from countries whose economies are slower than the United States. TRUSTEE FRANK asked if the current account deficit includes money flows and the trade deficit is just a small part of that. MR. O'LEARY confirmed Trustee Frank's understanding. He further noted that investments abroad have resulted in dollars coming back to the United States, primarily through the purchase of Treasuries. TRUSTEE FRANK asked if there are more dollars going overseas than are coming back into the United States. MR. SHAFER

noted there are limited things that can be done with the dollar in foreign countries. Foreign investors either have to lend the dollar back to the United States or buy something in the United States. TRUSTEE FRANK asked what is meant by the fact that the current account is out of balance by \$6 billion. MR. O'LEARY stated this suggests that the dollar should be less valuable. MR. SHAFER questioned why, if the United States was to depreciate the value of the dollar by allowing inflation to cut into it, would a foreigner want to own it. There are other factors at play. This morning it was reported there are \$1 trillion United States dollars in foreign central bank hands.

TRUSTEE FRANK asked what effect this deficit has on the United States economy. MR. O'LEARY believed it should contribute to the weakness of the dollar, which makes exports more competitive and imports more expensive. MR. SHAFER stated that the idea of moving a factory to China would be less attractive if the dollar weakens because the cost advantage is lost. MR. O'LEARY noted that oil is traded in dollars and so, in effect, it could be argued that with the depreciating dollar the price of energy has gone down if you were in a strong currency. TRUSTEE WOHLFORTH understood oil prices have stayed up in part because of the depreciation of the dollar. MR. O'LEARY stated that people in Europe have not experienced the same energy price increase that has been experienced in the United States. Oil producers might, at some point, suggest denominating in some basket of currencies instead of the dollar.

MR. SHAFER noted that while the market for currency is enormous and largely free, there are road stops within that market. For instance, the Chinese has pegged their currency to the dollar, so regardless of what is done to depreciate the dollar, the effects he was discussing would not occur. This is one reason he believed the Administration has been pushing to undo the pegs.

MR. O'LAERY stated CAI believes the economic recovery will continue, but growth will remain modest. At some point the Federal Reserve will conclude there is sufficient liquidity and more should be done to not let prices escalate. At a CAI conference last week a representative from PIMCO said it would be the end of 2005 before the 10-year Treasury is at 5% or more and in that sort of environment the shorter end of the curve could be in the 2.5% to 3% range. A 5% interest rate on a 10-year Treasury is low compared to the 15% rate in 1982.

TRUSTEE FRANK asked if the downward trend that has been experienced since 1982 is expected to continue. MR. O'LEARY responded

that the secular decline in interest rates is over, but that does not mean the next trend is an increase. If long-term inflation is 3.5% or less, a case could be made for interest rates in the 4% to 7% range. In the post-WWII period inflation ran an average of 4%, so relative to that period, CAI does not see inflation being even at that average. If inflation stays that low, a case can be made for interest rates also staying low.

TRUSTEE FRANK asked if excess spending, federal government actions, demographics, or something in the global economy would cause inflation to rise. MR. O'LEARY responded that monetarists would say the United States is awash with liquidity so money will find a way to be re-priced and there is a lag from the creation of liquidity to that acceleration in prices; liquidity has been created. Another point of view is that structural deficits will create inflation. Deficit numbers are treating Social Security the way the system was designed in the 1930s, pay as you go. The cost of Social Security in 30 years will be much greater than it is today and that is a long-term contributor to structural deficits. TRUSTEE FRANK understood that both monetary and fiscal policy would argue for greater inflation. MR. O'LEARY agreed and noted that, to the extent the dollar is over valued and there are cheaper producers of goods and services elsewhere, the United States would be importing some inflation because things will cost more when denominated in dollars.

CHAIR BRADY noted remarked that the dollar was over priced in Europe several years ago, but that difference continues to increase.

GREG RENKES joined the meeting telephonically at 2:23 p.m.

MR. O'LEARY continued his presentation. He stated that investors are either the owner of an asset or a lender to someone and over the long-term, if the economy grows, owners fare better than lenders. All the sub-asset categories are some combination of ownership and lending.

MR. O'LEARY reviewed the trailing five-year return for the S&P 500 compared with the lagged earnings/price (earnings yield) using it as a naïve forecaster of stock returns. He recalled the period when there was a total disconnect between the earnings yield and price return; that has now been erased. He remarked that this analysis indicates that stocks are not cheap based on earnings yield; they do not seem to support a very high expected rate of total return. He stated this is evidence of the fundamental relationship between stock prices and earnings.

TRUSTEE FRANK asked about the relationship between long-term Treasury yields and price/earnings. In response to this question, MR. O'LEARY reviewed a comparison of earnings yield and the 10-year Treasury yield, which indicates a relationship between the two. This comparison supports the contention that stocks are inexpensive. Price/earnings ratios currently do not look high relative to interest rates, but interest rates are expected to increase.

TRUSTEE WOHLFORTH asked for an explanation of the analysis of the ratio of S&P 500 earnings yield and 10-year Treasury yield. MR. O'LEARY explained that the earnings yield is the reciprocal of price/earnings. TRUSTEE WOHLFORTH noted that there is currently not the same exposure to the oil shock that existed 25 years ago. MR. O'LEARY recalled when energy prices quadrupled in the 1970s and people thought that was horrendous. However, the average mileage of the cars in service in 1973/1974 was less than 10 miles per gallon. Suddenly there was much greater utility in creating more efficient vehicles. Oil is arguably a less important part of the economy now, but it is likely that a big disruption in oil supply would have large impacts. MR. STORER stated the impact of higher oil prices is less onerous in managing corporate America and even Japan, which is more vulnerable to oil shocks, is not suffering through these rises; oil is being used more efficiently.

MR. O'LEARY reviewed a comparison of yield to worst (current yield to maturity) for the Lehman Aggregate bond market and the expected bond returns. He noted that this analysis plots the five-year annualized return and the yield to worst, which is used as a naïve projector of future returns for the bond market. Given the current level of the bond market, the best guess is a 4% plus return looking out over the next five years. CAI's single point figure is 4.75%, which is the same as the figure used last year. That figure is higher than the current yield to maturity on the bond market, but because interest rates are going to go up, the yield will go up without a concomitant drop in price. TRUSTEE WOHLFORTH asked for an explanation of what is represented by yield to worst. MR. O'LEARY explained, if there is a callable bond, it presumes that whoever holds an option on the bond acts rationally. For example, if interest rates fall, it presumes mortgages will be refinanced. TRUSTEE FRANK asked what is the yield to worst today. MR. O'LEARY replied the yield to worst for the Lehman Aggregate at the end of 2003 was projected to 2008 at just over 4%.

MR. O'LEARY next reviewed the yield to worst (current yield to maturity) for the Lehman Aggregate domestic fixed income index from 2001

through 2004. There is a significant change in the daily yield to worst from 12/31/02 to 1/02/03, but interest rates did not change much during the whole year. The drop in yield to worst on 6/13/03 was extraordinary; this was when deflation worries were at their peak. Then rates shot back up, part of which reflects the importance of the mortgage market to the bond market. When refinancing occurs as a result of lower interest rates, portfolios that contain mortgages are greatly affected as those loans are called. Many investors utilize Treasury futures to manage the duration of their portfolio, which increases as interest rates rise and decrease as interest rates fall.

MR. O'LEARY noted that rates were at their high for the year in September 2003 and they then dropped off for the rest of the year. TRUSTEE FRANK understood that, if rates go up, people who are worried they will rise further sell long obligations so they do not lose principal, which means the price will go down and the yield will go up on longer obligations. That is contrary to the expectation that short-term rates can pop a few percentage points without affecting long-term rates. MR. O'LEARY agreed with Trustee Frank's statement and noted that CAI's projection is consistent with the situation he had just outlined because fundamentals will ultimately prevail. TRUSTEE FRANK asked if the expectation is that rates will over correct and then settle back. MR. O'LEARY replied in the affirmative.

TRUSTEE WOHLFORTH asked if people are increasing their use of futures. MR. O'LEARY replied that there is a great deal more use of futures. He noted that a graphic representation of the duration of the bond market shows that as rates went down, durations went to incredibly low levels; they are now back at a more typical level. Most bond managers manage against the index, so if the index duration goes down, they reduce the duration in their portfolio.

MR. O'LEARY noted that inflation has decelerated dramatically, which has had a major influence on assets, liabilities, and spending. CAI has plotted the core CPI and the CPI against the unemployment rate since 1994. The core CPI is in the 1% range and the CPI is in the 2% range. That difference largely reflects energy and food prices.

MR. O'LEARY reviewed CAI's 2004 capital market projections, again noting that they are nearly unchanged from last year. The inflation projection is held at 2.6%, cash returns are low at 0.1%, bond returns are held at 4.75%, and equity returns of 9% are built from fundamentals including a 3% to 4% real GDP growth, which translates into 5.5% to 6.5%

nominal earnings growth, a 2% dividend yield, and a 0.5% to 1% buy-back yield. Although income in real estate is good, real estate return is held at 7.6% because of valuation pressure. He noted that CAI recently moved from a Class B+ office space in San Francisco to a Class A space and is paying the same rent. There were even inducements to get CAI to move into the space. CHAIR BRADY asked if this lower rental rate situation is a result of consolidation, not new production. MR. O'LEARY replied that the San Francisco real estate market was hurt by dot-com businesses that either contracted or ceased to exist. TRUSTEE CORBUS understood that CAI's capital market analysis is that real estate values are so high that returns are relatively low, but CAI's experience in San Francisco is the opposite. MR. O'LEARY explained that, even though real estate is getting decent incomes, valuations were being built on unreasonable expectations of income growth. So some valuation contraction might be experienced because people will put more realistic income streams into their projections. TRUSTEE FRANK understood they are changing their cap rates to reflect the market realities of alternative returns.

MR. O'LEARY continued summarizing CAI's 2004 capital market projections. He indicated that private equities return is held at 12% which is a 3% premium over public markets, and premiums of international equity over domestic and small cap over large cap have been narrowed. He reviewed a chart containing specific projected 2004 annual return rates, projected standard deviation (risk), projected yield, and the 2003 projections for each asset class for comparison purposes. He noted that CAI reverse engineers these figures by using data that produces a reasonable expected projection; CAI does not want its clients to radically shift policies from one year to the other because there is not sufficient precision in this estimating to merit such action. He highlighted that broad domestic equity is not changed other than a slight reduction in the risk expectation. Large cap is 10 basis points higher and small cap is 20 basis points lower. International equity is 30 basis points lower than last year. There is no change in domestic fixed income. There is also no change in the defensive area, which is a 1- to 3-year fixed income investment, or in TIPS. High yield and non dollar bonds also have no change. TRUSTEE FRANK asked how the figure of 4.4% was determined for TIPS. MR. O'LEARY replied that CAI looked at the real return and was conservative on the inflation expectation.

MR. STORER remarked that the basis of CAI's projections include an expectation the dollar will weaken and that companies in developed nations should ultimately have the same expected return on stocks, yet international equity returns have been reduced. MR. O'LEARY noted that

CAI has raised the S&P returns and international earnings account for approximately 35% of the earnings of the companies in the S&P 500; whereas, international earnings account for 15% of the overall economy. There is still a 50 basis point premium of international equity to the S&P 500. MR. STORER noted that for private equity CAI listed only post venture capital. MR. O'LEARY stated that is the estimate for private equity, including venture capital.

TRUSTEE FRANK asked if the dollar is considered over value because of the current account deficit or is there some other indicator. MR. O'LEARY replied that purchasing power parity is the indicator, that is, the relative price of the same thing around the world. TRUSTEE FRANK asked if the current account deficit is an indicator of that. MR. O'LEARY replied that it is a contributor; it could be that the other currency is under valued relative to the dollar. MR. O'LEARY stated a product produced in the United States is not as competitive abroad when the dollar is over valued. TRUSTEE FRANK explained he wished to understand why there was not conversation three years ago about the dollar being over valued. MR. O'LEARY noted that CAI has been making this claim for five years. He stated that trends of over valuation or under valuation of currencies tend to last a long time.

MR. O'LEARY next reviewed an efficient frontier analysis of six asset mixes yielding a variety of returns, standard deviations, and Sharpe ratios. He indicated that only small changes were made to this table from last year's analysis. In order to reach an expected return of 9%, all investments would be in equity-type assets. To reach an expected return of 7.5%, 33% of all investments would be in bonds and 10% would be in real estate. If alternative investments (private equity) and international bonds are included in the efficient frontier analysis, a return of 8.79% could be achieved with 70% in equities, 9% in bonds, 11% in real estate, and 10% in alternative investments.

TRUSTEE WOHLFORTH noted that this analysis indicates a more aggressive asset allocation would be needed in order to get the return the Fund has projected. MR. O'LEARY agreed with Trustee Wohlforth's statement. He noted that in order to achieve a 5% real rate of return objective with an expected inflation rate of 2.6% requires an earnings rate of 7.6%. In order to do that, alternative investments would need to be increased. If alternative investments and international bonds are not included, 57% of the overall portfolio would need to be in equities. MR. STORER indicated that an asset allocation would be presented in March that has a real rate of return expectation of 5%. He noted that he wants to

expand the Fund's investment flexibility because statutory limitations will be reached in virtually all asset classes. TRUSTEE WOHLFORTH asked how that effort is faring. MR. STORER replied that the legislation will be introduced next week and there have been some preliminary meetings on the topic. TRUSTEE WOHLFORTH asked if the legislators would see CAI's presentation. MR. STORER replied that nothing is scheduled, although something could be scheduled in conjunction with the Fund's March meeting. He noted that things were put on hold because of the Conference of Alaskans scheduled for February 10-12 in Fairbanks. MR. O'LEARY stated that sub-asset categories could also be increased in order to reach the 5% real return figure. MR. STORER noted that the broad market has always been used in presenting returns for the equity market, but it may be prudent to show separate returns for small cap and large cap equity.

TRUSTEE FRANK asked if there is perhaps too much focus on return. MR. STORER stated the objective is to achieve the return objective with the lowest volatility. He believed there has been greater expected volatility with less commitment to equities at other times in the Fund's history. The issue is whether the risk level associated with a certain asset mix is acceptable to the Trustees. MR. O'LEARY noted that volatility figures have come down slightly. TRUSTEE FRANK asked that the Trustees receive a future educational presentation on the definition of risk and equate that to volatility.

BREAK 3:10 p.m. to 3:20 p.m.

KPMG CONTRACT RENEWAL

MR. STORER explained that five years ago the Permanent Fund contracted with Peat Marwick KPMG to provide auditing services to the Fund. The contract was structured as a three-year contract with two one-year renewals. The Board approved the five-year relationship, however, he wished to inform the Trustees that the contract will be extended to complete the full five-year term. The five-year contract ends at the end of next year at which time staff will bring an RFP forward for a search for an auditor, in which KPMG is expected to compete. MR. STORER noted that Trustee Wohlforth, Chair of the Audit Committee, posed questions that were answered in a letter from Kathy Porterfield with KPMG. He invited questions or comments from the Trustees.

TRUSTEE WOHLFORTH stated he was happy with the answers supplied by Ms. Porterfield to the questions he had posed. He supported exercising the renewal option on KPMG's contract. MR. STORER noted that the

renewal is embedded in the contract, so no motion is needed. The contract will be extended for the last year, without Board objections.

KATHY PORTERFIELD noted she had indicated in her letter that she would supply a copy of KPMG's code of conduct, which she would leave with Mr. Storer.

SECURITIES LITIGATION UPDATE

MR. STORER indicated Mike Barnhill would be calling in to address this issue. TRUSTEE RENKES offered to bring Mr. Barnhill to the telephone. MR. STORER indicated the Trustees had been supplied with a letter from the Department of Law outlining litigation issues, as well as a memorandum from Mr. Barnhill to Mr. Storer and Gary Bader, CIO with the Alaska State Pension Investment Board, on the same topic.

Awaiting Mr. Barnhill's arrival, MR. STORER indicated the staff has been meeting with the conveners of the Conference of Alaskans and conference facilitator Brian Rogers to prepare educational materials on POMV. He was pleased that POMV is being considered separately from spending. As it now stands, POMV will be addressed first, followed by the plan respecting the Constitutional Budget Reserve, and then a discussion of a spending plan. Chris Phillips is scheduled to do a brief presentation on the modeling of returns.

TRUSTEE HUDSON supported highlighting the POMV educational effort at the Fairbanks Conference of Alaskans. He recommended that Mr. Storer make himself available to the opposition group for presentations as well.

Joining the meeting telephonically, Assistant Attorney General MIKE BARNHILL explained that the Attorney General's office began systematically following securities litigation filed in federal court on behalf of all the State's funds at some point last year. There is a great deal of securities litigation and it is incumbent on managers of funds to become acquainted with this litigation and to become involved when the State's interest is sufficiently material. Last year Investor Responsibility Support Services was retained to monitor the State's portfolios. That firm has access to transaction data at the Bank of New York and whenever a class act lawsuit is filed in federal court, they obtain the relevant transaction data for the subject of the lawsuit, calculate the portfolios' damages under a variety of formulas, and post it on their secure website, which is accessed by a password. The State can then determine the level of attention it wishes to give to that particular lawsuit. The State has been working with this entity for seven months and the service has the

potential of being relatively useful. The problem is that the system might not be quite perfected, so there have been some concerns with the quality of the data and accuracy of calculations. They are doing something no other vendor has done and they do not have enough clients to fully support the kind of service they want to provide.

MR. BARNHILL has now asked for direct access to custodian data from the Fund so that he can access transaction data in the event that he needs to make calculations himself. He was unsure whether this is the best way to monitor class action securities litigation either, but several methods are being investigated. The Department of Revenue/ Alaska State Pension Investment Board (DOR/ASPIB) is involved in the WorldCom litigation, although the Fund is not. The DOR and ASPIB had purchased certain private placement bonds from WorldCom in December 2000 and the Fund did not. Those bonds were not covered by the pending class action, so the only way to get recovery for the losses incurred as a result of buying those bonds was to file independent action, which was done. The Fund's losses are covered in the pending class action.

There are two litigation proposals being worked on behalf of the Fund. One is independent litigation on behalf of all of the State's funds in the AOL Time Warner matter. Three firms have been interviewed that have submitted proposals to represent the State in these litigations. Two of those firms came to Juneau while the other was interviewed by telephone. It was felt that each of these firms could represent the State quite well, but Lieff Cabraser of San Francisco was selected, primarily based on the low contingency fee negotiated with them of 8.5% without trial and 13.5% with trial. Lieff Cabraser has drafted complaints that have been given to Mr. Barnhill and the Attorney General's office has spoken with several money managers who traded in AOL Time Warner on behalf of the Fund and the DOR/ASPIB. TRUSTEE FRANK asked if hourly rates are paid in addition to the contingency fee negotiated with Lieff Cabraser. MR. BARNHILL replied in the negative. TRUSTEE WOHLFORTH asked if the cause of action relates to the AOL Time Warner merger. MR. BARNHILL replied in the affirmative.

MR. BARNHILL indicated the other matter under serious consideration is Qwest Communications. There are media reports involving Qwest, a major telecommunications company located in Denver that had engaged in a series of sham transactions designed to inflate revenues. The Department of Justice brought criminal charges against various executives at that firm. The stock crashed from \$50 to \$4. The State's damages are

estimated between \$50 and \$80 million. When losses exceed \$50 million the question arises whether individual litigation should be pursued.

MR. BARNHILL indicated his memorandum outlines the pros and cons of remaining a passive member of the pending class action or opting out in the case of Qwest, which is the same question presented by the AOL Time Warner case. Various studies have been done analyzing class actions and the findings are that invariably settlements are extremely poor. There has been an increasing trend for institutional investors to opt out of class action cases and try to get a better recovery for their funds. There are risks in so doing, one of the biggest of which is that the law is not as well developed in the area of securities litigation, if the matter is pursued in state court. The Attorney General's office believes courts in Alaska would be favorably inclined in deciding matters of securities fraud in which the State has been damaged. To the extent there are unknown risks involved, the State can opt back into the class action or amend the complaint to add federal claims. Typically in federal class action litigation the time to opt out is not usually until midway into litigation. The Attorney General's office recommends opting out with both Qwest and AOL Time Warner.

MR. BARNHILL indicated the final part of his report speaks to cases in which the State has been approached to file, but has declined.

TRUSTEE HUDSON asked what costs are involved if the Fund stays in the class action lawsuit. MR. BARNHILL replied there are no out of pocket costs to the State, but the State would have to accept whatever result occurs in class action litigation. Objections can be made to the settlement, but generally speaking, the courts do not accept those. MR. STORER commented that there is a cost in terms of litigation; the law firm's fee is netted out of whatever settlement is received. He asked if the fees are higher fees in this instance. MIKE BARNHILL stated that in the case of AOL Time Warner, class counsel's fee is a sliding scale fee ranging from 12% to 17% of the recovery compared with a negotiated fee to the State by class counsel of 8.5% without trial and 13.5% with trial.

TRUSTEE WOHLFORTH asked what amount was recovered in class action settlements during 2003. MR. STORER replied that figure is available, however, he did not have it with him. The amount recovered has increased commensurate with the bubble in the stock market. He indicated Chris Phillips could email the sums recovered to the Trustees.

LEGISLATIVE UPDATE

LAURA ACHEE, Research and Communications Liaison, indicated she had provided a written update of legislation in which the Fund is involved. The first piece of legislation is a supplemental request for FY04 for a communications plan. She spoke with OMB and was told the supplemental bill will be sent to the Legislature on Monday and will include a request for \$300,000 and a request for language that gives the Fund leave to advocate in addition to educate on POMV. Jim Baldwin at the Attorney General's office changed the language slightly. The largest concern is language in the Fund's statutes that indicate the Fund may not be political, but he felt the work is educational and not political. Mr. Baldwin changed the language to state "consistent with Alaska Public Office Commission guidelines." However, the Fund is still not certain that legislation is not needed that exempts the Fund from that statute. The Fund wants to ensure there is full legislative backing for the Fund's action, should it be challenged at a future date.

A subcommittee meeting was scheduled for today at which the FY05 amendment funding communications would have been considered, but that meeting was canceled. At the last Board meeting, the Trustees took action to move ahead with changing language increasing investment flexibility. After discussions with various legislators, a limited version was sent to Representative Samuels, chair of the Legislative Budget and Audit Committee. That version included language cleaning up the basket clause, alleviating the concerns over the prohibitions on investing that are contained in the statutory list, and also broadening the basket clause to 15%. There is some concern that the timing of this legislation could distract from the discussion on POMV.

MS. ACHEE reported that House Joint Resolution 31 was introduced and is in the House Ways and Means Committee. This bill would distribute a large portion of the Fund to currently eligible Alaskans, there would be no dividend program, and the earnings remaining would be used to fund government. There has been work in committee to tighten the language of the bill. There is a stipulation that the \$15 billion that remains in the Fund would fall under a POMV system. The committee also changed the calculation to distribute \$12 billion to eligible Alaskans. The chair of the Ways and Means Committee feels there is some consideration for the bill, but it has a long way to go in the House and there is no companion bill in the Senate.

MR. STORER asked whether he should address the February 2, 2004 memorandum from the Department of Law to Governor Murkowski.

TRUSTEE RENKES felt it was appropriate at this time to indicate to the Trustees there is a draft bill regarding removal for cause and the Governor is considering putting it forward as the Governor's bill. CHAIR BRADY asked if this is clarification on removal for cause or does it also include language instituting permanent, longer, staggered terms. TRUSTEE RENKES replied that the draft legislation provides for permanent, longer, and staggered terms for Trustees.

TRUSTEE HUDSON asked if a fiscal note has been requested in relation to the House Joint Resolution 31. MR. STORER replied that such a request was made and the result is a negative fiscal note because reducing the Fund by roughly 40% would have the result of a dramatic drop in management fees. TRUSTEE HUDSON felt this legislation should be watched closely and it is worthy of a broader discussion amongst the Trustees in terms of what such action would do to the investment of the funds and the consequences if it were to happen. MR. STORER stated it is likely that the current asset allocation and objectives would be retained, but with a smaller amount; no fewer Fund personnel would be required. The Corporation was asked how long it would take to liquidate that large a sum and Mr. Storer told them it would involve a period of up to 90 days. TRUSTEE CORBUS noted there would be an impact on the Permanent Fund Dividend Division because more investigative work would be required on dividend applications.

TRUSTEE WOHLFORTH was concerned with cutting back on the Fund's requested expanded investment legislation. He did not see why asking for expanded investment ability would overload the legislature. MR. STORER explained that legislative changes are being submitted on increasing the basket clause in one piece of legislation and another piece of legislation is being submitted to eliminate restrictions on various asset classes. It is clear the latter is the one with which legislators are most uncomfortable. The legislation becomes more confusing if these issues are combined. He stated that he and Bob Bartholomew have been meeting with key elected officials, recognizing there will be some concern about the timeliness of the issue. He stated it is important to strive to get as much latitude as soon as possible.

CHAIR BRADY concurred with Trustee Wohlforth's remarks and thought that language regarding removal for cause could be inserted into legislation as well. MR. STORER assumed that all the issues of reticence will exist well after this year and he did not want to slow other important processes for some theoretical events. He wanted each issue to be evaluated independently.

TRUSTEE FRANK asked if the issue is finding a legislator that is receptive to introducing legislation dealing with these issues. MR. STORER indicated that he asked to speak to the leadership privately so they understood the reasoning behind the legislation and in the hopes of reducing the number of committees reviewing the legislation. TRUSTEE FRANK asked if there is a legislator willing to sponsor the legislation. MR. STORER replied that the Fund's legislation is introduced through Legislative Budget and Audit, of which Ralph Samuels is the chair. TRUSTEE FRANK stated his experience was that many legislators do not have legislation to sponsor, but would like to sponsor legislation. He thought more might be accomplished by a legislator who wants to accomplish something. MR. STORER explained that requests for legislation are to be neutral, so they are submitted through Legislative Budget and Audit.

MR. STORER stated he met with Senator Seekins recently, who is chair of the Senate Judiciary Committee, and he told him his intent was to have a hearing on POMV the morning of February 9, 2004.

TRUSTEE COMMENTS

TRUSTEE WOHLFORTH stated he believes Mr. Storer, Ms. Achee, and Mr. Bartholomew are skillful in the legislative area and his remarks were not intended to be critical. He assured them they have the Trustees' full support in advancing whatever they feel is appropriate.

TRUSTEE CORBUS stated he has had recent inquiries about the Fund double inflation proofing. He asked that this subject be revisited at a future Board meeting, particularly arguments why that is not the case. MR. STORER suggested this topic could be discussed at the Board's March 2004 meeting. He explained that one-third of the Fund's principal is from mineral contributions, one-third is from inflation proofing, and the final one-third has been special appropriations. There are those that view special appropriations as double inflation proofing. Staff can provide information on the history of that. TRUSTEE FRANK understood that appropriations from the earnings reserve to principal did not change the calculations for inflation proofing. MR. STORER stated that once they become part of the principal, they are included in inflation proofing; the earnings reserve is not inflation proofed.

FUTURE AGENDA ITEMS

MR. STORER stated staff is trying to keep current on action items, provide contemporary education for the Trustees, and revisit each of the Fund's programs.

ADJOURNMENT

The meeting was adjourned at 4:10 p.m.

APPROVAL OF MINUTES

Carl Brady, Chair

Date