

**State of Alaska
Department of Revenue
State Investment Review Meeting
February 15, 2022**

MEETING SUMMARY

Meeting Details:

Start Time: 10:00 AM

End Time: 10:54 AM

Department of Revenue Staff present:

Lucinda Mahoney, Commissioner of Revenue
Zachary Hanna, Chief Investment Officer
Pamela Leary, Director of Treasury
Victor Djajalie, State Investment Officer
Emily Howard, State Investment Officer
Sean Howard, State Investment Officer
Scott Jones, Head of Investment Operations, Performance & Analytics
Ryan Kauzlarich, Accountant IV
Mark Moon, State Investment Officer
Hunter Romberg, Investment Data Analyst
Alysia Jones, ARMB Liaison Officer

Investment Advisory Council (IAC) Members present:

William Jennings
Jerrold Mitchell
Ruth Ryerson

I. Introduction

Mr. Hanna welcomed everyone and introduced Emily Howard, the portfolio manager for the State's cash portfolio (AY70). He said that it was the only pool that invests funds on behalf of both Treasury and ARMB accounts.

II. Fixed Income Cash Management

Ms. Howard provided an overview of AY70, the Short-Term Fixed Income investment pool. Ms. Howard explained that a large portion of the fund is held in Treasury Bills (46%) and Overnight Repurchase Agreements (6%) to ensure adequate liquidity and that nearly half of AY70 is held in spread product To achieve the highest possible return.

Mr. Hanna asked how different the pie chart on slide 3 of her presentation would look if they were in a more normal environment. Ms. Howard said that they keep a pretty level sector exposure and that generally the balance is the liquidity vs. the extra spread within the spread sectors. Mr. Hanna asked if it was fairly common to have roughly 50 percent in super liquid, super secure instruments. Ms. Howard responded affirmatively, noting that it was a function of their liquidity requirement. Ms. Howard reviewed each of the spread products in detail and provided examples of each type.

Ms. Howard also noted that LIBOR was discontinued for most tenors as of 12/31/21 and SOFR (Secured Overnight Financing Rate) is the heir apparent to LIBOR. She said the majority of AY70's corporate holdings are in floating rate notes and those maturing after June 2023 are all benchmarked to SOFR. Ms. Howard shared the net investment performance for AY70 as of December 31, 2021 over various time horizons.

Commissioner Mahoney thanked Ms. Howard for her presentation and commented on the appropriateness of the level of detail.

III. State Investments

Mr. Hanna introduced Victor Djajalie, as head of the fixed income group.

Mr. Djajalie discussed current market conditions, commenting that 2021 was a very difficult year. Global economies have made a decent recovery, but the emergence of various virus variants throughout the year created a wave of volatility and repositioning across sectors. He noted that REITs was the top performing asset, followed by equity and commodity.

He said domestic equity delivered a stellar performance, while international equity was fair and appeared undervalued. In terms of fixed income, it had been a challenging year with a lot of volatility in rates. Mr. Djajalie said that U.S. economic growth remained resilient despite disruptions caused by the pandemic. He noted that unemployment had reached 3.9%, which was slightly above the pre-pandemic rate of 3.5%.

Mr. Djajalie said inflation was on the rise and may not be as transitory as expected. He noted that CPI had reached 7 % in December - the highest it has been in decades.

A. December 31, 2021 Performance – Commissioner's Report

Mr. Djajalie walked through the Commissioner's Report. In regard to relative allocation, he noted modest overweight in domestic equity and REITs and slight underweight in fixed income and international equity. He said overall performance was in line with target. For the quarter and fiscal year domestic equity was up 7 bps and 9 bps respectively.

Mr. Djajalie also reported that as of yesterday they had basically gained all the lag back for AY70. In terms of the fixed income portfolio, he said they generally maintain a defensive posture in terms of interest rate exposure. He said plans with equity-heavy exposure did very well, while those with bond-heavy exposure had a challenging year.

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. In the event such an opportunity arises, a summary of the robust non-routine investment process is included in each SIR meeting packet and non-routine investments remains a standing item on the quarterly meeting agendas.

C. 2022 Capital Market Assumptions

Mr. Hanna touched on segments of Callan's 2022 Capital Markets Assumptions slide deck, noting that changes were minimal. He said for State portfolios, most of the emphasis for this year would be on how

the yield curve changes between now and when they do the asset allocations and thoughtful consideration of potential shifts in time horizons.

Mr. Hanna noted that Callan did increase their inflation expectation 25 bps, from 2 percent to 2.25 percent and said he was modestly surprised that Callan effectively made no changes to the public equity assumptions.

Dr. Jennings said in reviewing Callan's slide deck, the two obvious things to discuss were inflation and the equity risk premium numbers. He said the equity risk premium numbers seemed large and asked Mr. Hanna for his opinion on those numbers. Mr. Hanna responded that given the all-time highs in almost all respects of equity markets, he was surprised that they had not reduced equity expectations moving forward. He said he believed Callan was comforted by what they viewed as the very high quality of earnings and noted that did not fully resonate with him. He said that Callan's capital market assumptions were higher than those of most other providers and explained that in terms of utilization, staff try to be thoughtful of the risks that may be implicit in the assumptions.

Dr. Jennings commented that there was a lot of diversity amongst capital market assumption providers. He said the question was what the implications to the asset allocations were and would it lead them to do something different if the numbers changed.

Mr. Hanna thanked Dr. Jennings for his observations and suggested the group officially transition to Agenda Item IV. and invited Dr. Mitchell and Ms. Ryerson to provide comments.

IV. IAC Comments

Ms. Ryerson asked Commissioner Mahoney if the State included a projected income from the portfolio in its budget; Commissioner Mahoney responded affirmatively. Ms. Ryerson then asked how they predict what the projected income will be given the volatility of the markets. The Commissioner explained Mr. Hanna comes up with that using the asset allocations for each of the different funds and invited Mr. Hanna to provide additional explanation.

Mr. Hanna explained that they come up with both a short-term return expectation and a long-term expectation for those funds that have a longer-term horizon and discussed characteristics of the funds. Dr. Mitchell mentioned recent headlines and what he believed to be unusual predictions made by Ray Dalio and Jeremy Grantham. He commented on Dalio's statement about the U.S. heading to civil war and discussed Grantham's argument that we are in a super bubble environment.

Dr. Mitchell said that any steward of funds should encourage clients to realize that lower returns were ahead of us.

Dr. Mitchell then circled back to Dr. Jennings' comment regarding asset allocation and capital markets, stating that the GMO asset forecasts were radically different than Callan's. He commented that as institutional managers they are dealing with very long-term assets, and they should focus on being good stewards of the funds.

Dr. Jennings added that dramatic changes to the portfolio are not what we do, that tilts or slow to rebalance are reasonable and plausible responses.

Commissioner Mahoney asked for clarification on what the “mean” is in the statement “reverting to the mean”.

Dr. Jennings explained that GMO’s aim points tend to look at really long runs and historical price ratios and where they think the market will adjust tends to be low. He referred back to Jeremy Grantham’s point that when bubbles pop, there is no guarantee that it reverts back to the mean.

V. Future Agenda Items & Calendar Review

Mr. Hanna reviewed potential topics for the upcoming meeting.

The next meeting is scheduled for May 10, 2022.

VI. Other Matters for Discussion – None.

VII. Adjournment

Commissioner Mahoney thanked everyone for their time and stated that she would be eager to hear comments from the investment advisors regarding inflation at the next meeting.

There being no further items for discussion, the meeting adjourned at 10:54 a.m.