ALASKA RETIREMENT MANAGEMENT BOARD MEETING

Location of Meeting
Goldbelt Hotel - Cedar Room
51 Egan Drive, Juneau, Alaska

MINUTES OF
January 12-13, 2006

Thursday, January 12, 2006

CALL TO ORDER

Chair GAIL SCHUBERT called the meeting of the Alaska Retirement Management Board (ARMB) to order at 9:00 a.m.

ROLL CALL

Seven ARMB trustees were present at roll call to form a quorum. Commissioner Corbus arrived at 9:10 a.m.

ARMB Board Members Present
Gail Schubert, *Chair*
Sam Trivette, *Vice Chair*
Gayle Harbo, *Secretary*
Commissioner Bill Corbus
Martin Pihl
Commissioner Scott Nordstrand
Larry Semmens
Mike Williams

ARMB Board Members Absent
Bob Roses (excused)

Investment Advisory Council Members Present
Dr. William Jennings
Dr. Jerrold Mitchell

Consultants Present
Robert Johnson, legal counsel
Michael O'Leary, Callan Associates, Inc.

Department of Revenue Staff Present
Tom Boutin, Deputy Commissioner
Gary M. Bader, Chief Investment Officer
Bob Mitchell, Manager of Fixed Income Investments
Susan Taylor, Comptroller
Judy Hall, Liaison Officer

Department of Administration Staff Present
Kevin Brooks, Deputy Commissioner
Melanie Millhorn, Director, Division of Retirement and Benefits
Traci Carpenter, Division of Retirement and Benefits
Kathy Lea, Division of Retirement and Benefits
David Duntley, Division of Retirement and Benefits
Tim Adair, Division of Retirement and Benefits
Christine Maiquis, Division of Retirement and Benefits
Sheri Gray, Division of Retirement and Benefits
Donn Stewart, Division of Personnel

Invited Participants and Others Present
Chester Johnson, Government Finance Associates
Cynthia Weed, Preston Gates Ellis LLP
Jeffrey Sinz, Municipality of Anchorage
Kevin Ritchie, Alaska Municipal League
Kristin Erchinger, City of Seward
Derek Miller, Representative Kelly's office
Jack Kreinheder, State Office of Management and Budget
Cindy Spanyers, APEA/AFT
Mike Barnhill, State of Alaska Department of Law
Michael Kirk
Don Gotschall
Various legislative staffers and others who did not sign in

PUBLIC MEETING NOTICE

JUDY HALL confirmed that public meeting notice requirements were met.

APPROVAL OF AGENDA

MS. HARBO moved to approve the agenda. MR. SEMMENS seconded.

MR. TRIVETTE mentioned a letter from Senator Elton to the board, dated January 9. The Chair said she intended to speak on that letter as part of her chair report.

The agenda was approved without objection.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES

MICHAEL KIRK, a retired Teachers' Retirement System (TRS) member, related that at one time he brought to the actuary's attention that the assumptions on which retirement plans operate were basically assumptions from the 1930s — specifically, how long a person has to work, how much he/she contributes, and how long they benefit in retirement. He quoted from *King Lear*, "Nothing comes from nothing." In order for a plan to remain solvent, there has to be an awareness of who contributes what to whom and for how long. He said the actuary told him that he did not know what he was talking about. But experience nationally since that time has shown that he did know what he was talking about. He cited the motto "Out of many comes one," in the context that many have had to contribute to his retirement of 20 years.

APPROVAL OF MINUTES

MR. TRIVETTE moved to approve the minutes of the November 29-30, 2005 meeting. MS. HARBO seconded.

CHAIR SCHUBERT stated that a couple of board members had several technical corrections to the minutes that were not substantive that she would give to staff to make, if there was no objection.

There being no objection, the motion passed unanimously.

REPORTS

1. Pension Obligation Bond Panel

Deputy Commissioner of Revenue, TOM BOUTIN, introduced the panelists: MICHAEL O'LEARY, CFA, Executive Vice President of Callan Associates, Inc., the general consultant to the Alaska State Pension Investment Board (ASPIB) for the past 14 years, as well as to the Alaska Permanent Fund Corporation Board; CHESTER JOHNSON, Chairman and founder of Government Finance Associates and the State of Alaska's financial advisor continuously through good economic times and bad since 1983; CYNTHIA WEED, counsel with Preston Gates Ellis, LLP, and the State Bond Committee's bond counsel for the past 10 years, as well as bond counsel to some of the larger Alaska municipalities; and JEFFREY SINZ, a former trustee and chair of ASPIB, currently Chief Fiscal Officer for the Municipality of Anchorage and prior to that held the same position with the Kenai Peninsula Borough.

[Commissioner Corbus arrived at 9:10 a.m.]

Michael O'Leary, Callan Associates, Inc.
[MR. O'LEARY used slides in his presentation, a paper copy of which is on file at the ARMB office, and he provided some published material on pension obligation bonds, also on file.]

MR. O'LEARY said the subject before the panel reminded him of the TV commercial for oil changes, where the message was, "You pays me now, or you pays me later." In a nutshell, that is how he thinks of pension obligation bonds. The debt is the unfunded liability, and pension obligation bonds represent a way of refinancing the debt. As with any refinancing, there are potential benefits and there are potential pitfalls. He said his objective was to have a good discussion about the issues associated with pension obligation bonds. There is no right answer as to whether it makes sense to issue the bonds or to not issue them: it is unique to each particular circumstance.

MR. O'LEARY stated that at the moment the retirement systems are significantly underfunded. The challenge is that future contributions must cover not only the underfunding but the earnings lost because of underfunding. That is a significant component of the total cost. Every year when the actuary is developing the actual cost number, they are presuming that the assets are there to generate that rate of return. In effect, it is a leveraged return expectation — having to earn 8.25% on an asset base that is not there. If the sponsors somehow issue bonds, immediately the system is less underfunded because the money comes into the system and is thereby generating earnings. From the system's narrow perspective, being fully funded and continuing to earn the historic return, the system will be better off. But somebody has to pay the cost of the bond service, and there is no guarantee that the system will achieve the earnings expectation during the life of the bond. If it does not achieve the expected earnings, then the sponsoring entities will have to pay not only the debt service cost (interest plus repayment of the debt), they will have to continue to pay the normal cost associated with the pension system, as well as the future potential unfunded liability.

MR. O'LEARY addressed the use of leverage by pension funds. He said most pension systems do not consciously employ leverage, although they may have leverage in particular segments of the portfolio, such as owning real estate that may be debt financed. So leverage is not foreign on the investment side of things, but it is the classic double-edged sword.

MR. O'LEARY said that a young defined benefit pension plan (Company A), where the liabilities are far in the future and the retirement cannot occur before age 60-62, has a very long-term investment horizon. If it is a final paid plan, the magnitude of that future liability is highly suspect because who knows what inflation is going to be, not only over the 30-plus years of the working life of the average employee but also over their retirement. What is known is that the normal cost of the pension system is going to be comparatively small relative to that future liability. For those reasons, many would argue that that type of plan could have a very aggressive investment policy, meaning a high equity orientation. The rationale for that is that future contributions are very large relative to today's corpus of the plan.

MR. O'LEARY stated that the typical active worker in ongoing defined benefit plans is in their forties, so there is still a long-term horizon for that worker, but it is a lot shorter than the hypothetical Company A he described in the above paragraph. In the typical ongoing plan, the corpus is large relative to the future contributions for the active employees. So a little bit less aggressive investment policy is typically thought to be reasonable.

MR. O'LEARY said the other end of the spectrum is a closed plan where there are no active employees and no new benefits being earned, except for perhaps some post-retirement benefit increases. (That is not the case for PERS and TRS because the current active employees are earning new benefits.) So one could argue that the investment policy for that type of program should be comparatively conservative - typically heavily bond oriented because the liability is pretty well defined. When the last participant dies, theoretically the pension fund would have zero assets.

Putting the information in the context of PERS and TRS, MR. O'LEARY stated that on July 1, 2006, no new active participants go into the defined benefit plan. But the average employee age is still less than 50. It is a very long time before the plan stops accruing benefits, but incrementally, the benefits that are being accrued are less than for the typical ongoing plan. So the liabilities are still uncertain, particularly because of the medical component and inflationary exposure of the liabilities, but will become more clearly defined as time passes.

MR. O'LEARY said right now, absent the infusion of any significant amount of money, the board knows that the contributions will have to be a huge portion of the revenue stream looking ahead. From an investment perspective, that results in a fair amount of imbedded dollar cost averaging. Somewhere down the road it would be appropriate to shift or evolve the investment policy toward a more conservative policy. That brings up an important issue. If the system were invested exclusively in U.S. government bonds, an appropriate discount rate would be 4.5% to 5.0%. What would be the effect on the liabilities if the discount rate used was 5.0%, rather than 8.25%? Liabilities would rise significantly. One rule of thumb is that every percent change in the discount rate might be a 10-15% change in the amount of the liabilities. The question is, is there a finite target that the system is funding, and what assumptions is that target based upon? In the case of PERS and TRS, those future liabilities are being discounted at a rate of 8.25%. If the board changes that discount rate, it would change the calculation of the present value of those liabilities. The actuaries always add a caveat on the reasonableness of a discount rate by looking at the asset mix of a fund. And if a fund has a policy of being a hundred percent invested in bonds, the actuary could not professionally accept an expected return of 8.25% in today's environment.

Referring to a chart of asset mix policies and expected returns that he showed the board at its initial meeting in October, MR. O'LEARY said a very mature, risk-averse plan might be toward mix 1 or mix 2, while a very aggressive plan might be toward mix 6. Most plans are striving to achieve returns somewhere near those of the ARMB.

MR. O'LEARY stated that issuance of pension obligation bonds fundamentally levers the employer contribution risk. The debt service on a pension obligation bond is fixed, so there is clearly less flexibility associated with that portion of the pension cost. If the State has a bad year and the price of oil is in the teens, the fact that revenue has dried up does not provide any flexibility in the payment on the debt service. In addition to the higher, more fixed payment, the employers would continue to make normal cost contributions, as well as dealing with potential future underfunding. While it might appear that the pension cost is more fixed, no one knows the answer until the bonds are paid off. If the fund achieves the actuarial discount rate return and has a lower cost of borrowing, that should reduce total pension costs. If the fund earns less than the borrowing cost, it makes the problem bigger.

MR. O'LEARY next addressed how pension obligation bonds impact asset allocation decisions from a strategic perspective and from a practical perspective. Pension obligation bonds should not significantly affect asset allocation decisions from a strategic perspective. If the board has an appropriate policy it probably should not be altered. However, the board's risk tolerance may be different in that circumstance — trustees may be less willing to strive for the same rate of return. There is no specific right answer on risk tolerance. But, for example, the board may say that contribution volatility is a more important decision variable for it than total ultimate net cost of the pension program. So it is conceivable that from a strategic perspective the board might wish to rein in the volatility a bit. Somebody else looking at the exact same facts may say that the system is now well funded and it can afford a little bit more volatility in order to further reduce the pension cost. That is a personal decision that the board would have to make collectively.

MR. O'LEARY said that apart from that there are some pragmatic issues that have to be factored in. If somebody had a bond issuance in 2002, right when the market was in the midst of free-fall, and invested the proceeds per their long-term policy immediately, the taxpayers could go through the roof before the bond strategy had an opportunity to work. If the short-term result is poor, it seems to exacerbate the problem rather than help it, even though it may be the appropriate thing to do longer term. Then there are whole asset classes, like private equity and real estate, where the portfolios have to be time diversified in order to get the anticipated returns. During that interim period, while waiting for the premier general partnerships to raise a fund, the money has to be invested somewhere else. So, depending on the size of the cash inflows, the actual investment process may require the board to have a transition target allocation — or be lucky or unlucky in the timing of the investments. The magnitude of the pension obligation bond proceeds in the case of PERS and TRS would be very significant, but the markets are very large and the proceeds could probably be invested in a reasonable span of time.

MR. O'LEARY said that a pension obligation bond issuance would very quickly change the cash flow pattern to the retirement system, so planning liquidity needs becomes more of an issue. He did not find that troubling in the intermediate term, but it would call for a gradual shift to a more conservative asset allocation eight to ten years out.

MR. O'LEARY posed the question, what if Alaska had issued pension obligation bonds in the past? If it was three years ago, the retirement system would be a lot better off. The fund has achieved an 8.84% return over the last three fiscal years, and the cost of financing would have been well below that. If it was done five years ago, the retirement system would be worse off — so far. Over the past ten years, it would be pretty much a push. The system had an annualized return of 7.86%, so that would have been higher than the cost of financing pension obligation bonds, but the negative would have been that the system did not earn the 8.25% target, so the unfunded liability would have increased.

In closing, MR. O'LEARY mentioned the size of the deal — should pension obligation bonds get the retirement system to 100% funded or to some lower level? Many would argue that if Alaska went this route, it should go to some lower level, that something like a 90% target would be better. If the system were 100% funded, and there were three more years just like the last three years, it would create a political dynamic that might encourage bad decisions, such as reducing employer pension contributions or enhancing benefits. That has happened in the real world.

Chester Johnson, State Financial Advisor
MR. JOHNSON told a story about a large refinancing for a city where a banker/bond counsel was making a presentation to the city council before the important signing of the purchase contract. A city council member told the banker that he did not understand how selling more principal than the city would be repaying would save a lot of money. The banker/bond counsel replied that it was simply a miracle. MR. JOHNSON said he used the story to emphasize the point that borrowing money may seem like a miracle but it never is. You simply cannot make something out of nothing, or as Mr. Kirk stated earlier, "Nothing comes from nothing." Pension obligation bonds can be used effectively in certain circumstances. But when leveraging investments for retirement funds, it can be highly risky. To borrow to eliminate or lessen the size of an unfunded pension liability, and then to rely on the financial markets to cover the cost of the borrowing plus an increment, can work, and it did work for a period of time in the 1990s. But does it work for the long term, with debt going out 25 to 35 years? That is something to be carefully considered.

MR. JOHNSON reviewed what the rating agencies have said about the use of pension obligation bonds. The rating agencies will readily admit that there are some times when it appears that there are no apparent alternatives to the issuance of pension obligation bonds. For example, two of the more prominent issuers of the debt — the states of New Jersey and Illinois — have run out of choices, at least as seen by those governments. In New Jersey's case, the pension obligation bonds provided multi-year, upfront savings for budget purposes through the first few years following the issuance of the bonds. It was structured to provide 2% annual general fund savings in the initial years. Similarly, in 2003 Illinois needed some immediate budget savings. The bond issue was structured so that there were budgetary savings in the first two years by using proceeds to substitute for contributions for appropriations. But Illinois also wanted to decrease its unfunded liability, which reportedly was in excess of $35 billion at the time the pension obligation bonds were issued.

MR. JOHNSON said many people would say that pension obligation bonds have no effect on a rating. But Illinois's rating from Moody's was dropped a month before the state sold $10 billion in pension obligation bonds. POBs are conventionally sold as general obligation bonds or debt that is paid out of the borrower's general or chief operating funds, and as such, immediately affect the general credit position of the borrower, as follows:

1. Cash flow: Will the combination of the debt service on the newly issued pension obligation bonds plus other contributions and the normal cost expense less the earnings on the proceeds of the POBs result in an annual higher number?
2. Market risk: Will the market return disappoint and create even greater exposure?
3. Conversion of a soft liability into a hard liability: Pension payments can be adjusted without seemingly major credit and other repercussions, but once the liability has been converted to a debt obligation then the ability to adjust those debt service payments does not exist. The government can miss a pension funding payment but it cannot miss a debt service

payment. Rating agencies view pension funding costs as being subordinate to debt service cost. Relatedly, the government's flexibility has been reduced as the fixed charges have increased.

4. Increased debt ratios: Unfunded pension numbers are not part of the rating agency's computation of a government's debt load. They will say that unfunded liability factors into the judgment about liabilities, but you will never see unfunded pension liability included in a government's debt statement. However, when pension obligation bonds are issued that debt will immediately be added to the borrower's debt load as computed by the rating agencies. Depending upon the issuer, the additional debt could then push aside capital projects that would be more economically or programmatically productive, as viewed by the rating agencies, than the use of debt capacity for pension obligation bonds.

5. One other issue that does not immediately come to mind, but one that he has discussed with the rating agencies, is whether a 100% funded position is a good idea. It is surprising how many analysts have reservations about 100%-funded positions. He and others believe that a 100% funded position can create greater political vulnerability for the government. It probably creates an incentive for additional benefits, while a lower percentage probably does not. While the rating agency did not want to be quoted, he was told that that agency actually prefers less than 100% funded ratio. It is also interesting and informative that besides the rating agencies voicing some concerns, the research staffs of investment bankers have written about some of the credit problems with pension obligation bonds. UBS released a report in May 2005 that stated, in part, "We see the use of pension obligation bonds as a credit negative, as any exchange of a variable liability for a fixed one reduces long-term operating flexibility." UBS went on to soften the statement by indicating that the use of POBs may be the only avenue for some financially stressed governments.

MR. JOHNSON posed the question of whether the State of Alaska is in trouble credit wise as a result of the size of its unfunded pension liability. To answer that question he quoted from the 2005 rating agency reports. Fitch stated that the State's funding ratios have declined recently but also noted that the declines were "consistent with general equity market trends." S&P said that given the State's current condition, the State is allocating $30 million or 50% of the fiscal 2006 and fiscal 2007 burden to cover these costs on behalf of local governments. Moody's sees it a little differently: "The unfunded liabilities of the State's Public Employees' Retirement System and its Teachers' Retirement System are of some concern. The State has taken steps to address growth in these liabilities, passing legislation that will assign future employees to a defined contribution plan. The severity of the liability figures reported by the State is lessened to some extent by the fact that they include retiree health coverage, which under new accounting rules will begin to affect the retiree benefit liability picture for all states in coming years."

MR. JOHNSON said the State of Alaska enjoys a high rating of AA, in line with a strong state credit position. Based on a study he has seen, the unfunded pension liability ratio for Alaska is in the pack for states, some above and some below, but the State of Alaska does not stand out in any respect. Since Alaska includes health care costs, it is probably on average a bit better than the pack, based on the study. He said he did not think that Alaska is in the position that would require using pension obligation bonds for pension funding relief. He did not think that POBs would be an obvious answer for the State, despite Moody's desire to continue to monitor the State's pension funding liability, particularly taking into account the absence of concern voiced by both Fitch and S&P on the subject.

MR. JOHNSON stated that if a decision is made to use pension obligation bonds at the local or state level in Alaska, there are some structuring issues that should be mentioned. Because the bonds are taxable, the buyers are then different from those who normally buy tax-exempt bonds. Foreign purchasers, for example, have been active in the POB market. So have pension funds themselves, because the debt is taxable, and pension funds cannot take advantage of tax exemption. It will be important, therefore, to change the normal marketing of government debt to take into account the changed investor pool. Further, in the taxable market the use of non-callable debt is more prevalent. However, as the GFOA (Government Finance Officers Association) has cautioned its members regarding POBs, it is in the best interest of the borrower to incur some additional interest rate for that borrower to retain callability on the pension obligation bonds - at least after a certain period (say, after 10 years). Most POB debt can be very long, comparatively speaking. Therefore, not to have callability for the maturity of the issue could limit debt management flexibility significantly.

MR. JOHNSON suggested looking at the circumstances in which pension obligation bonds would currently be issued. There is a belief that POBs will be more extensively used in the future for the following reasons or a combination of these events: (1) revenues are just now recovering from an economic slow down; (2) there is lower market performance; (3) to lower employer contribution payments; and (4) the possibility of future increased exposure from post-employment benefit recognition. If this is true, there will be a good deal of competing bond issues. He suggested that there are two other factors that will limit the volume of POB debt. First, there is a rising interest rate environment. Selling long-term debt with higher interest rates can then narrow the differential between investment income from the proceeds and the cost of capital. That effect should at the same time be seen in the context of lower investment returns and expectations. For example, recent market performance, as judged by indices like S&P 500, stands in stark contrast to investment returns in the 1990s when the S&P 500 was increasing at 16% annually. So if POB debt had been issued in the early 1990s it could have been a wise move. But no one knows how the economics would stand up over the maturity of the bond issue.

In conclusion, MR. JOHNSON reiterated his beginning comment that there is no miracle and no alchemy with pension obligation bonds. And one must question whether the market risk and the credit risk associated with their use are worth the high-wire adventure.

There was a break from 10:02 to 10:22 a.m., after which presentations on pension obligation bonds continued.

<u>Cynthia Weed, State Bond Counsel (Preston Gates Ellis LLP)</u>
[MS. WEED used slides in her presentation, and a paper copy is on file at the ARMB office.]

MS. WEED indicated that she was not speaking on policy matters or offering any opinions about how to solve the pension obligation. She was starting with the presumption that the State and/or local governments had decided to pursue pension obligation bonds and was looking at how it could be done.

MS. WEED said that in Alaska the concept of debt refers to an obligation for borrowed money. There are generally two types of debt in Alaska, one that is referred to as general obligation debt and the other being revenue debt. If it were not for the state constitution, the legislature would have absolute power to authorize an unlimited amount of debt for any purpose whatsoever. But in adopting the constitution, the citizens of the state have imposed certain limitations on the ability of the state legislature and local governments to authorize the issuance of debt. Article 9, section 8 says that state general obligation debt has to be voter approved and that it be issued for capital purposes. So the State does not have the ability to do general obligation pension bonds without an amendment to the state constitution. Article 9, section 9 of the state constitution limits the incurrence of debt at the local level and requires voter approval. It also requires that the proceeds be used for capital improvements. So local governments cannot issue general obligation bonds to fund the pension obligations.

MS. WEED next talked about revenue debt. Article 9, section 11 of the constitution gives certain outs such that limitations on state debt in sections 8 and 9 do not apply to revenue debt or revenue bonds issued either by an enterprise or a public corporation. That leaves public corporations as an alternative.

MS. WEED mentioned debt that is not really debt. There are some types of debt that the market thinks of as debt, but Alaska's constitution and the Alaska Supreme Court do not consider to be debt. These are referred to as COPs, certificates of participation. They look like bonds, but they are based on a lease and lease-back structure. The State of Alaska has a very active COP program that it uses to fund the construction of facilities by leasing those facilities and making lease payments over a period of time. Those lease payments are made to a trustee, and the trustee takes those lease payments and securitizes them and sells them in the marketplace, where they look much like bonds. They are not debt for constitutional purposes, although the State manages those obligations and takes them very seriously. The reason they are not considered to be debt is because the State retains the right to walk away from the facility and not appropriate to pay that debt service. If the State were to walk away and leave the facility for the term of the ground lease the State would be legally excused from making those payments. If it did so, the holders of the certificates of participation would not be happy but they would not have any recourse against the State.

MS. WEED stated that Anchorage benefited from having a powerful representative in Washington, D.C., in 1986 when the tax code was amended, and Congress cut off the ability to do tax-exempt pension bonds. Alaska's representative preserved that in a transition rule for the Municipality of Anchorage, one of the last to be able to issue tax-exempt pension obligations. Anchorage did so and invested the money wisely in a contract that was paying sufficient money to pay the debt service on those bonds. Those pension obligations were callable, so they were advance refunded in 1994, and Anchorage is making out even better than they had before. Those obligations were issued as COPs, using the lease and lease-back structure, although the Municipality was not actually building anything. It was just a methodology for incurring tax-exempt debt and funding some pension liabilities. So that is one mechanism that currently might be available to do pension obligation financing.

MS. WEED said that HB 278 deals with another exception in the revenue bond limitation that authorizes public corporations to issue debt that is not subject to the constitutional limitations. The State of Alaska has over many years established a number of corporations (Alaska Housing Finance Corporation, etc.) that issue debt that is not necessarily used for capital improvements.

MS. WEED stated that HB 278 is designed to authorize the existing Alaska Municipal Bond Bank Authority, or potentially a corporation that may be set up by the Bond Bank, to issue debt for the purpose of assisting governmental employers in meeting their pension obligations (but not necessarily the State itself). The Bond Bank Authority would issue bonds and the proceeds would be used to fund the unfunded obligations of the local government entities. The bonds would be entirely within the limitations of the constitution. The question is where does the Bond Bank get the money to pay back those bonds. Presumably, the Bond Bank issues bonds, it loans the proceeds to local governmental entity, and the local governmental entity gives the Bond Bank a bond and promises to pay back the bank. The bond that the local government gives back is either a revenue bond or a general obligation bond. The constitutional limitations on debt apply to the local governments when they have obligations to the Bond Bank, in the same way that they would if they were selling bonds in the open market.

MS. WEED said she thought if the Bond Bank issues bonds and they provide the money to satisfy an obligation of a local government, it is creating a financial obligation on the part of the local government. How that obligation is satisfied is going to be subject to the constitutional limitations. It has been suggested that perhaps the local governments would use a mechanism like lease and lease-back, and then they would provide their payments to the State Bond Bank Authority. The Bond Bank in turn would use those monies to pay the debt service on the bonds. There have been suggestions about adding credit enhancement because that is not a model that has been done before at the Bond Bank.

MS. WEED explained that the role of the Bond Bank has been to consolidate debt and to provide access to the market but not necessarily to be a credit replacement, except in the context that the Bond Bank has reserves. In some instances, they have access to what is referred to as the "moral obligation" of the State to fund a reserve if there were ever a shortfall on the part of the Bond Bank. So accessing the Bond Bank market enhances the local government's credit rating. So what is being proposed would fundamentally change some of the credit issues associated with the Bond Bank, in terms of their market access and in terms of what the expectation is at the State level for providing funding backup through the Bank's reserve funds through intercept. The concept of intercept has existed for some time, and the State has the ability to intercept monies that go out to local governments if some local government fails to make its payments. Clearly, intercepting money is a politically charged option on the State's part.

MS. WEED said that HB 278 legally authorizes the Alaska Municipal Bond Bank Authority to issue bonds, notwithstanding that there are obviously numerous policy and other issues associated with structuring it at the Bond Bank level to deal with the different nature of the local governments' repayment obligation and how that blends into the State credit itself.

MS. WEED reviewed options that are not likely to happen: (1) a constitutional amendment to allow the State or any local government to go forward and issue pension obligation bonds; (2) the use of other sinking funds, such as "rainy day" accounts, that the State or local governments may have to take the place of pension obligation bonds; and (3) issue revenue bonds for capital projects to free up other resources, or "dollar switching."

MS. WEED stated that there is no perfect solution. She recommended the Government Finance Officer Association website, GFOA.org, for good, balanced information on pension funding, including questions that people should be asking before undertaking a pension funding program.

Jeffrey Sinz, Municipality of Anchorage
[MR. SINZ had a slide presentation, a paper copy of which is on file at the ARMB office.]

MR. SINZ first thanked the board for the opportunity to make a presentation on what he regarded as incredibly important issues to the employer participants in the retirement systems, as well as to the taxpayers of the local governments. He said pension obligation bonds are one potentially significant tool that is available in a situation that does not appear to have many readily available tools. POBs deserve a lot of discussion and consideration.

MR. SINZ said his perspective was primarily that of a local government financial manager and not as an expert in pension obligation debt as a financing tool. The Municipality of Anchorage believes that it would be premature to dismiss pension obligation bonds as an alternative. It is appropriate for the State of Alaska, through the ARM Board, and the Legislature to facilitate research about access to markets and the resources necessary to determine the proper participation in those markets.

MR. SINZ stated that there are multiple levels for the application of POBs. The ARMB could view pension obligation bonds as a system wide tool that it might want to pursue or not pursue in terms of addressing the benefits of the entire pension system. Beyond that, there are tools like HB 278, which creates a mechanism on a statewide level for individual local governments to access POBs either individually or in groups. Finally, there is the potential for individual employers, like the Municipality of Anchorage, to act independently. Since PERS is a multi-employer statewide retirement system, there is no ability for Anchorage to act entirely independently. But there is a potential ability for Anchorage to be an issuer of pension obligation debt, and then with the cooperation of the Alaska Department of Administration, to apply the proceeds from that debt toward the paydown of the Municipality's unfunded accrued actuarial liability.

MR. SINZ said that if Anchorage were to advocate for one other thing, they believe that PERS is a statewide system and as such the problem should be addressed in a systematic way. Individual participant employers, such as the Municipality of Anchorage, would prefer not to be put in a position of acting alone. They believe either the participation of multiple employers and/or a clear definition as it relates to the policies that affect these sorts of actions should be well defined on a statewide level. Before communities like Anchorage move ahead with something like POBs they should know clearly what they are getting into.

MR. SINZ said he was fond of the word "substitute," as in the use of pension obligation bonds as a *substitute* for unfunded accrued actuarial liabilities. From Anchorage's perspective, they are talking about substituting one type of liability for another, and, as was suggested earlier, a hard liability for a soft liability, hopefully at a lower rate.

MR. SINZ stated that the potential for significant financial benefits appears to be widespread among participating employers. The ultimate benefit for this type of financing transaction (POBs) is dependent upon future earnings performance. That is an unavoidable risk. There are administrative and timing issues that represent additional risk to employers, like Anchorage, that either act early or act alone. Few participating employers have ready access to the resources needed to properly analyze the use of and/or the sale of pension obligation bonds. Most of the participant employers in the PERS system are relatively small and resource constrained. The use of POBs is complex and has serious risk considerations. HB 278 is one example of a step toward having access to resources to analyze the situation and make prudent decisions. The State of Alaska can facilitate the use of POBs for those employers wishing to pursue that option and help mitigate many of the non-market based risks.

MR. SINZ said two responses to the large unfunded accrued actuarial liability have been (1) passage of SB 141, which resulted in the creation of the ARMB and creation of a Tier IV State employee, and (2) rapidly increasing employer contribution rates. Opportunities to either mitigate or manage the situation from an individual employer perspective are very limited. Substituting pension obligation debt for a portion of the unfunded liability is one of the few opportunities that the Municipality of Anchorage is aware of.

MR. SINZ presented some numbers to illustrate the challenge of a statewide unfunded liability of $3.41 billion (per the June 30, 2004 actuarial valuation), and what the result might be of substituting pension obligation debt for that unfunded actuarial liability. A Merrill Lynch report calculated that assuming achievement of an 8.25% earnings rate with those funds and a cost of debt of 5.8%, it produces a future value of potential savings to all participants of $2.5 billion. The present value of that potential savings using a discount rate of 5.8% is $1.2 billion. Using a higher discount rate of 8.25% (the PERS earnings rate) it drops the present value of the potential savings down to $876 million. The potential reduction in the past service component of the contribution rate is about 3.85%. He stressed that his example was just to illustrate the significance of the numbers associated with the potential savings and to show why other states and communities within Alaska find POBs an attractive tool to pursue.

MR. SINZ next presented figures to illustrate Anchorage's situation. The Anchorage share of the PERS unfunded liability totals $462 million ($288 million for the Municipality and $174 million for the PERS-covered school district employees). The Municipality's employer contribution rate went from 3.7% in FY04 to a projected rate of 28.7% in FY09. The school district went from 9.3% to a currently projected rate of 28.6% in FY09. When fully implemented, the combination of the two employer contribution rate increases translates to about 2 mills on the Anchorage property tax rate, which equates to about $500 a year additional property tax. So while looking at statistics and the national pension funding situation is interesting, these are real dollars that are significant to real taxpayers today. When it comes to the urgency of looking at pension funding options, the local governments have to face the taxpayers every day. Anchorage is highly dependent on property tax revenues as a source of funding, and the Municipality has a relatively high rate of taxation today, so $500 is real money to its people.

MR. SINZ stated that a Seattle Northwest Securities analysis of Anchorage suggests that there is a future savings of almost $213 million by substituting pension obligation debt for all or part of its unfunded pension liability. The savings was based on achieving the actuary's 8.25% earnings assumption over the term of the debt.

MR. SINZ reviewed the current risks of POBs: financial, administrative, legal and political. He said the financial risk is that the cost of the debt has to be lower than the earnings achieved on the proceeds from that debt over the life of the debt. In the most recent example for Anchorage the spread is roughly 2.25%, which generates the savings. He said he was not aware of any way to mitigate the financial risk — the ability to earn the 8.25% is affected by many, many things over a period of time. Viewed historically, there are reasons to believe 8.25% is an achievable rate of return. During the life of the Alaska State Pension Investment Board it exceeded the 8.25% earnings assumption during what were some extremely prosperous and extremely down market periods. But there are no guarantees, and it could work quite differently. He referred to Mr. O'Leary's earlier comments about timing, that over different periods the results of issuing pension obligation bonds could vary. In Alaska's case, a rising interest rate environment and the rising cost of debt means the spread between the cost of debt and the earnings potential of that debt may be closing and may even reverse at some point in the future. So the opportunity to do POBs may go away for a period of time sometime soon. He noted that Mr. Johnson covered the subject of ratings risk earlier, especially the down side. He suggested exploring the State of Oregon's extensive use of POBs, which had a different result than New Jersey and Illinois.

Regarding administrative risk, MR. SINZ said an accounting concern is whether there the Department of Administration currently has the capability to accurately account for the proceeds of a local government's POBs applied against its unfunded liability. Another administrative risk is how the sizeable cash proceeds of pension obligation bonds would be invested in a manner consistent with the approved asset allocation of the overall program. It also raises a question about the long-term investment of those assets. To the extent that an issuer of pension obligation debt has a very predefined investment objective, is it always going to be consistent with the earnings objective of the ARM Board over the life of the debt? For example, if the board, in consultation with the actuary, were to drop its earnings assumption to 7.5%, would it be consistent with Anchorage's needs as an issuer of pension obligation bonds, which may be depend on an 8.25% return? How the funds are segmented and if they are managed in a pool or separate is an undefined policy question that represents uncertainty and risk to the issuer of POBs. It should be resolved before any commitments are made.

Also under administrative risk, MR. SINZ mentioned the risk associated with how the cost of administering the program is allocated to employers. How that is affected by an inflow of cash from POBs is something else that would have to be discussed and clarified. Lastly, what if a pension obligation issue was highly successful over time and there was substantial excess proceeds generated? A great situation but what happens to the money? Plan flexibility is another issue that should be discussed and resolved before making any commitments regarding the POB approach.

MR. SINZ noted that Ms. Weed addressed the legal issues surrounding various financing types. From Anchorage's perspective, there appears to be capabilities on several levels, but it is still not clear at this point. Some clarity is needed; such as an HB 278 approach that defines and creates a clear mechanism for financing that would provide access to the POB marketplace.

MR. SINZ stated that political risk occurs in a number of ways. The Municipality of Anchorage does not want to be ahead of the curve on the pension obligation bond funding option but wants to be squarely in line with the State's thinking. Anchorage wants to participate in a manner consistent with the consensus view of a number of parties and not as a renegade participant that is off on its own.

In conclusion, MR. SINZ said that the Municipality of Anchorage believes that the State can and should facilitate access to pension obligation financing alternatives and help mitigate risks, primarily administrative and other risks that represent uncertainty but that are manageable and avoidable with good planning up front. Anchorage believes that HB 278 represents a step in the right direction but is not ready to go in its current form. The Municipality of Anchorage has reached no decision about the use of pension obligation debt as it relates to the municipality. They may very well conclude, after a period of research and consideration, that this is not an appropriate tool for the Municipality to use. But they believe strongly that the research done to date is preliminary and that this is an opportunity to be fully explored. Those that have the risk tolerance and the expertise to pursue this and choose to should be provided with access to that marketplace.

<u>Board Question & Answer / Discussion</u>
CHAIR SCHUBERT opened the forum up for questions and answers from Trustees and staff and for written questions from the audience.

MR. WILLIAMS asked if local voter approval is needed for the Municipality of Anchorage to issue pension obligation bonds. MR. SINZ indicated that he did not know for sure. The Municipality's preliminary look at it is that general obligation debt, which is typically associated with voter approval, is not an option. Anything the Municipality would do would be appropriation debt of some form, and whether it would have to go to the voters would have to be discussed with Anchorage's bond counsel, who is Cynthia Weed.

MS. WEED stated that the pension obligation that the Municipality of Anchorage has done (lease, lease-back debt) has not been subject to voter approval. Under the scenarios that are currently legal, she did not think that the existing structures that would permit the Municipality to issue pension obligation debt would require voter approval. But they have not seen all the ideas yet.

MR. SINZ added that what is required and what the Municipality chooses to do could be two different things. Ultimately, the Mayor and the Assembly would have to make the call to put something like this before the voters, despite the legal requirements.

MR. WILLIAMS commented that Mr. Johnson in his presentation had seemed to view the issuance of pension obligation bonds negatively because that is presently booking a liability. There are governmental accounting standards (GASB 43 and GASB 45) that soon will require all state and local governments to disclose their unfunded pension obligations, especially with respect to the health care costs. As more state and local governments have to disclose that unfunded liability, the raters will impute that information into the states' bond ratings. Where Alaska currently prefunds and recognizes its future obligations, and Alaska's bond rating would already reflect that, other states' bond ratings would be negatively impacted as they have to disclose their unfunded pension obligations. He supposed that in that regard Alaska would be situated to secure better costs of debt than other states.

CHESTER JOHNSON stated that the rating agencies have information about the unfunded pension liabilities for most states, and it is not a matter of whether a governmental entity recognizes the liability. The issue is what goes into debt ratio computations. Rating agencies look at four fundamental areas for credit ratings: debt, finance, administrative, and economic. While there are subjective factors that go into the credit ratings, there are objective factors as well. For example, the objective factor in the computation of debt is the net tax-supported debt obligation of the State of Alaska. The debt to personal income and the number of people, etc. becomes an absolute ratio, which is compared on a national basis. The computations that go into the debt do not include liability for pension funding. It may affect the judgment of the rating agency, and it may affect the more subjective side of credit analysis, but because it is not part of the debt computation, it does not affect the outcome. That is why he made the distinction between the hard liability and the soft liability, particularly as it relates to the computation of debt ratios.

Regarding his earlier reporting of rating agency comments about Alaska, CHESTER JOHNSON said neither Fitch nor S&P really commented on the State of Alaska's position. Moody's did and said there is concern, however, there are some mitigating factors with respect to unfunded pension liability at the state level. One is that the State has taken action largely as a result of the defined contribution issue. The other factor is that the State includes health care in its computation, which mitigates Moody's concerns about that. Over time, the rating agency expects other states to have to include health care in their own computations, as a result of GASB 45 in particular. While the State of Alaska is still within the pack of states, it will probably have a more overall positive relative position within the pack. That argues for less concern from a credit perspective about the State's unfunded pension liability at this point.

MR. SEMMENS asked if employer contribution rates of close to 29% for the Public Employees' Retirement System (PERS) would be of concern to a rating agency for a municipality's ability to repay debt. CHESTER JOHNSON replied that the rating agencies consider that the contributions made for pension funding purposes are subordinate to the payment of debt service because of the ability to make adjustments to the contribution payment over time. So as that percentage could rise over time, the fundamental underlying credit characteristics deteriorate, and that does have an impact on a municipality's overall credit position.

MR. SEMMENS questioned Mr. Sinz on why the Municipality of Anchorage would want to issue pension obligation bonds. MR. SINZ said relatively simple questions can have pretty complex answers. He referred to his presentation comments about the local impact associated with the increased PERS contribution rates, which he had converted to a local property tax rate equivalent of about two millage points. The Municipality of Anchorage is subject to a charter-imposed tax limitation whereby the rate of taxation cannot increase from year to year by more than the prior year's CPI plus the five-year average change in population. Each year creates a new base for the following year. So a two mill tax rate equivalent as a result of higher employer contribution rates to PERS consumes space previously occupied within Anchorage's limited taxation ability. That means that the Municipality has to make reductions elsewhere in its tax-supported budgets to offset the increased contribution to PERS. Anchorage continues to be primarily supported by property tax as a source of revenue, so the PERS contribution rate is a financial management issue that has to be addressed. To the extent that a tool becomes available to Anchorage that could help mitigate that impact, such as a pension obligation debt, the Municipality will pursue it until it reaches a conclusion. The conclusion could be that the risks are inappropriate when viewed against the benefits and not to use it, or the conclusion could be otherwise. The Municipality believes that examination of the pension obligation bonds idea needs to run its course and that it would be premature to eliminate the bond debt as a potential option.

Responding to MR. TRIVETTE's question about Anchorage reducing its budget elsewhere, MR. SINZ said that approximately 60% of the Municipality's operating budget is labor costs. He confirmed for Mr. Trivette that making reductions elsewhere in the budget to pay the increased employer contributions to PERS could mean getting rid of some city employees. MR. TRIVETTE commented that doing that would hurt the PERS system ultimately.

COMMISSIONER NORDSTRAND referred to Mr. Sinz's earlier statement that substituting pension obligation debt for all or part of Anchorage's share of the unfunded accrued actuarial liability could reduce the Municipality’s contribution rate by 2.6%. Using Mr. Sinz's scenario that a 28.7% employer contribution rate in fiscal year 2009 would be a $500 a year property tax increase to the Anchorage taxpayer, he asked approximately how many dollars a 2.6% reduction in the PERS contribution rate would represent.

MR. SINZ guessed about 20% would be shaved off the additional tax burden, or roughly $100. He stressed that these are representative numbers. Pension obligation bonds are just one tool to mitigate some of the impacts but do not offset the tax impact in any sense.

MR. PIHL observed that the FY04 employer contribution rates of 3.7% for the Municipality of Anchorage and 9.3% for the Anchorage School District were dramatically different than the projected rates of 28.7% and 28.6%, respectively, for FY09.

MR. SINZ repeated that the numbers were intended to be representative. He referred to Chester

Johnson's comments about how the PERS level of funding is viewed from a national perspective, what that represents in terms of the magnitude of the problem, and whether that magnitude suggests an approach like the pension obligation bonds being discussed. Viewed from the 30,000-foot level, the unfunded liability looks pretty tame. He said he was trying to present numbers that showed the impact at the local level where relative change is important, and the representative numbers are defensible.

MR. PIHL said he was not disputing the numbers, but part of the reason the State is facing this problem is because employer contribution rates were 3.7% or way under what they should have been to support the pension plans that were in place.

MR. SINZ said there is no question that the perception of the PERS pension plan status five years ago was radically different than it is today.

MS. MILLHORN inquired about the benefit and cost of callability for different bonds because it seemed like a flexibility feature that the State would want to have built in. She noted that that was one feature that New Jersey did not have in its bond issue structure, and it worked to their detriment when market conditions changed.

CHESTER JOHNSON explained that in the tax-exempt market, which entities like the State of Alaska and the Municipality of Anchorage use to fund capital projects, there is now an ability to call bonds after ten years at no premium. The perception is to do that to maintain debt management flexibility and take advantage of re-funding if interest rates drop. With non-callable bonds, there is no ability to refinance, or it could be very expensive to refinance. There is often a desire to call bonds in to set up what is known as a defeasance mechanism — put the proceeds from the refunding issue into an escrow and defease the contract under which the original bonds were issued.

CHESTER JOHNSON said that in the taxable market there tends to be a greater penalty involved for calling bonds. There is a hold harmless provision that is often used, which means basically pay the market rate for bonds to be called in. One of the cautionary comments on pension obligations bonds on the GFOA web site was to attempt to retain callability in any pension obligation debt issue which is taxable, in order to preserve flexibility in a larger debt management program.

MR. O'LEARY asked Bob Mitchell what the premium was on government instrument untaxed callable bonds. MR. MITCHELL replied that the premiums varied but were not trivial.

DR. JERROLD MITCHELL complimented the panel on their presentations and answers to the questions. He encouraged the board to look at pension obligation bonds as another possible arrow in its financial quiver, and not regard it as an "either you do it or you don't" situation. For example, if the pension system was currently 70% funded, and that was politically and financially uncomfortable, the board could go to 80% or 85% funded and use pension obligation bonds almost as an experiment to see how they work without incurring the kind of haunting or catastrophic fears that the board might have if it used the bonds to go to 100% funded. His advice is to look at debt the way a chief financial officer of a large successful company might look at — debt can be useful but you don't want too much.

MS. HARBO said she was willing to look at all options to pay the unfunded accrued liability, but pension obligation bonds do nothing to address rising health care costs, the real driver of the liability. She regarded the pension obligation bonds as analogous to the advertisements to take out a home equity loan to pay off credit card debt. She asked how the board would allocate the proceeds of pension obligation bonds because a lot of money would be dumped into the retirement funds all at once, and the ARMB has limited its investment managers to holding no more than 3% cash in portfolios.

MR. O'LEARY replied that the most common academic answer is to invest the bond proceeds immediately per the board's policy. However, that is very difficult to do. It is critically important to think through the process beforehand, before the board wakes up one morning with a few billion dollars to invest. Trustees would have to consider whether to maintain the current asset allocation policy or whether the ARMB's risk preference would change. The approaches that have been used have varied. One plan invested the proceeds almost overnight. Another plan placed the money into a conservatively invested subaccount and then gradually reinvested into the appropriate asset classes to capture the benefit of dollar cost averaging, but they did not change the underlying policy. They accepted being out of line with their longer-term policy for that transition period. How to invest the money is not a trivial issue, but the more fundamental issue is whether or not to use pension obligation bonds at all.

MR. BADER said he was curious about how much money from pension obligation bonds is actually available to invest, once all the attendant fees and expenses have been paid. CHESTER JOHNSON responded that the size of the bonds matters because fixed costs of a transaction can be spread over a larger base if the bond issue is large. He guessed the maximum cost level of issuance would be 2%, while the larger size bond issuance would cost maybe 1%.

MR. TRIVETTE inquired what would be the typical term of pension obligation bonds. CHESTER JOHNSON said somewhere in the range of 25 to 35 years. It usually tracks the amortization of the pension plan's liability.

CHAIR SCHUBERT read a written question from Jack Kreinheder of the Office of Management and Budget: "Do pension obligation bonds have any advantage over increasing the equity/fixed income investment allocation? For example, increasing equities from 60% to 80% of the portfolio would increase the assumed long-term rate of return at the cost of higher volatility and risk. Do pension obligation bonds incur the same or less risk?"

MR. O'LEARY said he did not immediately know the answer. He added that, theoretically, one would think there is a creditworthy entity on the hook to make a string of contributions, and to the extent that the IOU from the employers is a larger part of the portfolio, maybe the board could justify accepting more volatility in the existing asset classes in pursuit of a higher return. There clearly is a major school of thought that if you are underfunded there is incentive to take on more risk with those assets in the portfolio. The consequence of that can be very unsettling in the short term.

CHAIR SCHUBERT thanked the panelists for a great presentation.

2. Chair Report

CHAIR SCHUBERT reported that she met with Commissioners Corbus and Nordstrand to discuss membership changes in the various committees. Committee assignments will be on a future meeting agenda. She also testified by teleconference at the House Ways and Means Committee hearing on December 7, 2005. There were a number of others who testified, as well, including Jeff Sinz and Trustee Semmens. She participated in the Report to the Legislature Committee process, and the board will take up that matter later in the agenda.

CHAIR SCHUBERT indicated that the board had received a letter from Senator Kim Elton, dated January 9, 2006, requesting an analysis of the normal cost required to fund pension, health, and other benefits for Tier III employees and Tier IV employees. She asked staff to draft a letter to Senator Elton with that information for the board's review and her signature.

LUNCH RECESS

The Chair recessed the meeting for lunch at 11:46 a.m. When the meeting reconvened at 1:22 p.m., Trustees Pihl, Schubert, Trivette, Harbo, Nordstrand, Semmens and Williams were present. Trustee Corbus rejoined the meeting at 2:40 p.m.

3. Committee Reports

A. Health Care Cost Containment Committee

Committee chair MIKE WILLIAMS reported that the committee met on January 11 for the purpose of adopting a draft charter, a copy of which was provided to Trustees prior to this meeting. The committee also discussed some health care cost initiatives with the Division of Retirement and Benefits, and later in the agenda Ms. Millhorn would report on what the Division has been doing.

MR. WILLIAMS moved that the Alaska Retirement Management Board adopt the proposed charter of the Health Care Cost Containment Committee of the ARMB. MS. HARBO seconded.

The motion passed unanimously, 7-0.

MR. WILLIAMS indicated that the committee envisions meeting no more than once or twice a year because of how long it takes to adopt and implement health care cost initiatives.

B. Report to Legislature Committee

Committee chair LARRY SEMMENS reported that the committee met twice in Juneau since the last board meeting. The committee's report is on the agenda later today.

4. Chief Investment Officer Report

MR. BADER reported on the following items:

Net-of-fee Performance Information - Per Trustee Semmens's request, the packet included an exhibit of 10-year investment returns net of fees to compare to appropriate index returns. Lazard Asset Management is the only manager in the domestic large cap equity group that earned less than the S&P 500 Index return of 9.94% over the last ten years. Lazard is a global equity manager that manages domestic equities as well as international equities. Lazard's international equity component outperformed the MSCI EAFE Index over the last ten years.

Trust Company of the West, a domestic small cap manager, has been placed on the Manager Watch List for its underperformance over a three-year period. Staff will be reviewing TCW's performance with the board in six months. Recently TCW's returns have improved considerably.

The two high yield bond managers were recently hired, and their returns were below the index for the last quarter.

MR. O'LEARY indicated that Callan can now routinely generate net-of-fee return numbers relative to the appropriate indices.

MR. PIHL questioned why Tukman Capital's returns for the last one and three years were not shown in red. MR. BADER explained that staff looked at the longest period of history with each manager. In Tukman's case, that was five years, and they have exceeded the S&P 500 Index return over that period.

Letter from Ron Peyton, Callan Associates reporting that the Securities and Exchange Commission (SEC) has concluded its examination of the investment consulting industry but has not yet issued an official notice. Mr. Peyton's letter goes into detail about Alpha Management, a registered broker dealer that Callan sold to the Bank of New York in 1998. There has been talk about whether the installment payments that the Bank of New York has made to Callan should be scrutinized.

MR. BADER said that as a charter member of the ASPIB he could state that nobody from Callan ever tried to influence the board to use Alpha Management's services.

[The packet also included copies of two ADV forms that Callan Associates filed with the SEC in 1999 and 2005 supporting the idea that Callan properly disclosed information regarding Alpha Management.]

Letter Regarding TCW Energy Fund - informing the board of a particularly successful investment that TCW made. MR. BADER noted that besides the 76% internal rate of return reported on the TCW Energy Fund, he was pleased that TCW was projecting a 15% IRR on the fund.

Rebalance Turner Investment Partners Portfolio and TCW Asset Management Portfolio - As required by board policy, staff was reporting that small cap domestic equities have had a good run. Staff initiated a rebalancing out of both the Turner portfolio and the TCW small cap portfolio to keep the asset allocation within the policy bands. The total of $87 million dollars was moved into the fixed income pool.

Proposed Rebalancing from Brandes Portfolio - MR. BADER reported that staff received a report yesterday that international equities were outside the asset allocation bands. There are $491 million with Lazard, $122 million with JP Morgan (an emerging market fund), $138 million with Capital Guardian (an emerging market fund), $716 million with Brandes, $527 million with Capital Guardian (developed markets), $276 million with State Street, and $284 million with McKinley Capital.

MR. BADER said the $716 million that Brandes manages is clearly overweight, and the risk should be spread among the many international managers. Brandes has done a phenomenally good job, and they built up these assets during a time when ASPIB did not have as many investment managers. He said he believed it was appropriate to take larger amounts from Brandes when an opportunity comes to rebalance the portfolio, in order to get back to a more balanced allocation among the various international equity managers. The prior board had directed staff not to take more than 25% from any one manager when rebalancing. Staff's letter to Brandes requested them to liquidate $181,282,000 or a little more than 25%, and he asked for board approval.

COMMISSIONER NORDSTRAND moved that the Alaska Retirement Management Board approve directing Brandes Investment to liquidate $181,282,000 of funds. MR. TRIVETTE seconded.

MR. WILLIAMS inquired if the ARMB would be able to reinvest in the Brandes portfolio at a future date, given that it is currently a closed fund. MR. BADER said he believed that Brandes would honor Alaska being able to reinvest up to $181 million but he was not certain.

MR. WILLIAMS asked if staff or the consultant saw any down side if Brandes did not accept any more money from the ARMB in the future. MR. O'LEARY replied that Brandes has been very disciplined in closing their business to new assets to protect their ability to do a good job for existing clients. However, Brandes values their relationship with Alaska. While there are no guarantees, he sensed that Brandes would be amenable to accepting additional reasonable allocations somewhere down the road. Brandes has proven that by their willingness to take additional assets on the defined contribution side.

Responding to MR. SEMMENS, MR. BADER said the $181 million from the Brandes portfolio would go into fixed income investments, which is also outside its target allocation but on the low side. MR. SEMMENS said he assumed that if all the international equity managers were performing equally well, then the board would take funds from them equally to bring the asset class back within the policy bands. MR. BADER said that would be true if the international equity portfolios were balanced to begin with. It is up to the board whether it wants 70% of one asset class with one manager and the remaining 30% spread among the other four managers. His presumption in taking funds only from the Brandes portfolio was that the board would want to equalize the manager portfolios as well as rebalance the international equity asset class.

MR. TRIVETTE asked if there was any other international manager that was doing poor enough that the board should consider taking some funds from their portfolio as part of the rebalancing. MR. BADER said no.

MR. BROOKS questioned how liquidating $181 million from the Brandes portfolio might affect the defined contribution participants who are invested in Brandes. MR. BADER said the Brandes option in SBS is a commingled fund, while the Brandes portfolio for the retirement systems is a completely separate account.

On a roll call vote, the motion passed unanimously, 7-0.

<u>Capital Guardian Rebalancing</u> - MR. BADER reported that staff moved $50 million from the Capital Guardian international portfolio to the fixed income account to bring fixed income closer to its target allocation.

<u>Letter Regarding Alaska Mortgage Investment</u> - MR. BADER said an investment banker wrote inquiring about the ARMB's interest in investing in a first mortgage on a property in Anchorage. The deal would be for about $7 million with a 10-year fixed rate of return. The ASPIB established a policy specifically prohibiting investment in Alaska mortgages when the State had several nonperforming mortgages. It has taken 13-14 years to unwind those mortgages. The board could ask one of its real estate managers to analyze the Anchorage mortgage deal, but staff's preliminary view is that it would not be investment-grade paper if it were rated. Also, the Anchorage property will likely find funding without the ARMB's participation. While the board is always on the lookout for a suitable Alaska investment, to have one mortgage of this size in the portfolio would be problematic for staff.

CHAIR SCHUBERT requested that the board review its policy of investing in Alaska mortgages in general to see if the policy should be continued. She recalled when ASPIB adopted its policy that the mortgage portfolio contained properties with contamination and other serious problems. She clarified that she was not speaking about the $7 million proposal that Mr. Bader just described but about a general review of the policy.

MR. SEMMENS said he supported the Chair's request.

MR. BADER stated that staff has been conducting a systematic review of all the policies with the board and could prepare a report on the Alaska investment policy for the February meeting.

<u>Recommendation to Place McKay Shields on Manager Watch List</u> - Staff received notification that Don Morgan of McKay Shields has resigned. He was the co-manager of one of the board's high yield portfolios. It is the Manager Watch List policy to place investment firms on the watch list when key personnel leave a firm. The intent is to closely scrutinize whether the personnel change

affects the investment style or results in poor returns. He asked for board approval.

MR. TRIVETTE moved that the Alaska Retirement Management Board place the McKay Shields high yield fixed income account on the Manager Watch List. MR. SEMMENS seconded.

The motion carried by unanimous consent, 7-0.

5. Financial Report and FY07 Budget Update

State Comptroller SUSAN TAYLOR reviewed the summary schedule that the board requested. It showed activity in the individual pension funds and the participant directed plans for the fiscal year through November 30, 2005, as well as for the month of November by itself. The retirement funds had total invested assets of $13.2 billion, and income fiscal year to date was $716 million. The Supplemental Annuity Plan and the Deferred Compensation Plan have earned a total of $794 million fiscal year to date and have total invested assets of $2.5 billion. The grand total for which the Alaska Retirement Management Board has fiduciary responsibility was $15.7 billion at November 30.

The investment earnings reports for all the Retirement Trust Funds for the fiscal year through November 30, 2005 were included in the packet. The Public Employees' Retirement System Fund has earned $485 million this fiscal year and has total invested assets of almost $9 billion. The fiscal year income for the Teachers' Retirement System Fund is $227 million, and the fund has a total of $4.1 billion in assets. The Judicial Retirement Trust Fund has $76.5 million in assets and has experienced a gain of $3.9 million for the five months ending November 30. The investment income for the Military Retirement Trust Fund was $0.5 million for the fiscal year on total assets of $14.3 million.

MS. TAYLOR next reviewed a schedule showing information for each investment manager. She pointed out that the portfolio also has about five mortgage loans, most of them non-performing, and staff is in the process of garnishing permanent fund dividends for payment of that debt. She also drew attention to schedules showing monthly activity for the Supplemental Annuity Plan and the Deferred Compensation Plan.

MR. WILLIAMS asked if the Alaska Target 2025 Fund was now an investment option to Deferred Compensation Plan participants. He added that he did not recall any announcement to that effect. MS. TAYLOR replied that the Alaska Target 2025 Fund is now an active investment option, and notification would have gone out from the Division of Retirement and Benefits. MS. MILLHORN said she would forward that information to Mr. Williams.

Regarding the board's FY2007 budget request, MS. TAYLOR reviewed her written staff report in the packet that explained some changes stemming from the Governor's proposed budget released on December 15, 2005. She said no board action was required at this time. If anything were to change, she would bring the budget back to the board.

6. Report to the Legislature

Committee chair SEMMENS thanked the other committee members (Trivette, Nordstrand, and Schubert) and staff for their work in preparing the draft report to the legislature.

MR. BADER briefly reviewed the staff report in the meeting binder, which covered the background leading up to a committee of the board working on the report to the legislature. He said that after some work on a draft the committee decided to reformat the report to focus on the five items that the legislature asked the board to address. The report was redrafted and the latest version is Draft #5 in the binder.

Under "long-term recommendations," MR. BADER said the committee decided to ask the actuary to provide actuarial calculations over various time periods, besides the 25 years that employer contribution rates are based upon. The reason was to consider whether the payoff period for the liabilities could be extended beyond 25 years and thus reduce the burden on PERS employers.

MR. SEMMENS stated that, based on the State's expected large budget surplus this year, the report contained a long-term recommendation that the legislature consider making a large one-time contribution or regular supplemental payments to the retirement systems. These State contributions would increase the funding status and reduce the employer contribution burden in the future. He said the Alaska Municipal League is requesting that the legislature cap employer contributions at 20%.

MR. PIHL suggested stronger wording of the recommendation requesting State contributions to the systems. He also asked for insertion of a statement to the effect that because of the 5% increase factor employer contribution rates continue to be below the actuarially determined rate. He said there should be immediate steps taken to stop the snowball from continuing to build.

COMMISSIONER NORDSTRAND stated that the Department of Law, in its overview of SB 141, concluded that SB 141 effectively repealed the regulatory limit of 5% for the PERS plan. He added that while he understood the ARM Board's purpose in encouraging the legislature — and effectively the governor — to contribute additional sums to PERS and TRS, he requested permission to abstain from that particular recommendation because it conflicts with the governor's current budget proposal.

Regarding short-term cost containment measures, COMMISSIONER NORDSTRAND reported that the Division of Retirement and Benefits is currently developing dependent verification procedures for retiree health care. The Division already enacted verification of dependents for active member health care, and that has been a very successful cost-containment measure. He suggested adding some mention of the Division's current efforts in the report to the legislature.

MR. PIHL said he recalled that a news release in November that indicated the governor was going to try to fund the 5% increase for all municipalities and communities across the state.

COMMISSIONER NORDSTRAND stated that the governor's current budget does not contain that appropriation.

MR. SEMMENS voiced agreement with Mr. Pihl's suggestion to use stronger and more direct language in the long-term recommendation to request contributions to the system.

Referring to page 35 of the November minutes, MR. TRIVETTE raised the issue of the actuary's reports not being completed until June 2006. He added that the committee was under the impression that one of the reports would be ready in March, and the board would have new data for a supplemental report to the legislature.

COMMISSIONER NORDSTRAND stated that the actuary's report in March will be a verification of the last Mercer report for prior years.

MS. MILLHORN added that Buck Consultants' first task is to do a replication of the June 30, 2004 actuarial valuations. Once that is done, they will commence work on the actuarial valuation reports as of June 30, 2005, which will come to the ARMB in March. Following that, Buck will conduct the experience study, which will be available in June 2006. Buck will come back to the board in the fall with the information on the experience study to be incorporated into the valuations through June 30, 2006.

COMMISSIONER NORDSTRAND confirmed that the board will have valuable information from the actuary to provide to the legislature in March, regardless of whether the board has reached any final recommendations in response to the legislature's request. He said it might be an evolving process.

MR. TRIVETTE asked if the board had to have a second actuary review Buck Consultants' report before giving the information to the legislature. MR. JOHNSON said the second actuary comes into play primarily for setting the actuarial contribution rate and not necessarily with respect to providing information to the legislature.

[Commissioner Corbus rejoined the meeting at 2:40 p.m.]

MR. BADER continued reviewing the draft report to the legislature. He said the committee believed it would be good to explain to the legislature what the new defined contribution plan is. The report identifies the investment options, includes a description of the health reimbursement arrangement plan, and gives an update on what the Office of Administrative Appeals has done to date.

As committee chair, MR. SEMMENS moved that the Alaska Retirement Management Board adopt the Report to the Legislature (identified as Draft #5 in the meeting binder). MR. TRIVETTE seconded.

MR. BADER said he had noted the changes that board members recommended while reviewing the report.

CHAIR SCHUBERT asked if staff could make the amendments and bring the revised report back to the board before the end of the meeting. MR. BADER indicated they could work in the evening, and he would present the rewritten report under the "Summary and Wrap-Up" on tomorrow's agenda.

MR. SEMMENS moved to table the motion. MR. WILLIAMS seconded.

Referring to page 7 of the draft report, MR. WILLIAMS inquired if the committee discussed adding a caution about making long-term decisions to address the unfunded liability of the retirement plans without the ARMB's input and actuarial data. He said he raised this question because the legislature today was holding hearings on pension obligation bonds.

MR. SEMMENS replied that the committee discussed that the report does not include any mention of pension obligation bonds. Since the board heard presentations on bonds from a panel today, the report could include language that the board would continue to research that funding option, without taking a position either way.

The motion to table passed unanimously, 8-0.

Break from 2:48 to 3:00 p.m.

7. Medical Plan Report

MELANIE MILLHORN, Director of the Division of Retirement and Benefits, gave a presentation on the medical health plans for the State of Alaska. *[A written report was included in the meeting binder and is on file at the ARMB office.]* She said the report was prepared at the request of the House Ways and Means Committee, which conducted meetings around Alaska during the interim to look at the unfunded status of the retirement plans. Everyone recognizes that health care cost is a primary driver of the unfunded liability, representing 37% of the accrued liabilities for PERS and 31% for TRS.

MS. MILLHORN stated that she attended a Ways and Means Committee meeting that heard from Commonwealth North, which has been studying the issue in Alaska. Commonwealth North formed a task force to assist policymakers in perhaps later developing solutions to a very complicated problem at both a national and state level. She asked anyone who has an opportunity to review the Commonwealth North report to send her feedback that she could incorporate into the Division's report to the legislature on the health plans.

MS. MILLHORN said the Division of Retirement and Benefits administers and manages two health care plans, one for the active employees and one for retirees. Both those plans became self-funded in 1997. Her written report included the demographics of both those populations, the cost drivers in Alaska, the authority for the health plans (Commissioner Nordstrand), the cost containment initiatives that have been implemented, and the cost containment changes that other plan sponsors are engaged in.

Responding to a prior request from MR. TRIVETTE, MS. MILLHORN stated that the retiree population is 28,311 members who have system-paid medical. There are 25,335 dependents. Another question that came from the Health Subcommittee yesterday was how many retirees live in Alaska. The valuation report shows that 65% of retired TRS members live in Alaska and 68% of PERS retirees live in Alaska. The health care costs in Anchorage are 40% higher than in Seattle. There are approximately 110,000 uninsured parties in Alaska, and consequently these people go to the emergency room, where, under federal law, the hospitals may not turn those parties away. As a result, it increases the premium costs for the parties who are insured.

MS. MILLHORN said there is a growth in enrollment for the retiree population, and claims costs are increasing. Those are two of the primary drivers, and they are not going to change. The board may in the future want more information about the legal constraints that the Division is required to recognize when making plan changes. Research has indicated that administrators can manage the costs of a health plan in two areas: plan design changes and eligibility audits. The Alaska Supreme Court in June 2003 concluded that the medical benefits for retirees are constitutionally protected under Article 12, Section 7. That decision also said that increases or decreases must offset one another. The Alaska Supreme Court ruled that a health plan could be looked at from the total member perspective rather than on an individual basis. That case was remanded back to the Superior Court and is due to go to trial January 17 in Anchorage for two weeks.

MS. MILLHORN reviewed several initiatives that the Division undertook to contain health care costs: (1) removing coverage for dependents aged 19-23 who were not attending school full time; (2) the retiree dependent eligibility verification process; (3) removing non-dependents who were not eligible for tax-preferred benefits; (4) network savings - negotiated discounts with preferred provider physicians and medical facilities; and (5) successful in getting approval to participate in the retiree drug subsidy through Medicare Part D.

MS. MILLHORN drew attention to a chart of retiree health plan premium increases for calendar years 2004, 2005 and 2006, compared to trend projections and Aetna's corporate trend.

MR. BROOKS stated that while the retiree health plan premium increases have been low for a couple of years compared to the trend, it is an anomaly and not a trend for Alaska.

Referring to an exhibit showing retiree plan claims from FY01 to FY05, MS. MILLHORN noted that while the medical claims experience has come down, the prescription cost has gone up — trending about 22% right now. So any way that the state can deal with the increasing prescription drug costs is very important.

In closing, MS. MILLHORN went to the last page of the report which listed the initiatives that other health plans are undertaking to help reduce their medical claims costs. Also on that page were the pending cost containment initiatives that the Division is researching.

8. Defined Contribution Plan Implementation Update

MS. MILLHORN indicated that the board binder contained a two-page report on the time line to implement the tasks related to SB 141. She said the Division of Retirement and Benefits is about half way toward the implementation date of July 1, 2006. The Division managers in charge of the various initiatives will be speaking to the board on tomorrow's agenda.

9. Division of Retirement and Benefits FY07 Budget Review

MS. MILLHORN reviewed the 2005-2007 operating budget, noting that personal services represents 61% of the budget. That amounts to $4.2 million in FY06. The FY07 operating budget does not substantially increase over the previous year except for personal services, which reflects the increase in the PERS contribution rate (approximately $371,000). The FY07 budget also contains $2.1 million for conversion of the existing non-vested members who elect to convert to the defined contribution plan.

MR. BROOKS pointed out that the State, as the employer, was budgeting for the conversion of non-vested members, and the cost would not be borne by the PERS and TRS retirement trust funds.

MR. SEMMENS inquired about the fiscal note for SB 141 in the FY07 operating budget. MS. MILLHORN replied that the fiscal note for the new defined contribution plan was all general fund dollars and not retirement system dollars.

MR. SEMMENS asked if there were new legislation proposed and the Alaska Retirement Management Board analyzed it and prepared a fiscal note if the money for the task would come from the retirement systems. MS. MILLHORN said that was correct. MR. SEMMENS remarked that he had a problem with someone coming up with an idea that he might not support but it requires the board to analyze that idea with the retirement systems' money. On the other hand, he could see that it behooves the board to do the analysis and communicate the impact of a change when that someone has the power to actually implement an idea.

COMMISSIONER NORDSTRAND explained that the Department of Administration, on short notice, has to analyze dozens of bills every day for the fiscal impact on the department.

MR. BROOKS added that the bottom line on a fiscal note often becomes a determining factor in whether the bill passes.

After a brief exchange with Ms. Millhorn, MR. WILLIAMS said it would be helpful for the board to understand how operating costs are expended to the retirement trust funds under the cost allocation plan.

MS. HARBO questioned why DOA administrative services increased by 27% in the FY07 budget. MR. BROOKS replied that the budget line represents an allocation within the Department of Administration that all the divisions pay to the administrative services. It is everything from paying bills to budget development to administrative services' share of the PERS contribution increase.

MS. MILLHORN drew attention to the actual expenditures for the fiscal year 2006 authorized budget. Through December 31, 2005, the budget is approximately 39% expended. She concluded with a schematic showing the money inflows and outflows for the Public Employees' Retirement System in 2005. For example, total administrative cost in 2005 was 0.44 of 1% of the average assets for the year. The Division has used this information to help the legislature and others understand the components associated with the retirement systems.

10. Response to Trustee Pihl Request

MR. BADER stated that at the last meeting Trustee Pihl asked for a discussion of a gas pipeline investment. He said Trustee Pihl had his questions addressed, and there was nothing further to report.

11. Second Actuary RFP Update

MS. TAYLOR reviewed the written staff report describing the background leading up to Department of Revenue staff's issuance of a Request For Proposal (RFP) for actuarial audit services on December 19, 2005. The due date for proposals is January 19, 2006. She asked the chair to appoint three board members to serve on the proposal evaluation committee. Once the committee has completed evaluating the proposals, it will bring a recommendation to the board at the February meeting.

CHAIR SCHUBERT selected Trustees Semmens, Harbo and Trivette, and they all agreed to serve on the proposal evaluation committee.

RECESS

CHAIR SCHUBERT recessed the meeting for the day at 3:47 p.m.

Friday, January 13, 2006

CHAIR SCHUBERT called the meeting back to order at 9:00 a.m. Trustees Williams, Harbo, Semmens, Schubert, Trivette and Pihl were present to form a quorum. Trustee Corbus joined the meeting at 9:34 a.m.

REPORTS (Continued)

12. Overview of Treasury Division

Portfolio Management
MR. BADER made a presentation on the portfolio management section of the Treasury Division of the Department of Revenue.

[The details of the presentation are included in slides, which are on file at the ARMB office.]

MR. BADER first discussed the Alaska Retirement Management Board. He said one of the board's fiduciary responsibilities is to determine appropriate investment objectives — setting the target return and target risk levels for the funds. The data is provided by Callan Associates, and the board will work on setting an asset allocation for the retirement plans at the March meeting. The board must also act only in regard to the best interest of the system's plans and beneficiaries. Previous boards have never been tempted to do social investing.

MR. BADER reviewed a flowchart of the portfolio management process, which all starts with setting investment objectives and constraints. He discussed the ARMB and Treasury tools: (1) the consultant; (2) the Investment Advisory Council; (3) staff; and (4) the asset managers. He reviewed the asset management structure, pointing out that the portfolio is diversified in order to dampen the volatility of the portfolio and to maximize returns. The board, when it is going to add an investment manager, also has to examine whether that incremental diversification is worth the incremental cost. The board's asset allocation decision is based on its tolerance for risk, the expected return and volatility of each asset class, and the correlation - how much each asset class return moves with another. An efficient frontier is the mix of assets that is presumed to give the highest rate of return for a given level of risk. That data is provided by Callan when the board sets its asset allocation. A pie chart of the current target asset allocation for the PERS and TRS trust funds was included in the presentation material.

MR. BADER explained that there are staff in the portfolio management section who work directly investing fixed income assets, while external managers are responsible for investing most of the equity assets. The internal fixed income portfolio manager is Bob Mitchell, and over the last three years the portfolio has outperformed the Lehman Aggregate Index benchmark and ranks high compared to other managers. About $2 billion of fixed income is internally managed, and $850 million is externally managed by BlackRock. Internal staff also manages roughly $75 million in a real estate investment trust (REIT) strategy, which arguably is part of the real estate asset allocation and is used to rebalance the portfolio.

MR. PIHL pointed out that the management cost of the internal fixed income portfolio is quite low compared to the fees for the external manager, BlackRock.

MR. BADER reported that the previous board made an active/passive decision regarding equity management, whereby slightly more than half the large cap domestic equity investments are index funds and passively managed. Equities are diversified in domestic and international and then further diversified by style, etc. within those two categories.

MR. BADER stated that part of the portfolio has been invested in private equity investments for more than six years. Unique to this asset class, there may be a negative return in the early stages of an investment as money is expended (the J-curve), but in time the goal is to earn an outsized return. The portfolio has survived the greatest part of the J-curve in this asset class, and now the portfolio is experiencing very good returns. Hopefully, the wind will be to the back as money from maturing investments is consistently reinvested.

MR. BADER said the previous board constantly struggled with the number of external managers, but it is a problem that many large funds experience. As the size of the assets increases, more managers are needed. Some managers, such as for small capitalization equity, do not have a large capacity, and the board would not want to be too large a part of one management firm's business. So it requires hiring several managers to take care of the asset allocation.

MR. WILLIAMS asked at what point would assets be large enough that the board should consider managing a portion of the assets internally at a lower cost. MR. BADER replied that returns are such an important component that they trump costs. While it would be cheaper to manage assets internally, staff would have to present a proposal to the board that showed they would also earn more. He said that as the portfolio management section fills its staffing positions they will continue to look at areas where they could be more cost effective and perhaps do some things in-house. Right now staff has nothing of that nature to propose to the board.

DR. JERROLD MITCHELL indicated he agreed with Mr. Bader. He added that there are certain asset classes which consensus holds are more easily done in-house by large public funds. If a public fund does anything in-house, fixed income is likely to be the asset type they start with. In that regard, the retirement fund is where a lot of its peers are. The more complex asset classes that are more staff intensive are the ones that remain externally managed.

DR. JENNINGS stated that the board is getting good value from the in-house portfolio staff managing most of the fixed income assets. The next thing to look at might be the index part of the domestic equities portfolio. But even adding in-house capabilities for indexing equities does not make it as simple as you might think. For example, there is trading and redundancy for coverage of vacations, etc. to consider.

Accounting and Support

Using a slide presentation, MS. TAYLOR gave an overview of Treasury Division asset accounting and operational support provided to the board. *[A copy of her overhead slides and a Treasury organization chart handout are on file at the ARMB office.]*

MS. TAYLOR discussed Treasury's asset accounting responsibilities under the following headings:

- Financial statements preparation.
- Annual audit by KPMG.
- Identify and maintain internal controls.
- State Street Bank - the ARMB bank custodian. People from State Street will discuss the bank's functions at the February board meeting. Asset accounting staff are on the phone with their counterparts at State Street multiple times a day. Treasury asset accounting reviews external manager reconciliations of holdings and cash to the custodian records.
- Compliance - with the board asset allocation guidelines, that investment activity is allowable, and ensuring that fund transfers are properly authorized and recorded. Encourage managers to make best efforts to participate in the commission recapture program. Further

development of the "middle office" function, hopefully a future topic to discuss with the Audit Committee.

MS. TAYLOR reviewed the comptroller office's responsibility to manage information technology, including:

- Mission critical support.
- Available 24/7 when needed.
- Technology upgrades.
- Internal fixed income trading - to ensure no down time, to maintain dual networks for trading, have a fail-over to backup server in place, and battery backup.
- State Street Bank hardware - dedicated hardware between the State and SSB in order to secure transactions.
- Disaster recovery initiative under review.

MS. TAYLOR briefly mentioned Treasury's division-wide operations support in the areas of budget preparation, accounting (bill paying), travel, procurement, personnel, and facilities maintenance. She informed the board that she was executing an amendment to an existing contract that the Department of Administration, Division of Finance has with Maximus Inc., the statewide cost allocation contractor, to assist her in documenting the current Treasury cost allocation methodology and to make recommendations on best practices. The contractor will be on site to do interviews at the end of this month.

MS. TAYLOR stated that SB 141 had a provision that requires the ARMB to contract for an independent audit of the state's performance consultant not less then once every four years. The board's fiduciary audit was done February 28, 2003. She said she expected the next audit to take place several years from now.

In conclusion, MS. TAYLOR said that she and her staff looked forward to working with the board to provide any help trustees need to fulfill their fiduciary obligations.

[Commissioner Corbus joined the meeting at 9:34 a.m.]

MR. TRIVETTE noted that the board's responsibility to hire an independent audit of the performance consultant was a new duty. MS. TAYLOR said staff would have to explore whether that audit would include Callan Associates, State Street Bank and the Townsend Group, all of which provide performance information.

MR. SEMMENS asked about the term of the contract with KPMG and if there were any renewal options. MS. TAYLOR said she thought the KPMG contract went until 2009 or 2010 with the renewal provisions. She offered to get the exact dates for the board. The audit contract is actually between the Department of Administration and KPMG, and then there is a reimbursable service agreement between the Treasury Division and the Division of Retirement and Benefits.

MR. JOHNSON clarified that there is a distinction between the requirement to use a formal procurement process for services, such as consulting, and the board delegating responsibilities to investment managers and custodians. There is a separate statute that speaks to those particular areas.

Revenue Deputy Commissioner TOM BOUTIN stated that Mr. Bader and Ms. Taylor have done excellent jobs of building up a team, which is not easy to do in state government and in Alaska. The staff positions are exempt and could mean political appointments. This administration has approved the professionals that management has believed could best do the jobs. He said remuneration is always important in attracting and keeping good people. The previous board, Commissioner Corbus, and the Governor's Office have been very supportive in requesting adequate funding for personal services, and Ms. Taylor has been effective in explaining the budget request to the legislature. If that were not the case, over time the Treasury Division professionals could become a "farm team" for other agencies that pay more.

MR. BOUTIN said that holding board meetings in Juneau is very important because investment managers are then available for staff members who cannot readily travel to meet them face to face and develop stronger working relationships.

<u>Division of Personnel - Trustee as State Employee</u>
MS. HALL introduced DONN STEWART from DOA's Division of Personnel, who was available to answer questions about the new status of certain trustees as State employees.

MS. STEWART explained that it was determined recently that board members in the State of Alaska meet the definition of employee under the Internal Revenue Service code. The Alaska Department of Law has reviewed the IRS determination and what needed to be done to be compliant. The State is having board members, who are not already State employees in some other capacity, placed into the AKPAY system so they will be charged taxes as employees. It is only affecting status as employees under that federal regulation, so there are minimal forms to complete.

MR. BROOKS stated that this was not something that the Department of Administration went looking for; it was a ruling the state got from the federal government. The ARMB was one of a few boards in the state that needed to make the change.

MR. SEMMENS asked if the new procedure affects trustees who do not receive an honorarium. MR. BROOKS said he would have to check and report back.

MR. WILLIAMS said that his quick read of the correspondence between the IRS and the State indicated that the context was only for income tax withholding on honorariums. The reporting of honorariums would basically change from a 1099 form to a W-2. It would be the State's determination to say whether or not a trustee would be eligible for any other benefits normally attendant with being a classified service employee.

CHAIR SCHUBERT noted that she and Mr. Pihl fill public member seats on the board, where one of the qualification requirements is that they not be beneficiaries of the retirement systems. She wondered how meeting the definition of employee under the IRS code might impact their status as public members on the board.

MR. JOHNSON said he supported what Deputy Commissioner Brooks said about the designation of employee being for IRS purposes only. So long as the de-link exists, there should be no problem in terms of qualifications for the public member seats on the board.

MS. STEWART said that was her understanding as well. The employee designation is basically a vehicle to run the honorarium through to withhold the federal taxes. Because the State of Alaska does not participate in Social Security under the federal system, it is a federal requirement that the affected trustees also be participants in the Supplemental Benefit System.

CHAIR SCHUBERT asked Mr. Brooks to look into that. MR. BROOKS said he would check and report back to the board in the afternoon.

MR. TRIVETTE commented that the honorariums have always been taxable but now the taxes will be withheld at the source. He asked who could do the verifications on the required forms.

MS. TAYLOR said she authorized Judy Hall to sign for the State.

CHAIR SCHUBERT requested Judy Hall to e-mail Ms. Stewart's e-mail address to all the trustees, in case they had any questions later.

State Travel Office

MS. HALL said she had worked with many of the board members to make travel arrangements through the State travel office for the upcoming education conference. She said there are a couple of other people at the Department of Revenue who can make travel arrangements for trustees if she is not available. Board members should always go through her to make their travel arrangements, but if they are in travel status and have a problem they have to call the State travel office.

MS. HALL drew attention to a staff report handout dealing with disclosures and reporting requirements, which were talked about at the November meeting. There are three statutory disclosure requirements:

- A financial disclosure report, commonly referred to as the APOC report, that public officials must file by March 15 every year.
- The Ethics Act requires disclosure of gifts valued over $150 if the gift was received in connection with being a trustee. Also required is a quarterly report from the ARMB chair to the Department of Law for any reported violations of this act. Ms. Hall had prepared a letter for Chair Schubert's signature for the fourth quarter of 2005.
- ARMB's specific statutory requirement that trustees disclose any interest in which assets under the control of the board are invested. Also, the board adopted regulations to restrict trustees from having a substantial interest in assets under the control of the board, and defined "substantial interest" as a 5% interest.

MS. HALL said the Department of Revenue developed a Board Investment Transaction form for trustees to report transactions. By completing and submitting the form at the time an investment transaction occurs, the trustee is in compliance with the reporting requirements of AS 37.10.

COMMISSIONER CORBUS stated that in the past Commissioner Wilson Condon prepared a memorandum to the effect that it was not necessary to submit transaction forms for trusts for which a board member was a fiduciary. He raised the question of whether that memorandum should be revisited under the ARMB statute.

MR. JOHNSON stated that the ARMB statutes are not particularly different than the ASPIB statutes with regard to disclosure requirements. However, over time there may be issues related to trusts that would require a reassessment by the Attorney General's Office.

COMMISSIONER CORBUS said he would try to find the memo so it could be reviewed because he is involved in a trust setup.

MR. SEMMENS inquired about the time frame in which to submit the disclosure forms. MS. HALL said it is not specified in statute, but the board and staff have generally regarded 30 days as timely reporting.

MR. PIHL asked if he would have to file a disclosure form if he added to or withdrew money from his accounts, which are handled by a bank on his behalf, or if he changed managers. MS. HALL said yes, he should report if he initiates a transaction.

MR. PIHL asked if he had to report an automatic withdrawal from an IRA account. MR. JOHNSON replied that Mr. Pihl would have to disclose any change in an investment, and if an IRA withdrawal constitutes a sale of an investment then he would have to disclose that.

13. Overview of Division of Retirement and Benefits

MS. MILLHORN said the management of the Division of Retirement and Benefits recognizes that the division touches people's lives, and they take that responsibility very seriously. Their mission is to deliver benefits to members in accordance with legal requirements. They have the fiduciary responsibility to administer five defined benefit plans and two defined contribution plans, and beginning July 1, 2006, they will have the responsibility to administer two additional defined contribution plans in accords with SB 141. The Division administers two self-insured health plans for active and retired members. It provides payroll for approximately 28,311 retirees. The Division provided counseling services to about 51,400 members in 2005. The retirement section processed approximately 2,100 retirements in 2005, and every year that number increases. The staffing level for the Division of Retirement and Benefits has not grown for about five years while the workload has increased. As a result of SB 141 they will be adding five new staff, some of which will be non-permanent positions. The Division is also responsible for annual financial reports.

MS. MILLHORN drew attention to the organizational chart for the Division before introduced the management team from Retirement and Benefits:

- DAVID DUNTLEY, supervisor of the defined contribution plan section — Supplemental Annuity Plan, Deferred Compensation Plan, and a small Dependent Care Assistance Plan. He said the SBS plan is the largest with about $2 billion in 34,000 accounts. Two full-time retirement and benefit technicians are devoted to ensuring that about 2,600 SBS refunds a year totaling about $130 million are properly processed and that people understand what they are getting. The Deferred Compensation Plan has about half a billion dollars and roughly 8,300 accounts, but it is more complicated because it is an optional plan. One focus is educating members about how the Deferred Compensation Plan works. He and an accounting technician are responsible for doing the monthly reconciliations and making sure that the record keeper, Great West, is paid the correct amount.
- CHRISTINE MAUQUIS works directly for Charlene Morrison in the accounting section and works with the employers. She described the section's responsibility for processing all employer payrolls, preparing financial statements for all the funds, internal auditing, and processing retiree checks.
- TRACI CARPENTER manages a data processing section that maintains and enhances the technology for member services and employer services. The mainframe houses the retirement system member data. The Division supports other programs such as the retirement calculator, the employer payroll data entry program, "my account" information for members to view their personal retirement data, and electronic viewing of account balances.
- TIM ADAIR is in charge of administrative support services, records management, bill paying, organizing the budget, and the cost allocation plan.
- KATHY LEA manages both the retirement section and the communication section. Four staff in the communication section put together the employee handbooks for the retirement systems, do newsletters to employees, and prepare forms and presentations. The retirement section is a staff of 39 that is responsible for the counseling and technical services for the defined benefit plans and the defined contribution plans. In Juneau there is the pre-retirement services unit, the retirement processing unit, the pension adjustments unit, the survivor benefits unit, the disability and appeal unit, and the benefit attachment unit. There are five counselors who travel from September to May to conduct on-site job visits and hold seminars in locations around the state.
- SHERI GRAY is the insurance benefits supervisor, standing in for Freda Miller. Miller's main job is to handle all contacts with the third-party administrators. Gray handles appeals from active and retiree members for eligibility enrollment, medical claims, and customer service complaints. There are six employees who handle the main customer service for all the members and their dependents. The section also is currently handling the retiree dependent eligibility verification project. The section acts as a liaison between the members and Aetna for any claims issues.

MS. MILLHORN said the staff is dedicated and committed, and the trustees should feel comfortable contacting these managers for assistance at any time.

MR. TRIVETTE thanked the managers for the work they do with active members and retirees.

Break from 10:28 to 10:40 a.m.

14. Tour of Treasury Division & Division of Retirement and Benefits

After canvassing her fellow trustees, CHAIR SCHUBERT postponed the tour until a later date.

15. Policy Review

<u>Watch List Policy - Resolution 2006-01</u>
MR. BADER stated that the watch list policy has been in place for several years. The board may terminate any manager at its discretion, and that is part of the watch list policy. However, the board may occasionally be dissatisfied with the investment results of a manager, and while some trustees may think it is time to make a change, other trustees may want to observe the manager until there is more information available. The watch list policy has a qualitative component and a quantitative component for placing a manager on the watch list and for removal from the list. The qualitative measures include such things as violation of investment guidelines, deviation from stated investment style, changes in ownership through mergers and acquisitions, turnover of key personnel, and litigation - either directly or indirectly. Each month portfolio management staff reviews the investment managers against the quantitative measures in the policy. Quantitative criteria include investment manager performance evaluated relative to their core benchmark, style benchmark, and peer group.

MR. BADER said that the previous board struggled with the list of watch list criteria from time to time but was never successful in coming up with something that was more attractive to them. The watch list policy is an incentive to staff to stay on top of things, and it brings troubled managers to the board's attention.

MR. BADER said staff was recommending that the board, by resolution, retain the watch list guidelines.

MR. SEMMENS <u>moved that the Alaska Retirement Management Board approve Resolution 2006-01 (relating to watch list guidelines)</u>. MS. HARBO <u>seconded</u>.

The motion passed without objection, 7-0.

<u>International and Domestic Equity Guidelines - Resolution 2006-02</u>
MR. BADER reviewed the staff report in the meeting binder. He said the guidelines that govern domestic and international equity investments apply to a number of portfolios managed externally. The guidelines are broadly written and address both separate accounts and commingled accounts. Staff is currently working with Mr. Johnson on examining the current investment contracts with managers. The investment contracts with separate account managers do not generally extend to all of the investment capability that is imbedded in the board's guidelines.

MR. BADER said staff recommended that the board approve the equity guidelines by resolution.

MR. SEMMENS moved that the Alaska Retirement Management Board approve Resolution 2006-02 (relating to investment guidelines for domestic and international equities). MS. HARBO seconded.

MR. TRIVETTE said he assumed that investment managers were aware of the watch list criteria when they signed the contracts. MR. BADER replied that staff is doing a better job of that as new managers are hired. One of the guidelines that is not a watch list requirement but which frequently troubles managers is the board's desire that the portfolios be fully invested. The board considers "fully invested" to be 3%. As a consequence, when managers have more than 3% cash in the portfolio, they are required to notify staff and explain the reason why. When international equity managers do a portfolio rebalance they generate surplus cash, and it is not something they should be beat over the head about.

MR. SEMMENS indicated he was pleased to see that managers are expected to beat the benchmark return net of fees. He asked when the board could anticipate getting the next commission recapture program report. MR. BADER said it is an annual report that Ms. Taylor provides, but he did not know when the next report would be.

The motion passed without objection, 7-0.

Domestic Fixed Income Guidelines - Resolution 2006-03
MR. BADER briefly reviewed the staff report for the domestic investment-grade fixed income investment policy, which applies to the internally managed fixed income portfolio and to the portfolio managed by BlackRock. He said the guidelines have been in place for several years and are typical of what most funds would have for guidelines. There are some limitations put on the amount of investments in any particular security and on the duration, which is a measure of sensitivity to interest rate changes. The internal fixed income portfolio is always well within the guidelines.

MR. SEMMENS moved that the Alaska Retirement Management Board approve Resolution 2006-03 (adopting the domestic fixed income guidelines). MS. HARBO seconded.

The motion passed unanimously, 7-0.

16. Future Planning

MR. BADER said he gave this presentation to the previous board, and it was their intent to move forward in these areas. However, that board knew that it would be going out of existence with the passage of SB 141, and this is the first opportunity to make the presentation to this board.

MR. BADER said that several years ago, when he worked in the Department of Administration and desktop computers were just coming into vogue, he realized how important technology and new ways of doing business are. The fundamentals of investing — the "blocking and tackling" — will always be the ability to analyze securities and to make judgments about how much and what proportions they will be in a portfolio. Things are changing in the investment world, and it is important to be informed about all those changes and then be skeptical when talking about implementing them.

MR. BADER stated that there are a number of things the board needs to be looking at, at least over the next year, as well as far into the future. Among those things are swaps and derivative products. While there is a fear of futures, many funds are using other investment classes to their advantage, and Alaska cannot be steeped in the old ways of doing business. The board needs to be skeptical but informed.

MR. BADER said the objectives for what staff intends to bring to the board over the next few years are improving performance, reducing risk, reducing cost, and increasing effectiveness. He described possible actions to achieve each of these objectives.

Improve Performance: (1) Find skilled managers in inefficient asset classes. Some examples that the board might look at are micro cap investing, international small cap, emerging market debt, and mortgage-backed securities.
(2) Increase indexing in efficient markets. Should the board be doing more indexing and saving fees, or is the fund right about where it should be? Consider portable alpha - finding managers who have a proven skill in some areas and overlaying that skill on other asset classes.
(3) Equitizing cash. There is almost $4.6 billion invested in domestic equities, but no portfolio can be fully invested at all times because managers need some cash for transaction purposes. As a consequence, there is idle cash in the portfolio, and staff invests the cash in fixed income instruments to produce a return. But those managers were hired to be in the equity market, and the board's planning and asset allocation is to have them invested in equities. To address that issue, either internal staff or an external manager could look at the cash balances each day and buy a futures contract, which is an investment in equities indirectly. Staff believes that avoiding the drag of frictional cash on equity performance could enable the retirement fund to earn an additional $4.2 million a year.

Reduce Risk: (1) Explore additional asset classes, such as timber. The prior board actually approved a timber investment and then had a change of heart. However, some of the best-run endowments in the country are looking at international timber investments. That may not be right for this board, but it is incumbent upon staff to bring these asset classes to the board for review.
(2) Treasury inflation protected securities (TIPS) as a hedge against inflation. The pension funds are very sensitive to changes in inflation, and this is one way to help mitigate the changes. Commodities - there are futures strategies that are being successfully employed by some of the more progressive funds that warrant investigation. A very successful firm called Bridgewater advocates an all-weather portfolio approach. The board would probably find it useful to hear a presentation of their all-weather portfolio or their portable alpha strategies.

Reduce Cost: (1) Increase indexing in efficient equity markets. The previous board increased the allocation to indexing in the large cap domain.
(2) The use of active managers for research and economic analysis. Two of the internal portfolio management staff will be visiting McKinley Capital to look at, among other things, their software

for reducing tracking error. RCM and other firms have made similar offers to share information with staff.

Increase Effectiveness: (1) Improve technology. The cost of whatever technology that staff might be looking at is minor in comparison to its potential benefit to the retirement fund.
(2) Board practices. As the board adds to the number of managers, it becomes more difficult to get to know each firm. The past practice has been that managers appear before the board on a rotating schedule. Occasional investment panels where the managers share their best ideas with the board would be a more efficient way to find out what is going on in the market. Then the board could deal with the exceptions: pick the brains of the managers that are doing very well to see if their returns are an anomaly or a result of real skill, and delve into the managers that are doing poorly. Finally, the board should review the watch list and termination process.

MR. PIHL praised the chief investment officer for his progressive management and said the board should endorse the planning that Mr. Bader just presented, by motion if that was appropriate.

MR. BADER thanked Mr. Pihl and the board.

CHAIR SCHUBERT indicated that a motion was not required for a commendation to the chief investment officer, but she believed a motion was in order to go forward with the education component of the CIO's future planning presentation.

Planning and Education Conference
MR. SEMMENS moved that the Alaska Retirement Management Board direct staff to move forward with the planning for an educational conference. MS. HARBO seconded.

CHAIR SCHUBERT stated that the educational conferences proved enormously helpful to the former trustees and staff in terms of learning about new products and strategies that the board could then implement. Staff was able to attract high-level people in the investment industry to address and educate the board. For those reasons, she supported the motion.

MR. BADER said the initial planning is to have the educational conference in New York City in late May or the first week of June. But before staff can proceed, the board needs to set an actual date for the conference.

CHAIR SCHUBERT suggested that Ms. Hall contact trustees by e-mail to find a suitable date.

MR. TRIVETTE said he thought it was important to have a motion on the record showing that the board endorsed the CIO's plan to explore approaches to improve the performance of the investments. He added that people sometimes question what the board is doing to make things better. The board's endorsement of the plan shows that the trustees are paying attention to the ideas and understand what the board should be exploring.

MR. SEMMENS stated that he took the advice of the investment advisory council and read the book

"Pioneering Portfolio Management" by Swenson. He endorsed the book and encouraged his fellow trustees to read it. He said if staff or anyone else had any information on self-study courses that might help him be a better trustee he would like to hear from them.

On a roll call vote, the motion passed unanimously, 7-0.

17. Summary and Wrap-Up

Report to Legislature (continued from January 12)
MR. BADER provided copies of draft #6 of the report to the legislature, which incorporated changes that board members suggested during the prior day's review of draft #5. He spent a few minutes pointing out those changes for the benefit of trustees.

As committee chair, MR. SEMMENS moved that the Alaska Retirement Management Board adopt the Report to the Legislature (identified as Draft #6). MS. HARBO seconded.

MR. JOHNSON asked if there had been any discussion about how the board would deliver the report to the legislature.

MR. BADER said the recommendation was that the board approve the amended report and authorize the board chair to transmit the report as described. The description includes the intent that the letter of transmittal request that the chair be allowed to appear before an appropriate legislative committee to present the report.

CHAIR SCHUBERT stated that she intended to take the chair of the Report to the Legislature Committee, Trustee Semmens, with her.

For the record, CHAIR SCHUBERT stated that Commissioner Nordstrand indicated yesterday that he would abstain from approval of the action because there was a component in the report to the legislature that does not comport with the Governor's budget.

Roll call vote
Ayes: Williams, Semmens, Pihl, Harbo, Trivette, Schubert
Nays: None
Abstain: Corbus

COMMISSIONER CORBUS said he abstained for the same reason that Commission Nordstrand had indicated yesterday.

NEW BUSINESS

1. Disclosure / Action List

MS. HALL stated that a disclosure memorandum in the meeting binder listed the transaction reports received since the last board meeting. An updated action list includes a legislative component, in response to several trustees asking to be kept apprised of ongoing legislation that might affect the pension funds.

2. Legal Report

MR. JOHNSON reminded the board that it has the obligation to adopt regulations and policies per SB 141. He recommended that the board actively consider what regulations it needs to go forward with. He said Ms. Hall presented a list of pending areas for the board. One issue is the 5% cap on the contribution rate, which was related to the PERS circumstances. Another area is further board education on pension obligation bonds in case it considers making a recommendation in the future. One piece of the equation that was not really discussed yesterday was how the whole idea of issuing pension obligation bonds would work with respect to the administration of it - one employer becoming a pool within a pool, etc. In the past, the PERS board heard appeals by at least two employers for relief in a subsequent year (a credit) because they were overfunded in their particular contribution accounts. The Division of Retirement and Benefits and the Attorney General's Office at that time argued that that was not appropriate, given the overall pooling concept of PERS. The PERS board went along with those arguments and denied the employers' ability to gain a credit. To take that one step forward with the pension obligation bond concept, how would that work if there was an infusion of money coming in from a bond issuance by a particular employer? He said Mr. Sinz spoke about the administrative issues without identifying what the problem areas are. But it might be a subject of some discussion if the board is engaged in the process of looking into POBs.

MR. JOHNSON stated that there are at least three resolutions from the ASPIB days that relate to dealing with securities litigation primarily. There was a memorandum of understanding between the Alaska State Pension Investment Board and the Attorney General's Office. This board may want to consider presenting that issue to the Litigation Committee, chaired by Commissioner Nordstrand, who was previously involved in some of those issues as the deputy attorney general, to see if there are changes in process or policy that the ARMB should know about.

Saying that Ms. Millhorn mentioned this earlier, MR. JOHNSON said there is a trial commencing on Monday in Anchorage on the issue of medical coverage and the types of diminutions that can or cannot be allowed. The outcome will be very important to the PERS and TRS provisions.

Regarding adoption of regulations, MR. BADER said he understood that the previous process was that a board would propose regulations and the Commissioner of Administration would approve them. He wondered what the board's role would be to withdraw the 5% cap on the annual increases in contribution rates.

MR. JOHNSON explained that the old issue of PERS and TRS not being able to react except in response to submissions to them was something unique to the PERS and TRS situation. There is a transitional rule that carries forward the regulations. There is the potential, at least for PERS, of having to repeal the 5% contribution cap regulation that Commissioner Nordstrand alluded to yesterday, at least to the extent that it runs contrary to the requirement that the normal costs be paid off in any kind of a rate increase. There is a question that floats around as to whether the regulation is in effect and how it affects things. Some initiative ought to be undertaken to resolve that.

MS. MILLHORN reported that the Division of Retirement and Benefits has a contract with former attorney general John Gaguine, who is reviewing all the PERS and TRS regulations and the new regulations for the defined contribution plans. Mr. Gaguine indicated that 2 AAC 35.900 would be repealed as part of the regulation package. She said she has spoken to Commissioner Nordstrand with regard to that regulation package and project underway. The Division would come to the ARMB with a listing of all those regulations and any changes. Then Commissioner Nordstrand has final authority to adopt the regulations as they pertain to PERS and TRS and the Division of Retirement and Benefits.

MR. BADER said he would coordinate with Ms. Millhorn because it sounds like the Division of Retirement and Benefits is on top of the regulations matter and will be bringing something to the board.

With regard to the mandate that the employer contribution rate at least cover normal costs, MR. PIHL said he believed there were some cases where the contribution rate does not do that today. If the contribution rate for the Municipality of Anchorage was 3.7% in FY04, and adding the 5% contribution cap to that each year, he questioned whether Anchorage was yet up to a normal cost rate. He said there are a lot of things to wrestle with in getting the monies that will be necessary to fund the pension funds. He thought the State should look at a match incentive program to encourage municipalities to meet their own unfunded liabilities. For example, if a municipality would put in another 5%, the State would match it.

MR. BROOKS stated that there have been discussions about how to create an incentive for employer contributions. The Division of Retirement and Benefits has asked the actuary to provide an analysis of what it would take to stop the funding shortfall from growing. The Division may even be able to communicate the actuary's report to the board by e-mail or other means before the next meeting.

MR. SEMMENS said he was pleased that the Department of Administration has asked the actuary for that analysis. However, he believed those kinds of questions should go through this board, or at least that the board be informed at the time that the actuary was asked to do the analysis. Such a courtesy would foster a team effort toward finding a solution.

MR. BROOKS said it was a point well taken, but the request to the actuary was very recent, and the board was hearing about it timely.

MR. TRIVETTE stated that some of the legislators were talking about this topic at the Ways and Means Committee meeting on Wednesday this week.

MS. CARPENTER reported that she was at the House Ways and Means Committee meeting this morning, and Representative Weyhrauch had received three bills back from drafting, which he intends to introduce next week, that will address some appropriation issues.

Regarding a response to the letter from Senator Elton, CHAIR SCHUBERT asked staff to prepare a letter for her signature and then work with Retirement and Benefits to get a response to him.

OTHER MATTERS TO PROPERLY COME BEFORE THE BOARD

As follow-up to the earlier questions about trustees as State employees, MR. BROOKS said his preliminary answer is that withholding would be federal income tax, Medicare (if appropriate), and SBS. He said he would be pursuing the SBS contribution question further with legal counsel.

CHAIR SCHUBERT requested that the matter be placed on the February meeting agenda.

PUBLIC/MEMBER COMMENTS - None.

INVESTMENT ADVISORY COUNCIL COMMENTS

DR. JENNINGS said he was looking forward to helping the board deal with the proposals that Mr. Bader reviewed in his future planning presentation. While some of the proposals may seem a bit scary at first glance, the board has consultants and the investment advisory council to help with some of the technical issues. He praised Ms. Taylor's operation for moving forward on a middle office and having compliance officers. When the board starts talking about futures, swaps, and some of the more complex investment products, knowing that there is a good control function at the Treasury Division's asset accounting section should be reassuring to the board.

DR. MITCHELL added his compliments to Mr. Bader for his future planning and to Chair Schubert for suggesting that an education conference is important. He said the investment business has always been one where speed counts, but it seems that it has never been more so than now. Asset classes that are attractive on Monday, maybe they are not so attractive on Wednesday, and by Friday it's better than you don't do them. Managers that seem to be number one in their field get filled up very quickly, so even if a fund wants to hire them they are closed. A board that has a future plan and that is already conversant with these various asset classes and with the capabilities of managers within those asset classes really has an advantage. When the time seems right, the board can move without saying it has to think about things for a couple of meetings before taking action. He stressed that retirement pension funds are long-term investors, but getting into an asset class before everyone else does is beneficial. Getting in with a manager that is good is also beneficial — in other words, buying right is at least half the game.

TRUSTEE COMMENTS

MR. PIHL informed fellow trustees there would be an Audit Committee meeting on February 15, the day before the next board meeting. The committee will be working on a mission statement and discussing the middle office operations, among other things.

MR. SEMMENS requested that the board be kept apprised of the progress of the new actuary and whether they will be able to deliver on time. He also asked that if the actuary has preliminary information that might be interesting to the board to let the trustees know, even if it is not at a regular meeting date. He requested that staff inform the board about anything that should come to their attention regarding implementation of the new defined contribution plan. Because this is so critical, he asked for a regular update at the next board meeting.

MS. HARBO thanked staff for putting together the panel on pension obligation bonds, which she found very informative. She also thanked the committee that worked on the report to the legislature because it was an excellent and comprehensive report.

FUTURE AGENDA ITEMS

Items were noted throughout the meeting, and there was nothing to add.

ADJOURNMENT

THERE BEING NO OBJECTION AND NO FURTHER BUSINESS TO COME BEFORE THE BOARD, THE MEETING WAS ADJOURNED AT 11:37 AM ON JANUARY 13, 2006, ON A MOTION MADE BY MS. HARBO AND SECONDED BY MR. SEMMENS.

Chair of the Board of Trustees
Alaska Retirement Management 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 presentation details, please refer to tapes of the meeting and presentation materials on file at the ASPIB office.

Confidential Office Services
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