CALLAN ASSOCIATES

Municipality of Anchorage Trust
Statutory Distribution Implications

Overview

The Municipality of Anchorage Trust's governing statutes result in a complex management situation that has important implications for the Municipality. The Investment Advisory Commission has asked Callan to comment on the current approach and alternative approaches that might better meet the original objectives of governing statutes.

Callan Associates Inc. is an investment consulting firm and does not offer legal counsel. We base our understanding of the Trust mechanics and requirements on our general industry experience and on the input provided by the Municipality. Naturally, legal counsel should provide opinions regarding legal issues.

Our Understanding

The Trust corpus may not be distributed under any circumstances. Assets held in a "reserve" account may be distributed. At inception, certain assets were identified as reserves and all others were used to establish the Trust.

Each year, earnings are available for two purposes. They are:

1) inflation proofing – an amount determined by multiplying the annual rate of change in the Consumer Price Index by the corpus of the Trust is to be added to the corpus of the Trust;
2) available for use – the balance, if any, is available for appropriation and sums not appropriated may be retained in reserves, invested and available for future appropriation.

Inflation proofing ensures that the real value, or purchasing power, of the Trust is maintained and that future distributions will also grow to keep up with inflation. Earnings are the sum of interest and dividend income, realized gains and losses and the change in unrealized gains and losses incurred in the annual calendar period.

The Problem

Earnings will be highly volatile due to volatility in the financial markets. The inflation-proofing requirement will increase the volatility of the sums available for distribution. At the Trust's inception, the amount targeted for appropriation was a comparatively high proportion of the initial corpus. As a consequence, the initial reserve component has been largely utilized to meet

initial distribution requirements. Thus, the flexibility to maintain regular distributions that existed at the establishment of the Trust has been utilized.

We have modeled the consequences of the existing distribution approach. Our analysis (completed in 2000) illustrated that there was a high probability that the Municipality would be confronted with periods during which no distributions could be made from the Trust. This analysis, which used actual historic financial market returns, demonstrated that there have been and likely will continue to be prolonged periods during which financial markets simply do not produce positive after inflation returns. Over the long term history of financial markets, there have been numerous multiple year periods during which stocks and bonds have failed to achieve a positive "real" (after inflation) rate of return.

The Challenge

The MOA Trust is an important source of revenue to the Municipality. Naturally, significant year to year variability in revenue is undesirable. Our understanding is that the current distribution approach (linked to earnings after inflation-proofing) cannot be modified without a change in Charter.

The long-term objective inherent in the establishment of the Trust was the creation of a reliable source of growing revenue to support governmental operations currently and in the future. It is very similar in concept to charitable foundations and educational endowments. Other organizations with similar long-term objectives but different legal restrictions have adopted some variant of the following to achieve their objectives:

1) utilize some smoothing technique to reduce the volatility of distributions and improve the probability of reasonable consistency in such distributions
2) utilize a percent of market value distribution basis (often of rolling average market values) to ensure a reasonably stable distribution pattern regardless of shorter-term earnings. The percent of market value is based on long run expected earnings.

In your current situation, the only apparent alternative available to smooth distributions is to attempt to maximize the assets held in reserves. A large reserve balance provides the flexibility to make future distributions even if short-term earnings are insufficient. The only way in which the reserve balance can be increased is through an allocation of earnings (or the appropriation of funds) to the reserve account. In other words, some portion of earnings would have to be retained in reserve and not spent. It is important to note that this approach would not solve the inherent problems of the current approach. Rather it would simply reduce the magnitude. Naturally, it could only be implemented if annual earnings were sufficient to cover inflation proofing requirements, spending needs and the build-up of reserves.

Private foundations and endowments have dealt with the challenge of preserving purchasing power of trust corpus and distributing a reliable and growing income stream by linking current distributions to reasonable long-term estimates of earnings. For example, the majority of educational endowments utilize a distribution formula that limits spending to some percentage of

the market value of endowment assets. Similarly, private foundations, which must meet Internal Revenue Code requirements, must distribute 5% of market value in order to retain their tax-exempt status. Most endowments employ some smoothing technique such as 3-5 year averaging of market value in order to minimize year-to-year fluctuations in distributions.

The key to making an "endowment" type of spending policy work and meet the objectives of maintaining the purchasing power of corpus while simultaneously distributing a consistent and growing sum is to limit the percent of assets distributed to an amount that is consistent with long-term financial market returns.

We have studied long-term financial market returns for major asset classes (stocks, bonds etc) and provided numerous studies of long-term return patterns to the Municipality. These studies demonstrate that balanced portfolios comprised of stocks and bonds in proportions similar to those permitted under current Municipal statutes have produced slightly more than a 5% real rate of return. There have been protracted periods (such as much of the 1970's) when such real returns were not achieved; however, these periods of shortfall have been more than offset by other protracted periods during which the real return exceeded 10%. Thus, on average, the long run return has met the requirement.

We, therefore, have strongly endorsed the Municipality's actions to recommend a Charter change that would link Trust distributions to a percent of market value approach. We further believe that the specific smoothing technique contemplated and the percentage limitation contained in the proposed change are fully consistent with the original intent of maintaining Trust purchasing power.

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March 22, 2002