[Mr. Hutton in the chair]

MR. MARZ: Good evening, ladies and gentlemen. My name is Richard Marz, and I'd like to take this opportunity to welcome you all here to the annual public meeting of the Alberta Heritage Savings Trust Fund Committee. I'd also like to introduce the Minister of Revenue. The Hon. Greg Melchin is with us tonight. Greg, give us a wave. The chair of the committee and MLA for Edmonton-Glenora is Mr. Drew Hutton. Richard Magnus is the committee deputy chair and MLA for Calgary-North Hill. Welcome, Richard. Debby Carlson is a committee member and MLA for Edmonton-Ellerslie. George VanderBurg is a committee member and MLA for Whitecourt-Ste. Anne and feels that he established an attendance record last year when we had the meeting up there. I'm not sure of that. I'll have to check the figures later. Welcome, George.

I'd like to take this opportunity to especially thank Olds College and the Olds College Centre for Innovation for the tour that they provided to the committee members this afternoon – it was, I think, a very memorable occasion for all of us and an educational experience – as well as Ed Banner from Pharmacaps, who also gave us a tour of their facility. Also a thank you to Hildebrand Motors for providing transportation for the committee members to get to and from the airport and around town today.

The purpose of the annual meeting of the committee is to approve the business plan and the annual report of the heritage savings trust fund. The committee is an all-party committee, and we also review and receive regular reports on the performance of the fund. We conduct an annual public meeting in a different location each year to update Albertans on the management of the fund and also to solicit input from Albertans on the fund's objectives. As you can see, there's a mike on the floor tonight, and there will be opportunity for you to ask questions or to provide comments to us about the fund. I'd like to point out that this meeting is recorded in the official legislative record, in *Hansard*, so your comments will be recorded.

I'd like to point out as well that Alberta is the only province that has a fund such as this. It was established in 1976 with $620 million from oil and gas revenues as well as a special contribution of $1.5 billion. Over the last 26 years the fund has contributed over $25 billion to the province's general revenue fund, and the latest figures, as of June, show that the fund is currently worth about $11.8 billion. So it's certainly been a very important part of Alberta's past, and it will be a very important part of our present as well as our future.

At this time I would also like to introduce some people from the Hon. Greg Melchin's department that are here with us tonight that are responsible for the day-to-day management of the fund and staff from Revenue communications and the Legislative Assembly Office. We have with us Laurence Waring, director of external fund management, investment management division of Alberta Revenue; Peter Orcheson, senior manager, investment management division of Alberta Revenue; Cathy Housdorff, director of Revenue communications; Tammy Forbes, Revenue communications. I'd like to thank you especially, Cathy, for all the work you've done in helping get this evening organized. Karen Sawchuk is the committee clerk. She's also here. Glenn Shepherd is executive assistant to Mr. Melchin, and Michelle Grove and Greg Morgan are from *Alberta Hansard*.

I'd also like to acknowledge and thank Myrna Christoferson and Kay Johnston, who are my assistants, for all the work they've done in helping set this up tonight. Thanks very much.

I'd also like to introduce Ken Nicol, who is the Leader of the Official Opposition. Ken is here tonight with us. Welcome, Ken.

Now I'd like to call on the committee chair, Drew Hutton, to kick things off.

THE CHAIR: Thank you, Richard. I'd also like to thank you and your staff for setting up the tours today, and I think I speak for the committee when I say that we certainly learned a lot about Olds College and that we enjoyed the tour of the plant as well. It was a very enjoyable day, and we look forward to this evening's meeting.

Our presentation is going to be split into two. Several members of the committee will walk through the history, mission, structure, governance, and operation and performance of the heritage fund. Laurence Waring from the Department of Revenue will discuss operations and performance of the fund, and then we'll have a question-and-answer period following that. At this point I'll turn it over to my vice-chair, Richard Magnus.

MR. MAGNUS: Thank you, Mr Chairman. I'd just like to thank everyone for attending today. It was interesting looking around the room. I think I know everybody here but about eight people, and it looks like a fairly friendly crowd. We'll chat with you about it later.

The heritage fund was started in 1976 and is a unique aspect of Alberta's financial situation. No other province has such a fund. From 1976 to 1983 it grew with 30 percent of oil and gas revenues going into it. The fund reached a peak of just over $12 billion in 1987 and has remained around that value ever since. From 1982 to the present all income from the fund was transferred into the general revenue fund to meet the financial priorities of the province. Further spending on capital projects ended in 1995. The bulk of the fund's investments up to 1996 was in fixed-income instruments such as bonds and money market securities.

7:10

An obvious question raised by this chart – and I'm assuming, Mr. Chairman, that we've got the right chart, because I'm kind of sitting behind the screen here. The question raised by the chart is: why has the fund not grown since 1987? The value of capital projects is not included, and after 1982 nearly every dollar of income generated by the fund was taken out of the fund and used within the general revenue fund. Those dollars were used to support programs in various sectors such as health, education, and infrastructure. The only exceptions were '97, '98, and 2000, when $176 million, $25 million, and $230 million were retained for inflation-proofing.

Thanks, Mr. Chairman. Are you going to introduce Debby, or shall I?

THE CHAIR: I will introduce her. Debby Carlson from Edmonton will move on to the next slide.

MS CARLSON: Thank you, Drew. As indicated by this chart, the heritage fund has made a substantial contribution to the province's revenue. From 1977 to 1986 the income grew dramatically. This reflected the growth of the fund and the fact that interest rates were substantially higher in that period. The income of the fund has since declined, reflecting the fact that the fund has not grown, and interest rates have declined as well. In fact, interest rates peaked in 1981, with federal government bonds yielding 15.2 percent, then declined to 9.8 percent by 1991, and then further declined to around 6 percent. As most of the fund was invested in interest-paying securities, as the securities matured and were rolled over, it was at continually lower rates of interest.

The total investment income over the period has been substantial, amounting to over $25 billion. This income does not include the impact of legacy investments, which continue to make social and economic contributions. One example is the Alberta medical research fund. This fund was started in 1980 with a $300 million contribution by the heritage fund. At June 30, 2002, it had a value of $872 million. Not only does this provide an immediate impact in terms of the advances in medical science, but it has also provided a competitive edge in the biotechnology industry.

By 1996 concerns were raised about the sustainability of investment income. Many people were wondering whether we should sell off the fund and just pay down the debt of the province. If it was decided to keep the fund, how should it be managed in the future?

George VanderBurg now will discuss how these issues were ultimately resolved.

MR. VANDERBURG: Thank you, Debby, and thank you for being a good sport too. It's not often that an all-party committee gets to tour the province and the Minister of Revenue gets to pay our expenses, so thank you, Mr. Minister, as well. We've had a really enjoyable day. The people of Olds really went the extra mile to make us feel welcome, and it was very educational, so thank you, Richard.

A key factor in the resolution of those issues was a broad consultative process. In fact, in 1995 questionnaires were sent to Alberta households, asking specifically whether Albertans thought the fund should be sold off or retained and, further, if it was retained, how it should be managed. As a result of that process, it was decided to retain the fund but manage it on a new basis.

The mission of the fund would be to focus on maximizing the financial return. This will allow current and future generations of Albertans to gain the maximum benefit from the fund. In addition, provisions are in place to allow the fund to grow. Given the province's strong fiscal position in 1999 and 2000, $230 million of income was retained in the fund. This offset the impact of inflation.

Finally, the new legislation and business plan for the fund call for professional investment management. It was decided that the policy investments would be sold and the fund would be managed on the same basis as an institutional endowment fund. The issue in 1996 was how to get from an income-oriented fund to a fund that would give us an opportunity to maximize the potential financial return on the fund.

I'm going to ask Drew Hutton to speak to the structure and the transition of the fund.

THE CHAIR: Thank you, George. The heritage trust fund in 1996 was largely made up of fixed-income securities and short-term investments. The emphasis was on maximizing short-term income to meet the fiscal needs of the province. A program was implemented to gradually shift the fund into what we call an endowment portfolio, as you see on the chart.

What do we mean by an endowment fund? Well, endowment funds are very common within institutions like universities, and as mentioned earlier, an endowment approach is used to fund medical research in Alberta. Capital is put aside and invested, and investment income is used to fund expenditures on an annual basis. The higher the return, obviously, the higher the spending that the endowment fund can support. There may be times when investment income is not as great due to the performance of capital markets. However, an important rule in the management of an endowment fund is not to spend the underlying capital.

Two portfolios were created: the transition portfolio and the endowment portfolio. The transition portfolio would gradually decline, with $1.2 billion to $3.6 billion being transferred to the endowment portfolio each year. This transfer of assets from the transition portfolio to the endowment portfolio was largely completed in June of this year.

How has the endowment portfolio been structured to meet the goal of maximizing long-term returns? The short answer is equity investments. Over longer periods equities have outperformed bonds, but they can be more volatile, and certainly over the last several quarters we have seen the evidence of that volatility. The volatility is having an impact on the fund's current income given that the transition is almost complete. When we come to discussing the future, a major issue for the fund will be managing the volatility of income.

One of the keys to the new heritage trust fund is transparency. Every quarter an investment report is provided on the fund both in printed form and on the Internet. Copies of the latest quarterly report, the 2002 first quarter, are available at the front of the room, and we would be happy for you to take one here today, or we can put you on a mailing list for the future as well. In addition, an annual report is prepared and published within three months of the end of the province's fiscal year, which is March 31.

Another key is accountability. We have clearly defined benchmarks that we use to measure the performance of the fund. We have adopted a well-defined standard of care in the management of investments, the prudent person rule, which is the basis of the investment management industry. We have instituted public meetings such as this one to discuss the fund and its performance.

Finally, the fund's performance is reviewed quarterly by this committee of the Legislature and by the Investment Operations Committee, which is composed of private-sector individuals with financial and investment experience.

I will now turn the meeting over to Laurence Waring to discuss the operations of the fund.

MR. WARING: Thank you, Mr. Chairman, and members of the committee. We're going to change the focus a little bit and talk about the day-to-day management of the fund. The fund's investment management is the responsibility of the Minister of Revenue, who has already been introduced, to my left, and the day-to-day management of the fund is delegated to the staff of the investment management division of Alberta Revenue. I'm the director of external fund management and, at least temporarily, the acting CIO until about 8:15 tomorrow, when my boss comes back. My associate here is actually the alternate portfolio manager.

We're actually going to split the speaking duties tonight. I'm going to start off with just an overview of the decision-making and talk a little bit about our investment philosophy, a bit about the structure. Then Peter is going to take over and talk about our investment policies, the benchmarks, the performance, and a little bit about the fund in the future. As we move along here, if you have any questions, please feel free to stop me, and I can give answers, or you can wait until the end of the presentation.

7:20

In terms of decision-making, the one thing that I'd like you to take away from this slide is that the fund is being managed on a professional basis – this was mentioned earlier in the presentation – and within our investment management division we're probably ranked about the fifth largest investment management operation in Canada. We actually manage about $35 billion in total, of which the heritage fund is about $11 billion or $12 billion. We consider ourselves to be a very professional organization. We have 17 people with their CFA, certified financial analyst, designation and another seven who are in the process of completing that discipline of study. We have in total 41 employees with an average of almost 10 years' investment experience.

We also make extensive use of external managers; in fact, that's my area of accountability. Of the $35 billion, we have about $10 billion that is externally managed. What we mean by this is that we've gone out and we've searched basically, literally, around the world to find investment advisers that we can draw upon to take on very specialized mandates. For example, we're not going to invest in Japanese equities out of Edmonton. We actually go and hire investment teams that are specialized in that area.

In terms of investment philosophy, one of the things that I'd like to highlight is that, for want of a better phrase, this is mistake-prone activity investing, and the reason why we say that is that we're really dealing with uncertainty. We make investment decisions with, at the end of the day, knowledge that we have at the time, but in hindsight you find out that it may be something different.

For example, we make investment decisions on what we feel a monetary policy will be, what the management plans within different companies are going to be, but at the end of the day there is an element of uncertainty in all of that. I mean, we really don't know what's between Allan Greenspan's ears. We assume that there are brains there, but in terms of what he plans to do with interest rates, well, that's really his own call, and we won't know until he does it. Similarly, we're not going to know if planes are going to run into the Trade Centre or if there's going to be an anthrax scare. At the end of the day we're not going to know if fraud has occurred in companies until that is actually uncovered. So we're taking all of this uncertainty and the best information that we have available and we're trying to make investment decisions.

In terms of our philosophy, there are a couple of things that I'd like to highlight. One is that we're very risk aware when we're making investments. When we look at every investment that we make, we're looking very carefully at what position we're taking relative to the market and to our benchmarks, and we're obviously weighing out the effects as to whether or not the investment represents good value.

Similarly, we have a strong belief in diversification. Basically, what we're trying to do in terms of diversification is make sure that the investments are broadly invested, such that if there is a problem in one company or one investment, in aggregate the investments will deliver what we want. Again, there could be some situations where companies don't perform as well as they should, managements don't deliver on their business plans, and there will be some companies that are more successful than others, and being broadly diversified, you minimize that risk.

We're also very disciplined investors, or we believe that we're very disciplined investors. There's an awful lot of emotion that works its way through marketplaces. In fact, over the last year and a half we've certainly seen a lot of that emotion not only in the marketplace but spill over into the media, and to be blunt, it's been a very difficult 18 months. In fact, the last time it felt like this in terms of emotion in the marketplace goes back for me to '82, when interest rates were peaking in this country. It was interesting because at that time I was working on Bay Street for a consulting firm, and I was going and visiting brokerage houses every day. Every day going down there you get on the elevator with bond traders, and the conversation was sort of like this: "Well, how much money did you lose today?" "Ah, $10 million. How much did you lose?" "Ah, $20 million." You get on the elevator the next day: "How much did you lose today?" "Fifteen million." I mean, this went on for as long as interest rates went up, and it was a brutal bear market for interest rates. The interesting thing is that at the worst of that despair and emotion, if you had bought a long bond, 20 years later you would've made the best trade of your life.

So it's very important, when we look at investing, that we develop disciplines that prevent us from being swept up in the emotions of the marketplace. The two emotions are fear and greed, and markets are often a creative tension between those two.

The other thing is that we're very much long-term investors, and I think that's critical when you are an investor. What's the long term? Well, 10, 20 years. When you're developing an investment strategy, it's not necessarily going to come to fruition right away, and I think that when you take a balance of discipline and longer term, you have to be able to see through the volatility that you're dealing with. That's very critical for a fund like the heritage fund, where we have a very significant equity content. That equity content is based on extensive long-term analysis which shows that in the long run equities outperform bonds, but you pay for that outperformance in the coin of volatility. The belief is and the endowment structure is based on the notion that we're going to maximize the long-term return. We realize that year to year it is going to be quite volatile, but we are going to realize that income over the long term.

We're also very cost-effective, and we pay very strong attention to cost. In fact, our cost for investing the heritage fund works out to about 11 or 12 basis points. That's comparable to an MER that some of you might see in a mutual fund, which for most retail investors probably runs about 150 to 250 basis points. That cost-effectiveness really comes from our scale of operations.

Finally, we focus on our core competencies. We don't try to do everything in-house. We focus on what we can do well, and what we need to use outside advisors on, we're more than happy to go out and work with them as well, in terms of external managers.

I'd just like to spend a moment on where the fund is currently in terms of its asset mix. You can see that at this point we have about 7 percent in real estate, a fairly significant exposure in international equities, US equities, and Canadian equities, and a relatively more modest exposure in bonds. The key here, though, is that it's broadly diversified. There is significant equity exposure, and a large part of that exposure is through international equities. One of the things that you have to keep in mind is that Canada represents only about 3 percent of the world capital markets. In fact, if you look at the structure of our capital markets, it tends to be quite skewed to very specific industrial sectors. To get that broad diversification in terms of international leaders, in terms of companies, and also in terms of different types of sectors, you really have to go internationally to manage the risk of being in equities.

Then, lastly, we do make extensive use of external managers.

With that, I'd like to turn it over to Peter to continue the discussion.

MR. ORCHESON: Thank you very much, Laurence. I'd like to now turn the discussion over to the policy benchmarks used for the fund, and here we've actually highlighted three, the first being the cost of debt, the second, relative return, and finally the policy benchmark return.

On the cost of debt one could ask the question: if the fund is not earning the same rate of return that we're paying on our debt, we may want to go out into the market, use part of the fund, and pay that debt down. There are a few issues there. On our debt the yield is about 5.4 percent. Recently the fund hasn't earned that, but the question is – you know, you have to look forward – can the endowment portfolio earn a better return than you're paying on your debt? So before you make that decision, you really have to assess that.

Secondly, even if you do make the decision to go into the market and buy back your debt, there are issues involved. Alberta debt is very highly rated and a highly sought after security. It tends to be very expensive to buy it back. Even with the market value that the bonds are trading at, you may have to pay 20 or 25 percent more to buy it back in. So as a strategy it's probably best, if you in fact did decide to pay some down, to wait until it actually matured.

The second benchmark, relative return, is essentially asking how everyone else has done in the industry. It's difficult as a manager to be measured this way because it's impossible for me to tell today who is going to be the median manager for the coming year. It's not actually investable. There are also differences in objectives and constraints of different types of funds which dictate a different investment policy and, therefore, different returns in the end.

7:30

The final benchmark I'd like to highlight is the policy benchmark return, which is the market rate of return in the market that you've invested in; for example, the TSE 300 or the S & P 500 or the Nekkei. What we do there is we try to beat the actual benchmark return when we're making investments. For an active manager it's an excellent way of assessing performance, because if you can't beat the market return, there are index funds that are available. So you can get exposure without actually running an active fund, and we do run an active fund. We also feel that on the policy benchmark return it's the best measure because it actually measures what we do on a daily basis. We're out there trying to beat global benchmarks.

On performance. Now, obviously the last couple of years have been difficult. We'd certainly like to be bringing a happier story for the last two years, but as Laurence pointed out, we've gone through one of the worst bear markets in history. Equity markets are down some 30 and 40 percent. The numbers that you're seeing here are certainly not the unmitigated disaster that a portfolio invested entirely in equities would have produced because of the effect of diversification. Bonds have done quite well, and real estate investments have also done quite well.

As far as the endowment portfolio is concerned, on the one-year basis we're down 2.4 percent and on the two-year basis we're down 4.8 percent. Moving down to the bottom of the chart there, we see that the total fund return is better than that: down 1.2 percent on a one- and two-year basis. That reflects the fact that we've been transitioning out of the transition portfolio, which is primarily fixed-income securities, and fixed income has done quite well.

As far as the two benchmarks you see in the middle of the slide there, on the policy benchmark return we have performed better than the benchmark, which shows that we have actually been outperforming the various indices that we've been investing in, which is a good sign. I mean, we would like to obviously bring positive returns, but at least it is a sign that your manager is doing something for you.

The Royal Trust median. That is, again, a measure of how competitors in the business have been doing, and they've done well. This index is actually made up of a lot of small pension funds that have defined liability streams, so they tend to have a little bit more fixed income in them. Were we to get an improvement in equity markets, our endowment portfolio would certainly move ahead of the Royal Trust median.

Again, the transition was largely completed in June of '02. I mean, it's a process that has taken place over the last several years, moving more into the endowment portfolio with a higher equity rate. As a result, the endowment portfolio is going to dominate the performance, and volatility is likely to become more apparent, because the fact is that equity securities are more volatile. Over longer periods of time we feel that we will get paid to accept some of that volatility and be rewarded with higher returns. As some of you may have noted, over the last couple of years we have made some headlines and, you know, some of them not particularly positive. From my perspective it's not an issue that we may have lost some money in Nortel or we may have lost some money in Cisco. The fact is that I don't think it would be prudent to be in a fund that didn't have any equity securities, because you'd lose some diversification and you wouldn't be in an asset class that has produced solid returns over long periods of time.

My last point there. The increase in future income levels will be dependent on the degree to which the fund is allowed to grow. We could design a fund that produced more stable levels of income, but over time we feel that those levels would be lower.

With that, I'd like to turn things over to the chairman.

THE CHAIR: Thank you very much, Peter, and thank you, Laurence.

At this point in the meeting we'll be moving over to you folks, but I want to thank the minister and all his officials for coming this evening to be a resource. Before I turn the mikes over, did you care to say anything, Minister? Please do.

MR. MELCHIN: Never give us an opportunity at the mike.

I want to thank everybody, also, for taking the time to come. I want to also tell you that from my own experience we really do have a team of investment professionals, both by training and expertise and experience, that manage the heritage fund. We made some decisions a while ago. We've gone through it as to a long-term investment strategy, and that's key to keep in mind as to how you would invest. We'll be happy to entertain some questions.

I would just want to raise another question, that's outside of the purview of this committee. You should have received in the mail over the past week a survey to everybody, to every home, that talks about the heritage savings trust fund. We're interested in finding out – and be really clear since it's your fund and it's your money – what you would view as the key reasons that we should save for the future. Now, this survey is not about getting rid of the fund. It's not about trying to eliminate it, because we know Albertans value it, and we will see that it's there now and in the future.

The key concern that I've had is that if we're going to properly invest the fund for the future, we have to know what it's there for. Just to illustrate, if for yourself you're planning on saving money, you usually have identified for what reason you're going to spend it in the future. If you have no anticipation to spend savings in the future, it's no better than just throwing the money away. You normally might want to save for your children or your grandchildren. You might want to pass some inheritance on to them. That's kind of the concept of the first question in there of an endowment, of leaving some money for the future. We know that oil and gas moneys won't stay there forever, so do you want to leave some money for future generations? That's been a key component of the heritage fund since it was formed in 1976 and, I suspect, will continue to be such a key component of it going forward.

The heritage fund, created in '76, had multiple reasons for saving and actually had multiple purposes in it. That was only one of the reasons that the heritage fund was created. You and I have usually many reasons for which we save, not just one. Another reason why you might save is that you might lose your job, might have a loss of income. Business might be down. You might need some cash reserves on hand to handle just the volatility and risk of life. We know that revenues in the province are quite volatile because of oil and gas revenues, so a reason for saving is to manage the volatility of revenue, the income. When you have high revenues, you save. When they're down a little bit, you might use, but you'd need a mechanism to replenish in the good years what you had saved.

A third reason why you might save. You know, you and I would save for maybe a home or a car or investment in expansion of a business. One of the original mandates of the fund was to use up to 25 percent of the heritage fund for capital projects. There would be a means to replenish the fund. You have to save in the first instance, but you could use some of it for those key significant capital costs rather than incurring debt, that you put some of the equity into it.

So those are kind of the questions we're asking. There are really no right or wrong reasons for why you save. We're looking forward to and I'd just encourage you to complete the survey and mail it in. Your opinion will count. It will form the basis of the policy as we go forward. Furthermore, there's a web site, www.albertaheritagefund.com, where, if you wish, you could respond to the survey. That'll be completed by November 22. We'll announce the results probably early in the new year.

Thank you for taking the time to come out and for your interest in the heritage fund. It's served the province well, has earned over $25 billion over its life. It's helped the province in many ways. It has helped lately in our focus to pay down debt. Our debts were $23 billion. They're down to $5 billion. So rather than building up the fund in a savings account, we've attended to paying down a debt and in a lot of ways have saved us significant interest bills every year as a result.

So thanks for your time. We'll be happy now to turn it back to Drew. Thank you, Drew.

7:40

THE CHAIR: Thank you, Mr. Minister. I appreciate your comments.

This concludes the formal presentation portion of the evening, and now we'll turn the mike over to you folks for any comments or questions. If you would be so kind as to walk to the mike, give your name. As Richard mentioned earlier, the record is taken by *Hansard*, and you can actually pick up a transcript of this meeting at www.assembly.ab.ca. So we're open to any comments or questions at this time.

MR. GANSER: I just have some questions. On the one chart you indicated 41 employees. Are those people employed full-time to administer this fund?

MR. WARING: That's the staff complement of the investment management division, and that is 41 investment professionals. We not only invest this fund, but we also invest six pension plans, two or three other endowment funds, and a number of other specialty funds.

MR. GANSER: Okay. Well, with this number of employees do you know what it costs to administer this each year?

MR. WARING: Yeah. It's roughly – we think in terms of basis points – about 11 basis points of the fund. In terms of the dollar amount, that's actually in the quarterly report, and it's right at the back under note 8, administrative expenses, page 21. Unfortunately, this one is on the quarterly, so I have to look at the annual. It's about $3.9 million on the quarter, so, say, about $16 million. The bulk of the expense is not actually direct fund expenses or the internally managed investment pools. To do that, administration works out to about $900,000 for the quarter. Three million of that is actually what we pay to the third-party investment managers. Then on a one-year basis it should be in a similar spot in the annual report.

THE CHAIR: Just a point of clarification that the employees within the Department of Revenue do manage over $35 billion. That's where the 41 employees come into play, and they manage fund managers. Is that a fair assessment?

MR. WARING: Yes, and we also manage money directly ourselves, but it would depend on comparative advantage, the skill set.

MR. GANSER: The one thing I was looking at was in the paper. It indicated that last year the income earned was about $700,000 on the fund. Is that accurate?

MR. WARING: Seven hundred million.

MR. GANSER: They must have missed some zeros. It shows $700,000, and it's kind of alarming when you look at what the figures were and what you're telling me, you know, the cost is. So it's $700 million then.

MR. WARING: It was last year, yeah.

MR. GANSER: That is about a third of what it normally would be?

MR. WARING: No. We've been running around $900 million to $1.1 billion a year.

MR. GANSER: So it's down about 20 or 30 percent.

MR. WARING: Yeah.

MR. GANSER: Okay.

MR. VANDERBURG: Just further to that point, I know that I was talking with my fund manager, that manages mutual funds that my wife and I invest in, and it's about 2 and a half percent. In comparison, Peter or Laurence, what would be the percentage?

MR. WARING: We'd be about .12.

MR. VANDERBURG: Yeah. So it's very low for the volume of dollars that we invest in for management compared to the private sector.

MR. ANDERSON: I'm just curious. When Nortel composed such a large component of the TSE, if your approach was conservative, did you factor that risk in and maybe keep your holdings in Nortel down?

MR. WARING: In aggregate we were underweight in Nortel, and actually at that point, when Nortel was running the strongest, we were moving to a lower weighting in Canadian equities in general.

MR. ORCHESON: Just to follow up on that point, you know, we have some active managers, and we also do some passive management, which is essentially just buying the index. When you do that, you're buying a capitalization-weighted group of companies that actually make up the whole index, so you are going to be exposed to all the names in the market. Now, why would you do that if you feel that you have the expertise? Well, the fact is that the evidence on active management versus buying indices is somewhat mixed. It differs depending on what market you're in, so there are going to be exposures to events such as Nortel if they are in the indices. But, of course, let's not just talk about the Nortels. Let's talk about some of the success stories too, and of course there are lots of them out there.

THE CHAIR: Anybody else?

MR. WITHAGE: Peter, you talked about looking at the future and that it was wise to stay with the investment in equities. What is your projection in terms of getting to plus numbers? What are the portfolio's projections in terms of getting to plus numbers? I mean, like with everything else, it has to be your best guess.

MR. ORCHESON: Right. That's a loaded question. I would say that prices have dropped significantly in the stock market. Earnings have dropped as well, but prices have probably dropped more, so we're getting down to what might be considered more reasonable valuations. We're also a significant way into a recession, certainly in the U.S. You know, I hesitate to say that we're going to see positive returns this month or next month, but I think that just given the reasonable valuation – I don't want to say earnings momentum, because companies don't appear to have a lot of momentum, like the broader indices – the real downdraft on the earnings side appears to have come to a close. So I would say that, you know, we're building value, and I would certainly think that over the next two years we're going to have some decent returns. Quite often what happens after you've gone through a period of an extreme bear market is that the returns in the initial couple of years on the way out are quite strong to the positive side. That's certainly my hope.

MR. WARING: Just to add to that, as Peter pointed out, there is a fair amount of value coming back into the market. If you look back over the last two years or 18 months, we've certainly seen the valuations come down, and in all probability most of the adjustments are behind us. But, as Peter pointed out, when that turning point is going to be is not something that you can really forecast. Going forward, I think we're a lot more confident that we'll see some better value in the marketplace.

MS MITCHELL: Hi. Welcome to Olds. A quick question for you: over the 25 years that we've had the fund, what is the average rate of return over that 25 years? I'm kind of interested in outcomes of major initiatives that have been funded over that 25 years.

Thanks.

MR. WARING: Well, actually I'm not sure about the 25-year return. One of the problems is that we've had changes in policy through the piece. I'll have to check to see if there is some data on that.

7:50

In terms of major initiatives one of the better ones to talk about, which we've already mentioned, is the medical research fund, which started off with $300 million and has grown to almost $900 million and has spent about $700 million over its life on medical research in this province. It's actually been quite a dramatic success story. I believe the scholarship fund also was funded in a similar fashion. Certainly, you can go to a lot of buildings in this province that were built with it: the Foothills in Calgary and I think the Tom Baker and the Walter C. Mackenzie, the Kananaskis. The last annual report of the old heritage fund, under the old rules in '96, has actually quite an extensive list of the capital projects.

MR. MELCHIN: We've actually also put in the survey that you've received an extensive list of capital projects. About $3.5 billion of the fund was invested in capital projects over the life of the fund, so it's got a range of buildings, properties. There's the Kananaskis, Fish Creek park, the Walter C. Mackenzie, just for a sampling. There is a lot of infrastructure capital that's there in place benefiting us now and for well into the future.

Other initiatives. I do think it's important that you realize that the key initiatives that have come through have to do with the spawning of other endowment funds, like the scholarship fund. There are many who would know that the Rutherford scholarships, that our children receive when graduating from high school, come from a fund that was established from the heritage fund. Medical research is a very key one. Three hundred million dollars were put into that in origin from the heritage fund to spawn that endowment fund. But very significant to the province is $25 billion of income that's been earned, some years with very significant rates of return because interest rates in the '80s were very high, as you know. It's nice if you're investing, which this fund has. It wasn't so great if you had your mortgage coming up for renewal, like many of us had, and you had those high rates, but our debt is a significant benefactor, having been reduced from 23 years down to five because of having had cash from things like the heritage fund, where we do save from a peak. We used to pay about $1.7 billion in interest. Now it's closer to about $500 million and falling. We save substantial amounts of interest expense every year. So the heritage fund benefits a lot of our day-to-day programs and the reduction of debt.

MR. BIRCH: I was led to believe that back in the '80s the heritage fund was used for a lot of loans for other provinces and other organizations. I was wondering if those have been paid back or what the rates are that were supposed to be paid.

MR. WARING: All of that was paid back. In fact, a lot of those loans were at very high interest rates, and at every opportunity a lot of the provinces that borrowed paid them back as quickly as they could simply because they were very, very good interest rates. As the minister pointed out, we wouldn't have generated the amount of investment income that was generated if they weren't paid back flat out. I think the last one that was paid out was a New Brunswick loan in December of 2000, but they've all been paid back in full. There were no defaults, and the interest rates were very good.

MR. MELCHIN: I should also say – I don't know necessarily always what raised this – that with respect to loans there were a number of loans that were provided to companies to diversify the economy. Really, in the early '90s it was the policy of this government to get away from that as a policy, not to get into picking the winners and losers in business, no longer continuing that, so the heritage fund has not continued that.

The reason I raise that is it does have one loan remaining in the heritage fund. The Prince Rupert grain terminal is on the books for about $91 million still remaining in the heritage fund. All the other loans from all the other companies have been settled and are no longer part of it. The rest of the fund is clearly in stocks and bonds, real estate, as a normal pension fund would be managed.

THE CHAIR: I'd also just like to add that locally it has had an impact. Banner Pharmacap, that employs – what is it? – 160 employees, had heritage trust fund dollars put into it in its inception.

MR. LACHMAN: If we were to change parties in the next election, are things locked in place with this heritage fund, or could another government just do whatever they want with that money?

MR. MELCHIN: You know, your Legislature has the power to legislate, so I would say to you that they are your representatives and it's very important that you know which policies they stand for. You can lock it in by legislation – and we do have parameters in legislation for the purpose of the fund right now – but it's also possible for a future Legislature to change a policy. So I don't know that there's a guaranteed way to say that it could never be changed.

We know that Albertans want the fund kept. It's been a promise of this government to follow the wishes of Albertans on this fund, and we've heard it overwhelmingly that this fund is for the future. I was talking with Ken on a talk show just the other day in Medicine Hat, and I suspect that would be similar to the Liberal Party. I think we all recognize that this is Alberta's fund. It's your money; it's not mine as an elected official. It's our fund, and we hold this in trust for the future, to benefit today and the future.

MR. ANDERSON: I'm just trying to put the value of the fund into perspective. When we talk about gross debt and net debt position of the province, can you define that in terms of what our liability is? If we've got $12 billion in assets theoretically in the fund, do we have offsetting provincial debt to that extent on a net basis?

MR. MELCHIN: I've been talking that we had a peak of $23 billion of debt. It was the peak of the debt that we had. That was the operating debt, the operational debts that have come in, but basically right now we have $5 billion of debt remaining plus another couple of billion dollars that we have cash set aside for from past years' surpluses waiting for debt to mature. So we actually have more than $5 billion of debt outstanding, but we have the cash set aside to bring it down to $5 billion as soon as it matures over the next year or two. So really the net effective debt that we have is $5 billion. I would say to you that in simple terms that really is our gross debt.

MR. ANDERSON: That would be like term debt. Is that correct?

MR. MELCHIN: It's term debt. It matures over different times. That's correct. In fact, there is a maturity schedule in this survey as well that shows when the $5 billion matures. The bulk of it comes due in 2005 and '06, but there's quite a bit of it that takes until 2013 and '14 and later to actually mature, the smaller amounts. But the bulk of that remaining $5 billion, close to just under $4 billion of it, will come due by the end of 2006.

MR. ANDERSON: So in theory – and I don't suggest that you do this – if you manipulate a portion of that heritage fund and wipe out the remaining debt of the province . . .

MR. MELCHIN: That is one of the questions of your choice in the survey. The question is: do you use it as it comes due? It was mentioned earlier that it would cost us too much of a premium to go out and buy this debt in the marketplace. It's so widely held by Canadians and around the world, potentially, that we have such a great credit rating in Alberta, it's going to be at a premium. So it is more of a question as it comes due. You wouldn't want to pay financial penalties, like a penalty to prepay your mortgage, the same type of problem. You wouldn't want to do that. It just wouldn't make financial sense. So, yes, an option that we are allowing you to choose is: as it comes due, would you use the heritage fund, if you need it – because surpluses may be able to answer that question without the heritage fund – to repay the remaining debt? That's a question you'll be able to answer.

8:00

MR. WARING: Just a technical point in terms of how much is actually being paid on debt servicing. I mean, we have debt, but in terms of sort of budgeted expenditures of almost $20 billion, our interest expense, debt servicing, is about $585 million. So that's just to give you an idea of the magnitude.

As the minister pointed out, if you go back a couple of years when the operating debt peaked, there was a substantially higher proportion of expenses. In Alberta we have a law that says that a dollar of expense must equal a dollar of revenue. Obviously, with debt servicing costs you're not getting a dollar back in services; right?

MR. ANDERSON: Just to clarify. There's operating debt. Is there capital debt, then, as well?

MR. WARING: No. Everything is considered just simply unmatured debt. We don't distinguish between operating and capital debt.

MR. MELCHIN: The only debt that I would add to this which really is outside of operating capital is Alberta Finance & Mortgage Corporation. The municipalities can borrow, so there's that corporation that allows the municipalities to borrow, but it's an offset of revenue and expense for the province. So it really isn't a debt question to the province, but it is facilitating municipalities to borrow.

THE CHAIR: If there is nobody else going to the mike, I'd like to thank the people who asked questions. I also want to thank you all for coming out this evening. As the minister said, this is your fund, it is our fund, and I encourage you to fill out the questionnaire. I encourage you to go to our web page for the Assembly if you have any comments or questions following this. I'd like to thank Karen Sawchuk, the committee clerk, for setting up tonight, as well as Michelle and Greg from *Hansard*, as well as Cine Audio for working the mikes for us this evening. If anybody would just like to stay behind and discuss the fund informally, that will be fine.

I'm going to turn the mike over to our host for the day. Richard will close the meeting, and as chair I thank you for your time.

MR. MARZ: Well, thank you, Drew. Again I'd like to thank everyone for coming and add my encouragement to fill out the questionnaire. I can tell you from the scientific research I've done in the constituency via the coffee shops and telephone calls that there's a diversity of opinion in our constituency about the questions, and it is important that we hear about that.

The way our markets have performed in the last year kind of reminds me of a cartoon that was circulated in some of the major papers about three or four months ago, where an elderly lady was watching her husband withdraw out of the mattress some money that he had sewn in over the years, and she said: well, Charles, it appears you've outsmarted the finest financial experts once again. That's just about the size of it.

We've heard tonight about some of the great ways the fund has performed over the last 25 years. Right now we're not performing as well, and that seems to make more news than the good news, but over the long haul I believe the fund is going to perform well for Albertans again in the future, and I think we just have to kind of ride out the storm and practise discipline.

So with that, I'd like to thank the committee once again for taking time to come down. It's always a joy for an MLA to showcase parts of their constituency to their legislative colleagues, and I am certainly happy to have everyone come out today to do that.

Thank you.

[The committee adjourned at 8:04 p.m.]