F I S C A L   I M P A C T   R E P O R T

SPONSOR HAFC **DATE TYPED** 2/18/2004 **HB** 209/HAFCS

SHORT TITLE Permanent Funds Investment In Real Estate **SB**

ANALYST Garcia

REVENUE

Estimated Revenue		Subsequent Years Impact	Recurring or Non-Rec	Fund Affected
FY04	**FY05**			
		FY06: $70.0; FY07: $135.0; FY08: $271.0	Recurring	General Fund
$7,400.0 (increase in market value)	$14,400.0 (increase in market value)	Greater Than $14,400.0 (increase in market value)	Recurring	Severance Tax Permanent Fund

(Parenthesis ( ) Indicate Revenue Decreases)

Synopsis of Bill

The bill allows a 10 percent allocation from the Severance Tax Permanent Fund (STPF) only for real estate investments and investments in hedge funds. The bill does not reference the Land Grant Permanent Fund (LGPF), and thus none of the new allocations will be made from the LGPF and will not require a ¾ vote for passage. The bill does not allow direct investment in derivatives and short-selling from the State Investment Office, but does allow the investment office to invest in hedge funds.

The bill will allow the State Investment Council to invest up $360 million of the market value of the STPF (as of the December 31, 2003 market value of the fund) and an additional $360 million from the STPF in real estate. Currently, the SIC can invest 3 percent of the market value of the Land Grant Permanent Fund or roughly $225.8 million in real estate.

Significant Issues

1) Background of Investments: Currently, the State Investment Council (SIC) is not authorized to invest in hedge funds and is limited to invest only 3 percent of the market value of the land grant permanent fund in real estate assets. Consequently, the bill will allow the investment agency the ability to invest in hedge funds and10 percent of the STPF in real estate.

Hedging is the practice of buying and selling a particular asset to offset an otherwise risky position. For example, if a company knows its going to gain $1,000 for each 1 cent increase in the price of an asset, but also knows it will lose $1,000 for each 1 cent decrease in the price of the asset; the company can hedge by taking a short futures position on the asset. If the asset decreases, the short position makes up for the decrease in the prices of the asset to net the investment loss at zero. On the other hand, if the price of the asset goes up, the loss to the company is only the price of buying the short position, thus resulting in a net investment gain.

Hedging is a common practice among institutional investors and is a strategy that attempts to protect a portfolio against market downturns. Moreover, the derivative market, otherwise known as hedging, is a huge market internationally. The futures, options, and forwards markets dwarf the equity markets in size and are growing rapidly.

Real Estate investments do not include speculation in raw land (which are prohibited by SIC policy). The classic core investment is an office building that is almost completely leased to an investment grade (BBB or greater by Standard & Poor's) tenant for longer than 5 years.

Real estate behaves differently than other financial assets. The very nature of real property makes these investments illiquid and unique. Unlike stocks, cash flow to tax exempt investors is not reduced by income tax. Although real estate equity and stocks both represent ownership interest, real estate has many characteristics that provide stable income. Like bonds, the majority of returns from real estate are generated from cash distributions. Unlike bonds, property values are not adversely affected by inflation.

2) SIC contends the ability to use the additional investment strategies will provide added diversification effects that will (1) reduce or maintain the same level of risk of the portfolio; and (2) increase the expected return of the portfolio. Specifically, investments in hedge funds are regarded by the SIC advisor to typically have higher risk-adjusted returns.

3) According to SIC's advisor, New England Pension Consultants (NEPC), the additions of hedge funds and real estate add no economic risk, as measured by standard deviation, to the portfolio. However, an implicit risk does exist to the portfolio. The risk lies in oversight of the hedge funds.

- Risk lies in the ability of the SIC to develop a comprehensive due diligence process that chooses sound hedge funds and monitors them extensively.
- The success of the asset relies on investment fund manager skill

Without a well structured management and implementation plan that adequately oversees the hedge fund asset class, the portfolio return is at risk due to the complexity of the asset. Thus far, SIC has not provided a management or implementation plan of how the organization will oversee this new asset class.

4) The LFC subcommittee on Investment Performance and Pension Review can further study this complex issue in the interim.

FISCAL IMPLICATIONS

The fiscal impact research was conducted by New England Pension Consultants (NEPC), the SIC investment consultant. NEPC included a 10 percent asset allocation in real estate investments and hedge funds in its projections and concluded the proposed changes would increase the total return to the STPF by 0.40 percent without increasing risk. For FY04, the increase in allocation to the two asset classes would result in an estimated increase in the STPF market value of $7.4 million (from the 4.7 percent distribution from the STPF). The estimated increase in the market value of the STPF for FY05 from an increase in these investment classes would amount to roughly $14.4 million. Because the distribution formula for the STPF is determined on December 31 of each year for the next fiscal year, the FY05 distribution has already been determined and the bill will not affect FY05 distribution but will increase the FY06 distribution. The estimated increased general fund revenue from the increase in market value of the STPF from the bill is $70 thousand for FY06, $135 thousand for FY07, and $271 thousand for FY08.

The first year estimate assumes that only one-third of the real estate will be placed in FY05. The SIC's real estate policy anticipates that this minimum will be invested in publicly traded real estate investment trusts (REITs) and real estate "mutual funds" for institutional investors that are easily placed and redeemed. Finally, the out-year estimates for all these proposals assume no growth or compounding in permanent fund market values; they are all based on the December 31, 2004 balance of $11.1 billion.

As of December 31, 2004 the severance tax permanent fund market value was roughly $3.6 billion. The additional allocations from the bill will not affect the Land Grant Permanent Fund and will only affect the Severance Tax Permanent Fund.

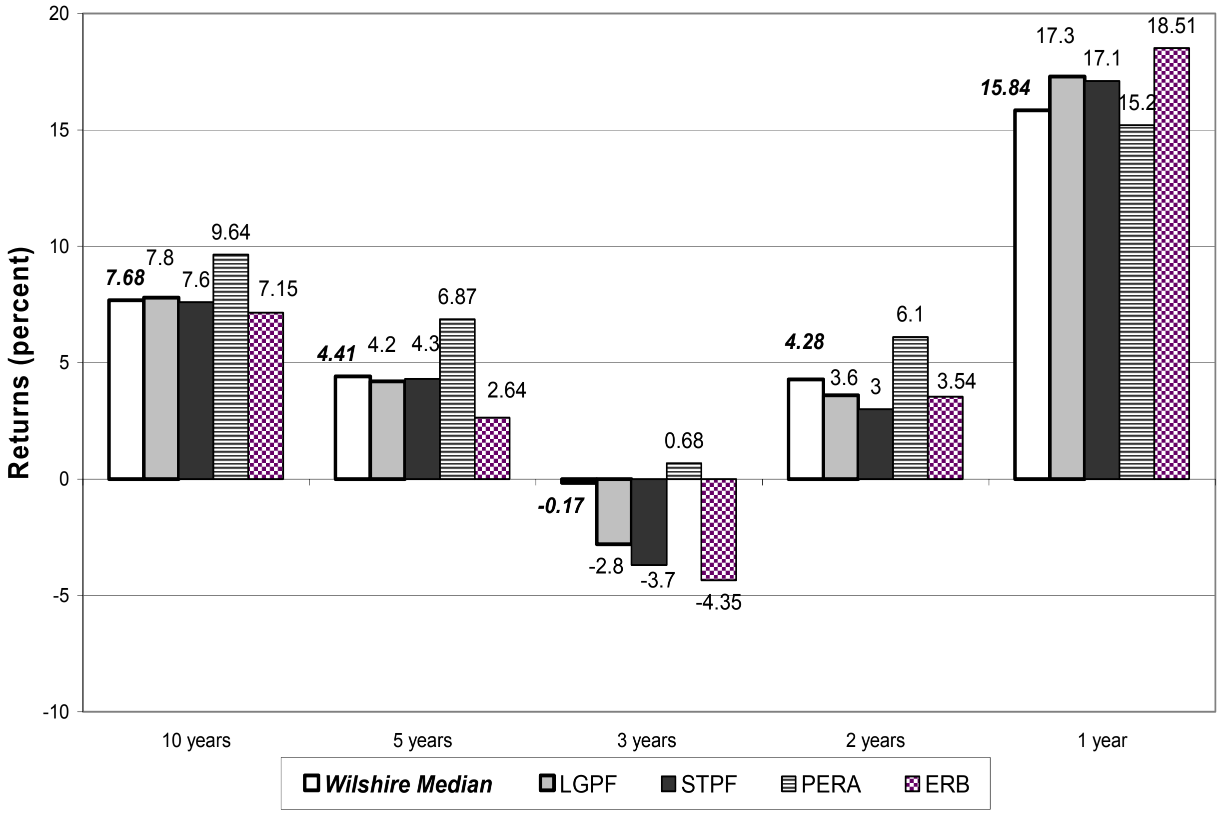
ADMINISTRATIVE IMPLICATIONS

Although the SIC proposal raises the expected return of the portfolio and does not raise the standard deviation (risk), there are still risks to using the new asset classes. Chief among the risks is the ability of SIC to implement and adequately administer the assets. For instance, successful investments in hedge funds are dependent on investment manager skill and a mechanism that properly monitors investment fund managers. SIC has experienced problems in its due diligence mechanism in another asset class, private equity, that resulted in the investment council backtracking on approval of a few deals. As a result, it is necessary for SIC to present a plan on how the investment agency will implement and oversee this possible new and complex asset class and the fund managers in order to establish the program on good footing from the start.

OTHER SUBSTANTIVE ISSUES

The figure below provides a long-term comparison of one-year, two-year, three-year, five-year, and ten-year returns of the Land Grant Permanent Fund (LGPF), Severance Tax Permanent Fund (STPF), the ERB Fund, and the PERA Fund versus the median public fund return in the Wilshire universe. The figure shows that for 10 years ended September 30, 2003, the median public fund in the Wilshire universe returned 7.68 percent. This amount is below the actuarial assumption and expected return of 8 percent for PERA, ERB, and SIC. Also, the LGPF outperformed the median slightly, while STPF performed roughly at median but still below 8 percent. On the extremes, PERA significantly out-performed the median and in fact is one of the top performing public pension fund in the country for 10 years while ERB significantly under-performed the median public fund in the Wilshire universe by approximately 500 basis points. Additionally, for five, three, two-year returns; SIC and ERB have under-performed the median public fund in the universe.

Figure 3. State Investment Agencies Long-term Returns



Risk Adjusted Return - The historical average return of an asset or portfolio can be extremely misleading and should not be considered alone when selecting assets or comparing the performance of portfolios. One also has to take into account the historical variability or riskiness of return. The following table shows the return of different assets per unit of risk; the statistic is known as a "Sharpe ratio".

Sharpe Ratios by Asset Class	
Asset Class	**Ratio**
Core Bonds	0.15
Mortgages	0.17
Mid Cap Equities	0.29
Large Cap Equities	0.33
Int'l Equities	0.33
Real Estate	0.34
Hedge Funds	0.43

Source: NEPC

As the table shows, hedge funds currently have the highest risk adjusted return of any major asset class. The second highest level of risk adjusted return is found in real estate. This result drives a considerable part of the fiscal impact shown above.

POSSIBLE QUESTIONS

Is this a proposal that needs further study and possibly referred to the LFC for interim study?

DG/lg:yr:dm