ALASKA RETIREMENT MANAGEMENT BOARD MEETING

Location of Meeting
Anchorage Marriott Hotel
820 West 7th Avenue
Anchorage, Alaska

MINUTES OF
October 11-12, 2005

Tuesday, October 11, 2005

I. CALL TO ORDER

TOM BOUTIN, Deputy Commissioner of the Department of Revenue, called the meeting of the ARM Board to order at 9:00 a.m.

II. ROLL CALL

ARM Board Members Present
Martin Pihl
Sam Trivette
Gayle Harbo
Gail Schubert
Larry Semmens
Bob Roses
Scott Nordstrand
Mike Williams
Bill Corbus

Consultants Present
Rob Johnson, Legal Counsel
Michael O'Leary, CAI

IAC Members Present
Tim O'Brien
Bill Jennings
Jerrold Mitchell

Department of Revenue Staff
Tom Boutin, Deputy Commissioner
Gary Bader, Chief Investment Officer
Susan Taylor, State Comptroller
Judy Hall, ARMB Liaison

Department of Administration
Kevin Brooks, Deputy Commissioner
Melanie Millhorn, Director, Division of Retirement and Benefits
Charlene Morrison, Chief Financial Officer

III. PUBLIC MEETING NOTICE

JUDY HALL confirmed that proper notice had been made of this meeting.

IV. APPROVAL OF AGENDA

MS. HARBO moved for approval of the agenda. MR. PIHL seconded.

There being no objection, the agenda was approved.

V. PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES

MR. BOUTIN noted that there were teleconference capabilities at this meeting for those who wished to participate via telephone.

SARAH HORNBERGER, representing the Retired Public Employees of Alaska (RPEA) as chair of the Medical Insurance Committee, stated she is a 42.5 year resident of Alaska. She served as high school teacher and principal in the Bristol Bay Borough, retiring as a teacher and a public school administrator and for 12 years was a school board member for Lake and Peninsula School Board. She is also a former small business owner/operator. She is a life member of NEA and NEA Retired, as well as RPEA. She has been attending Anchorage meetings of the PERS and TRS Boards since 1999. The dedication and performance of those boards to protect the trust fund was impressive. The willingness of the boards to work with organizations to maintain and protect the fund was commendable and reassuring. The proof of that cooperation is the success in bringing down prescription drug costs to the fund. She believed that, had other medical program recommendations of the boards and cooperating organizations such as RPEA been followed, much greater savings would have been realized. This new board faces the task of doing the work that three separate boards were doing in the past and doing well. She hoped the board would continue the cooperation with RPEA and other groups to work with them to further the good of the retirement trust fund. She also hoped the board would continue work in the area of medical insurance. The work in which the PERS and TRS Medical Committee was involved up to their demise was very valuable. She asked that the board appoint a committee of retired lay people representing the various public employee unions to work with the board to make decisions on the wise use of the medical insurance fund. Contrary to what many in the current State Administration seem to believe, the retired public employees of Alaska are very concerned with the protection and preservation of the retirement trust fund. She stated she has the messages of many of the 850+ members of RPEA who responded to the medical insurance survey last spring. They asked again and again how to help preserve the fund and save money through it on their medical expenditures. Many expressed concern that the State showed no concern for conserving the fund.

CHUCK BORG, former member and Vice Chair of the PERS Board, stated he has attended many ASPIB meetings over the last 7 to 8 years and was always impressed with their professionalism and dedication. He expected this group would follow in that tradition. In a former career he had several years of experience in health care administration. He stated it is not clear to him what role this board would play with regard to the health care plan. He asked if the word "management" in the ARM Board title means it manages only investments or does it play a role in how the investments are spent. He hoped that the ARM Board would get involved in the spending if only to become familiar with the provisions of the health care delivery plan. He stated that too often the reaction to the threat of increasing health care costs is to curb or remove benefits, which he felt should only be done as a last resort. As an example of what can be done, several years ago the joint committee of the PERS and TRS Boards asked the Administration to launch a pilot program designed to hold down the escalation of drug costs by getting members to use generic drugs and mail order. In the first year, the savings achieved through that program exceeded expectations. After this pilot program, several other areas were identified for cost savings: establishment of preferred provider organizations, case management, and disease management for people with chronic illnesses. Curbing the incidence of diabetes would not only save on the treatment of the disease, but also on the associated diseases diabetes triggers. The same is true for cardiac diseases. Steerage of patients under 65 into preferred provider organizations can save money. A good, proactive patient education program would be effective. The plan has been in existence for some time and the question arises if it has kept up with changes in method of delivery of health care . He suggested responsible, long-range planning that would require up front money for planning and execution, but will in the long-term result in a healthier, less expensive population. He feared that without a body of interested, intelligent individuals as the ARM Board asking pointed questions to improve the provisions of the plan, in the future there might be a knee jerk reaction to cut the benefits and provisions of the plan.

MR. PIHL asked if Mr. Borg prescribes to the principle of employees sharing in the cost of medical care. He felt that there is general agreement that good coverage is needed for medical access, but it might be wise for the employee to share in the cost of elective procedures. MR. BORG noted that not presenting to an emergency room is an elective procedure, by some measure. He stated he would hesitate with regard to sharing expenses. He would agree with some cost sharing for cosmetic surgeries. His emphasized that within the plan there are measures that can be taken to improve the quality of the plan, to improve the cost, and that will result in a healthier population.

MS. HARBO noted that the generic drug program started with PERS/TRS saved the State $1 million for every 1% of non-generic drugs that were switched to generic. She added that in 2004 there were 459 retirees under age 65 that cost the state $53 million in healthcare expense. If there were disease management programs for diabetes and cardiac, some of those costs would be saved. She felt that, since health care is the main driver in the unfunded liability, the ARM Board must take control over how health care is managed and how contracts are let for health care.

JAY DELANEY, Executive Vice President of Retired Public Employees of Alaska, stated his organization has worked well with the retirement boards in the past and expected to work well

with the ARM Board in the future. He hoped the ARM Board would look to the RPEA as a resource in helping fulfill its mission.

VI. ARM BOARD BUSINESS

1. Introduction of Trustees and Staff

MR. BOUTIN initiated introductions of Trustees, staff, and consultants.

2. Election of Officers for ARM Board

MR. TRIVETTE nominated Gail Schubert to serve as Chair. MS. HARBO seconded.

MR. PIHL moved to cast a unanimous ballot. MS. HARBO seconded.

There being no objection, the motion was unanimously approved.

MS. HARBO nominated Sam Trivette to serve as Vice Chair. MR. WILLIAMS seconded.

There being no objection, the Sam Trivette was elected to serve as Vice Chair.

MR. TRIVETTE nominated Gayle Harbo to serve as Secretary. MR. ROSES seconded.

There being no objection, the motion was unanimously approved.

MS. HARBO asked whether she could present a list of information she wished to have made available this afternoon, if possible. CHAIR SCHUBERT replied in the affirmative. MS. HARBO indicated she did not have the items under tabs 13 and 14 for the actuary's presentation tomorrow. She also wanted copies of the Division of Retirement and Benefits' (DR&B) budget from FY02 to the present so the ARM Board is informed of the past cost for actuary services. She also wanted copies of financials related to the healthcare trust; one is a statement of the net assets of the healthcare trust as of June 30, 2005, and the second is a "management discussion and analysis of the healthcare trust" that shows the assets of the trust from 2002 through 2004. She also asked to see the timeline for the selection of the third party administrator for healthcare; the current administrator is Aetna. A big portion of the dollars spent in Alaska for retirees is healthcare and she felt it is important for the ARM Board to understand how to negotiate the best possible healthcare savings and the best care. She also requested the statistics for the last five years for the retire/rehire bill whereby retirees are hired and effectively displace potentially new employees. This affects the cost of healthcare to the State of Alaska because is a cost shifting from the districts to the retirement system. That bill was sunsetted but was renewed. She stated she does not have a current publication from the State on the state of the TRS and PERS systems. She asked for information on a federal bill called Employer Provided Retirement Savings Act (ERSA) and hoped Mr. Johnson or Mr. Barnhill could find out more information on that. This bill seeks to consolidate al the current 401(k), 403(b) and 457 plans into a single plan. This would have quite an impact on both active members and retirees.

CHAIR SCHUBERT suggested these items be included under New Business on tomorrow's agenda. She asked that Ms. Hall distribute this list of requests to the Trustees.

3. Legislation Overview

a. SB141 Review: Board Responsibilities

For more information on this presentation, refer to the document entitled "Overview – Senate Bill 141" kept on file at the ARM Board offices.

JUDY HALL, Liaison Officer, provided a brief overview of SB141. She explained this legislation creates defined contribution and health reimbursement plans for TRS and PERS members hired after July 1, 2006. It establishes the Alaska Retirement Management Board to replace the ASPIB, PERS and TRS boards. It moves the appeals process into the office of administrative hearings. It continues the university retirement programs. It provides that non-vested PERS and TRS defined benefit members may elect to transfer to defined contribution plan. It provides that members may roll over other 401(k) type accounts into their defined contribution account. It provides that political subdivisions and public organizations may participate in the defined contribution plan.

MS. HARBO asked if the ability for non-vested PERS and TRS defined benefit members to transfer to defined contribution plan would occur after July 1, 2006. MS. HALL replied in the affirmative. MS. HARBO asked whether, if members elect to transfer, would they also be giving up their healthcare benefit because the tier they are in now goes to the date of hire. She assumed this would mean they are giving up their healthcare by transferring to the defined contribution plan. MS. HALL replied that the rules are to be established and she would expect that is what would happen.

MS. HALL reviewed the characteristics of the defined contribution plan for teachers and public employees hired after July 1, 2006, including how contributions are established, their percentages, how employees are vested, and the ratio of vesting.

MS. HARBO noted that PERS members also can continue in the SBS program and, if they are not under Social Security, they get a matching percentage contribution.

MS. HALL explained other components of the defined contribution plan, including retiree medical health insurance, a health reimbursement arrangement plan, and death and disability benefits. The percentage is initially established in the statute and the Board will certify going forward.

MS. HARBO noted there is nothing established for TRS in regard to disability. MS. HALL replied this would need to be established in the next legislative session.

MS. HALL next reviewed the language in SB141 that establishes the Alaska Retirement Management Board. It sets out the Board's primary mission to serve as the trustees of the assets of the state's retirement plan, the supplemental annuity plan, and the deferred compensation program. The Board has the fiduciary obligation to manage and invest these assets in a manner that is sufficient to meet the liabilities and pension obligations of the systems, plan and programs. The Board may, with the approval of the commissioner of revenue and with the agreement of the responsible fiduciary, manage and invest other state funds so long as the

activity does not interfere with the Board's primary mission. In making investments, the Board shall exercise the powers and duties of a fiduciary of a state fund under AS 37.10.071.

The Board's powers and duties include holding meetings, keeping records, adopting investment policies for each fund, determining appropriate investment objectives for the defined benefit plans, assisting in prescribing policies for proper operation of systems, providing a range of investment options for SBS, defined contribution for PERS and TRS, and deferred compensation, establishing a rate of interest annually credited to each member's account and rate of interest to health reimbursement arrangement plan account, adopting a contribution surcharge as necessary under 39.35.160(c), and coordinating with the administrator for annual actuarial valuation to determine system assets/liabilities, funding ratios, and to certify to employers an appropriate contribution for normal costs and appropriate contribution for past service liability.

MR. SEMMENS asked who is the administrator of the plan. MS. HALL explained this is the Commissioner of Administration.

MS. HALL continued her review of the ARMB powers and duties, including reviewing actuarial assumptions prepared and certified not less than every four years, reviewing health cost assumptions annually, having all actuarial assumptions reviewed and certified by a second actuary before presentation to the Board, contracting for an independent audit of the state's actuary every four years, contracting for an independent audit of the performance consultant every four years, obtaining external performance review to evaluate investment policies and report to the fund fiduciary, reporting to the governor, legislature, individual employers, and LB&A by the first day of each legislative session, and developing an annual operating budget. The ARMB may also employ investment advisors to review investment policies, enter into an agreement with the fiduciary of another state fund in order to assume the management and investment of those assets, contract for other services necessary to execute the Board's powers and duties, enter into confidentiality agreements, and the Board may appoint an investment advisory council composed of at least three and not more than five members. MS. HALL noted that compensation for trustees is also outlined in SB141.

MS. HALL next reviewed the reports and regulations required for the ARMB. The Department of Administration and Department of Revenue staff have met and assigned each of the regulations to each of those departments. She noted that a special report to the Legislature is required within 120 days of complete board appointment or 15 days after the first day of the legislative session, whichever is first. This report must include: preliminary assessment of financial health of all plans; assessment of actuarial services purchased by the board; recommendations for additional legislative or administrative policy to improve the financial health of the plans; short- and long-term recommendations for the unfunded liability; recommendations for legislative procedures regarding fiscal notes for new legislation affecting the retirement plans. A report is also required to the governor, legislature, individual employers, and LB&A by the first day of each legislative session. The ARMB must coordinate with the administrator for annual actuarial valuation to determine system assets/liabilities, funding ratios, and to certify to employers an appropriate contribution for normal costs and appropriate contribution for past service liability. The ARM Board must also notify presiding officers of the Legislature if notification is received from the IRS that the section regarding transfer of a

member account from defined benefit plan into defined contribution plan is disqualified for tax purposes.

MS. HALL next reviewed the changes to the defined benefit plan under SB141 for the TRS, PERS, and Judicial and Military retirement systems. This changes the employer contribution and interest rates being assessed by the ARMB rather than the former PERS and TRS. MS. HALL explained that the administration of the plan rests with the Department of Administration, DR&B for maintaining plan accounting and member's individual accounts. The commissioner of administration or designee is the administrator of the system.

b. Fiduciary & Statutory Responsibility

For more information on this presentation, refer to the document entitled "Fiduciary & Statutory Responsibility" kept on file at the ARM Board offices.

ROB JOHNSON, Legal Counsel, and MIKE BARNHILL, Assistant Attorney General, presented to the Board. MR. BARNHILL, Assistant Attorney General with the Department of Law (DOL), stated the DOL provides comprehensive and top quality legal services to its clients, including the ARMB. Typically the Department assigns an Assistant Attorney General to a client and in some cases outside counsel is hired to work as a team with an Assistant Attorney General. The role of the Attorney General is outlined in Title 44. The Attorney General represents the State in all civil actions in which the State is a party. The Attorney General administers all State legal services including the furnishing of written legal opinions to the governor, the legislature, and all state officers and departments that the governor directs, and gives legal advice on proposed legislative measure upon request by the legislature. The Attorney General may, subject to the power of the legislature, enact laws, make appropriations, and settle actions.

MR. BARNHILL explained that SB141 made some changes to specific statutes governing the provision of legal advice to boards in the pension context. Previously the Attorney General was specifically designated as attorney for the retirement system. There was no specific designation of which he was aware for the TRS. There was a provision in law authorizing the ASPIB to employ legal counsel, subject to the approval of the Attorney General. He was not sure that ASPIB ever exercised its powers completely under this provision because ASPIB's outside counsel was hired by the DOL, not by the ASPIB. AS 37.10 authorizes fiduciaries of state funds to utilize legal counsel for assistance in investment matters on a continuing limited term basis. This was not changed by SB141. All of these statutes are subject to the Attorney General's comprehensive powers as outlined in Title 44.

MR. BARNHILL stated the Attorney General is specifically designated as counsel for the PERS system. The same provision is made for the TRS and for the ARMB. This will be implemented using a team approach with the assignment of a battery of Assistant Attorney Generals and outside counsel. There are two subject areas for which this board is responsible: benefits and investments. On the benefits side the Assistant Attorney Generals that will be providing advice are under the Labor and State Affairs Section. On the investment side the team has been Jim Baldwin, Mr. Barnhill, and Mr. Johnson as outside counsel. Mr. Baldwin recently retired and Mr. Barnhill assumed his position. When a replacement is hired to fill Mr. Barnhill's previous position, that individual will be in the commercial section. MR. BARNHILL solicited any

suggestions members of the ARMB may have about how the Attorney General office can best serve the retirement systems.

MR. JOHNSON noted that the ARMB as fiduciaries are embarking on new territory under new statutes and a new set of regulations and provisions as fiduciaries. As a fiduciary under a board of directors would look to Title 10, board member of a trust would look to Title 13 for guidance. There are also public entity provisions that outline the responsibilities of a fiduciary. There is also case law and restatement of trusts that guide fiduciary activity.

In addition to general provisions that guide fiduciary activity, there are specific provisions that prescribe fiduciary duty or responsibility. These include trust documents/statutes, charter, articles of incorporation and bylaws, and policies and procedures. The ARMB will be asked to adopt, at least on an interim basis, the policies and procedures that were adopted by the ASPIB.

MR. JOHNSON reviewed AS 10.06.450 that outlines the duties of care of a member of a board of directors. A director must act in good faith and in a fashion reasonably believed to be in the best interest of the corporation and with the care, including reasonable inquiry, that an ordinarily prudent person in a like position would use under similar circumstances. ERISA, the federal law that applies to 401(k) plans, does not apply to the ARMB; however, ERISA provides a scope for courts when looking at issues that arise in the context of an argument over fiduciary responsibilities. ERISA states: "...a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries" and "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." MR. JOHNSON explained the ARMB must consider matters in the context of its fiduciary responsibilities.

MR. O'LEARY noted that the ERISA provision that a fiduciary should discharge his duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." is referred to as a prudent investor standard, which is a higher standard. MR. JOHNSON stated that given that the ARMB obligation is to be working with a public retirement instrument, the ARMB would be held to a higher standard than the typical citizen.

MR. JOHNSON stated that the Alaska Supreme Court recently stated that "... the fiduciary duty is 'the highest standard of duty implied by law.'" He indicated that there have been no claims challenging inappropriate fiduciary behavior by the previous boards. The lack of these challenges is evidence of the excellent assistance given to the boards over time. Another recent Alaska Supreme Court case found that "a trustee must, by statute, administer the trust solely for beneficiary's benefit. This requires the trustee to act at all times in good faith with respect to the trust. This is a high standard, but a trustee is a fiduciary of the highest order."

MR. JOHNSON explained that where there is a question about the proper fiduciary interest involved Alaska courts have been willing to apply equitable jurisdiction over trusts. It is incumbent upon the ARMB to resolve issues and only as a last resort go to the courts because the involvement of the courts results in a decision by an entity other than the ARMB.

MR. JOHNSON compared the existing ASPIB statute to the new ARMB statute with respect to responsibilities. This is a reminder of what the Legislature intended to be the changes between the ASPIB and ARMB. In addition to investments, the ARMB is charged with managing and investing assets in a manner that is sufficient to meet the liabilities and pension obligations of the systems, plan, and program. Because the ARMB is charged with managing the assets in this manner, the question arises whether the investment approach must be revised to meet the liabilities and pension obligations and over what period of time this is required to occur. He suggested that early in the process the ARMB must, with the assistance of the Departments of Revenue and Administration, determine what horizons are being considered. MR. JOHNSON noted that the new statute requires that the board shall exercise the powers and duties of a fiduciary of a state fund under AS 37.10.071.

MS. HARBO asked what other state funds are referred to in the provision in 37.10.210 stating "the board may with the approval of the commissioner of revenue and upon agreement with the responsible fiduciary, manage and invest other state funds so long as the activity does not interfere with the boar's primary mission." MR. JOHNSON replied that the ARMB could be charged with managing other funds, such as the Children's Trust Fund, the Exxon Valdez Trust Fund, etc.

MR. JOHNSON reviewed 37.10.071, which clearly states the ARMB's responsibility "in exercising investment, custodial, or depository powers or duties under this section (is to) apply the prudent investor rule and exercise the fiduciary duty in the sole financial best interest of the fund entrusted to the fiduciary." This does not use the word "expert" and there is not a further incorporation, as there was in AS 14.25.180, that the standard that is to be applied under 37.10.071 for ASPIB is in regard to the management of large trust investments. He noted, however, that the ARMB certainly has the obligation to engage in its fiduciary duties in the context of the nature of the trust. MR. JOHNSON stated that among the various duties of the ARMB are the parallel provisions regarding setting rates for employers. AS 14.25.070 reads "an employer shall make contributions to the plan in amounts sufficient, after subtracting member contributions, to provide the benefits of the defined benefit plan. The amounts shall be calculated by employer contribution rates certified by the board against the sum total of the base salary paid to members." Subsection (B) states "the employer contribution rate may not be less than the rate required after subtracting the employee contribution to fully fund the actuarial calculated benefits expected to be earned by active members during the fiscal year." This is the instruction to the ARMB. He counseled that as the ARMB sets employer contribution rates, they listen carefully to the actuary, the staff, and consultants.

MR. SEMMENS asked if SB141 changes the requirement to fully fund the trust retirement systems. MR. JOHNSON believed it is more clearly stated, but not changed. MR. SEMMENS understood the PERS Board had the responsibility to set the rate. He was confused why the PERS Board set the rate less than the actuary recommended. He thought that was the point of

Mr. Johnson's presentation. There was a regulation in place at that time that limited the rate increases to 5%, however, that did not limit the board's ability to set the rate at whatever they thought was appropriate. MR. JOHNSON felt Trustee Semmens' point is well taken and goes to parsing out the responsibilities of the board. When fixing a rate, the board needs to assess what satisfying the system requirements means. For PERS there was a regulation that provided, as a means of reducing the potential impact of change from time to time, that no employer would have to suffer a rate increase higher than 5% in a particular year. The actuarial presentations were worked, he presumed, with that in mind, but also presented the rate from an actuarial perspective that were needed to fully fund. The TRS Board did not have the 5% rate provision. He referred to a transitional provision in SB141 that talks about "orders and regulations issued or adopted under authority of law amended or repealed by this Act remain in effect for the term issued, or until revoked, vacated, or otherwise modified under the provisions of this Act." The regulation literally says that the effect shall be no more than 5% for an employer, but that is not actually a limitation on the rate the boards set because the boards set a consolidated rate. Based upon the presentations made and the advice received, the boards chose to set the rates as they did. He submitted that the ARMB must review these issues anew.

MR. JOHNSON suggested that in analyzing its duties and responsibilities, it is important for the ARMB to consider the entities that have an influence on employer contribution rates. These include within the context of the defined benefit plan that Alaska's Constitution requires "no diminution of benefits." Other issues that have influence on contribution rates are administrative decisions, appeal decisions, investment decisions by the ARMB, investment implementation by the Department of Revenue, legislative actions, demographics and health care claims, and employer decisions. MR. JOHNSON expanded on the anti-diminution provision. He noted that Alaska is the only state constitution that makes reference to state pension funds. It is the principle element and source of litigation concerning the retirement systems over the years. It states that "membership in employee retirement systems of the State or its political subdivisions shall constitute a contractual relationship. Accrued benefits of these systems shall not be diminished or impaired." This has been interpreted by the courts beginning with Hammond v. Hoffbeck in 1981, in which the courts said if a right is fixed, it cannot be taken away unless equivalent rights are provided. That case was decided after the decision to provide medical health coverage for employees and retirees. Two subsequent cases in 1991 and 2003 have refined the non-diminution concept.

MR. JOHNSON reviewed an uncodified provision in SB141 that requires a report to the legislature by the ARMB containing its assessment and recommendations, as provided in Section 141, within 120 days after appointment of the ARMB or 15 days after the legislative session begins, whichever is earliest. This board must work toward delivery of this report. This report must include a preliminary assessment of the financial health of all public employees' retirement plans and teachers' retirement plans; assessment of the actuarial services purchased by the board; recommendations for additional legislative or administrative policy to improve the financial health of the retirement plans; short-term and long-term recommendations for addressing the unfunded liability of the retirement plans; and recommendations for legislative procedures regarding fiscal notes for new legislation affecting the retirement plans.

MR. JOHNSON explained that the ARMB speaks and acts as a board, not as individuals. The members must attend to its mandate and adhere to the ethics act and disclosure requirements. He noted that a video is available through the Department of Law with respect to the Executive Ethics Act. He explained that Sarbanes-Oxley has created a culture of disclosure. The ARMB must have a consistent decision-making process and the written record of the ARMB decisions is important as the board is responsible for making the best decisions possible based on the information available. Third party evaluations are also advisable. The ASPIB utilized the services of an independent financial audit service at one point in time. MR. JOHNSON reiterated that the ARMB member's job, as a fiduciary, is to make good faith, prudent decisions regarding the trust or entity for which s/he has accepted responsibility. He noted that satisfaction of the trustee's duties does not require that decisions must be ultimately successful.

MR. JOHNSON advised the ARMB to make decisions that are consistent with its mandate, have a rational basis, and are rendered through a demonstrable process.

MR. TRIVETTE indicated it is not clear to him in the discussion in SB141 regarding the various funds the State holds in trust whether the ARMB has any responsibility for those funds. MR. JOHNSON was not certain of the answer to this question. He thought there would be some sense that the ARMB has responsibility, but those internal funds have historically been managed by the Department of Administration. MR. TRIVETTE thought this would be important for the ARMB to understand at some point in the future. He noted that page 3 of SB141 speaks about the administrator of the fund meeting annually with the board to review the condition and management of the retirement systems and to review significant changes to the policies, regulations and benefits. He asked what role the ARMB has in being proactive in this area. MR. JOHNSON felt this process would be evolving; this board does have a role in the administration of the system. He thought this was an example of the legislative intent that there be cooperation.

MR. PIHL asked for a copy of AS 14.25.070. MR. JOHNSON indicated 14.25.180.C no longer exists; that referred to management of large trust investments. 14.25.070 is the contribution by employers under the TRS, which Mr. Johnson could supply in its entirety; some sections of that were amended by SB141. The analogous PERS section is 39.35.270.

MR. TRIVETTE remarked that 37.10.220(a) is written generally and requires that this board shall assist in prescribing the policies for the proper operation of the systems and take other actions necessary to carry out the intent and purpose of the systems in accordance with AS 33.10.210-37.10.390. He asked if there is anything specific in this of which the ARMB should be aware. MR. JOHNSON stated this provision requires the ARMB's assistance. The dimensions of the ARMB's role are not clear and will likely evolve. MR. TRIVETTE asked if the comments made this morning requesting involvement of the ARMB in the medical area would fall within this provision. MR. JOHNSON replied that this could fall within this provision.

BREAK 10:37 a.m. to 10:47 a.m.

c. Resume Discussion: Fiduciary Responsibility

GARY BADER explained that when the ASPIB assumed responsibility for the pension funds approximately 13 years ago, at which time there was a formal acceptance of the fiduciary duties.

Arguably, Section 9 gave that responsibility to the ARMB, whether or not it is formally accepted. Staff felt it would be well for the ARMB to formally accept responsibility to be fiduciary of the system. He stated that in his judgment when the ARMB accepts responsibility as the fiduciary of the system, it is saying it will be objective in its decision- making, balance decisions between risks and returns in making investments, accept responsibility to monitor the activities of the staff in the Department of Revenue and the Department of Adminsitration to the extent the ARMB responsibilities are performed by those staff, be obligated to investigate, diversify the portfolio, and have a duty of loyalty that requires the trustee to act exclusively for the benefit of the beneficiaries as opposed to acting for the trustees' own interest or that of third parties. The ARMB will also be accepting responsibility to be impartial in decision-making, only accept reasonable costs for services provided to the system, and understand that there may be instances when the ARMB can reasonably delegate responsibilities to the appropriate staff.

MS. HARBO moved to approve Resolution 2005-01 accepting fiduciary responsibility. COMMISSIONER NORDSTRAND seconded.

MR. PIHL noted that Mr. Johnson said the ARMB duties are to meet the benefits and there is a tremendous unfunded liability. He asked if the ARMB is accepting responsibility to find resolution to the unfunded liability because, without that, he questioned how the ARMB will meet the responsibility of meeting benefits. MR. BADER interpreted the statute to require that the ARMB undertake the endeavor; he did not think the expectation was that the ARMB would solve the unfunded liability situation in the near-term. MR. PIHL remarked that Mr. Johnson's report noted that the ARMB will manage and invest the assets in a manner sufficient to meet the liabilities and pension obligations of the system, plan, and program. MR. JOHNSON understood the ARMB would be accepting the responsibility to undertake the endeavor and he did not think the statute required that the unfunded liability be met instantly. The Legislature is also requiring a report to submit long-term and short-term recommendations to fund the system. MR. PIHL felt the problem is compounded when one looks at the inflow and outflow of funds in the plan.

There being no objection, the motion was unanimously approved.

MR. BADER explained the ASPIB was established more than 13 years ago and during its existence numerous policies and procedures for the operation of the system were put into place. Staff recommended that all of the contracts and policies should be affirmed by the ARMB in order to move forward and then in a systematic fashion the ARMB should evaluate each of the policies and procedures in place and make changes as they feel necessary. The day-to-day management of the funds of the system, which is over $14 billion, is currently occurring. The Department of Revenue staff is named in statute as the investment arm of the ARMB and the CIO has been charged with the responsibility of implementing the policies, procedures, and investment plan of the board. This resolution appoints Mr. Bader in his role as CIO as the person responsible to carry out the investment responsibilities of the ARMB and he was requesting that delegation, consistent with everything done in the past by the Department of Revenue on behalf of the pension funds.

MR. PIHL moved to approve Resolution 2005-02 delegating certain responsibilities as outlined to the Chief Investment Officer. MS. HARBO seconded.

There being no objection, the motion was unanimously approved.

4. Fund Financial Presentation and Budget Review

For more information on this presentation, refer to the document entitled "Fund Financial Report" and "Proposed FY07 Budget" kept on file at the ARM Board offices.

SUSAN TAYLOR, State Comptroller, explained her presentation is intended to make the ARMB members conversant about the funds over which it has jurisdiction. She began with a review of the PERS system. The total invested assets in the PERS totaled $8.8 billion and investment earnings of $248.9 million as of August 31, 2005. She explained that the graph entitled "asset allocation versus target allocation" depicts the percentage of investment in each asset class. Staff monitors each segment of the fund to ensure the bands established by the board are not breached; staff contacts manager(s) when this occurs in order to rebalance. MS. TAYLOR explained the Treasury Division prepares preliminary financial statements on the third business day of the month and finals on the tenth business day of the month. The ARMB will receive the most recent financial information available. She noted that she has not changed the fund financial reports in the three months she has been in her position, but should the ARMB want to see other information or this information in a different format, that direction is welcome.

MS. TAYLOR next reviewed the TRS system, which has total invested assets of $4 billion and cumulative earnings of $116.1 million. She noted that income includes realized and unrealized gain/loss, commission recapture and securities lending. The Judicial Retirement Trust fund has total invested assets of $75.2 million and investment earnings of $2 million. The Military Retirement Trust Fund has total invested assets of $14.6 million and investment earnings of $300,000.

MS. TAYLOR reviewed the Investment Managers Report, which includes all of the investment managers except fixed income. This report also shows the percent of cash held by external managers; managers are limited to 3% cash by policy. Bank of Ireland is holding more than 3%; the relationship with that manager is terminated and they are in the process of liquidating their assets. The ARMB has contracts with all of these external managers to manage the fund's assets.

MS. TAYLOR indicated she has provided the ARMB with information on investment pools, which were not previously provided to the ASPIB. She noted that not every retirement fund is invested in each of the pools, so if there is interest in continuing to receive these reports, this can be clarified in the presentation. She indicated that the securities lending income is trending lower than the prior fiscal year. This is due to the fact that the Federal Reserve has been increasing interest rates and, because the collateral is invested at short-term, the opportunity for earning is less. She suggested that perhaps the ARMB would like a periodic update of the securities lending program rather than a presentation at each meeting, given that this program earns approximately $4 million per year.

MS. TAYLOR next reviewed the Supplemental Benefits System (SBS), including the beginning invested assets, change in asset value, contributions and withdrawals, transfers, and the ending invested assets in each of the asset classes. She noted that the Alaska Balanced Fund is the default option in SBS. MR. O'LEARY noted that the Alaska Balanced Fund was for a long time

the only major investment option and was the default option for a time. The fact that the Alaska Balanced Fund remains the largest fund reveals something about participant behavior.

MR. PIHL asked that the Investment Managers Report be provided on a year-to-date basis as well. MR. SEMMENS indicated he also would like to see the fixed income in this document. MS. TAYLOR agreed that it would be appropriate to include all assets.

MS. TAYLOR reviewed the monthly financials for SBS, which holds a total of nearly $2 billion. She then reviewed the financials for the Deferred Compensation Plan, which holds a total of approximately $460 million. This report format mirrors that of the SBS report.

FY2007 ARMB Budget Proposal

MS. TAYLOR next presented the FY2007 ARMB Budget Proposal. She explained the ARMB contracts with the Department of Revenue, Treasury Division to provide investment management, fixed income investing, asset accounting compliance and governance, and cash management. In the Department of Revenue budget there are components representing the Alaska Retirement Management Board operating expenses and custody and management fees. The largest recommended increase in the FY07 budget is in the area of Personal Services. There had been a problem in the way this line item had been budgeted in that there were increases in this area that were not shown in the ARMB budget. This is essentially a technical adjustment. There is also additional Travel for due diligence, Contractual increases, and a reduction in Supplies and Equipment. She noted that the budget process is fluid and this FY2007 ARMB Budget Proposal is a recommendation. If the ARMB wants to make changes, there is the opportunity to do so. She indicated that if she sees the need for changes when she projects costs for the current fiscal year, she would bring those back for ARMB review.

MR. SEMMENS asked how the relationship between ARMB and Department of Revenue, which is that the ARMB contracts with the Department of Revenue, differs from that of ARMB and Department of Administration. He did not see the latter in this budget. MS. TAYLOR indicated that this budget outlines the Department of Revenue related costs and she suggested that the Department of Administration speak to their budget. She explained that the Department of Revenue has an internal reimbursable service agreement (RSA) for the Personal Services portion of the ARMB budget. Other expenses related to the ARMB are directly charged to the ARMB budget. The Department of Revenue acts as staff to the ARMB and that is reflected in the budget. MR. BROOKS stated the Department of Administration would be providing budgetary information to the ARMB. The scope of the budget for DR&B for active and retiree programs is different than the Department of Revenue. Currently the Department of Administration is working with the OMB on the FY07 budget. There has only been one meeting with the Governor's Office to date on the FY07 budget, but the Department of Administration would be happy to present budget information to the ARMB in the future. MR. SEMMENS indicated he would appreciate a presentation from the Department of Administration. He was uncertain what authority the ARMB has in terms of questioning the budget. MR. BADER felt the ARMB has every right and responsibility to question the budget presented by staff. This budget does go to OMB and is ultimately subject to the Governor's final approval. MR. SEMMENS asked if the ARMB would go through an approval process related to the Department of Administration budget or would the Department of Administration simply bring forward its

budget as an informational item. MR. BROOKS suggested that the budget would be an informational presentation, to his understanding. He explained that the operating budget of DB&R is system costs. The liabilities of the system derive from other factors, such as medical, market performance, etc. MR. BARNHILL indicated this issue would be taken under advisement vis-à-vis the ARMB's fiduciary responsibility. Both the Department of Administration and the Department of Revenue have expenses that are paid for by the system. He indicated he would review the statute to see why the ARMB does not have responsibility for the budget of the Department of Administration as it relates to the system, but under the traditional role of a fiduciary, the ARMB would have responsibility to look at this very carefully. MR. SEMMENS noted that there are direct responsibilities of the ARMB, such as contracting with an actuary and auditing the actuary. Based on his experience, he believed the ARMB would be loath to approve something over which it has no control. MR. BARNHILL stated the statute requires the ARMB to coordinate with the Department of Administration with respect to the retention of an actuary. As Mr. Johnson discussed earlier, what is meant by "coordinate" will become clear in time. There are timing pressures with respect to the contract for an actuary.

MS. HARBO noted that she felt it was more sensible for the actuary contract to be under the Department of Revenue. She stated that when the PERS and TRS Boards requested an actuarial audit, it showed that the valuation statement in 2002 reflected the change in methods for both medical and healthcare, which affected the unfunded liability by decreasing it 21%. This also affected the employer contribution by an increase of 25%. If the ARMB is charged with understanding the unfunded liability, it would seem that hiring of the actuary and the actuarial contract would be under Department of Revenue. MS. HARBO noted that without healthcare the funding ratio for TRS is 93% and with healthcare included it is 63%. The problem is not with the ASPIB's investment management, it is the issue of healthcare cost containment. She felt the ARMB should be very active in the RFP for the third party administrator and in getting a handle on healthcare costs.

COMMISSIONER NORDSTRAND asked for a discussion of the increase in the Travel budget and what outside trips the ARMB takes. MS. TAYLOR explained these would be due diligence trips, educational conferences, etc. MR. BADER explained it is the duty of board members to be informed about the decisions being made and the board becomes more informed through educational opportunities. Historically the board has arranged for education conferences at which speakers on various topics appear before the board and present ideas and information. For the past several years the ASPIB coordinated with the Alaska Permanent Fund Corporation (APFC) Board and they attended those meetings as well; conversely, the ASPIB attended education conferences held by the APFC. Prior to the passage of SB141, there was a request that the ASPIB sponsor one educational session for both the ASPIB and APFC. MR. BADER offered examples of travel associated with educational purposes. COMMISSIONER NORDSTRAND noted that the proposed Travel increase is more than twice the budget last year for ASPIB travel and the fiscal note did not anticipate this increase. MS. TAYLOR explained that part of Travel is additional meetings that ASPIB felt would be important for the new ARMB to have budgeted. DR. JENNINGS noted that in Colorado there is a higher budget for new trustee travel. He also has studies of other state systems and by comparison, the Travel figure in the FY07 ARMB budget is quite low. MR. SEMMENS asked if this budget reflects adequate resources for board members to attend educational sessions, noting that he is very interested in attending training.

MR. BADER replied that he believes this budget figure is adequate for that purpose. He noted that ASPIB did not have this large a budget, but at its last meeting the ASPIB contemplated that the ARMB would need more funding in this area. He stated that staff would be asking if the ARMB feels there is time for members to participate in an education conference.

MS. TAYLOR noted regarding the state budget process that, to the extent these benefit system receipts are not used, they will lapse. The ASPIB wanted to ensure the ARMB had sufficient funds and for the budget to be transparent.

MR. PIHL felt that as the formation of committees occurs, the ARMB will find that the Real Estate Committee will likely need to attend a real estate conference and other committees that handle specific investment options would have the same type of need. He felt the ASPIB had acted appropriately to provide for the needs of the ARMB.

MS. HARBO moved to approve the FY2007 Working Budget. MR. TRIVETTE seconded.

By roll call vote, the motion was unanimously approved.

As the schedule permitted, Mr. O'Leary offered to make a presentation on performance reporting prior to lunch.

5. General Consultant

B. Performance Measurement

For more information on this presentation, refer to the document entitled "Performance Reporting Background" dated October 2005 and kept on file at the ARM Board offices.

MICHAEL O'LEARY with Callan Associates Inc. (CAI) remarked that performance reporting is important with respect to assets managed externally, and particularly with respect to the fixed income assets managed internally by Department of Revenue. Staff is monitoring what the contracted investment managers are doing. They are also monitoring what is transpiring in the portfolios for which they are responsible. Performance reporting helps document the results of investments, helps identify what is working and what is not, and helps formulate rationale expectations with respect to performance. There must be tools to determine if the investment path is consistent with achievement of long-term goals; this is difficult given that markets are volatile and managers can look good or bad based on short-term results. It is important that the ARMB separate the reality of the relationship with a manager from whether they are delivering what is expected.

MR. O'LEARY indicated that the ARMB must always consider its asset allocation and how that affects performance. Over the years he has found clients who are interested in how peers are doing and if a peer is doing better, they want to change what they are doing. PERS and TRS are now, in essence, frozen plans as of July 1, 2006; as a result, the participant base will become progressively older. Because of this, over time the appropriate asset allocation for those programs will and should change. It will become increasingly less relevant how the performance for those plans compares to the performance of a universe of plans that are not frozen. MR. O'LEARY noted that CAI is developing a universe of plans that are still operating, but are

frozen, in order to create a benchmark against which PERS and TRS can be measured. This may still not be relevant, noting that he believes there are only two states in the U.S. where retiring medical is funded. The ARMB must consider what is uniquely associated with this program that affects investment policy and influence performance.

MR. O'LEARY stated that market environment is significant and ongoing performance reporting helps the ARMB understand what biases it has in terms of asset allocation. Each manager, because of the desire for diversification, has something of a unique role. When an individual manager is evaluated, there is both a long-term goal and short-term factors that will affect their performance. CAI attempts to develop peer groups to help the ARMB assess the shorter-term performance of each particular manager.

Performance measurement and evaluation is both a science and an art. The science of performance measurement and evaluation has improved, but the art is difficult to define; even some of the largest investment management organizations are surprisingly dependent on key individual(s). Key individuals naturally change over time. Staff is a primary line of defense in this regard with consultants backing up the staff.

MR. O'LEARY explained that when CAI presents performance reports, the state of the art in the industry is to provide time-weighted rates of return. This is something that is routinely accepted in the industry, but it is not necessarily intuitive. There are some assets for which dollar-weighted rates of return maybe more appropriate. A time-weighted return is the return on a dollar from when it is invested to a specific time. A dollar-weighted return equal weights each dollar that is invested. As a result, periods with more money have more impact. Managers are accountable for delivering a time-weighted rate of return that is consistent with contractual guidelines. In terms of funded status, the actuary is not concerned with the time-weighted return, but rather with the dollar-weighted return. MR. O'LEARY noted that unless he indicates otherwise, all return figures presented by CAI are time-weighted. He stated that another convention in the industry is that in doing comparative performance analysis, the standard is to look at pre-fee returns. This is done because fees are related to the size of portfolios; smaller portfolios tend to have a higher fee burden. Therefore, comparing a broad spectrum of peers, the fairest frame of reference is to neutralize the size differential by looking at pre-fee returns. Ultimately, the ARMB must be very cognizant of fees as they might affect investment decisions. There is an ongoing debate whether passive management is better than active management in some asset sectors on an after-fee basis, but that cannot be determined without knowing the fees of active management.

MR. O'LEARY explained that often there is a difference between a manager's analysis of their return and the analysis done by CAI, which is attributed to the benchmark against which they are measured. Managers tend today to use style-specific benchmarks. The ASPIB held the view that every active manager should, in the long-run, outperform an appropriate broad measure of the market and was willing to consider style-specific measures of the market to better understand and evaluate shorter-term performance. He noted that if a manager does better than a style market, but poorer than the broad market, they should be closely scrutinized.

MR. O'LEARY stated there is also an issue with respect to style group comparisons. Value has tremendously outperformed growth over the last five years, so a poor value manager could indicate their performance is above median when compared to a broad universe of managers, but in comparison with a group of value managers, that manager could have fourth quartile performance. CAI was a pioneer in the development of style groups in the mid-1980s and, at that time, CAI was concerned that developing these style groups would result in people taking a shorter-term view of performance. In developing these groups, CAI wished to minimize the impact of survivor bias and reflect a real universe of managers in a particular style. Some style groups are large and robust and provide good frames of reference, while others do not.

MR. O'LEARY explained that the ARMB would be compared to other public funds. That comparison can be segmented by fund type or fund size, or can be made to all funds in the CAI database. When looking at asset category performance, CAI looks at each asset class as a total of all plan sponsors in the database. ARMB performance by asset category is also compared to a universe of managers, where relevant; this is particularly important in regard to bonds and international stocks and to a lesser extent in regard to real estate. The style groups are grouped by style, capitalization, duration, and country mixtures.

LUNCH BREAK 12:00 p.m. to 1:07 p.m.

5. General Consultant

B. Performance Measurement (continued)

For more information on this presentation, refer to the document entitled "Alaska State Pension Investment Board, Periods Ended June 30, 2005, Performance Review & Evaluation" kept on file at the ARM Board offices.

MR. O'LEARY reviewed a performance evaluation presentation given at the last ASPIB meeting. He indicated that CAI prepares and provides a report to staff that contains detailed analyses of each portfolio. The first part of each presentation is a market background. He noted that philosophically he thinks there are really only two assets, cash and equities, and there are other assets between that have a lending component or some form of equity interest. For example, in the third quarter of FY02 the Lehman Brothers High Yield Bond Index was yielding 10% more than Treasuries, which illustrates how even a bond is, in some market environments, like equities. The yield spread has narrowed appreciably and now in the fourth quarter of FY04 people are not getting paid to be in high yield because the spread to Treasuries is so narrow.

MR. O'LEARY reviewed the cumulative returns of equity versus fixed income, noting that the 5-year equity return figure is suffering from the bear market and the 3- and 1-year returns have improved due to equity performance. MR. O'LEARY stated CAI's performance report also contains rolling 1-year returns and cumulative returns for domestic versus international. He noted that while international outperformed in the last year due to currency it has under performed over the last 10 years, also because of currency. The weakening of the dollar in recent years has helped the performance of international equities. Small cap stocks have outperformed large cap stocks over the 1-year and 3-year periods. The 2000 smallest companies in the Russell 3000 Index, or two-thirds of that index, accounts for less than 10% of the market value of stocks in the index.

MR. O'LEARY explained how the Russell 3000 Growth and Russell 3000 Value indices are created. Over the 5-year period, value stocks had an annualized return of 7.2% and growth stocks had an annualized return of (9.9)%, representing an over 17% per year difference in performance attributable to style differences.

MR. O'LEARY next reviewed the portion of CAI's report that reviews each system. This report specifically showed the asset allocation of PERS, showing actual asset allocation and target asset allocation and the percent difference between the two. The asset allocation target has historically changed annually as a matter of practice. The asset allocation shown in this report is as determined by the ASPIB to begin at the beginning of this fiscal year. He noted that absolute return and private equity are under allocated for this period. This was the case in the past with regard to real estate. It is not unusual with less liquid asset categories to see the actual asset allocation differ from the target.

MR. SEMMENS asked if all the assets are marked to market, including real estate. MR. O'LEARY replied that all assets are marked to market, but illiquid investments such as real estate and farmland are carried at their most recent appraised value. Real estate is valued annually. In private equity, assets are carried at cost until there is a significant financial event such as another round of financing for the private equity company. He noted that policies in this area seem to be changing somewhat. The CAI report shows the most recent figures from the oversight manager's reports, adjusted for subsequent contributions to the date of the valuation. Annually, CAI will review the private equity portfolio with the board on a detailed basis. MR. SEMMENS asked if GAAP financial reporting would differ from the numbers in these reports. MR. O'LEARY replied that it should not differ.

MR. O'LEARY reviewed an analysis of the fund's asset allocation versus that of other public funds in CAI's public fund database. He noted that not every fund is invested in every asset category, so the analysis shows what percentage of the database has investment in each category. The "alternative" category is a catchall and for the Alaska fund's plan it includes private equity, other, and the returns from the hedge funds. He noted that the Alaska fund has a lower allocation to fixed income and equity than other managers do, but has investments in other categories that other public funds do not.

MR. BROOKS asked the size of the group in the CAI database. MR. O'LEARY replied that the database is comprised of over 100 plan sponsors and it includes the vast majority of state funds.

MR. O'LEARY explained that PERS had a 1.90% return in the quarter ended June 30, 2005 and TRS had a 1.92% return, the difference is attributable to cash flows. Each quarter, CAI examines whether the fund has done better or worse than its benchmark and the reason for that under or over performance. CAI analyzes both manager effect and asset allocation effect on performance. During the quarter ended June 30, 2005, TRS private equity and real estate and international returns were positive with the actual returns exceeding the target returns; all the other asset categories contributed negatively. Overall, the asset allocation effect was negative and manager effect was positive. International fixed income had a negative return in the quarter and the effective weight of that asset category was 4% compared to the target of 2%. MR. O'LEARY

explained that over a 4- or 5-year period the asset allocation effect should be zero, which would indicate that the actual allocation is even to the target.

For the fiscal year, the PERS return was 8.95% and the TRS return was 9.01%, both below the target return. The largest contributor to this under performance was domestic equity. MS. MILLHORN asked if these returns are net expenses. MR. O'LEARY replied that they are pre-fee, but the real estate number is net of fees and the private equity is net of partnership fees, but not net of the oversight manager fee.

MR. O'LEARY reviewed a scatter diagram depicting the Alaska fund's returns by major asset class categories of domestic fixed-income, international equity, and domestic equity compared to the appropriate benchmark over the 5-year period. Domestic equity has done slightly better than the S&P 500 Index, but has been more volatile. This is not a good comparison because small cap stocks have outperformed large cap stocks and ASPIB had a large exposure to small cap stocks.

Relative to other public funds by asset category, the Alaska fund's domestic fixed income has done slightly better than the market, international equity has done better than the market, and domestic equity performance is low.

MR. O'LEARY reviewed a 13.75-year attribution analysis indicating manager effect and asset allocation effect on the returns for PERS and TRS. He indicated there are also attribution analyses for other periods in this report. MR. O'LEARY next reviewed the cumulative total fund returns for the quarter, 1-year, 2- year, 3- year, and 5- year periods. He explained that this is useful information insofar as a frame of reference of how other plans in the database are doing. Because those other plans are active and open, this will become less relevant to this fund over time. For the 3- year, 2- year, and 1-year periods, the Alaska fund is essentially at median.

MR. O'LEARY noted that in considering performance it is important to be cognizant of time period effects. If there was a year of very poor performance five years ago, a cumulative 5-year return figure will reflect that. This makes manager evaluation difficult. As an example, he noted that Tukman, who was hired five years ago, had good returns five years ago, but in the last year had poor performance. The APFC hired them 2.5 years ago so they have had poor returns for the history of that relationship. He wished to emphasize to the ARMB the importance of the specific time period during which performance is measured.

MR. SEMMENS noted that in trying to understand the relative performance graph he was surprised to see the Alaska fund was outside of the area shown in gray in the last year. MR. O'LEARY explained that the top 10% and bottom 10% are excluded. The bar represents 80% of the group.

MR. O'LEARY noted that domestic equity has under performed for the year. The domestic equity component of the Alaska fund is large. He highlighted that the large cap component of domestic equity did not go down substantially over the 5-year period and returns are within the bar. The Russell 2000 Small Cap Index has not been a top quartile performer. MR. BADER asked how much of the domestic equity pool is measured in small versus large cap. MR. O'LEARY replied that the Alaska fund tends to have more small cap and less value than is

typical. He stated that the domestic small cap equity area has had significant under performance and steps were taken to address that by adding three new managers at the beginning of this year and terminating a manager in the fourth quarter of last year. He suggested the ARMB watch closely to see if the actions taken to remedy the problem has done so. MR. SEMMENS asked if action should have been taken sooner to address under performance. MR. O'LEARY reviewed the history of the small cap pool. The small cap pool was established in 1993. Throughout 2000 the small cap pool was doing extraordinarily well. At that time a manager , Putnam, was terminated because the team that was managing the portfolio left the firm. Those assets were reallocated among the three remaining managers, two of which had a growth orientation and the other had a core orientation. During that period there was knowing acceptance that there was a slight growth tilt to the pool. When the bear market began in 2000, that tilt continued so the under performance in 2000 was not unexpected. The question arises whether changes should have been made earlier, but even with the benefit of hindsight Mr. O'Leary felt that would not have come into play until late 2002. He explained that the decision was affected by the fact that the small cap area is capacity constrained, and fees are higher so having more managers is a financial consideration. Capital Guardian's role in the portfolio became more and more important and when they were not performing, it hurt more. He wished action had been taken sooner, but he personally did not advocate for that and he believed there were reasons to not do so.

MR. O'LEARY explained that the Alaska fund has one international manager, but international holdings of global managers are included in the international equity pool. The performance of the pool has been good over almost all time periods for the last five years. He explained that the MSCI ACW ex US Free Index is the broadest measure of international equities. The international ex emerging markets holdings should be compared to the MSCI EAFE Index. CAI's non-U.S. equity style group is the database against which this pool is compared. The performance of the fund's pool has been very good.

MR. O'LEARY next reviewed performance of the fund's domestic fixed income relative to total public funds. The majority of large public funds manage a significant portion of bond assets internally, but many funds do not manage anything internally. Until this year there were no high yield bonds in the Alaska fund portfolio while other public funds may have included those investments. Over nearly every cumulative time period the performance of the fund's domestic fixed income has been competitive and above benchmark.

The in-house fixed income portfolio has existed for the history of returns covered in the report and, for a portion of that history, BlackRock, an external fixed-income manager, complemented the in-house portfolio. Compared against the CAI core bond style group, the fixed-income portfolio has performed well. BlackRock has done well, although not as well as the in-house recently.

Mondrian is the fund's international bond manager that manages against an unhedged benchmark. He suggested that focus should be placed on performance relative to the benchmark rather than relative performance; the former has been very good.

MR. O'LEARY reviewed each of the fund's large cap managers. Capital Guardian manages a large cap portfolio. Their long-term performance has been excellent, but in the last year it has been slightly below the S&P 500 Index. McKinley Capital is a large cap growth manager whose recent performance has been weak but their longer-term results outpace their peers. MR. O'LEARY noted that this manager's performance is more volatile period-to-period than other managers. RCM manages a large cap portfolio. Their performance relative to other large cap growth managers has improved and they have very strong relative returns for the 5-year and longer periods. This growth manager has tended to be slightly more conservative and their performance pattern fits expectations. State Street runs an S&P 500 Index fund. Tukman has had attractive long-term results, but for the last three years their performance has been poor. MR. O'LEARY stated he is doing an on-site visit with Tukman next week to review their investment process. This is a small firm with a small number of holdings in the portfolio.

MR. O'LEARY next reviewed the fund's small cap managers. TCW has managed its portfolio for 3.25 years. This small cap manager can make significant bets relative to the benchmark, specifically in the technology sector. This has not yet profited the portfolio. Turner is a small cap manager that has managed for the Alaska fund for only 1.25 years.

Brandes, an international manager, has done well. Capital Guardian has managed an international portfolio for just less than four years and their performance is at the benchmark. Lazard manages a global portfolio against the MSCI World Index. Capital Guardian manages an emerging markets portfolio that has had better than benchmark long-term performance, but worse than benchmark short-term performance. For calendar 2005, their performance net of fees has outpaced the benchmark. JP Morgan also manages an emerging markets portfolio. They have done better in recent periods.

A REIT portfolio was begun in December. This portfolio is managed internally, is comparatively concentrated, and it looks for low valuation REITs. There are three absolute return funds (funds of funds); two are compared to absolute return funds and one to a long/short hedge fund. It is still too early to comment on performance of these funds.

MR. O'LEARY stated CAI also measures the SBS and Deferred Compensation portfolios. These performance figures are net of fee portfolios. These portfolios are compared relative to mutual funds, which also are net of fees. MR. O'LEARY reviewed a list of funds, including the Balanced Fund, Long-Term Balanced Fund, four Target maturity funds, State Street S&P 500 Fund, State Street Bond Fund, BGI Tactical Asset Fund, Brandes International Fund, Capital Guardian Global Balanced Fund, Citizens Core Growth Fund, T. Rowe Price Small-Cap Trust, and T. Rowe Price Stable Value Fund. He quickly reviewed the component funds used to build the balanced funds (large cap, small cap, international equity, government/corporate bonds, GNMA, and money market). He then reviewed asset distribution of the Deferred Compensation plan. He explained that the acronym CAI MF refers to a mutual fund style group to which the funds are compared. There are a host of issues related to the individual programs that in the past have been SBS and Deferred Compensation and in the future will be defined contribution. The ASPIB had an SBS Committee that reviewed things like modifying the target maturity funds over time. He felt that many improvements have been made in the last decade to expand the options available to plan participants.

6. Actuary Introduction

For more information on this presentation, refer to the document entitled "State of Alaska PERS-TRS Actuarial Overview" kept on file at the ARM Board offices.

MELANIE MILLHORN, Director, Retirement & Benefits, introduced Mercer Resource Consulting, the Division's retained actuary for 20 years. They have compiled presentation material that lays the foundation for the valuation report they will present subsequently in the meeting. She introduced Sam Martin, lead senior actuary, Chris Burns, and Brad Lawton who specializes in the medical component.

MR. MARTIN explained he would begin with a presentation as background to the 2004 actuarial valuation report. He noted that the presentations are as of June 30, 2004 and do not include the enactment of Tier 4 for PERS and Tier 3 for TRS as authorized by SB141.

MR. MARTIN explained the purpose of the presentation is to provide an overview of the basic principles, funding goals and aspects of an actuarial valuation. He explained that total system costs are defined as: benefits paid plus administration expenses equals employer and member contributions plus net investment income/loss. He stated that actuarial methods are used to attempt to allocate system costs over time in an orderly fashion, but do not change the ultimate cost of the system.

The system funding goals adopted by PERS and TRS were to: provide relatively stable contribution rates over time; to include the retiree medical benefits; to move toward a 100% funded ratio of assets to accrued liabilities; and pay benefits during the working lifetime of members. He explained that an actuary measures plan liabilities and assets, compares assets and liabilities (funding ratio), and determines the annual contribution (calculated rate). The funded ratio is the ratio of assets to accrued liability. The funded ratio for PERS and TRS is broken out based on non-medical benefits and on total benefits. The funding ratio based on valuation assets, non-medical benefits is 91.2% for TRS and 119.7% for PERS; the total benefits are 62.8% for TRS and 70.2% for PERS.

MR. PIHL asked what is the calculated rate. MR. MARTIN replied that it is the contribution rate determined under the actuarial method to move toward the 100% funding goal.

MR. MARTIN reviewed the board-adopted rates for FY06, which is based on the FY03 actuarial valuation: the TRS rate is 21.00% for FY06 and 16.77% for PERS. The FY07 rates are yet to be determined. He stated it is important to note that the 16.77% rate shown for PERS is the average employer rate and specific rates vary based on the funded status of the particular employer.

COMMISSIONER NORDSTRAND asked what was the calculated rate for FY03 that resulted in the FY06 contribution rate. MR. MARTIN replied that for TRS the rate was 38.85% and for PERS it was 25.63%.

COMMISSIONER CORBUS asked what is the difference between valuation assets and market assets. MR. MARTIN replied that market assets is the market value of the assets at the valuation

date. The valuation assets is a smoothing method to bring in gains and losses over time to smooth out the contribution rates.

MR. MARTIN explained that plan liabilities are the value of a future benefit commitments based on the following set of assumptions: probability of death, probability of disability, probability of termination, expected date of retirement, and expected date of death. Other assumptions include investment earning, salary increases, medical inflation, employment patterns, cost of living adjustments, and others. In addition to assumptions, data is used to determine the liabilities and methods are used to allocate the liabilities over time periods.

Specific key assumptions are: 8.25% is the annual investment earning rate, the 1994 Group Annuity Mortality Table was used, 4.0% to 6.0% annual salary increases, a 3.5% total inflation rate, and medical inflation.

MR. BADER asked if a set of assumptions used today are likely to be different than those used in this valuation. For instance, are there new mortality tables. MR. MARTIN replied that when the next experience study is performed, the mortality table would be reviewed.

DR. MITCHELL asked if these assumptions are common to all actuaries or Mercer-specific. MR. MARTIN replied that they are plan specific assumptions. DR. MITCHELL asked if another actuary would have the same assumptions for this plan. MR. MARTIN replied that they would not necessarily have exactly the same assumptions, they would use the set of assumptions that provides the best estimate at the point in time they determine the valuation.

MR. ROSES asked on what basis the 3.5% inflation rate is determined. MR. MARTIN explained that this rate is based on long-term inflation.

MS. HARBO noted that the core inflation rate used by the Bureau of Statistics is only 2.0%. MR. MARTIN replied that the 3.5% is a long-term assumption.

MR. TRIVETTE asked when the next mortality table is due. MR. MARTIN replied there is a 2000 Mortality table and during the next experience study it would be appropriate to review the applicability of that table to the system. MR. TRIVETTE asked upon what the 4% to 6% annual salary increases projections are based. MR. BURNS explained that these rates are based on inflation and depend on the group with which the member is affiliated. MR. TRIVETTE asked if this is State of Alaska data. MR. BURNS replied in the affirmative.

MR. MARTIN reviewed the medical cost trend assumption, which begins at 9.5% in FY05, trending down over 5 years to an ultimate rate of 5%. Prescription drug trends begins at 14% in FY05 and trends to 5% at FY14.

MR. PIHL asked the rationale for this decline. He noted that the CPI is assumed to be 3.5% and this analysis assumes that medical costs would trend to 5% at FY14. MR. MARTIN stated that Mercer assumes that future health care inflation will be higher than the CPI. MR. PIHL asked how this assumption is determined. MR. LAWSON explained that Mercer uses a standardized process to determine its long-term inflation assumption and adds onto that the expected excess in

the growth of national health expenditures. Currently that is estimated to be 1.5%. That also takes out the expected impact of population growth and the assumed impact of aging or mortality. MR. PIHL asked if this is a conservative or an aggressive assumption. MR. MARTIN felt this is Mercer's best assumption based on the best information available at the time that the valuation was done. MR. LAWSON added that Mercer's assumption would be a generally accepted assumption.

MR. MARTIN next reviewed the actuarial cost method, which allocates the total present value of future benefits into past (accrued liability) and future (normal costs) components. The accrued liability is based on service to date. The future normal cost is the anticipated liability associated with future service for active employees. For the PERS and TRS, the projected unit credit PUC method was used to determine the accrued liability by multiplying service to date over total service. The normal cost is determined by dividing the total present value of the benefits by the total anticipated projected service. The normal cost represents the value of the benefits that are expected to accrue in the upcoming year.

Asset valuation methods are used to smooth the effects of short-term market volatility on contribution rates. This is commonly used in long-term planning. The method is used by PERS and TRS to spread gains/losses over a 5-year period and was phased in beginning June 30, 2002.

MR. MARTIN explained that the unfunded liability is the difference between the assets and the accrued liabilities; the ratio of the assets to the accrued liability is called the funded status. The actuarially determined calculated contribution rate is expressed as a percentage of payroll. The calculated rate is equal to the normal cost rate plus the past service cost rate. The normal cost rate is the value of expected benefits accruing in the coming year. The normal cost rate for PERS is 22.44% and for PERS is 20.13%. The average member contribution rate is subtracted from the normal cost rate to determine the employer normal cost rate. The past service cost rate is determined using amortization methods to systematically bring the unfunded liability to the 100% funding goal. The amortization method used by this system is intended to pay off the unfunded accrued liability over 25 years.

MR. BADER asked why the average member contribution rate deviates from the statutory rate. MR. BURNS replied that the PERS rate is a weighted average between the police and fire rate. For TRS it is an average between the teachers who pay 8.65% and those who pay 9.65%.

The past service costs for the systems were: $2.278 billion in unfunded accrued liability for TRS and $3.414 billion in unfunded accrued liability for PERS. The amortization of that amount over 25 years as a level percent of payroll is $146 million for PERS and $219 million for TRS. The ratio of the amortization payments to the total salaries results in the past service rate of 28.02% for TRS and 14.87% for PERS. MR. MARTIN explained the total employer contribution rate is the total of the employer normal cost rate and the past service rate.

MR. MARTIN summarized that over time contributions exactly equal benefits paid plus expense minus investment income. Actuarial methods allocate costs over time periods and uses normal costs and accrued liability to determine calculation rates.

MR. SEMMENS asked if there are comparable statistics to allow comparison of the Alaska system rates to other systems' rates. MR. MARTIN replied there is survey information of rates of other public funds. A custom comparison could be prepared for the State of Alaska. MS. HARBO noted that NEA publishes a book comparing the largest 100 public pension funds that she could obtain for Trustee Semmens.

BREAK 2:30 p.m. to 2:41 p.m.

7. Valuation Report

For more information on this presentation, please refer to the document entitled "State of Alaska, Public Employees' Retirement System and Teachers' Retirement System Actuarial Valuations as of June 30, 2004" dated October 11-12, 2005 and kept on file at the ARMB offices.

SAMUEL MARTIN with Mercer Consulting began the review of the actuarial valuations as of June 30, 2004. He explained the valuation issues include the fact that the actual contributions are lower than actuarial contributions and investment return for FY04 exceeded the assumed 8.25% return at 14.6%. There are included in this report recommended changes to the medical methodology and assumptions. The valuation estimates also reflect the Medicare Modernization Act of 2003.

MR. O'LEARY explained that the board has for years been looking at a 7.70% target rate of return, given an inflation assumption of 2.6% generated by CAI. If he had been told inflation would be 3.5%, he would expect earnings to be higher. But if he could convince Mercer that inflation is 2.6%, he presumed Mercer would recommend a lower discount rate. MR. MARTIN indicated this is correct. MR. O'LEARY noted that if the system earned 7.8% five years from now, it would appear to be on target, but Mercer would note there is an investment experience loss. MR. MARTIN explained the expected return on asset assumption is a combination of the inflation assumption and real rate of return assumption. If the underlying inflation rate differs, the total expected return would be different. The return from an actuarial standpoint is long-term and expectations may be different than that of an investment consultant. MR. O'LEARY stated that Mercer has a 4.75% real return assumption imbedded in its work. MR. MARTIN indicated this is correct, based on the asset allocation.

MR. MARTIN reviewed the components of an actuarial valuation: data, assets, assumptions, methods, plan provisions all as of the date of the valuation. He reviewed the average contribution rate and board-adopted contribution rate for PERS and for TRS for FY06. MR. PIHL asked if Mercer recommended the contribution rates. MR. MARTIN replied that the contribution rate is the rate Mercer would expect would bring the fund to a 100% funding goal at the end of 25 years. MR. PIHL asked what were the actual contribution rates. MR. MARTIN replied that the contribution rates were adopted by the boards.

MR. MARTIN reviewed a history of the funding ratio for 1979 through 2004. There was a drop from 2001 to 2002. He then reviewed the July 1, 2004 normal cost and accrued liability, comprised of active participants, terminated participants, retirees and beneficiaries. The total accrued liability is $11.4 billion for PERS and $6.1 billion for TRS. MR. MARTIN noted that the non-medical constitutes 56% of the normal cost for PERS, while medical constitutes 44%.

Non-medical constitutes 61% of normal cost for TRS, while medical constitutes 39%. The accrued liability is comprised 63% of non-medical and 37% of medical for PERS and 69% non-medical and 31% medical for TRS.

The assets as of June 30, 2004 were $8.1 billion in market value for PERS and $3.9 billion for TRS. The actuarial value was $8.0 billion for PERS and $3.8 billion for TRS, indicating a small gain that has not yet been reflected. MR. JOHNSON understood that FY04 contributions is the amount contributed by employers and employees, not the return on investments. MR. MARTIN indicated this is correct. He indicated that this analysis shows both FY04 contributions and FY04 benefit payments.

MR. MARTIN next reviewed unfunded liability. For PERS this figure is $3.4 billion and for TRS it is $2.3 billion, totaling $5.7 billion for the two systems. MR. O'LEARY stated he is always astounded by how the discount rate affects the magnitude of the unfunded liability. He asked what would be the change in unfunded liability if the discount rate were 1% lower. MR. MARTIN replied it would be in the range of 13% to 15% for a 1% change in the discount rate; this is very plan-specific depending on demographics and how the liabilities are weighted.

MR. MARTIN next reviewed the sensitivity of the liabilities and assets, noting that if there were a 5% liability increase there would be a 3.4% contribution rate increase for PERS and 4.7% increase for TRS. A 5% decrease in assets would cause a .3% increase for PERS and .5% increase for TRS annually.

CHAIR SCHUBERT asked how the 5-year and 25-year smoothing periods were chosen. MR. MARTIN replied that the 5-year smoothing period is common among funds. The 25-year smoothing period was adopted as part of presentations to the PERS and TRS Boards; a variety of different amortization periods were presented.

MR. O'BRIEN asked if the smoothing period was reduced from 5 years to 3 years. MR. MARTIN replied that this would depend on whether there were gains or losses in the prior three years. In a 3-year method, the dollar amount of gain/loss in one year would be recognized over the 3-year period. MR. O'BRIEN noted that dropping off 2000 and 2001 when large losses were experienced would change liability drastically. MR. MARTIN replied that the smoothing period through June 30, 2002 would recognize those losses and they would be amortized over 25 years. MR. BURNS indicated the current method was to reset to market as of 6/30/02 so the returns of FY00 and FY01 are not reflected in these valuation assets.

MR. O'LEARY noted there had been a smoothing technique previous to FY02 and in FY02 Mercer changed the actuarial value of assets to the market value of assets and adopted a 5-year smoothing tool. MR. MARTIN stated this is correct. Mercer reset to market 6/30/02 and is phasing in a 5-year smoothing. Mercer reset to market partially because the losses in the prior years would have built volatility into coming years. MR. PIHL asked if it would be prudent to reverse the 5-year and 25-year period in order to be conservative when faced with unfunded liability. MR. MARTIN explained the purpose of the asset smoothing method is to smooth out short-term losses. The unfunded liability in this situation represents a longer-term obligation and therefore is spread over 25 years. MR. JOHNSON understood that the 5-year smoothing is being

phased in, so the period in operation is only a 3-year rather than a 5-year period. MR. MARTIN replied this is correct. The value of assets was reset to market in FY02, so in FY03 there was one year of experience, of which one-fifth was phased into the current valuation.

MR. SEMMENS asked if the amount that is smoothed is the only change from the assumed rate. MR. MARTIN replied in the affirmative.

MR. BADER thought it was likely that, since the system is currently contributing less to the fund than Mercer's computed rate, all things being equal, it will be even less funded at the point of the next valuation. MR. MARTIN replied that there would be an expected loss. MR. BADER suggested hypothetically that there was a windfall investment gain equal to the under contribution and stated he understood the methodology fully recognizes under contribution, but not the investment gain. MR. MARTIN stated it would be recognized over the next five years. MR. BADER presumed that the FY05 study would show more unfunded liability than this report. MR. MARTIN indicated that this would be the case, to the extent the board adopted rate is less than the actuarial rate.

MR. TRIVETTE asked, if only two years of smoothing have occurred to date, when would the five-year period restart. MR. MARTIN responded that Mercer's reset to market is being phased in beginning in FY02. Over the next three years it will be fully phased in for a 5-year period. MR. TRIVETTE asked if the previous years are not considered. MR. MARTIN replied that the method used as of 6/30/04 recognizes two years of smoothing. MR. O'LEARY asked what is the typical discount rate used by public funds and what is the typical discount rate used for funding purposes by corporations. MR. MARTIN replied that for public sector funds the most prevalent discount rate is 8.0%. For corporate plans he was unsure. MR. O'LEARY noted that with corporations there is a separation of the investment return assumption and the discount rate for calculation of liabilities. MR. MARTIN stated this is true for corporate accounting. For funding purposes, typically the same rate would be used for a discount rate and for return on assets. MR. O'LEARY asked if the corporate rate is around 8.0%. MR. MARTIN replied in the affirmative.

MR. MARTIN continued his presentation. He indicated the difference between the FY06 contribution rate and FY07 contribution rate for PERS is 25.63% to 28.19% and for TRS is 38.85% to 41.78%. The difference between the actuarially calculated rate and the board-adopted rate would cause an increase in the contribution rate of 0.89% for PERS and of 1.24% for TRS.

MR. BROOKS noted that these rates calculated a 5% step up of the rate until the employers were paying the fully calculated rate. MR. MARTIN presumed Mr. Brooks was referring to the assumed contribution rate in future projections. The rates being shown are calculated based on the accrued liability on the date of 6/30/04.

MR. MARTIN noted that there is virtually no impact on the contribution rate based on investment experience because an FY03 loss was offset by an FY04 gain for PERS; the same is true for TRS. He explained that valuation assets are assumed to return 8.25% annually, the asset method recognizes 20% of the investment gains or losses in the current and preceding four years (this was reset in 2002), and the market and actuarial values for the two funds are slightly different.

MS. HARBO noted that in 2002 Mercer changed the way they looked at healthcare and also reset the assumed premium rates. That, combined with the gains and losses change from the corridor method, the elimination of the corridor method, and adoption of the smoothing method caused a 21% drop and almost a 25% increase in the employer contribution rate that was recommended. She further noted that 50% of the increase for the recommended employer rates was attributed to healthcare. MR. MARTIN agreed with Trustee Harbo's remarks; the change in the unfunded liability from FY01 to FY02 was largely attributed to resetting the healthcare and the healthcare trend to more accurately reflect the current situation. MS. HARBO stated Mercer had been underestimating - by at least by a proportion of ten - healthcare problems. At the September 2004 meeting it was noted that because Mercer was not doing well with healthcare assumptions, there were tremendous changes in the funding ratio and the employer contribution rate. MR. MARTIN stated it is appropriate and prudent to review assumptions from time to time and make changes as necessary to reflect the current situation.

MR. MARTIN reviewed market return versus actuarial return on assets for 03 and 04. In 2003 the market return was 3.2% and the actuarial return was 7.2%. In 04 the market return was 14.6% and the actuarial return was 8.2%.

MR. MARTIN stated that the salary increases contributed to the contribution rate for FY07 by 0.08% for PERS and 0.54% for TRS. Demographic experience contributed 0.54% for PERS and (0.85%) for TRS.

MR. ROSES asked if the demographic figure includes retire/rehire employees. MR. BURNS replied that all demographic changes are reflected in the demographic figure.

MR. LAWSON explained that a number of refinements to the medical assumption development process are commended for the next valuation. The objectives considered were: to verify and refine the basis for valuation and evaluating the impact of Medicare reform; an independent review of the claims development methodology; update the claims basis used in the valuation with more recent experience; and refinement of the current valuation assumptions in advance of the next formal assumption review. The areas of changes being recommended include: claims cost methodology, claims costs, Medicare offset, aging factors, and trend. Aging factors is an explicit recognition of the impact of aging on the group as a whole.

MR. LAWSON reviewed two primary concerns raised by the Board at the March 22, 2005 valuation meeting. First, that the short-term and longer-term trend rates were too low and, second, that the grade down period for those rates was too short. He explained that trend rates are complex assumptions to set and modify, and they significantly impact valuation results. Mercer expressed appreciation for the questions raised by the Board. MR. LAWSON explained that a health valuation trend letter was delivered to the Division on April 26, 2005, which he understood has been included as reference for the ARMB. This letter discusses several items, including specific claims experience analysis, trend rate calculations under various methodologies and time periods, use of the tier redesign project assumptions, and other considerations including the Mercer Actuarial and Financial Steering Committee published guidelines, general marketplace observations and Mercer 2004 Health Survey, and the Deloitte

Consulting LLP calendar year 2005 rate projections. There was also discussion of ultimate trend rates and grade down periods.

The Division requested an independent evaluation of the healthcare trend rates from Deloitte, which rendered opinions in several areas. He quoted from Deloitte's evaluation of healthcare cost trend rates. He stated that Mercer's current recommendation and Deloitte's independent evaluation recommend no change to the healthcare assumptions presented during the March 22, 2005 meeting. For future years, Mercer recommends re-evaluating health assumptions on an annual basis, including the per capita health care cost, trend rates and related assumptions, and Medicare offset.

MR. LAWSON reviewed the current claims cost methodology and the proposed methodology. Under the current methodology, a total rate for all retirees equals a current premium rate. From this a pre-65 cost and a lower post-65 cost for retirees are determined and both were increased with appropriate trend. Under the proposed methodology, an analysis of claims is completed based on claims information and enrollment information, and paid claims for June 2001 through May 2004 are tabulated and an average annual claim amount is determined. Four adjustments are applied to that rate: participation adjustment to account for the differences in exposures between the experience period and current census, a trend factor to trend historical claims from the midpoint of the experience period to the midpoint of the valuation period, incurred claims adjustment to restate paid claims on an incurred basis, and adjustments to paid claims to account for changes in the plan. Administrative costs are then added to arrive at total projected costs, and distribution of per capita claims cost is developed by allocating total projected costs to the population census. The allocation process is separate for medical and prescription drug costs. MR. LAWSON reviewed a numerical table depicting the medical analysis of claims cost.

MS. HARBO noted there is a more complete page of this analysis in the TRS valuation and it says that when claims are figured, actives are used, but this analysis appears to be all retirees. MR. LAWSON indicated that this is an analysis only of retirees.

MR. LAWSON next reviewed a comparison of the current claims cost methodology to the proposed methodology. He noted that the current costs are per retiree per month while the proposed are per member per month. Moving to developing a cost for each person being covered under the system allows for a more accurate valuation of each participant according to their demographic status. He noted that the revised pre-Medicare costs are less and Medicare eligible costs are greater.

With respect to Medicare, which is the amount of system-incurred costs paid for by Medicare, Mercer recommends a revised offset of 85%, based on an experience study of pre-65 and post-65 members. Currently, no explicit Medicare offset is assumed. This methodology results in a more robust and accurate analysis of the amount of claims paid by Medicare.

The recommendation also includes the introduction of aging factors. Aging factors represent the expected incremental increase in claims cost as an individual ages one year. For example, medical claims are expected to be 3.5% higher for a member age 57 compared to a member age 56. Currently there are no explicit aging factors in the evaluation process.

Costs are expected to increase as age increases, but Medicare offset also increases.

MR. LAWSON next reviewed the factors used to determine trend levels, which include the most recent 36 months of claims experience by coverage category, Mercer's Actuarial and Financial Steering Committee retiree medical trend guidelines, Medicare trend forecasts, and current market observations.

The current healthcare cost trend valuation uses a combined medical/prescription drug trend beginning at 12% and grades down by 0.5% to a level of 5.0%. The recommended assumptions use separated medical and prescription rates with the medical trend beginning at 9.5% and grading down 0.5% to a level of 5.0% and an initial prescription drug trend rate of 14% trending down by 1% to a level of 5%.

MR. LAWSON next reviewed the Medicare Prescription Drug, Improvement and Modernization Act of 2003. The prescription drug benefit is the most significant change to Medicare since inception and provides significant savings opportunities for sponsors or retirees. Other opportunities include health savings accounts, which can be used as employee funding vehicles. For the State's purpose, most of the uncertainty surrounding this legislation has been resolved as the State will likely be pursuing the federal subsidy.

MR. LAWSON next reviewed the distribution of system claims costs by pre-Medicare and Medicare eligibility status and by medical and prescription drug coverage categories.

MR. BADER understood there is a choice to either have employees contribute or to opt for federal subsidy. He understood the Division has recommended that the employees keep their current benefits and he presumed the Division would get the subsidy. He asked whether an analysis was provided to the Division. MR. LAWSON believed that Mercer had provided some initial education. He understood Deloitte is currently assisting with that process. MS. MILLHORN indicated that the application has been submitted and received. MR. BADER asked if the subsidy is in the figures in Mercer's presentation. MR. LAWSON replied in the affirmative.

MR. LAWSON noted that 26% of the claims cost are incurred by Medicare eligible retirees while 74% are incurred by pre-Medicare eligible retirees. Medicare reform impacts the system in two ways. The first is savings to the system. Beginning in 2006, the federal government will provide a cash incentive payment to plan sponsors that maintain prescription drug plans that are at least actuarially equivalent to Medicare Part D. Plan sponsors will get 28% of the subsidy for their covered drug costs from $250 to $500 per participant. Due to its rich benefits and lack of premium benefits, the system plan meets the definition of actuarially equivalent.

Mercer has estimated the Medicare eligible prescription drug costs would be $32.2 million, the estimated subsidy would be 23.3% of that, and the estimated savings would be $7.5 million. MR. LAWSON noted these are 2004 dollars and the subsidy will not be received until some time in 2006.

The second impact of Medicare reform is a cost to the system. A special provision affecting physicians in Alaska is expected to result in more than a 52% increase in the average physician fee schedule payments for 2004. Assumptions made in valuing this change were that the portion of physician services performed in the state are 65% and the portion of medical expenses related to physician costs are 61%. These assumptions were based on the best available data from Aetna.

MS. HARBO understood that the increase in physician fees was for a short period of time. MR. LAWSON replied he could investigate this, but that was not his understanding. He noted that the assumptions made for this benefit would only have applicability in one or two valuation cycles and then the actual claims would be used to calculate claims costs. Medicare eligible physician reimbursements are estimated at $27.1 million of expense, the estimated increase would be 20.6% and the estimated cost increase would be $5.6 million.

MR. LAWSON indicated that claims cost savings would change with Medicare reform from $225.7 million to $223.6 million. The Medicare eligible prescription drug portion goes from 14% to 11%, reflecting the subsidy, and conversely the medical portion goes from 12% to 15%.MR. LAWSON reviewed the expected impacts of Medicare reform on the expected system claims cost for a member aged 65. There is little to no change for pre-Medicare medical costs and there is an expected increase of 20% for Medicare eligible medical costs from $1,052 to $1,262. Prescription drug costs do not change for re-Medicare members, while Medicare eligible members would see a reduction of approximately 24% from $1,491 to $1,132. He felt it was important to be mindful that Mercer's claims cost development assumptions key around members age 65. Age 65 claims costs are moved to earlier ages or later ages using the aging factors discussed previously.

MR. PIHL referred to page 35 of the presentation, an analysis of claims cost per member per year by age band, and stated he is amazed at the amount of Medicare offset and asked if it includes what a physician might be unable to collect. MR. LAWSON thought that amount would be included. He noted that this figure was built on actual claims experience. MR. PIHL was amazed at the size of the Medicare cost offset developed by Mercer, noting that in his own experience it is nowhere near that. MR. LAWSON stated that one difference is that benefits levels offered to pre-Medicare members are high so that when they become Medicare eligible there are likely costs that are no longer covered.

MR. MARTIN stated that the combined effect of the changes described by Mr. Lawson would be a 1.03% increase in the contribution rate for PERS and 1.94% for TRS.

MR. SEMMENS understood that the assumptions for medical were exceeded. He had difficulty understanding that fact. He asked if there would be 1% to 2% assumption increases in the future due to medical. MR. LAWSON stated the current change is a reflection of the change in methodologies, the introduction of aging factors, etc. This would to him be a one-time change. Going forward any gains or losses would be due to experience. For example, the experience of the system in 2004 was negative in one of the rate projections by Deloitte. At that point, that low claims experience would be rolled into the valuations and float through resulting in a lower per capita health care cost, which would mean an experience gain. MR. SEMMENS understood this

explanation means that there should not be an expectation of a 1% to 2% increases in medical assumptions going forward. MR. LAWSON confirmed that the expectation would be no change.

MR. TRIVETTE asked how Mercer captures demographic changes, such as the rapidly increasing number of people retiring. MR. MARTIN replied that this is captured; as the data is received, it indicates the classification of the member, either active or retired. If they are active, Mercer assumes there is the possibility of future benefit accrual and if they are retired their benefits decline. MR. TRIVETTE stated that assuming people are retiring at a higher salary than new employees, the salaries being paid into the system would seem to create a significant impact. MR. MARTIN replied that this could be offsetting in terms of liability; it is captured as an explicit component in the data.

MR. MARTIN next presented information on projections. He explained that Mercer considers projected populations and associated projected contribution rates and funded status. These were effective for the June 30, 2004 valuation and do not include Tier 4 and Tier 3 for PERS and TRS. These projections show 5% caps in place for contribution rate increases. Three population growth scenarios are contained in the evaluation: 0% growth, 1% growth, and 2% growth. There is an assumption that new entrants replace members who die, terminate, retire or become disabled. These new entrant profiles are based on the average new entrant profiles from the prior three years. Future liabilities and asset returns are calculated at 8.25%. An actuarially calculated contribution rate is adopted each year, beginning in FY06, but Mercer has assumed the rate will not increase more than 5% per year for either PERS or TRS.

MR. BADER asked if the change in Alaska's retirement law invalidates the second assumption that new entrants replace members who die, terminate, retire or become disabled. MR. MARTIN indicated this is correct. MR. BADER indicated that the projections were accurate at June 30, 2004, but not now. MR. MARTIN agreed that they do not reflect the new tier.

MR. MARTIN reviewed projected PERS active participant count based on a 1% annual population increase through 2030; Tier 3 increases over time while Tier 1 and Tier 2 decrease over time. The projected inactive participant count based on a 1% annual population increase shows Tier 3 increasing over time. These same projections for TRS active participants shows Tier 2 increasing and Tier 1 decreasing over time with a 1% population growth, and inactive participants would also experience a Tier 2 increase and Tier 1 decrease.

MR. MARTIN stated the projected calculated rate is expected to increase for many years under all population increase scenarios. These rates decline toward the end of the projection period when the 25-year amortization period is satisfied. The average population increase for PERS over the last 10 years is 0.8%. Calculated rates increased to above 32% under the 1% population scenario. Factors contributing to the rate increase include the fact that actual contributions are less than the actuarially calculated rate, new entrants come into the system at lower pay levels than exiting members, thereby diluting the pay-off of unfunded liabilities, and funding ratios reach 100% by the end of the 25-year amortization period. These same observations can be made for the TRS system, with the rates for TRS increasing to 49%, even under the 2% population increase scenario. Factors contributing to the rate increase include the fact that actual contributions are less than the actuarially calculated rate, there is a two-year lag between when

the actuarially determined rate is determined and when it is implemented, new entrants come into the system at lower pay levels than exiting members, thereby diluting the pay-off of unfunded liabilities, and funding ratios reach 96% by the end of the 25-year amortization period. MR. MARTIN reviewed graphic representations of the 0%, 1% and 2% population growth scenarios in terms of contribution rates for PERS and TRS, and the funding ratios for PERS and TRS. The PERS funding ratio is currently 70%, it trends down for the next couple of years, and then increases trending toward the 100% funding goal. The TRS funding ratio is currently 63%, it trends down for the first couple of years, and then up toward the 100% funding goal.

MR. MARTIN stated that if the contribution stayed at the current rate for PERS and TRS, the system funding deteriorates under all three population scenarios. The effect of this on the PERS funding ratio is that the 70% ratio would trend to approximately 40% at the end of 25 years; the TRS funding ratio would trend to approximately 20% at the end of 25 years.

MR. MARTIN reviewed projections under different economic scenarios in which all the assumptions and methods used in the projections are the same, except for the total portfolio investment return rate. The base case is 8.25% return, an optimistic case of 9.00% and a pessimistic case of 7.50%. If investment return were 9.00% into the future, there would be lower contribution rates. If the return were 7.50%, there would be higher contribution rates.

MR. O'LEARY understood and appreciated the utility of looking at the various growth presumptions before the change in the retirement program, but in effect all of this analysis is irrelevant, given the change that has been made in the retirement program. MR. MARTIN agreed with this statement. MR. O'LEARY thought an issue that deserves consideration is what happens when there is not a replacement of an active employee that retires and how much greater the sensitivity of everything is to each of the assumptions. For example, the discount rate assumption will have a shrinking pool and when the last participant dies, there should be zero assets. That introduces the possibility of participating entities asking whether there is some way to do better than this program. They might question if it would it be better for them to have people retire earlier. He asked how the ARMB should consider those options. He asked if this presentation should be updated to reflect the fact that population will decrease, not increase. MR. MARTIN did not feel this information is irrelevant in that it provides historical information. In looking forward he felt it would be appropriate to reflect the new tier. This presentation is what was presented in March 2005. An analysis including the new tier is planned. MR. BROOKS thought the contribution rate graphs would flatline at the normal cost rate once the past service costs are paid because under a defined contribution plan there is always 100% funding because the contribution is the full amount. MR. MARTIN agreed that with a defined contribution plan, the amount contributed equals the cost. MR. BROOKS also noted that an employer rate would be calculated irrespective of tier; the difference between the normal rate and the contributed rate would retire the past service cost. MR. MARTIN stated that is a model that would work. The only component that would have variability is health care.

MR. MARTIN next reviewed a projected contribution rate analysis for TRS also using the base case of an 8.25% return, an optimistic case of 9.00% and a pessimistic case of 7.50%. If investment return were 9.00% into the future, there would be lower contribution rates. If the return were 7.50%, there would be higher contribution rates.

MR. MARTIN reviewed a projection illustration. An explicit projection of the new Tier 3 and Tier 4 has not been done. However, to give the ARMB an idea of what might be the cost projection and contribution rate projection, this information was prepared. This illustration projects contribution rates for PERS and TRS. The graphs model a new tier alternative with normal cost rates of 8.00% for PERS and 8.75% for TRS. This is based on 2003 data and valuation methodology, except medical assumptions and methods were based on the June 30, 2004 valuation and using a 1% population growth scenario. The new Tier 4 and Tier 3 normal cost rates were expected to be 9.6% for PERS and 11.6% for TRS. The current Tier 3 and Tier 2 normal cost rates are expected to be 10.74% for PES and 11.71% for TRS. Based on these assumptions, it is expected that the new Tier 4 and Tier 3 projected contribution rates would fall below the current plan.

MR. ROSES understood the contribution rate that is being suggested and upon which the ARMB must decide is based on a 25-year amortization of the deficit and on a projected 1% increase in population coming into the system that is not going to occur. MR. MARTIN replied that the projections show the effect of the 1% population increase on the contribution rates going forward. The calculated rate does not consider new entrants. MR. ROSES asked if the 25-year amortization takes a population increase into account. He presumed that amortizing a deficit over 25 years would result in part of that amortization being offset by any increases to the fund in terms of contributions or investment returns. MR. MARTIN responded that the liabilities and assets as of the valuation date are considered.

MR. SEMMENS stated he would be interested in knowing how he could analyze whether or not the actuary has done a good job. MR. MARTIN replied that no actuary would be entirely correct in its predictions. Actuaries set the framework for rates and allocating costs based on a set of reasonable assumptions. The system is set up to account for the fact that the projections will not be entirely what is experienced. A gain or loss is amortized over 25 years and assumptions are adjusted along the way to reflect the best estimate at the current point in time. Experience studies are done to be sure the assumptions are right. SB141 requires review of those assumptions, there is an actuarial audit, and Mercer has in the past had a review of its assumptions by Deloitte. Mercer utilizes standard valuation processes.

COMMISSIONER NORDSTRAND referred to pages 4 and 5 of the presentation and asked whether a calculation has been done to determine what would have been the result in terms of the funded ratios going forward if the Board had adopted an FY06 25.63% contribution rate. He felt that an analysis of the actuary's performance could be based on what their recommended rates would have done over time. MR. MARTIN suggested that assumptions are set that are reasonable at the time. The board must be comfortable that the assumptions are reasonable. To establish a framework in which there are reasonable assumptions to determine a calculation rate, one would expect that the rate would be the same the next year. At the end of the amortization period, the expectation would be that the normal cost would be contributed. There are outside factors that could and have changed that for this system and systems across the country. COMMISSIONER NORSTRAND reiterated that if the actuary recommends a rate and a lower rate is adopted, there is less money coming into the system than the actuary felt was necessary to achieve a downward trend. MR. MARTIN replied that this is correct, and that would result in a

contribution shortfall. If there is a difference between the average contribution rate and the board-adopted rate, there would be a loss in the upcoming year.

COMMISSIONER CORBUS referred to page 6, a graph showing historical funding ratios, and recalled when he served on the ASPIB during six years when the funding level was over 100% and then in one year the funding level for PERS went from 100% to 78%. He asked if some sort of heads-up was in order to the board, given this drastic of a drop in one year. MR. MARTIN commented that the rate dropped from 101% to 75%. Mercer reported the sources of that change during the normal reporting cycle at June 30, 2002. Assets were trending down in that period. He noted that at the valuation date and after the valuation is completed, the sources of the change are determined and reported to the board. COMMISSIONER CORBUS noted that this was a substantial change apparently with no advance notice to the Board.

MR. JOHNSON noted that going forward under SB141 there are a number of redundancies built in with respect to the provisions for actuaries. He felt there must be clarification of what is meant by the requirement for a review by a second actuary and a 4-year audit. Going forward, it appears the ARMB must hire more than one actuarial firm.

MR. PIHL asked how much of the unfunded liability has accumulated year-by-year due to the 5% limitation on increases to the contribution rates. MR. MARTIN replied that this could be determined, but he did not have that information at this time. MR. PIHL explained he wanted to see a year-by-year analysis of the shortfall created by the difference between the actuary recommended rate and the fact that the rate adopted was subject to a 5% limitation. That difference resulted in a massive build-up of unfunded liability on a cumulative basis. MR. MARTIN indicated this could be calculated. MR. PIHL understood that the cumulative impact would continue for a number of years. MR. MARTIN agreed that if there is a 5% cap limitation continuing, and the board adopted rate is less than the actuarial recommended rate, a loss would be expected in the coming year. MR. PIHL believed the cumulative impact would continue to occur for the next 5 to 7 years. MR. MARTIN stated that it would take that long before the adopted rate catches up with the actuarially determined rate. MR. PIHL asked if the limitation is 5% of the rate or five percentage points on the rate. MR. MARTIN replied that it is percentage points.

COMMISSIONER NORDSTRAND noted the contribution rate for FY07 for PERS is 28.19% and if the ARMB adopts 16.77% plus 5%, it will not equal that. This deficit is not being diminished so a loss is going to continue. The cumulative impact will continue until the system is funded at the actuarially recommended rate. MR. BROOKS indicated this was a consideration with regard to how much of a contribution rate increase could be handled in a single year. He thought the actuarial rate could be reached in 2009. The FY06 budget impact of a 5% increase was just under $400 million.

MR. PIHL understood that the actuarial projection does not recognize the 5% limitation on increases in the contribution rate. He noted that, if the actuarial projected rate is 28% and the current rate is only 16%, the 5% limitation would not allow an increase to the recommended 28% rate. He felt the cumulative impact of the 5% limitation should be reflected in the projections. MR. MARTIN responded that the projection illustrations do recognize this, as

shown on page 66 of the presentation. MR. BROOKS stated that the projected contribution rates shown on page 66 step up through 2009. MR. PIHL asked whether two years ago when the system faced the unfunded liability and had to recognize the 5% limitation that was recognized in the actuarial projections. He did not see that was done. MR. MARTIN explained that in determining the calculated rate, Mercer assumes that the calculated rate is made into the future. In tracking the calculated rate from one year to the next Mercer shows an associated loss because the calculated rate not is being met. The calculated rate is the normal cost plus the unfunded liability amortized over 25 years.

8. Summary of Day

GARY BADER stated the ARMB has been advised that it is expected to report to the Governor and Legislature on the first day of the legislative session. A special report is required 15 days after the Legislature begins with a preliminary assessment of the funds and perhaps long- and short-term strategies. Near the end of the meeting, staff has recommended 2005 and 2006 meeting dates for the ARMB. The only meetings scheduled before the legislative session are for November and January, but if the ARMB is going to be expected to provide these reports to the Legislature, there must be discussion of when that will take place and who will speak on behalf of the Board. There are also audits and other things that must be accomplished and the ARMB might want to discuss whether or not to use committees to do some of that work.

DR. MITCHELL stated he is involved in a dozen boards and, in his experience, the work set out for the ARMB is considerable and will require a great amount of time.

MR. WILLIAMS thought Mr. Bader brought up a key issue in terms of the role of this board, whether it is policy or administrative. Given the size of the task ahead of the ARMB, he would be reluctant to be the entity responsible to administer the policies the ARMB sets.

MR. PIHL felt that Ms. Schubert's role as chair will mean a great deal to the success of the ARMB. He felt the ARMB should be in agreement that Ms. Schubert should be compensated for the significant time that will be involved for the work required. CHAIR SCHUBERT asked to delay this suggestion until it is clear what time demand exists. She would prefer to not be compensated for tasks that take one to two hours a day. MR. PIHL suggested that Mr. Bader and Ms. Hall could tally what Ms. Schubert's involvement is on a monthly basis and he felt she should be compensated.

MR. SEMMENS asked whether, in light of the reports the ARMB is expected to produce, would the ARMB discuss the potential need for additional meetings or is this discussion more appropriately held until later in the agenda. CHAIR SCHUBERT indicated this topic would be discussed later in the meeting and she suggested that perhaps the worksession could be moved up to resolve some items. MR. SEMMENS indicated he had compiled a list of questions and he thought that, if the ARMB is going to make recommendations to the Legislature about how to fix the problem, there should be time set aside to discuss that. MR. PIHL indicated he also has a list of questions.

RECESS 4:36 p.m.

ALASKA RETIREMENT MANAGEMENT BOARD MEETING

Location of Meeting
Anchorage Marriott Hotel
820 West 7th Avenue
Anchorage, Alaska

MINUTES OF
October 11-12, 2005

Wednesday, October 12, 2005

I. CALL TO ORDER

CHAIR called the meeting of the ARM Board to order at 9:00 a.m.

II. ROLL CALL

ARM Board Members Present
Martin Pihl
Sam Trivette
Gayle Harbo
Gail Schubert
Larry Semmens
Bob Roses
Scott Nordstrand
Mike Williams
Bill Corbus

Consultants Present
Rob Johnson, Legal Counsel
Michael O'Leary, CAI

IAC Members Present
Tim O'Brien
Bill Jennings
Jerrold Mitchell

Department of Revenue Staff
Tom Boutin, Deputy Commissioner
Gary Bader, Chief Investment Officer
Susan Taylor, Comptroller
Judy Hall, ASPIB Liaison

Department of Administration
Kevin Brooks, Deputy Commissioner
Melanie Millhorn, Director, Division of Retirement and Benefits
Charlene Morrison, Chief Financial Officer

9. Actuary Assumptions & Contribution Rates

CHIAIR SCHUBERT understood the ARM Board was being asked to adopt the June 30, 2004 valuation prepared by Mercer Human Resource Consulting. SAMUEL MARTIN with Mercer clarified that the June 30, 2004 valuation includes the revised medical assumptions and methods.

MS. HARBO moved to adopt the June 30, 2004 actuarial assumptions as presented. MR. SEMMENS seconded.

MR. SEMMENS asked if there is a recommendation from the Administration on this item. MR. BROOKS indicated the Administration would recommend the 5% increase in the contribution rate. He remarked that regardless of what is done, there would be a $6 billion shortfall; altering the assumptions will only affect that slightly. He noted that a 5% increase would set a rate that is below what is needed, but it takes into consideration the budget implications on all the employers; it also continues the underfunded status. Some of the early estimations were that this could have a $5 million impact on employers. MR. SEMMENS asked if this vote is to set the rate or approve the actuarial assumptions. CHAIR SCHUBERT replied that the subject of the motion is the latter. MR. SEMMENS clarified that his question is whether the Administration is in agreement with the actuarial report. MR. BROOKS stated there are approximately 23 major assumptions in the report and, while each one could be argued, given the facts that Mercer had at the time this report was compiled, the assumptions that went into the rate development are valid. The Administration supports the findings in the report, recognizing that this is an inexact science. He remarked that while another actuary could develop a different rate, it would not be drastically different. MS. MILLHORN added regarding the Board's concerns with the medical cost trends and the mortality table that an independent review was done in May 2005 by Deloitte, and their conclusions were that neither the medical cost trend nor the mortality table were unreasonable.

MS. HARBO stated that despite the concurrence of Deloitte with the medical assumptions, she still had concerns that the projections showing medical rates trailing off to a 5% increase in the future is too low. She felt that, even with assurances from Deloitte, she could see nothing that indicates medical costs would decrease. She felt it would be better to use a lower decrease in the medical increase rate. She felt that this was a concern of members of the PERS and TRS Boards in March 2005 and even Deputy Commissioner Brooks said at that meeting that he was concerned those rates were not correct. MS. MILLHORN stated this is an area of concern and SB141 has a requirement that the medical assumption is reviewed annually.

MR. SEMMENS asked why the new assumptions for medical affected TRS more than PERS. MR. LAWSON stated there is no difference between TRS and PERS in terms of the medical assumptions, so the difference is likely demographic. MS. HARBO explained that the members of the TRS system tend to live longer. She also had concern that the cost of prescription drugs

will not go down as people are using more and more prescription drugs. The method Mercer used of breaking out medical and prescription drugs was important.

MR. PIHL personally felt that the actuarial assumptions are not and have not for many years been conservative enough. He has not seen the equivalent of an IB&R factor in these rates such as is used in workers compensation.

COMMISSIONER CORBUS arrived at 9:10 am.

MR. PIHL shared Ms. Harbo's concern that the medical rate decrease is not appropriate. He suggested adopting these assumptions at this time because they are leading to a contribution rate that is so far above what the ARM Board is likely to set as a rate that these assumptions are basically academic.

COMMISSIONER NORDSTRAND concurred with Trustee Pihl's remarks that adding 5% to the current rate achieves an adopted rate that is so far below the rate that is recommended by the actuary that this is an academic exercise; it is 15% below the TRS recommended rate. He remarked that no one believes that there can be a single rate increase to the actuarially recommended level. He was glad to see the analysis that a 5% per year increase would continue until 2009 and then the 25-year amortization of debt can begin.

MR. SEMMENS agreed with these remarks, but noted that in 2001 the actuary said the rate would be at 6.77% for the next 25 years because their assumptions told them that. The boards were criticized for not recognizing that this was wrong. The ARM Board members are not actuaries and that is why he wants to know how he can tell the quality of the actuarial report. If the ARMB does not believe that medical costs will go down to 5%, given that is a very large component of the report that will tell the State of Alaska and the Legislature the amount of the shortfall, and that shortfall is actually significantly higher because the assumptions are wrong, the ARMB will be criticized for not recognizing that. He appreciated the fact that the Administration has reviewed this report and recommends adopting the assumptions.

MR. BROOKS suggested this report could be viewed as a provisional action in order to move forward. This afternoon the Board will hear a presentation on the new RFP for an actuary. One task for the consultant will be to do an analysis as of June 30, 2005. He suggested that the report to the Legislature in January could recognize that a current valuation is occurring. The FY04 valuation could be accepted with qualifications, which leads to an FY05 valuation.

CHAIR SCHUBERT asked if the motion should be amended to indicate that the approval is provisional or should that be reconsidered when the FY05 valuation is available. MR. JOHNSON indicated that the ARMB could choose to do either.

MS. HARBO moved to amend the motion to indicate that this is a provisional recommendation. TRUSTEE ROSES seconded.

MR. TRIVETTE also felt uneasy about many parts of Mercer's report. He felt the ARMB should meet with the new actuary to discuss issues of concern before they begin the valuation process so that they understand the viewpoint and concerns of the board, as well as those of its consultants.

COMMISSIONER NORDSTRAND asked what is the effect of adopting a provisional rate, noting that he assumed this is the rate upon which the members of the system can rely in planning their budget for the next year. MS. HARBO noted that this motion is only to adopt the report as provisional, not the rate.

MR. TRIVETTE called the question on the motion to amend.

By roll call vote, the amendment passed with Commissioner Nordstrand objecting.

By roll call vote, the main motion passed unanimously.

MS. MILLHORN explained that in June 2005, after the PERS and TRS Boards met in March and did not adopt the FY07 rate, communication was sent to 155 PERS and 57 TRS employers advising them that the valuations were not adopted and the employer contribution rates were not finalized. The Administration recommended that for budgetary purposes the employers look at a 5% increase from the FY06 rates. A 5% increase was discussed with the Legislature because PERS regulation 2AAC35.900 had a 5% cap associated with the employer contribution rate. MR. JOHNSON stated a PERS Board regulation put a cap on the amount of increase that can be applied to any PERS employer; this does not apply to the TRS system. That regulation was adopted in 1995. SB141 includes a transition provision and in Section 139 it says "orders and regulations issued or adopted under authority of a law amended or repealed by this act remain in effect for the term issued or until revoked, vacated, or otherwise modified by the provisions of this act." The Assistant Attorney General has observed that the regulation would be superseded "to the extent application of the regulation would result in an employer contribution rate that is less than the rate required, after subtracting the member contribution rate, to fully fund the actuarially calculated benefits expected to be earned by active members during a fiscal year." This would mean that the regulation would be in effect because the rate is not dampening the effect so much as to supersede it. In short, one could argue that the regulation is still in effect. He felt there was ample justification, notwithstanding the 5% regulation, to go forward as proposed.

MR. SEMMENS moved to adopt the contribution rate for PERS at 21.77%, a five percentage point increase over FY06, and adopt the contribution rate of 26.00% for TRS, a five percentage point increase over FY06. MS. HARBO seconded.

CHAIR SCHUBERT noted there is a memorandum in the packet explaining that the Department of Administration recommends adoption of the employer contribution rates.

MR. SEMMENS noted it is interesting that this year most employers absorbed a 5% increase but the State of Alaska has covered that 5% increase. If the Legislature does not appropriate the funds to cover this 5% and the 5% from last year, the impact will be 10% on employers this year. He was curious whether the State has actually contributed the monies that were appropriated to the fund. MR. BADER indicated that transmittals are done through the Department of Revenue

and he thought that, if there had been a large transmittal, he would have noticed. MS. MILLHORN indicated that SB46 appropriated $37 million to DR&B and she believed that has taken place, but she would confirm it has occurred.

MR. PIHL wanted to be sure the rates being adopted meet the minimum standard of Section 14.25.070 that says the employer contribution rate may not be less than the rate required after subtracting the member contribution rate to fully fund the actuarial benefit expected to be earned by members. MS. MILLHORN stated the provision in 14.25.070 was intended to never fall below the normal cost rate on the calculated rate by the employer. It was determined during the analysis accompanying SB141 that beginning in 1998 the rate had incrementally been decreased for PERS and it was intended never to not fall below the normal cost rate going forward. This statute provision requires that the normal cost rate for services for members as of the valuation date going forward never fall below that ceiling going forward. The normal cost rate for PERS and TRS is approximately 13%.

MR. SEMMENS noted that the ARMB heard yesterday about its fiduciary responsibility to set a rate that covers liabilities. He asked if the Board is breaching its fiduciary responsibility by setting a rate that is less than the actuary says is necessary to meet the liabilities of the system. MR. JOHNSON felt that built into this action is the thought that the Board would work to meet that goal. He felt the Board was working toward achieving that goal and making rational choices, given the situation.

MR. BROOKS wished to be clear that the regulation setting a 5% limitation applies to PERS only. TRS has also used this limitation, but this restriction does not formally exist for TRS.

MR. PIHL hoped the ARMB would ask the Legislature to fund the shortfall that these rates may add to the cumulative impact he discussed in his remarks yesterday.

MS. HARBO noted that the TRS recommendation was not limited to a 5% cap, but TRS also was only advisory and the Department of Administration, which could have raised the rate at any time over that 5% increase. She understood that PERS was required to set the rate at no more than 5% per year over the existing rate.

MS. MILLHORN added that the regulation in place for PERS with respect to the 5% cap could be repealed, if the ARMB wished to pursue that.

By roll call vote, the motion passed unanimously.

CHAIR SCHUBERT asked to reorder the agenda to consider the discussion of the defined contribution plan and IAC at this time in order that Dr. Mitchell could before his departure.

11. Defined Contribution Plan Options

For more information on this presentation, refer to the document entitled "Individual Investment Account Options" kept on file at the ARM Board offices.

GARY BADER stated SB141 created a defined contribution plan for all new employees hired July 1, 2006 and thereafter. Testimony was given before the Legislature that the defined

contribution plan would be similar to the Supplemental Benefits System where a menu of options would be available to participants; this board would select those options. For more than a decade the State of Alaska has operated the SBS. Problems with that plan were the genesis of the ASPIB because certain decisions created investments that were not only under performing but were at risk of not paying the beneficiaries at all. An Investment Loss Trust Fund was created in statute and the ASPIB was then established. Over time the SBS plan changed in its construction. It began as a plan with only one option for employees, which is now the Alaska Balanced Fund. During the Hickel Administration other options were added. The current slate of investment options includes the Balanced Fund, the Long-Term balanced Fund, Target 2010, Target 2015, Target 2020, Target 2025, S&P 500 Fund, Government/Corporate Bond Fund, Stable Value Fund, Tactical Asset Allocation Fund, International Fund, Global Balanced Fund, Core Growth Fund, and a Small Cap Fund. The target funds were designed to go to cash at the time of employee retirement; this was about to be reviewed by the ASPIB before passage of SB141.

During the review of SB141 by the Legislature, the implementation date was thought to be July 1, 2005. Because he wanted to be prepared to have a plan running by that date, MR. BADER began working on developing that plan. He spoke with Barclays, which operates defined contribution plans, and is familiar with what is required for those. Barclays uses a strategy similar to SBS, but their fee structure was far higher than was being paid in SBS. Staff also spoke with State Street Bank, which provides index funds. While their funds are in the current SBS, it was not felt that making the entire program index-like by turning its management over to them would result in a significant advantage. Lastly, staff spoke with Capital Guardian and received proposals from them; in his judgment their proposal was not feasible. They did not propose a comprehensive plan, realizing the fee structure of the current SBS plan. Staff then entered into discussions with all of the providers of SBS options. Staff did not want to offer a program that would work to the detriment of SBS participants. All but one of the SBS providers has agreed that the addition of a defined contribution program in 2006 would not adversely affect the SBS program. Barclays did not concur; they are considering terminating their Tactical Asset Allocation Fund and, therefore, were not willing to add that option for the defined contribution plan. Staff is not recommending that fund in the defined contribution plan.

In order to provide the same investment options currently available in many of the funds managed by T. Rowe Price, those would have to become a commingled trust rather than separate accounts. This would effectively create a situation where two State of Alaska funds were investing in these trusts; there would be no other investors. MR. BADER stated he has informal agreements for fee reduction from at least one of the providers.

MR. BADER explained that the Stable Value Fund in SBS was created fairly recently by converting investments that were previously held in a cash account. The plan administrator and ASPIB felt that this account was preferred to cash holdings. A Stable Value Fund existed in the Deferred Compensation plan at that time, but it was not considered appropriate to invest the SBS funds into the Deferred Compensation fund as it would not be in the best interest of SBS participants. He thought this same situation would exist if the new Defined Contribution Plan offered the Stable Value Fund in which SBS is invested. After talking with T. Rowe Price, it was decided the account would begin as a cash account and eventually become a stable value plan.

The other difference between SBS and the proposed Defined Contribution Plan is in the Target 2025 plan. The website indicates, and the next mailing from the Division of Retirement & Benefits will include information, that the new Target 2025 plan will become available. The Target 2025 has a different glide path than the existing target funds, which ultimately become cash at the target date. This change would likely have been recommended and approved by the ASPIB.

MR. BADER felt that adopting a plan that has benefited the participants and has never been criticized for its investment performance was prudent. He stated it is important that this decision be made quickly. Employers need to be advised of what investment options are available in the Defined Contribution Plan. He noted that at the last ASPIB meeting, there was a unanimous recommendation that the ARMB approve the plan before it.

MS. HARBO moved to adopt Resolution 2005-03 regarding Defined Contribution Plan Menu of Options. MR. ROSES seconded.

MS. HARBO stated she listened to the ASPIB's discussion of this issue and agreed that this is a good choice. She asked if the Balanced Fund would be a default option, as it is in SBS. She was concerned about education of new members coming into the system in 2006. She also wondered who would be responsible for the choices, but assumed it was the Department of Administration (DOA). She asked if members would be able to be invested in more than one fund and would they be able to transfer between funds as they watch the market. She asked if the target funds go from a higher risk investment to a lower risk investment over time. MR. BADER replied in the affirmative. MS. HARBO assumed that a 2030 and 2035 plan would be added in time. MR. BADER explained that the Target 2025 is before the Board for purposes of simplicity. If there were a 2030 and 2035 options, they would begin with a 90/10 stock/bond asset allocation. MR. O'LEARY noted that the 2025 target presumes there would be no claims prior to 2025. MR. BADER stated that is presumed, however, it is not possible to know who will leave earlier; those wanting a shorter investment horizon should be investing in the Alaska Balanced Fund. The Long-Term Balanced Fund is the current default option and staff recommends that it would continue to be the default option. He indicated that the Department of Administration would shepherd the education function.

COMMISSIONER NORDSTRAND felt the proposal was sound and the methodology of having something similar to SBS is sound. He questioned whether, in setting up the Defined Contribution Plan, consideration had been given to bundling recordkeeping and education as part of the investment options plan. He believed that, although these options could be selected with very good fees, there is also the aspect of recordkeeping and education for which there may be large fees. He wondered if recordkeeping and education could be obtained through investment option providers for a reduced fee. He also wondered if some service would provide financial advisors regarding their investment options based on their individual risk factors. He wondered if there is a connection between education and choosing the investment options that should be considered. MR. BADER responded that there is always the possibility that those doing the education might believe another investment option should be considered; carrying this to the extreme would mean that all possible investment options would need to be open to the plan. He stated if one wants the best education, best practice is to find the best educator; if one wants the

best investment, best practice is to find the best investor. He felt that a bundled approach is sensible for small employers with limited resources and staff and a small plan that does not have the economies of scale the State of Alaska currently enjoys. He stated that the State can demand the best in each of the investment options and can do the same for recordkeeping. The Department of Administration had $150,000 in the fiscal note on SB141 for education, which he felt would buy a great deal of materials and staff education or seminars for school districts, government finance associations, and municipalities around the state. If it does not, there is a budgeting question, not an investment question.

MR. WILLIAMS understood that the default is the Long-Term Balanced Fund. In his experience, he believed most State employees are not investment savvy and if they all default to the Long-Term Balanced Fund, an employee will not have sufficient assets for retirement 30 to 40 years into the future. He asked if either the Department of Revenue or the Department of Administration envisions that education will contain some amount of financial advice with respect to asset allocation among the various options. At the same time, he questioned if it is appropriate for either the ARMB or the departments to take on the risk of giving advice. MR. BADER noted that the target funds are designed to accommodate an employee who wants to make one investment decision at the beginning of their career and not make follow-up decisions throughout their career. He noted that Barclays is discontinuing its Tactical Asset Allocation fund in order to put more emphasis on target funds.

DR. JENNINGS stated there has been research on default options. He felt that as fiduciaries, the ARMB is giving better advice by having the Long-Term Balanced Fund as a default. He thought that the participants would likely review the full menu of retirement plans rather than making the distinction between SBS and others. He stated there is also research that says that having two sets of options that are very similar is an appropriate fiduciary action.

MS. HARBO recalled that when SBS was established there was considerable member education. MR. BADER replied that CIO Bob Storer and Division of Retirement & Benefits staff member Anselm Staack conducted a statewide seminar explaining the SBS options.

MR. BADER further noted that if the incremental cost of a bundled approach were calculated over the career of a teacher with a salary of $48,000 that grows 3.00% per year over a 30-year period, the first assessment would be $.20 and the last assessment would be $383. They would have spent $41,000 for investment advice over the life of their career. He felt it was important that this advice is paid for by those who consume it, rather than by others who may have no need for that advice.

COMMISSIONER NORDSTRAND asked if those in the Defined Contribution system who want advice would go to an advisor and be charged a fee. MR. BADER stated there is $150,000 already available more that could be sought through budgeting to provide that advice. He felt that any advice that is paid for by constant reduction in earnings from the fund is too costly an approach. COMMISSIONER NORDSTRAND asked if the cost of recordkeeping and education is a budget item that would be paid for by the State and continue to grow, as necessary. MR. BADER stated his calculation assumes that recordkeeping would be paid for by participants. This is how the defined benefit system currently works.

MR. O'LEARY stated CAI has done quite a bit of work with defined contribution plans and has been aware of changes in best practices. He stated there is an understandable blurring of the line between education and advice. In the industry, advice is perceived to be some way of explicitly suggesting to a participant a particular investment course. This gives rise to the question of cost, as well as the liability associated with the quality of the advice. Education is, by today's standards, very sophisticated and the participant might perceive it as advice. He noted that there is software available through providers that allows a participant to input information about their goals, etc. and then recommends an investment path. This is part of education. He stated that education is typically an explicit software package that is designed around the options made available to participants. Since most of the options in the Defined Contribution Plan are built around index-like funds, they are good tools for modeling. There is a fee to access that service. He noted that there is disappointment on the part of plan sponsors regarding the utilization of that type of offering.

DR. JENNINGS stated that the cost of education is in the low single digits. The proposal before the ARMB takes advantage of the large size of the SBS. It would probably be bid by someone trying to initiate a relationship with the system. His concern with a bundling approach is that it would lead to confusion in that there are two different plans and one would need to understand how one is invested versus the other. A member would get advice only on a part of the total options if there were a bundled approach. He felt a disaggregated approach is the best practice for a plan of this size.

COMMISSIONER NORDSTRAND understood from this discussion that the general trend is not to seek bundled options. DR. JENNINGS indicated this is correct for this size of plan; much smaller plans might be interested in a bundled approach. For this scale of proposal with the target fund and the default choices, an unbundled approach would be the standard.

MS. MILLHORN understood from the Division's research of other states that a key component of setting up defined contribution plans is the financial advice received by individuals in the instance when this is the individuals' core retirement plan. With supplemental plans, education has become more sophisticated over time, but this will be the core retirement plan of an employee. For example, Nebraska provides financial advice to their members. West Virginia did not provide financial advice and they are one of the pension systems that is going back to a defined benefit plan. They are doing so because they failed on the educational financial advice for their members and because, by going to a defined benefit plan, they are reducing their employer contribution rate because their defined contribution component, as represented in the media, is a rich benefit. She felt that, according to the research the Division has done, it is important to provide financial advice to members. In order to meet due diligence elements and to set up the defined contribution plan properly and protect the interests of the members, the financial education advice is a key component along with the investment options as a package. The question is who should pay for that cost. The Division's research indicates that the financial advice component, based upon the Ibbitson model, carries a cost of 50 to 60 bp.

DR. JENNINGS believed that the State of Florida also implemented a defined contribution plan and they used an unbundled approach. They were also switching from a full up offering as

opposed to a supplemental approach. He noted that 401(k) offerings in the corporate environment more typically use the bundled approach for a smaller scale plan.

MS. MILLHORN stated when Florida set up their defined contribution plan they had financial advice and the employer paid for the cost associated with that advice because they felt it was very important. In paying for those costs, the employer has been highly criticized because the employer cost of setting up the defined contribution plan in a three- to four-year period expended $30 million. A bundled approach might force a contractor to pay for the cost associated with the financial advice and later that bundled approach can be changed to an unbundled approach. She thought that start-up costs are a factor that should be carefully considered. She suggested that a bundled approach could be used initially and thereafter unbundled. She understood that the existing process began as a bundled approach and is now unbundled.

MS. HARBO felt the education of new employees is important and ongoing. She hoped the $150,000 given to the Department of Administration to provide information to new employees continues. She mentioned that the defined contribution plan in Florida is optional, not mandatory as it is in Alaska. Because it is mandatory in Alaska, it is important that people understand the decisions they make when they become an employee. She would like to see a plan presented to the ARMB on how that education would occur.

MR. BADER stated the Department of Revenue entirely supports good education for participants. The proposal today is for investment options. It is possible to have one without the other.

In answer to the last question Ms. Harbo posed about an employee's ability to transfer from one fund to the other, that is how SBS works today and that is envisioned for the new plan.

MR. SEMMENS asked if the bundled approach could or would cost the member more than what Mr. Bader has described as best practices where those elements are separated. MR. BADER responded that in bundling investment options and education, the provider has to plan that everyone will participate in whatever program is offered for education and will charge accordingly; the actual experience may be somewhat different. By bundling, a restricted universe of investment options is accepted and a fee is paid that he felt should be dependent upon the user. He noted that the Ibbitson product is already available, by request, from the current recordkeeper. He did not believe there was a need to assume the implementation risk of creating new investment options, new recordkeepers, and perhaps custodians. MR. SEMMENS understood the resolution before the ARMB is only one part of this program. He asked if Mr. Bader would anticipate the ARMB would be involved in the selection of a recordkeeper or education provider/program. MR. BADER replied that when discussions of the defined contribution plan began it was the view that the existing SBS recordkeeper could be used, but that changed. He felt a question could be put to the Department of Administration how they would propose to provide education. He believed education could be provided through existing providers.

MS. TAYLOR remarked that from an operational standpoint, the timeline of what needs to be done to make the ARMB's first major initiative accessible is to initially select the investments.

Then the Department of Administration can work to select the education and financial advice as well as the recordkeeper. Trying to get all of this in place will take some time; and she wished to make this point from an operational standpoint.

DR. MITCHELL stated the ten investment options being proposed are very good; they are not so narrow as there is no choice, but not so broad as to cause confusion. The managers selected are among the best. Purely from an investment point of view, he felt these are good choices.

MR. PIHL understood that the administration of the plan is the responsibility of the Department of Administration, so these responsibilities will be addressed in the Division of Retirement & Benefits. The ARMB's concern for education is laudable, but he felt the ARMB should look to Department of Administration to come up with the answers.

COMMISSIONER NORDSTRAND agreed that the Department of Administration has responsibility for this. The point he was raising was whether or not an opportunity is being missed by not doing an RFP to obtain a bundled program, evaluate the proposals, and see what the fees and elements are. If that approach is not desirable, the separate approach could be taken. However, it would not be possible to go back to this consideration at a point in the future.

MR. BOUTIN remarked that time is of the essence. He indicated there have been many meetings between the Department of Revenue and the Department of Administration regarding implementation of the defined contribution plan. While this plan looked far off in July, it is now imminent. He further remarked that with an unbundled approach, if plan participants came to the ARMB and said there were some lackluster results in some of the plan options, this Board could review those and come up with proposed alternatives to those options. In a bundled approach, the costs of education, recordkeeping, investment returns and cost of money management will be hidden. From a best management practice standpoint, it is clear that an unbundled approach is more desirable so that investment options can be reviewed on their own merits. If the education is costly, that can be reviewed on its merits. He had no view whether education and recordkeeping seem to fit together. He felt that having distinct investment options and distinct recordkeeping and education is appropriate.

By roll call vote, the motion passed unanimously.

MR. ROSES moved to adopt Resolution 2005-04 regarding the Target 2025 Plan Option. COMMISSIONER NORDSTRAND seconded.

MR. O'LEARY noted that CAI believes the approach of evolving toward a target maturity that is something other than cash is prudent and appropriate and CAI strongly recommends this type of approach for both SBS and the Defined Contribution plan.

By roll call vote, the motion passed unanimously.

BREAK 10:30 a.m. to 10:40 a.m.

12. Investment Advisory Council

GARY BADER explained that the ASPIB had a requirement to have an Investment Advisory Council (IAC) comprised of no less than three and no more than five members. Through RFP three IAC members were appointed: Jerrold Mitchell, Timothy O'Brien, and William Jennings. Dr. Mitchell worked for Wellington Management for 27 years managing domestic and international equities. He has been CIO for the Massachusetts Retirement Funds and is currently CIO of a $700 million Boston foundation. Dr. Mitchell's contract expires June 30, 2007. Mr. O'Brien has over 30 years of experience in the investment management industry and positions as an auditor of investment management companies for a CPA firm. He spent 12 years as a member of the board of trustees for the Colorado Public Employees' Retirement Association and, among his other duties, served as chair of the audit committee. Mr. O'Brien's contract expires June 30, 2006. Dr. Jennings is professor of finance at the U.S. Air Force Academy. His research bridges the gap between theory and real-life investment management. He has a doctorate in finance from the University of Michigan and is a Chartered Financial Analyst. He serves on four other investment boards. Dr. Jennings' contract expires June 30, 2008. Yesterday the ARMB approved rolling forward all contracts previously approved by the ASPIB, but because SB141 made the IAC permissive rather than mandatory, this item is being brought before the Board. Staff finds that the IAC provides benefit to the staff and the Board.

MR. PIHL <u>moved to continue the contracts of the three members of the Investment Advisory Council</u>. MS. HARBO <u>seconded</u>.

MR. TRIVETTE indicated he has attended ASPIB meetings for years and has observed and spoken with the IAC members. He felt that the advice of the IAC is needed, primarily in this time of transition. The backgrounds of each member are quite diverse and they bring things that will be useful to the ARMB.

By roll call vote, the motion passed unanimously.

10. Capital Markets Presentation

For more information on this presentation, refer to the document entitled "Capital Market Theory & Asset Allocation" kept on file at the ARM Board offices.

MICHAEL O'LEARY with Callan Associates Inc. (CAI) believed the ARMB was well aware that asset allocation is arguably the single most important decision any board makes and it is important to have a common framework for making those decisions. There may be areas where a member might have a different personal perspective, so it is important to understand the perspective that is commonly in use in the industry, how others view analysis of asset allocation and understand the shortcomings associated with it, as well as its key attributes.

MR. O'LEARY reviewed various asset types and their level of risk. The least risky asset is a short-term investment such as Treasury bills. He noted that every investment entails some type of risk, even a so-called "riskless" investment. He explained that there are a variety of ways of assessing risk and he would review those commonly used in the industry.

MR. O'LEARY explained that from 1926 though 2003, large cap stocks returned 10.4%, small cap stocks 12.7%, long-term corporate bonds returned 5.9%, and T-bills returned 3.9%; during

that time inflation was 4%. He noted the average risk premium of each of these asset classes over T-bills, as well as the standard deviation (volatility). MR. O'LEARY reviewed a graphic representation of annual stock market returns from 1926 to 2003, during which the average return was 10.4%. He noted that there were only a few calendar periods over this span that saw an average return between 8% and 12%. He noted that, despite the average, in any given year, the odds are that the return will be different from the average.

Investment professionals define risk as the "uncertainty of return" rather than the "risk of loss." An investment professional may have an investment process they describe as low risk, but they may invest only in stocks; by saying they are low risk, they mean their process has a low risk of having a result that is significantly different from the benchmark against which they manage.

MR. O'LEARY reviewed one-year rolling returns from 1977 through 2003 for both stocks and bonds, noting the extreme difference in volatility between these two types of assets. He next reviewed a list of risk types, both qualitative and quantitative. There is political risk such as those that exist in emerging markets. There is environmental risk such as in real estate. There is legislative risk such as changing authority, benchmark risk, and return risk. There is a risk whether there is liquidity to realize the value of an investment; a rational investor would choose a liquid investment over an illiquid one unless there is added compensation for the illiquidity. There are currency risks such as with investments outside of the U.S. There is inflation risk, particularly in terms of the impact on future liabilities. There are also risks of default. Boardroom risk exists in terms of long-term policies and whether a board has the ability to stay with an investment that is not working in the short-term. This is pragmatically a huge risk for public pension funds. Systematic risk is essentially market risk. Markets return above average or below average returns and trying to earn a greater return can result in achieving a lower return. Career risk exists in terms of influencing judgment. There is the question of whether people are willing to say what they think or are they saying what you want to hear.

Capital market theory focuses on the use of benchmark and return measurement, and on systematic and non-systematic risk; the latter can be mitigated through diversification.

MR. O'LEARY reviewed an illustration of using standard deviation of return in the field of investment. In this illustration, if an expected annual return is 9.0% and the standard deviation of return is 16.9%, then two-thirds of the time a one-year return would be between (7.9%) and 25.9%. He remarked that there is a question of the validity of return figures if they are subject to a 3% to 4% standard of deviation. He noted that the NCREIF Real Estate Index has an observed standard deviation that is less than that of a bond, but the risk associated with real estate is greater than that of a U.S. Treasury bond.

MR. O'LEARY explained that in developing asset allocation there must be an expected return and a measure of risk, as well as some measure of the interaction of one asset category with another, or correlation. Harry Markowitz, who received a Nobel Prize for work he did in 1952, opined that investors in aggregate are rational and are only going to take more risk if they expect to earn a higher return. As a result, they will choose the combination of assets that will achieve the highest return for the lowest risk. The Board must consider what level and what types of risks it can accept when it sets its asset allocation. MR. O'LEARY explained that in building a

portfolio, assets should not be totally positively correlated. He explained a theoretical set of positively correlated stocks. He noted that just because two stocks are positively correlated does not mean they necessarily would have the same return. He reviewed a graph depicting two assets with a very high correlation and explained if they were perfectly correlated, they would have a correlation of +1, if one was going up and the other down by the same degree, they would be perfectly negatively correlated -1. MR. O'LEARY stated there are no assets that have a statistically meaningful negative correlation. Overall portfolio risk is reduced and return is made more consistent through diversification of stocks. Most of the time bonds have a positive correlation with stocks, but sometimes this is not the case and therein is the value of holding them.

MR. O'LEARY stated that combining assets or managers with low correlation improves diversification, whereas combining assets or managers with high correlation's provides little or no diversification benefit. An efficient portfolio, for any given rate of return, has lower risk than any other portfolio; otherwise stated, for any given level of risk, no other portfolio provides superior returns to an efficient portfolio. The entire efficient frontier is equal in CAI's view, regardless of where a portfolio sits within it because each client may have a different set of risk tolerances.

MR. O'LEARY explained that for the major asset classes that have a long-term history the historic record captures most of the risks that are likely to be encountered. From 1926 through today, there has been the Great Depression, wars, price controls, interest rate fixing, recessions and recoveries, and different tax regimens. Looking at this time period, one can get a sense of what is a reasonable expectation for equities earnings over bonds, for the volatility of returns, and for the relationship of different types of major asset classes to things like periods of stable pricing, moderate inflation, high inflation, and declining inflation. When focusing on the major asset classes it is CAI's perspective that standard deviation is useful to define a set of expectations going forward. MR. O'LEARY emphasized that his statement referred to major asset classes, which would not include, for instance, hedge funds, which is a manager using various tools to develop a pattern of hopefully good returns. He explained that in attempting to compose a portfolio that rests in the efficient frontier, an investor should not ignore sub-asset class investments.

For more information on this presentation, refer to the document entitled "2005 Capital Market Outlook," dated January 2005 and kept on file at the ARM Board offices.
MR. O'LEARY explained that in working with clients to set asset allocation, CAI develops 5-year projections of the expected return and the standard deviation, and a correlation estimate. He noted that the mean expected return for stocks is never lower than the mean expected return of bonds and the mean expected return for bonds is not lower than the expected return for cash. This does not mean that there will not be five-year periods where bonds will not outperform stocks or bonds will not outperform cash; those periods are captured through the spread in return. CAI's 5-year projections are formulated in light of current economic circumstances. Reviewing the 80 years of stock market returns, CAI looks not only at the nominal return for equity, but also at the real return, that is exclusive of inflation. This reveals that the real return for stocks over a 5-year period are generally 5% to 8%. For bonds, the data for which is less reliable than stocks

because of the periods when interest rates were set, the real return is 4%. For cash a return of .5% is expected.

DR. JENNINGS commented that the ARM Board's governing legislation, as well as best practices, require that there is a liability awareness iteration of mean variance optimization. There are tools that add one layer of sophistication to what Mr. O'Leary presented and factor in what liability would do with regard to the inputs. MR. O'LEARY stated CAI has done two integrated asset liability studies. This presentation is on assets only. The integrated asset liability study shows how liabilities change with inflation and how that affects asset choices.

MR. O'LEARY next reviewed the 2005 capital market outlook prepared by CAI. He explained that embedded in the 5-year projection is a longer run projection, given that at the end of the 5-year period, the market value of various assets will be affected by what people are anticipating over the next 5 to 10 years. He explained that CAI's quantitative research group drives the analysis. They examine long-term trends in every asset category, as well as correlation and volatility. They talk to others in the industry and the Client Policy Review Committee that adopts the inputs used in the model. CAI also reverse engineers so that if CAI's best thinking on a particular asset class results in something outlandish in the model, the input assumptions will be reviewed and modified. The capital market outlook report discusses the economy at the time the report was prepared and the position of the market in an economic cycle. The report concludes that the economy is still in recovery with growth continuing and shifting from the consumer. CAI is impressed with profit growth and productivity and does not believe housing growth will end. The projection tries to assess Federal Reserve policy and government stimulus/restraint, and considers the current account deficit and what that means. Over the very long-term there is no reason to think international stocks will do better than domestic stocks, but in the intermediate term CAI thinks international stocks will do slightly better than domestic stocks, in part because of the current account deficit.

The report looks at the financial market and a variety of relationships, such as the earnings/price ratio for the S&P 500 compared to the 5-year return for the S&P 500. In 1998/1999 there was a disconnect between the two. At that time, CAI narrowed the spread between the expected return for stocks and the expected return for bonds.

MR. O'LEARY noted that the payout on stocks exceeded the interest yield on bonds through the 1950s. From 1981 through the end of 2004, bonds have consistently had higher income yield than the earnings yield on stocks. With the bear market, that has changed and now stocks have a higher earnings yield than the interest yield on 10-year Treasuries. The Federal Reserve believes this indicates there is not great over valuation apparent in the stock market. This could change if stock earnings or interest rates went up significantly, or if earnings went down.

MR. O'LEARY next reviewed the returns of the Lehman Aggregate from 1981 projected through 2009, noting that this market is a strong predictor of returns. CAI uses the yield to maturity as the projection for the 5-year total return for the bond market. MR. O'LEARY noted that the largest points of discrepancy between the 5-year annualized return and the yield to worst was in periods of high interest rates.

CHAIR SCHUBERT asked what this means for the ARM Board as a practical matter. MR. O'LEARY explained that when thinking of policy, the ARM Board must consider with what assumptions it is most comfortable. For instance, if the portfolio was comprised 100% of bonds, in today's market the return would be approximately 4.75%, which would be a 1.25% real return based on the 3.5% inflation rate presented by the actuary; the actuarial rate presumes a 4.75% real rate of return.

MR. O'LEARY reviewed the 5-year projections in the 2005 capital market projection work done by CAI. He explained that historically CAI's projections have been less optimistic than others. There was a period where their projections were more optimistic than others because of the range of expectations around the projections. Currently the system is awash with liquidity and real returns are low across all asset classes. A barometer for that is the Treasury Inflation Protected Securities (TIPS) rate, which has a real rate of return at less than 2%. Several years ago that rate was up to 4%. If someone asked that the ARM Board build a strategy that protects against inflation, the Board could invest in U.S. government guaranteed inflation protected securities, but that would yield a real return of less than 2%.

DR. MITCHELL understood that CAI's projected annual return is built from fundamentals. He asked if the standard deviations are mathematically calculated. MR. O'LEARY replied that all inputs are best estimates that are based on as much history as possible. Standard deviation and correlation estimates will almost always be somewhere between the most recent rolling 5 years and the long-term average. Of the inputs, correlation changes the most and unfortunately they are very important, but very volatile.

MR. O'LEARY explained that each year the projections are presented with the changes from the previous year highlighted in order that CAI's clients understand the risks embedded in the projections. CAI develops various asset mix alternatives, containing major asset classes only. Each alternative has an expected return, standard deviation, and Sharpe ratio.

MR. PIHL asked which mix closely resembles the existing Alaska portfolio. MR. O'LEARY replied that the Alaska portfolio is closest to Mix 6 (page 37), which has an expected return of 7.75%. He also noted that CAI's inflation number is much lower than that of the actuary.

MR. BROOKS asked what is the impact of the horizon used by the actuary and that used by CAI in terms of the inflation number. MR. O'LEARY indicated that the actuary is using 13 years as a duration figure and CAI's duration is shorter. He stated that a 3.5% inflation figure is reasonable when thinking about a 40-year number. MR. BROOKS asked if it is wrong to use different assumptions for liabilities than for investments. MR. O'LEARY stated that if he used 3.5% as an inflation figure in today's market, he would not own a bond, which would be a bad outcome. The market is collectively saying that inflation is going to be less than 2.6%. Thought should be given to the situation that the inflation sensitivity of the liabilities is greater than that of assets and what are the implications if the inflation figures are wrong in either case. Theoretically contributions to the pension fund remain while people are working and the disbursements are made after they stop working and over a long period of time. During the period of disbursements, they are still potentially benefiting from inflation. For that individual, there is an assumption that all the necessary contributions have been made. Very long-run inflation is

therefore an appropriate frame of reference and that should be a conservative figure because funding is done over a shorter period of time. In a plan such as the Alaska plan has become, the ability to deal with future unanticipated inflation is truncated with the finite group that has been created. He noted that the accountant community is suggesting in terms of pension disclosure that that liability should be valued based on a riskless asset. He emphasized that there is a 13% to 14% increase in liability for every 1% decrease in return expectation.

MR. O'LEARY reviewed a table of efficient frontier asset mixes for 2005 that has added absolute return, private equity, high yield and other asset classes to the major asset classes.

For more information on this presentation, refer to the document entitled "Specific Asset Allocation Policy Recommendations," dated March 1, 2005 and kept on file at the ARM Board offices.

MR. O'LEARY reviewed a presentation made to the ASPIB in March 2005 prior to adoption of the current asset allocation. He began with a review of the PER/TRS asset allocation policy of 36% domestic equity, 15% international equities, 24% domestic fixed income, 2% non-dollar bonds, 9% real estate, 6% private equity, 2% high yield bonds, 3% absolute return, and 3% other. That asset mix would produce an expected return, given the inputs, of 7.83%. He reviewed the one-year expected return from PERS, TRS, Military or Judicial, given the inputs and excluding the top and bottom 10% of returns, which would range from -6.12% to 23.85%. This range is so broad that it is not helpful, but when the time horizon expands, the range becomes compressed. Over the 5-year period, the 90th percentile return is 1.35% and the 10th percentile return is 14.72%. The average is 7.83% for PERS/TRS compared to 6.49% for Military and 7.68% for Judicial. There is a 46% probability that the return will be better than the 8.25% and better than 50% that the return will be better than 7.60%. MR. O'LEARY quickly reviewed the return expectations over 1-, 5- and 10-year periods for each of the retirement systems.

MR. O'LEARY cautioned the Board to not attach precision to minute or rapidly changing segments of the market. He also suggested that the Board challenge all the input assumptions because those assumptions will control the expected return. The inputs provide an order of magnitude gain for being more or less conservative. He noted that the current policy has been affected by the current lower return environment and, because there is a huge premium for consistency in return, investors err on the side of over-diversification.

DR. MITCHELL felt that in the environment Mr. O'Leary described, there is an advantage to be gained by further diversification and diversification into more non-traditional asset classes that have lower correlation with the traditional asset classes. In some forward-looking pension funds and in the endowment and foundation area there is a move away from the general stock/bond allocation and more toward specialty, less liquid, investments. He noted this puts a premium on manager selection because the difference between best and worst managers in specialty investments matters significantly more than in general stock/bond portfolios. MR. O'LEARY noted that in the 1970s the typical public fund had little or no exposure to equities. Meaningful equity exposure occurred during the 1980s and 1990s, albeit below the typical corporate exposure. Now the typical public fund is essentially at the same stock/bond allocation as the typical corporate plan. Corporate funds have moved away from high equity allocations, largely because of regulations.

MR. SEMMENS indicated he had questions related to yesterday's attribution analysis presentation. Yesterday, the information Mr. O'Leary provided was trailing 12 months and the 13.75 years since inception and by quarter. Over the entire 13.75 years the manager effect has been worth three basis points (bp) and in the last year the manager effect has varied between -35 bp and -39 bp. He asked if it is fair to quantify that 3 bp over the 13.75 years and compare that to the fees paid to earn that. MR. O'LEARY replied that it is fair to make this comparison, but the measurement challenges and biases must also be understood in order to make a judgment. He firmly believed that if the Board does not believe it can identify managers who will deliver better than benchmark returns, asset class by asset class, there is the option of owning the asset class at low fees. MR. SEMMENS asked what is Mr. O'Leary's assessment of the earnings results over the last 13.75 years. MR. O'LEARY replied there are biases that have affected that comparison in terms of growth versus value and large cap versus small cap. He felt that in the large cap area it is reasonable to make a meaningful allocation to passive. MR. SEMMENS was disturbed that the very asset classes that Mr. O'Leary suggests be trended toward indexing have the highest negative manager effect. MR. O'LEARY felt this should be viewed positively because it reinforces that indexing is an appropriate path to follow. MR. SEMMENS found this disturbing because the Board is already on this path, yet there is still a negative manager effect in this asset class. He asked whether, if this data were presented on a 3-year and 5-year basis, the picture would be better. MR. O'LEARY indicated he would get this information to provide to the Board at a later time. He gave the example of investing all of the system's money with RCM, which has out performed the broad market over the long-term but over the last five years has under performed. At some point in the late 1990s there was a wide difference between growth and value managers with growth managers doing much better than value. It was exceedingly difficult at that time to hire a manager who had poorer than benchmark performance and had a value orientation. This happened to ASPIB, so there was less efficient diversification in styles than was ideal at that time. Small cap has generally outperformed large cap, but there will be periods where the reverse is true. He noted that the S&P 500 compared to core stock portfolios has been a third quartile for the last five years. The average stock has done better than the weighted average stock over the last five years. For the previous 5-year period, the S&P 500 would have been a top quartile performer. There is no right answer. He noted the State of Washington has historically been 100% passively invested in domestic equities and they have just engaged some enhanced index managers. That pension plan is also trending toward active in international has equities. If the ARM Board does not think that active managers can add value or that the Board can identify, retain, and stay with the average active manager, its investments should be in passive. He noted that it is most difficult to make this decision in the large cap arena.

MR. SEMMENS asked if there is cost information to compare the value added by a manager versus the cost of that manager. MR. BADER indicated this could be calculated. He noted that the ASPIB made a larger commitment to passive within the last six months based on the observations Trustee Semmens is making and the research done by staff. MR. SEMMENS felt that an important component of a decision about a manger is what one is getting for the fee that manager is paid.

MR. TRIVETTE noted there have been events in recent years including huge increases in medical costs, in prescription drug cost, the Iraq war, and hurricanes Katrina and Rita, and asked

what impacts these will have in the coming years. MR. BADER felt these things are taken into account. CAI develops its asset allocation recommendations based on solid rationale and the board adopts those projections, staff tries to stay close to that efficient frontier over the course of a year. MR. O'LEARY noted that the managers are also able to become more conservative or aggressive within their discipline. Bond managers also tilt at the margin in recognition of the market.

LUNCH BREAK 12:12 p.m. to 1:30 p.m.

Awaiting the arrival of presentation materials for the Actuary Selection agenda item, the Board dealt with the meeting calendar.

15. Meeting Calendar – Future Agenda Items – Discussion

MR. BADER explained that staff has compiled a calendar for trustee review and comment. He noted that some meetings are scheduled one quarter apart in order that performance information can be provided by Mr. O'Leary.

MR. TRIVETTE thought the reports due from the ARM Board in January would seem to require more meetings than this proposed calendar includes. He suggested there also be a meeting in December. MR. BADER replied that typically the ASPIB has scheduled a December meeting. He suggested the ARM Board members refer to their calendars to determine their availability for a meeting in December. Nearly all members responded that they would be available after December 10. COMMISSIONER NORDSTRAND asked whether it is necessary to hold a meeting November 29-30 and then again two weeks later. He also asked if all the meetings would be held in Anchorage. MS. HARBO suggested that the Board meet an extra day or two in November rather than have an additional meeting in December. CHAIR SCHUBERT asked if a November meeting would then be combination worksession and board meeting. MR. BADER felt that a board meeting followed by a worksession was appropriate. MR. WILLIAMS asked whether, if the intent is that a draft report be reviewed at the November meeting, that report would be ready in draft form for review. MR. PIHL assumed that Mr. Bader would prepare the draft report. MR. BADER noted that an actuary must be appointed and have time to get the data and do the necessary work on that data before a report can be prepared. He thought it would be hard to have definitive information, but he presumed the actuary would need at least a month to work with the Division of Retirement and Benefits to get data files transferred. MS. MILLHORN replied that the normal schedule is that the data is transferred from the Division to the actuary in October and the first draft valuations are available for review in February/March 2006. MR. BADER thought that everything provided to the Legislature in January would be preliminary because a valuation report would not be available. Once an actuary is in place and various questions are posed to them, their analysis will require some period of time. He did not believe the actuary would be prepared to do this before January. MS. HARBO noted that the ARM Board is hiring the actuary today and there will be nothing received from them until February/March 2006. Therefore, the preliminary report will have to include what the ARM Board has done so far, what is done at the November work session, and what plan is laid out by that time.

CHAIR SCHUBERT thought if a work session is held in November, the January 12-13 work session could be eliminated. MR. BADER explained staff envisioned the Board using the January work session to come to an understanding about its mission statement and goals and objectives, and to set its course. This first meeting has been addressing administrative details and selecting an actuary. He asked when the Board might want a strategic planning session.

MR. PIHL felt that meeting two days in November and two days in January is an appropriate schedule. He felt the two days in January are needed to finalize the report to the Legislature. In November, the Board could consider what the report would include.

CHAIR SCHUBERT wondered whether a burden was being put on the two Commissioners' calendars. COMMISSIONER NORDSTRAND asked when the report is due to the Legislature. MR. JOHNSON replied that it is due the earlier of 120 days from appointment of the ARM Board or 15 days from the start of the legislative session. COMMISSIONER NORDSTRAND agreed with Trustee Pihl that the time between November and January meetings could be used to finalize the report. CHAIR SCHUBERT asked if the January meeting would be held in Juneau. MR. BADER replied in the affirmative. CHAIR SCHUBERT asked if the February and March meetings should be held in Juneau or Anchorage, given that the Legislature is in session. COMMISSIONER CORBUS felt it would be best to meet in Juneau, given his other obligations. CHAIR SCHUBERT stated the January, February and March meetings would be held in Juneau.

MR. TRIVETTE thought it would be a good use of the Board's time to spend some hours with the actuary in a work session in November and to suggest items to be included in the draft report. MR. BADER believed that could be accommodated in a two-day meeting in November.

CHAIR SCHUBERT invited a representative from Senator Stedman's office to speak to the issue of the timing of the report. MILES BAKER, staff to Senator Stedman, understood from his involvement in SB141 and the section of the legislation that speaks to the report that there is an expectation that the Board will select a new actuary and the information from the valuation will not be available until March 2006. He thought the Legislature is expecting a report that presents a strategic plan for the Board.

MR. PIHL hoped that committee structures would be established based on trustee expertise and interest prior to the November meeting. MS. HARBO agreed with this suggestion. She was aware that ASPIB had 8 or 10 committees and she felt the ARM Board committees should be established as soon as possible. She was suggesting a day be added to the November meeting to accomplish this. MR. BADER noted that in the past the chair has asked for indication from trustees which committees they would like to join. He felt a committee to provide guidance in crafting what might be included in the report to the Legislature, such as the Board's view on pension obligation bonds, earnings assumptions, etc. would be helpful. The mandate of how funds are invested in the defined benefit program is not well defined in the legislation. He agreed with the formation of committees at the Board's November meeting. CHAIR SCHUBERT concurred and suggested this be scheduled.

COMMISSIONER NORDSTRAND suggested limiting the number of committees, given that there are only nine members of the ARM Board. CHAIR SCHUBERT explained there were committees under ASPIB as new investment types were considered.

MR. SEMMENS noted that the items on the calendar proposed by staff are investment related, while the mandate of the ARM Board is broader than was that of ASPIB. He has been told that this board is being looked to find ways to address the unfunded liability. MR. BADER suggested the formation of an unfunded liability committee and perhaps a committee to address possible savings through healthcare.

CHAIR SCHUBERT suggested that she work with staff regarding committee structure and perhaps the Board can be contacted via email.

13. Actuary Selection

For more information on this presentation, refer to the documents presented to trustees as handouts kept on file at the ARM Board offices.

MELANIE MILLHORN, Director of the Division of Retirement and Benefits, Department of Administration, asked that Mr. Johnson begin this agenda item. MR. JOHNSON noted that this evaluation would involve review of information contractors have provided and asked whether this discussion should be held in executive session. MS. MILLHORN replied there are three items: responses to Trustee Harbo's information request, a recommendation for the actuary which she would ask be discussed in executive session, and providing some information on the timeline for implementation of SB141.

MS. MILLHORN indicated that Trustee Harbo requested the Division's budget from FY02 to present and all Trustees had been given a packet including the Division's FY99 through FY05 budgets. She understood Trustee Harbo had wished to review the Division's budget before making a decision on the actuary selection. She noted that the Actual expenditure for the Division in FY05 was $10.3 million. She noted that Travel was $100,000, which is the lowest in the six preceding years. The Supply line was $108,000, also the lowest in the six preceding years. The majority of the FY05 budget is Personal Services, which is $6.4 million for FY05, and Contractual Services, which is $3.6 million. The workload of the Division increases annually as members retire within the system. A total of $1.2 million has been returned to the system each year. The Contractual Services amount of $3.6 million is relatively consistent with the previous four years.

MS. HARBO clarified that she had requested the actuarial services costs over the last four to five years. MS. MILLHORN stated that the itemized costs associated with Mercer's contract would be reviewed in executive session.

MS. MILLHORN indicated that a copy of the health financial statements was provided in response to Trustee Harbo's third request. She indicated that the Division's web page contains the PERS and TRS financial statements, the actuarial evaluations from 1976 through 2004, the audits, and the comprehensive annual financial reports for 1996 through 2004.

In response to Trustee Harbo's fourth request, a timeline for the RFP has been provided to the Board. The fifth request was for the statistics that relate to the retiree return initiated by HB242 and enacted by HB161 in the last legislative session. She stated a report has been made available, as well as a fact sheet and information on HB 161. There is an actuarial analysis in the report that went to the Legislature that describes all of the positions for PERS and TRS and all the participants by employer that are enrolled in HB242. This report is also on the web page.

MS. HARBO noted that the retiree health fund assets under medical at June 30, 2005 is $128 million, nearly $11 million in EBA, and $100 million in long-term care. She wanted ARM Board members to be aware of the money in this trust fund because one of the suggestions of the health committee was that some of this money could be invested at a better rate of return than it is achieving now.

MS. HARBO thanked Ms. Millhorn for compiling the information she had requested.

MS. MILLHORN indicated that in response to Trustee Harbo's sixth request, a comprehensive financial report for PERS and TRS had been provided. This is on the Division's web page. In the past Kathy Porterfield, the independent auditor with KPMG, has provided a briefing to the board regarding the results of this report. The new comprehensive annual financial report (CAFR) will be available in December 2005.

Trustee Harbo's seventh request involves the federal legislation on ERISA. MS. HARBO indicated she wanted the Board to have this for information because it is fairly new. If anything happens with it will affect 401(k), 403(b) and 457 plans.

MS. MILLHORN requested that an executive session be held to discuss the actuary RFP. She indicated that parties that have a relationship with the State of Alaska may remain in the room during the executive session.

COMMISSIONER NORDSTRAND moved to convene an executive session to consider the RFP for the actuary. MR. SEMMENS seconded.

MR. JOHNSON suggested the executive session is with respect to personnel matters, since there is a comparison between individual entities, and there is also a relationship that would potentially impact the finances of the entity. This is the basis for the motion.

There being no objection, the motion passed unanimously.

EXECUTVE SESSION 2:10 p.m. to 2:26 p.m.

MS. HARBO moved to accept the recommendation of the Proposal Evaluation Committee to select Buck Consultants as actuary. MR. TRIVETTE seconded.

By roll call vote, the motion passed unanimously.

CHAIR SCHUBERT asked if there should be action on a second actuary. MR. BARNHILL felt this could be addressed at a future date.

MS. HARBO thanked the Proposal Evaluation Committee for their work.

14. SB141 Implementation Plan

For more information on this presentation, refer to the document entitled "SB141 Implementation Timeline" kept on file at the ARM Board offices.

MELANIE MILLHORN indicated that the Division has laid out the critical path associated with SB141. Key components have been identified, timelines established, and tasks ordered. This information was being presented for the ARM Board's review. She stated that implementation is on task and staff feels confident that the established milestones can be met.

MR. TRIVETTE asked if there is sufficient funding to accomplish implementation. MS. MILLHORN responded in the affirmative.

VI. NEW BUSINESS

MR. TRIVETTE noted that at the last ASPIB meeting a presentation was given by KPMG. At that meeting there was discussion that KMPG is under deferred prosecution. He felt it was incumbent on the ARM Board as fiduciaries to secure information on this situation. He asked that staff provide this information at the next meeting of the ARM Board.

VIII. OTHER MATTERS TO PROPERLY COME BEFORE THE BOARD

MR. TRIVETTE noted that the Ways and Means Committee of the Alaska State House has been conducting public hearings around the state on the funding shortfall. He believed the Committee would be asking the ARM Board members to attend a meeting in Kenai next month. He asked if this is something that Trustees would normally attend, and if so, what would be the process. MR. BADER indicated that he would recommend accepting a committee invitation and the Chair should designate which Trustees might attend.

IX PUBLIC/MEMBER COMMENTS - None

X. INVESTMENT ADVISORY COUNCIL COMMENTS

MR. O'BRIEN felt this first meeting of the ARM Board had been productive. He acknowledged the great amount of work before the ARM Board in order to balance the assets and liabilities of the system. In discussing the schedule for the next year, he wondered if it was better to meet more frequently rather than to have longer meetings. He felt that shorter meetings are more productive, although he is sensitive to travel schedules and time commitments. He felt that the Board would need to meet more than the five times outlined in the proposed 2006 schedule. He encouraged the Board to consider the education conference the former ASPIB held annually.

DR. JENNINGS remarked that there is an annual IAC meeting at which the IAC members review the system's asset managers in detail; that is scheduled for November 11, 2005 at Callan's offices in Denver. He expected a report to the Board in November.

MR.TRIVETTE was aware that Callan provides a training opportunity in January. MR. O'BRIEN replied that the Callan Conference is held in San Francisco in January. CAI also has the Callan College that provides more in-depth information on topics such as passive versus active, benchmarks, etc.

XI. TRUSTEE COMMENTS

MR. PIHL requested a history of the actuary calculated contribution for PERS and TRS for last 15 years, the rate recommended by the respective boards, and what rate was set. He also wanted for both PERS and TRS and combined a year-by-year development of the unfunded liability going from the point where the funding was overfunded to today. For both PERS and TRS he wanted to see a year-by-year analysis of the dollar impact difference between the actuarial assumption and what occurred in reality. He also requested information on the amount of unfunded liability developed each year as a result of the 5 percentage point limitation on increasing the rates. He explained he would like to see the ARM Board adopt a legislative goal of having the Legislature fund any difference between the adopted contribution rate and what is actuarially necessary not to have an increase in unfunded liability going forward. He reiterated his earlier urging to form committees as quickly as possible.

MS. HARBO suggested that the Board read the actuarial audit report on Mercer. She noted that it is also interesting to read the September 2004 minutes of the PERS and TRS meeting where there was a report on some of the errors Mercer had made.

MR. SEMMENS thought there were several possible solutions, ranging from the Legislature putting all the surpluses into this fund down to what is really reasonable. He suggested the ARM Board Trustees think about possible solutions as individuals. He asked whether individual Trustees could ask staff to gather information prior to the next meeting of the ARM Board. For instance, he was curious about the pros and cons on pension bonds. He thought there would need to be information to support recommendations to address the unfunded liability situation.

MR. TRIVETTE asked if the ASPIB did work by email. MR. BADER replied that the ASPIB frequently used teleconferencing. He stated that staff would respond to any email from a Trustee immediately.

COMMISSIONER NORDSTRAND cautioned that Trustees be cognizant in writing emails that they are creating a public record that is subject to disclosure upon request. MR. BADER noted that teleconferences are publicly noticed and held in a public place so that the operations of the Board are fully transparent.

CHAIR SCHUBERT thanked the Board for electing her to the position of Chair.

XII. STAFF COMMENTS

MR. BADER noted there was reference to integrating liabilities into asset allocation and, as Mr. O'Leary noted, that has been done periodically. Staff is also working with the State Street Advisors on the campus of Harvard to model asset liability and currency overlays that might help improve returns. T. Rowe Price is also doing work for the system in this regard. He thought

this might be somewhat responsive to the legislative language about taking liabilities into consideration.

MS. MILLHORN noted that the National Association of Retirement System Administrators has a library of information on pension obligation bonds, including the upside and downside. She offered to assemble that package and send it to Trustee Semmens.

MS. TAYLOR indicated that Trustee Semmens provided feedback on the fund financial report and she appreciated any input from other members. She also noted that Trustee Pihl provided her with a draft charter for the audit committee of a board in which he is involved.

XIII. ADJOURNMENT

MS. HARBO moved to adjourn the meeting of the ARM Board. COMMISSIONER NORDSTRAND seconded.

There being no objection, the motion passed unanimously.

THERE BEING NO FURTHER BUSINESS TO COME BEFORE THE BOARD, THE ARM Board MEETING ADJOURNED AT 2:45 PM ON October 12, 2005.

Chairman of the Board of Trustees
Alaska State Pension Investment Board

ATTEST: Gayle W. Harbo
Corporate Secretary

Note: The summary minutes are extracted from tape recordings of the meeting and are prepared by outside contractors. For in-depth discussion and presentations, please refer to tapes of the meeting on file at the ARM Bard offices.

WORDSMITH
Kimberly D. Stalder
Anchorage, Alaska