State of Alaska
Department of Revenue
State Investment Review Meeting
February 10, 2021

MEETING SUMMARY

Meeting Details:
Start Time: 10:01 a.m.
End Time: 11:08

Department of Revenue Staff present:
Lucinda Mahoney, Commissioner
Mike Barnhill, Deputy Commissioner
Zachary Hanna, Chief Investment Officer
Pamela Leary, Director of Treasury
Shane Carson, State Investment Officer
Victor Djajalie, State Investment Officer
Scott Jones, Head of Operations and Analytics
Mark Moon, State Investment Officer
Michelle Prebula, State Investment Officer
Hunter Romberg, State Investment Officer
Stephen Sikes, State Investment Officer
Alysia Jones, ARMB Liaison Officer

Investment Advisory Council (IAC) Members present:
William Jennings
Jerrold Mitchell
Ruth Ryerson

I. Introduction

Commissioner Lucinda Mahoney and Chief Investment Officer (CIO) Zachary Hanna opened the meeting.

II. 57 Years of Investing: Some Observations

Dr. Mitchell thanked the Commissioner and CIO Hanna for the opportunity to reflect on his 57 years in the investment world. He said that he had presented a similar presentation 7 years ago to the Alaska Permanent Fund and although today's environment was vastly different, his observations remained essentially the same.

Dr. Mitchell presented the following ten observations:

1. **An Institutional Investor's Default Asset Class should be the U.S. Stock Market** – Dr. Mitchell asked the group if you were forced to only own one asset class and hold it forever, what would it be? He said for him the default for institutional investors would be the U.S. stock market as measured by the S&P 500 Index. He said the historic return series of the U.S. stock market is long, rich, and to be trusted; while historic returns from more recent asset classes like infrastructure, private equity, absolute returns, or MLPs, are not as statistically significant. He noted that over the past 100 years, the S&P data showed an average return of close to 10 percent, which meets the requirements of most institutional investors. He also said that over the past 100 years, the S&P has been up 75 times and down 25.

2. **Remember Investment Management is a Business and All Investment Managers are Salesmen –** Dr. Mitchell said that most investment managers are far richer than their clients and suggested the group recall Fred Schwed's book, published in 1940 entitled *Where are the Customers' Yachts?*

3. **Economic Forecasting is Notoriously Inaccurate** – Dr. Mitchell explained that most main line indicators do not tell you much about what the stock market or your own specific holdings will do long term.

4. **Market Insights are Temporary and Usually Self-Correcting** – Dr. Mitchell said that you shouldn't be the last investor to buy into a hot asset class or fail-proof investment approach and that being early was important.

5. **Risk** – Dr. Mitchell said that higher risk does not always equate to higher return and warned people to be careful about how they measure risk.

6. **Performance Measurement** – Dr. Mitchell said that past performance was no guarantee of future returns. He said if you allow a manager, consultant, or fund sponsor fund the freedom to choose the benchmark, the cohort, and the time period they will all be in the first quartile.

7. **Return Assumptions –** Dr. Mitchell recommended having realistic return assumptions and not expect funds to do too much better or too much worse than the broad markets they are invested in. He said small, consistent gains win.

8. **Investment Theory -** Dr. Mitchell said investment theories and models are useful, but that they don't always work in the real world.

9. **Doing Nothing is Sometimes Better than Doing Something –** Dr. Mitchell said there is a strong tendency among professional investors to show activity, change benchmarks, change asset allocations, etc., but often the most successful investors are those who change very little and do very little – they buy and hold, and hold, and hold.

10. **Smartest Person in the Room is Not Always the Best Investor** – Dr. Mitchell said that while intelligence helps, you have to have a talent for investing to be successful at it.

Commissioner Mahoney thanked Dr. Mitchell for his comments and said that in times when she is struggling, she will look back at these observations.

III. State Investments

A. December 31, 2020 Performance – Commissioner's Report

CIO Hanna shared a periodic table of investment returns by asset class, showing annual capital market information for 2011 through 2019, and quarterly information for 2020. He noted that the fourth quarter of 2020 was a strong rebound for equities, following the poor performance in the first quarter. While international led the way in the fourth quarter, it had been lagging in previous quarters and still lagged the U.S. for the year. Fixed income was up modestly, and the cash equivalents return was next to nothing due to very low rates. CIO Hanna stated that some of this would be reflected in the performance of the state funds later in the presentation.

CIO Hanna reminded the group that the Commissioner is the fiduciary of 7 billion in state assets, which includes several funds over 500 million in size including the Constitutional Budget Reserve, two General Fund accounts (GEFONSI I and GEFONSI II), the Power Cost Equalization (PCE) fund, the Public School Trust fund, and the Retiree Health Insurance funds.

CIO Hanna shared the relative allocations and asset allocation deviations from target for the end of 2020, all of which were very close to target. The largest deviations were 37 and 38 basis points away from target. He explained that these funds are typically rebalanced at month's end and most funds have 5 percent bands around their target asset allocation, so all are well within their tolerances. He also mentioned that staff were looking at the state's rebalancing policy and may recommend changes in the future including reducing the rebalancing strategy to quarterly and further considering how bands are treated.

CIO Hanna explained that the asset allocation process occurs each year and involves a selection of asset classes and pools used to construct asset allocations. Victor Djajalie and his team manage the broad market fixed income pool internally using the standard bond benchmark – the Bloomberg Barclay Aggregate Bond Index. The Domestic equity pool is passively invested in a Russel 3000 fund managed by State Street, and the International equity is currently passively invested to an ACWI ex-US IMI index, also managed by State Street. The short-term fixed income pool is managed internally using the 90-day T-Bill benchmark and invested in a number of high-quality, short-term cash equivalent instruments.

CIO Hanna reported on the 4th quarter performance for 2020, noting the alignment with the information on the periodic table of investment returns shared earlier in his presentation. Equities showed very strong performance with international up 17.1 percent, and domestic up 14.6 percent. The 3-month numbers for the fixed income pool was 78 basis points for cash and the numbers for their cash pool were at 5 basis points. In terms of relative performance, he reported that the fixed income team continued to do a nice job generating excess returns and were up in both broad market and short term. For equities, domestic was slightly under benchmark and international was slightly over.

CIO Hanna also shared the relative performance for each fund, which showed the combination of each asset allocation and investments in the individual pools. All were very close to the benchmark, as expected and both fixed income and equities were largely positive. He explained the pools have their own independent cash flows and there can be a little drift with those, but that there is tight tracking error for these funds. For actual plan performance, the equity heavy portfolios had largely performed over 11 percent for the quarter.

B. Non-Routine Investments

Non-routine investments are investment opportunities that fall outside the scope of the Department's existing investment opportunity set. The Department does not currently have, nor is presently contemplating any non-routine investment opportunities, however this topic will be a standing item on the SIR meeting agendas in the event such an opportunity arises. CIO Hanna explained the diligence process for evaluating non-routine investments involves several independent points of input, including this group.

C. 2021 Capital Market Assumptions

CIO Hanna re-reviewed the state's asset allocation process, stating each year staff reviews and makes recommendations considering specific fund investment objectives, risk tolerance, and other attributes. He said capital market assumptions had been decreasing for years, largely due to declining growth and inflation expectations and that Callan's year-over-year decrease for this year was the most significant one he had seen.

In January, Callan released their capital market assumptions (CMAs) for 2021. CIO Hanna said that both risk, as measured by standard deviation, and the correlations between asset classes were mostly left intact. Returns were reduced across the board, led by fixed income cash assumptions which were heavily influenced by current rates. He reported that cash came down the most at 125 basis points, but noted from Callan's perspective, it still had a 1 percent (100 basis point) return assumption over the long term. Equities and most risk assets were down by roughly 50 basis points. CIO Hanna pointed out that Callan had reduced the inflation assumption by 25 basis points for accounts with real return perspective, such as public schools, which softened the impact of some of the other nominal return reductions.

In addition to Callan's CMAs, staff reviewed approximately six other CMAs from other providers, and noted that all were fairly consistent and largely driven by reduction in rates. CIO Hanna said staff look at a number of different CMA providers since they predominately do the investment policy and asset allocation work for state funds themselves, adding that they tend to follow Callan because it syncs up with information used by both the Alaska Retirement Management Board and Alaska Permanent Fund.

CIO Hanna said that given the current environment, staff is looking at whether to recommend adding a subset of REITs, TIPS, and High Yield bond to the state's asset allocation process.

Dr. Jennings said staff is looking at the additional asset classes he would have chosen and agreed that staff should look at the consultant they are closest too. He said most people calibrate off of J.P. Morgan's data because it includes approximately 50 asset classes and comes out earlier than other reports. He said the usefulness of looking at others is not in the actual assumptions, but in the write ups on how they got to their assumptions. He also suggested reviewing Horizon's annual survey which includes 30 other sets of CMAs. He noted that information is lost when everyone is averaged together, but said it is a useful calibration of what is the broad sense of what these things are.

CIO Hanna said from Callan and most other market participants' perspective, the shape of the efficient frontier is still strongly upward sloping, suggesting an expectation of a fairly robust equity risk premium. By comparison, Bridgewater's efficient frontier is mostly flat, indicating no expectation of any pick-up in returns as risk increases. Commissioner Mahoney asked if they considered that for private equity as well. CIO Hanna confirmed that.

CIO Hanna shared a summary of the risk tolerance framework that staff uses to evaluate state investment policy. The framework is part of the state's 300-page investment policy manual, which also acts as a historical record of the state's thoughts and management of the funds over the years. In the past anything with a higher than 10 percent probability of a one-year loss was considered to be high risk. CIO Hanna said very low rates change this dynamic considerably and suggested a more nuanced approach would be taken this year. He also highlighted that the current framework does not address measures of the magnitude of loss, which he suggested may be more important than the absolute probability of loss for many of the funds that they manage. For some of the funds, absolute principle protection is front and center.

CIO Hanna explained that they blend Callan's long-term capital assumptions with current rates to try and bridge the time horizon gap between Callan and other providers' long-term assumptions and the state's short-term focused asset allocations. He said one of the implications of rising interest rates is that fixed income investments that have some time sensitive exposure likely take losses and incorporating current interest rates into this process is one of the elements staff considers.

As a starting point, CIO Hanna showed the existing state asset allocations against Callan's 2021 CMAs. He said for long term expected returns, the difference was between 83 basis points for the PCE endowment and 72 basis points for a fund categorized with a High Risk Tolerance. He said the low rates pose a real earnings challenge as well as a principal protection challenge and suggested past approaches to asset allocations may no longer be applicable with where rates are currently. He also explained the 95% conditional value at risk (cVaR) is a measure of the average loss expected 5 percent of the time, and that, in his opinion, the potential magnitude of loss was still relatively low. He said that given the hyper-low rates, the typical way of looking at the information was no longer sufficient, and staff would be re-evaluating their approach. Potential adjustments include modifying downside risk assumptions and incorporating some measure of size of losses.

CIO Hanna said they tend to rely on approaches that are principle-based, transparent, and somewhat independent to avoid too much staff bias in the process but acknowledged that those standard ways of looking at things do not work as well now. He also commented on constituents' tolerance for loss and suggested there may be some subset of funds that will require a super-low-risk approach and said staff would be particularly thoughtful about managing risk in their cash pools and bond pools, given the low rate environment.

Looking ahead to the May SIR meeting, CIO Hanna outlined the next steps in the asset allocation process which includes: reevaluating each funds' investment objectives, risk tolerance, and other attributes; considering additional asset classes; reassessing risk-of-loss and risk categories in a low-rate environment. Draft investment policies and asset allocations will be presented to this group in May for input, with the intent to provide recommendations to the Commissioner for consideration in June.

D. IAC Comments

Dr. Mitchell said that REITs have changed so much and that now the largest ones are cell phone towers and other oddities in the class. He said if staff brings forward REITS, his recommendation was that staff separate the "real" real estate from the specialty REITs.

Commissioner Mahoney commented on the quandary that they are in with regard to the outlook, particularly for the short-term assets. She said constituents of those funds are used to higher returns and she suspects they will be disappointed if Callan's forecast comes to fruition. She said they will be seeking advice as they evaluate the asset allocations to determine how much more risk, if any they should take to get better returns on the money.

Ms. Ryerson said CIO Hanna has set up a great framework to look at the asset allocation. She suggested that if they look through participants to see who has a zero tolerance, there would likely be a lot that would say 'I can't afford to lose anything'. She said it is an incredibly difficult environment.

Dr. Jennings said the challenge is that you'll be making these assessments and projections for some of your constituents, whereas others may have a board or panel, and some informational conversations can help them to get comfortable with different levels of risk. He said the danger is that staff will have to calibrate while perhaps not knowing how the constituents or other interested parties will react. To Ms. Ryerson's point, he said to the extent that there is an opportunity for a decent conversation about level of risk, some may be willing to make that trade off, and others may be in a cycle.

CIO Hanna thanked everyone of their comments and said staffs' intent was to be open about the asset allocation process and show the struggle, in the hope that it will result in a better work product.

E. Future Agenda Items & Calendar Review

CIO Hanna said the May meeting agenda would be quite full working through the investment policy and asset allocation, and a discussion about rebalancing may be added if they have particular recommendations for that.

F. Other Matters for Discussion

None.

G. Adjournment

Commissioner Mahoney thanked the Treasury staff for putting the meeting together and the advisors for their time and comments.

There being no further items for discussion, the meeting adjourned at 11:08 a.m.