State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
MEETING

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

MINUTES OF
February 16-17, 2006

Thursday, February 16, 2006

CALL TO ORDER

Vice Chair SAM TRIVETTE assumed the duties of chair and 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.

ARMB Board Members Present
Sam Trivette, *Vice Chair*
Gayle Harbo, *Secretary*
Bill Corbus (present February 17)
Martin Pihl
Scott Nordstrand
Bob Roses
Larry Semmens
Mike Williams

ARMB Board Members Absent
Gail Schubert, *Chair* (excused)
Commissioner Bill Corbus (excused February 16)

Investment Advisory Council Members Present
Dr. William Jennings
Dr. Jerrold Mitchell
Timothy O'Brien

Consultants Present

Robert Johnson, legal counsel
Michael O'Leary, Callan Associates, Inc.
Jeannine Balsamo, Townsend Group

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
Steve Sikes, Investment Officer
Zachary Hanna, Investment Officer
Clay Cummins, Asst. Investment Officer
Joe Pelayo, Compliance Officer
Rich Wiggins, Investment 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

Invited Participants and Others Present
Kevin Ritchie, Alaska Municipal League
Brian Andrews, Smith Barney
Virginia Ragle, State of Alaska Attorney General's Office
Mike Barnhill, State of Alaska Attorney General's Office
Michael Kirk
Cindy Spanyers, APEA/AFT
Tom Harvey, NEA-Alaska
Thad Gray and Meredith Rerisi, Abbott Capital Management
Al Clerc and James Chambliss, Pathway Capital Management
Kim Chan, Lisa Tyrrell, Kirti Patel, Rajiv Mathur, Kevin Roy, Henry Disano, Adele Kohler, Neil Tremblay, and David Beach of State Street Bank
James Hearty and Sandi Christian, Relational Investors
Steve McDonald and Jeffrey Gundlach, Trust Company of the West (TCW)
Shoichi Miyasaka, Yoko Matsuoka and Mikio Shimizu, SPARX Securities
Matthew Walley and Steve Bolen, LaSalle Investment Management

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.

The agenda was approved without objection.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES

MICHAEL KIRK, a retired school teacher, distributed copies of an article from the February 2, 2006 *Bristol Bay Times* entitled "Audit needed to explain the PERS/TRS disaster." He said the unfunded liability in the retirement systems and retiree health plan happened from at least fifteen years of the actuary using statistics that the New Deal used successfully in the 1930s. If he were to buy a private annuity, the insurance company could not use actuarial statistics of the 1930s or it would go bankrupt. The insurance company would have to use up-to-date statistics. He said among the solutions put forth to address the state's shortfall in the pension retirement systems are for employees to work longer so the contributions by both the employee and the employer are larger. Regarding the health plan, he said he searched the internet and found that the German health system has existed since 1883 and has stood the test of time. He believes that unless health care is addressed nationally and within the state, it will result in bankruptcy and an inability to cope with new situations.

KEVIN RITCHIE of the Alaska Municipal League thanked the board for the time it has put in on the hugely important issue of the state's retirement systems funding. He referred to the draft resolution on the next day's agenda and said the Alaska government finance officers strongly support the opportunity to use pension obligation bonds. He stressed that pension obligation bonds are not the solution to the retirement systems' problems, but the bonds might be a valuable tool as some point for some communities. But that tool will not be in the toolbox for municipalities unless the legislature acts. He urged the board to consider the resolution favorably.

MR. RITCHIE said this board is winning a place in the hearts and minds of municipal governments and school districts around the state, and there is a lot of interest in what the board does. He believes there would be a lot of people testifying on pension obligation bonds by teleconference if they had the board's draft resolution in advance. In that regard, he offered his organization's services for public notification of the board's activities.

MR. SEMMENS stated that the legislature is looking to this board and others to come up with a solution for the underfunding situation. He thanked Mr. Ritchie for his efforts to bring the expertise of municipalities into the discussions and urged him to continue.

MR. RITCHIE said that using the people on the board to communicate with the municipalities is a good thing, and Mr. Semmens has participated in several teleconferences. In terms of crafting a solution, the only goal of the Municipal League is to make sure that the communities and school districts can still provide the public services they have to without having to curtail services because of pension debt. The Municipal League regards it as both a short-term and long-term issue and will go to any length to provide information or assistance to the board as it works toward solutions. Over time, municipalities and school districts were not watching the system closely, and now they are surprised to find out how much liability they have.

APPROVAL OF MINUTES

MR. SEMMENS moved to approve the minutes of the January 12-13, 2006 meeting. MR. ROSES seconded.

The motion passed without objection.

REPORTS

1. Chair Report

CHAIR TRIVETTE referred to a letter to the board from the Alaska Municipal League. Also distributed prior to the meeting was a report from the Division of Retirement and Benefits on the cost allocation plan.

2. Committee Reports

A. Audit Committee

Committee chair MARTIN PIHL reported that the committee (Trustees Semmens, Williams and Pihl) held its first meeting on February 15. The principal agenda item was approval of a draft charter, which will be presented at the March meeting of the board. Staff also briefed the committee on efforts to establish internal compliance review, which the committee encouraged be done by upgrading staff positions rather than adding staff.

B. RFP Evaluation Committee

Committee chair SAM TRIVETTE reported that the committee met on February 6 and evaluated the proposal. There were some questions, which staff provided answers for after communicating with the proposer. This item is on the agenda later in the meeting.

3. Trustee Employee Status: Tax and Legal Implications

Assistant Attorney General VIRGINIA RAGLE appeared to answer questions about the enrollment of all state board and commission members in the payroll system for federal tax purposes, the enrollment of members in the supplemental benefit system (SBS) plan, and the availability of the deferred compensation plan to them. She distributed a memorandum to board members that explained that program.

MR. BADER said that board chair Gail Schubert had asked at the January board meeting if membership in SBS was a conflict for the two public members of the ARM board, who may not be beneficiaries of any retirement system managed by the board.

MS. RAGLE replied that the Attorney General's Office has advised the Division of Retirement and Benefits that they believe SB 141 was drafted in a manner that recognizes the non-retirement system status of the SBS plan and deferred compensation plan. Regardless, the project to enroll board and commission members in SBS is one that the state perceives as being required by federal law. So to the extent that there might be some conflict with the qualifications for public members of the Alaska Retirement Management Board, the state would still have to do that enrollment.

COMMISSIONER NORDSTRAND stated that the Division of Finance spoke with the Internal Revenue Service about a number of issues and was told that Alaska was the last state in the nation to make this change.

4. Chief Investment Officer Report

CIO GARY BADER reported on the following items:

Report to the Legislature was completed and submitted on January 20, 2006. Trustee Semmens, accompanied by staff, appeared before the House Ways & Means Committee and answered questions.

Response to Senator Elton's January 9, 2006 letter. The response was written by the Treasury Division with information that came primarily from the Division of Retirement and Benefits.

Questions to Buck Consultants. The list of questions to David Slishinsky, the consulting actuary for Buck, is crucial for further responding to the legislature on possible approaches for solving retirement system issues. The first question asked the actuary to make a series of assumptions and then what would be the additional employer contributions to the system. Another question asked what would it take to keep the system from falling further behind. He said he expects the actuary to respond to these questions either concurrent with, or shortly after, the presentation to the board in March.

House Concurrent Resolution No. 27 deals with investing in companies that do business in countries that threaten the security of the United States and Alaska. For information purposes only.

Recommendation to Place Cornerstone Realty Advisors on Manager Watch List. Ellen Connor retired as chief executive officer, and David Ridley has moved into the CEO spot. It is the board's policy to place management firms on the watch list for additional scrutiny by staff if there are significant management changes.

MR. SEMMENS moved to place Cornerstone Realty Advisors on the Manager Watch List. MS. HARBO seconded.

IAC member TIMOTHY O'BRIEN said he concurred with staff's recommendation.

MR. O'LEARY said he did not claim to be knowledgeable about real estate managers, but he felt the recommended action was consistent with the watch list policy.

Without objection, the motion passed unanimously, 7-0.

Recommendation to Place BlackRock on the Manager Watch List. There has been a recent announcement that BlackRock, which manages about $800 million in fixed income investments for the retirement systems, is in the process of acquiring the asset management arm of Merrill Lynch. This acquisition will make BlackRock one of the largest asset managers in the world. MR. BADER said he spoke with the client relations person at BlackRock yesterday because staff has concerns about whether the deal will distract management, and about the amount of fixed income assets that BlackRock will eventually have responsibility for managing. Because of this major change, BlackRock meets the board's criteria for being on the watch list.

MR. PIHL moved to place BlackRock on the board's Manager Watch List. MS. HARBO seconded.

MR. O'BRIEN indicated he concurred with staff's recommendation.

IAC member JERROLD MITCHELL stated that BlackRock has been one of the most successful fixed income management firms in the country, and the leader has done a wonderful job in managing the acquisitions and expansion so far. This acquisition will make BlackRock a very large firm, and he believes they can do it, but they should be watched.

MR. O'LEARY said he was optimistic about the outcome, but the acquisition is significant enough to warrant BlackRock being on the ARMB watch list.

The motion carried, 7-0.

Recommendation to Remove Citizens from the Manager Watch List. Citizens runs a socially responsible equity fund for the SBS Plan and Deferred Compensation Plan. Citizens has been on the watch list because of some representations they made in the past, along with a poor investment return profile. They added staff and replaced the chief investment officer, and since that time Citizens has had very good performance and meets all the qualifications for good standing with the board. Staff was recommending that Citizens be removed from watch list status.

MS. HARBO moved to remove Citizens from the Manager Watch List. MR. SEMMENS seconded.

MR. O'LEARY commented that Citizens has had a terrific turnaround in performance over a year and a half, and he concurred fully with the recommendation.

The motion passed without objection, 7-0.

MR. PIHL raised the possibility of putting on the watch list any investment manager that takes a public position adverse to the interests of the State of Alaska. He did not wish to discuss a particular situation publicly at this point.

Trustees briefly discussed with the board's legal counsel, ROB JOHNSON, its legal charge to act in the best interest of the retirement funds, and whether the ARMB might be crossing the threshold into making investment-type decisions based on social issues - however well meaning. The discussion branched into investment managers being encouraged to contribute to political campaigns, an issue in other states but not a big concern in Alaska. If there were no legal barriers, the board might be able to ask the investment firms in the annual manager questionnaire to report their political contributions to statewide candidates.

MR. O'BRIEN stated that the board's responsibility is to the participants and beneficiaries of the retirement systems, and there may be a legal question about the extent to which those interests are aligned with the interests of the citizens of Alaska. The other issue is the "law of unintended consequences," where an aggressive board policy might throw cold water on some of the good investment managers that the board wants to have managing the retirement assets.

CHAIR TRIVETTE asked Mr. Pihl to work with staff if he wished to pursue the idea further.

MR. BADER continued reviewing items in his CIO report:

Presentation to RPEA Convention on February 23. MR. BADER said he would be presenting the investment side of the activities of the ARMB to the Retired Public Employees of Alaska convention in Juneau.

SB 141 Housekeeping Measures. A list of changes required before July 1, 2006 and other things that need to be done eventually was included in the board packet for trustees' information. The Departments of Law and Administration prepared the list and provided it to the legislature as a road map.

After a brief exchange, trustees decided to ask Ms. Ragle of the Department of Law to come back later in the day to answer some questions about the housekeeping measures.

Letter from Lowe Enterprises notifying staff that they would contribute $99,000 to the Ohio Police & Fire Pension Fund in an agreement with the Ohio Ethics Commission. There were issues related to what the Commission classified as excessive entertainment that involved Lowe and several other investment managers (who also made contributions to the fund).

MR. BADER stated that Lowe Enterprises manages a hotel fund for the ARMB that is doing well.

Investment Education Conference planned for early June. The previous board in the past invited the Alaska Permanent Fund Corporation board of trustees, the executive director, and the chief investment officer to also attend the conference. He asked if staff should draft a letter from the ARMB chair to the APFC board chair extending that invitation.

There was unanimous agreement from the trustees to invite their counterparts on the APFC board to the education conference.

Alaska Fund Size. A recent article in *Pensions & Investments* ranked Alaska's combined defined benefit and defined contribution plans as 73 among public and private plans for assets under management.

New Portfolio Management Staff. Rich Wiggins, a chartered financial analyst with a bachelors degree in business administration and finance from the University of Michigan and a masters in finance from the University of Colorado. He was president of the CFA society in Detroit and a former portfolio manager at Investors Management Services.
Nicholas Orr is an Alaskan with a bachelors degree from the University of Arizona and a

masters from the University of Hawaii, who brings exceptionally strong technology skills to the portfolio management team.

MR. BADER stated that the success of the retirement funds relies on having competent people making decisions and monitoring the investments. There is one vacant entry-level position that he hopes to have filled by the next board meeting.

2006 Legislation. The packet included several bills, including HB 238, sponsored by Representative Paul Seaton.

MELANIE MILLHORN, director of the Division of Retirement and Benefits, explained that HB 238 establishes a past-service liability account for employers that the Division would administer.

MR. SEMMENS asked if the legislature would be provided with actuarial data that assesses the impact of proposed judicial pay increases on the retirement fund. MS. MILLHORN said yes.

MR. BADER drew attention to SB 12, which has passed the Senate and is in the House. The bill relates to companies having headquarters in countries that support or ignore slavery or human trafficking. Staff is unaware of any scheduled hearing on the bill at this point.

MR. BADER stated that HB 475 is the bill being used for a lot of the cleanup legislation, and the latest version deals with the health reimbursement account.

MR. SEMMENS said the timing of the board's meetings may make it difficult for the full board to act on recommendations to the legislature this year.

MR. BADER said that even if the actuary gave the board information at the March meeting related to the four questions submitted to Mr. Slishinsky, the board would not be able to take action and forward a recommendation to the legislature before the end of the session because the full board does not meet in April. He said one way to approach this is to empower the committee that drafted the initial report to the legislature to prepare a letter of recommendations to the legislature on the board's behalf.

MR. SEMMENS said he felt it was important for the ARMB to provide specific recommendations to the legislature this year, if the board receives the actuarial information it requested in time. The original committee or a larger committee of the board could take on this task.

MR. WILLIAMS indicated he would have no problem if a committee drafted the follow-up report to the legislature. But the board chair also has authority to call a special board meeting if it is necessary to move quickly.

MR. JOHNSON pointed out that the provisions of SB 141 refer to a report by the ARM Board, so the legislature should fully expect that the recommendations would be from the full board. Even if a committee were empowered to do the work, he recommended a special board meeting for all the trustees to endorse the letter before it was forwarded to the legislature.

MR. SEMMENS asked if the Department of Revenue has to take any steps to implement the defined contribution plan. MR. BADER said yes, that contracts have to be amended with all the managers this board approves to be investment managers for the new defined contribution plan. This work is underway, and staff expects to be done by the end of February but not later than March 15. Then, depending on whether there is a new record keeper, there may have to be new relationships established with custodial banks that do not exist right now. That involves the Department of Revenue in a peripheral way.

5. Financial Report and Budget Update

State comptroller, SUSAN TAYLOR, reviewed the financial report as of January 31, 2006. The total assets for which the ARMB has fiduciary responsibility have increased to over $16 billion.

MS. TAYLOR said the annual appropriation of the employer contribution into the Military Retirement Trust Fund occurred in January. Staff will be looking into whether that appropriation can be done at the beginning of the fiscal year. She briefly reviewed the total invested assets and cumulative investment income for the fiscal year for each retirement trust fund.

MS. TAYLOR drew attention to the schedule showing the investment income per asset manager and noted that there was quite a bit of activity in January due to rebalancing, purchases in the "Other Investment Pool," and some real estate investments.

MS. TAYLOR stated that the Supplemental Annuity Plan has $2 billion in invested assets, and the Deferred Compensation Plan has assets totaling almost $500 million.

MS. TAYLOR informed the board that she requested additional authorization in the current fiscal year for custody and investment management fees. Fees are $3.5 million year to date out of a budget of $6.7 million. Staff is finishing paying the second quarter bills to see if any further adjustments need to be done.

MR. BADER added that investment manager fees are usually based on assets under management, so when Ms. Taylor reports that fees have gone up, that means the retirement system has made money.

Referring to the summary report on pages 1 and 2, MR. PIHL said it would be more informative if the third column was split to show contributions and withdrawals separately, rather than the net for the month. He added that the board needs to get a picture of the contributions coming into the system. MS. TAYLOR said she would make that change for the next report.

Returning to the large employer contribution to the Military Retirement Trust Fund in January, MR. SEMMENS commented that the fund would benefit if that contribution were made earlier in the fiscal year.

MS. HARBO inquired about when the state would be making a contribution of 5% to help employers with the increase in the employer contribution rate.

COMMISSIONER NORDSTRAND explained that whatever funds the governor and the legislature decide to ultimately appropriate for that purpose would have to be part of the budget bill when it is passed. Last year there was an appropriation of about $17 million directly from the Department of Administration's budget on behalf of Public Employees' Retirement System (PERS) employers. That appropriation took place in July/August of 2005. The policy on whether to help employers for another year, for how much, and when that would occur has not been acted upon yet for the FY2007 budget.

MS. HARBO asked if there has been any decision made about moving some of the $130-plus million in the retiree health trust managed by the Department of Revenue over to the ARMB's management.

MS. MILLHORN said she had asked Deloitte, the state's benefits consultant, to reconfirm their earlier conversation with the commissioner and deputy commissioner about the amount that the consultant would be comfortable with transferring out of the health trust fund. She received that information two days ago. She also got information from Mr. Bader that the retiree health trust fund earned 4.4% compared to the higher return for retirement system assets. She said the next step is for the Division of Retirement and Benefits to compile that information and submit it, along with a recommendation, to Commissioner Nordstrand for his consideration. That information should be available to the board in March.

MR. SEMMENS questioned why there needs to be a reserve balance in the health trust. MS. MILLHORN replied that the reserve balance helps avoid spikes due to health insurance premium increases every year. Also, there are retirees who do not have system-paid health insurance and must pay the premium.

The Chair called a brief break from 10:30 to 10:38 a.m.

6. Private Equity 2006 Tactical Plan

MR. BADER stated that in the past an alternative investments committee, chaired by Ms. Schubert, would review the annual plan for private equity investments prior to bringing it to the full board for approval. The private equity investments have progressed to the point where Ms. Schubert was comfortable proceeding with a presentation of the annual tactical plan directly to the board without a committee previewing it. He said Zachary Hanna oversees the day-to-day contact with the investment managers in the private equity program.

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

MR. HANNA introduced the board's private equity managers in attendance: Thad Gray and Meredith Rerisi of Abbott Capital Management, and Al Clerc and James Chambliss with Pathway Capital Management.

MR. HANNA stated that private equity partnerships generally make illiquid, long-term investments in private companies. These partnerships run the gamut from venture capital funds, which invest in small, early stage technology or life sciences companies, to large buyout funds, which invest in more mature operating companies. The appeal of the private market is driven by two factors. First, there are many more private companies than there are public companies, so there is a large opportunity set. Second, private companies are generally less efficiently priced and less efficiently operated than their public counterparts. This creates an opportunity for private equity partnerships to buy private companies at low valuations, to create additional value by making financial and operating improvements, and then to sell the companies at higher valuations. The primary reason fund sponsors invest in private equity is higher returns. The general return expectations are 300-500 basis points over public equity returns. The ARMB's benchmark for private equity is 350 basis points over the Russell 3000 Index return.

In terms of implementation, MR. HANNA said manager selection is critical. There is a huge return dispersion between the top quartile managers and the median manager: the average difference has been 15% over the past 15 years. The median returns are not acceptable. To invest with the top tier over time, access and careful due diligence and monitoring are required. Diversification is also important, since private equity can be a cyclical business. The goal is to build a portfolio of quality partnerships, well diversified by strategy, by industry, by geography, by investment stage, by manager, and by time.

Turning to private equity trends over the past several years, MR. HANNA said fund raising was close to all time highs for 2005, with buyout funds exceeding all prior years. Over the past five or so years private equity has become a fairly mainstream alternative asset class. High quality managers are typically heavily oversubscribed since institutional investor interest is so strong. Private equity investments were made at a similar pace over the last three or four years but were well below the level of 2005 fundraising. This raises some concern that there is an overhang of uninvested capital moving forward that may put downward pressure on returns. Looking at exit opportunities, the 2005 IPO (initial public offering) market was generally strong but very focused on mature businesses, as it was in the prior year. This was good for buyout funds but not good for venture capital funds. From a liquidity standpoint, there has been significant corporate acquisition activity over the past year, and buyout funds continue to use the high yield debt markets fairly aggressively to cut dividends.

MR. HANNA stated that for venture capital the most notable trend is that the technology market has not yet recovered, but the life sciences market is doing fairly well. The IPO market was fairly unfriendly to venture capitalists over the past couple of years, but corporate acquisitions are picking up (venture capitalists selling portfolio companies to corporations like Cisco rather than selling to the public market). There has also been a healthy trend of smaller size funds in venture capital over the past couple of years, but this is adding to another problem. A combination of these small funds and very high institutional investor interest is making access to venture capital probably more difficult than it has ever been. Finally, the Freedom of Information Act continues to be an issue for public funds in private equity. The most sensitive issue is the confidentiality of underlying portfolio company valuations and details. A small number of venture capital funds have gone so far as to deny access to public funds. This happened to the ARMB portfolio in 2004 but not last year. The bottom line for venture capital is that it seems to be improving but remains difficult to access.

For buyout funds 2005 was the year of the mega buyout. There were a number of funds raised that were in excess of $8 billion. This is far in excess of what had been raised in prior years, and these very large funds are focused on doing larger deals over time. There has also been a continued increase in club deals, where multiple partnerships join to make a buyout transaction. The jury is still out as to whether these large buyout deals are a positive trend or a negative trend. There has been a lot of activity in international buyouts and strong performance, particularly from European buyout funds. There is also increasing international exposure imbedded in domestic funds. Finally, leverage in deal prices is definitely on the rise. Both pricing and leverage multiples are at the highest levels since 1998 — probably not the best indicator in terms of making investments, but perhaps a good thing in terms of exiting investments. The bottom line for buyouts is that it is hard to regard larger funds, higher deal pricing, and increased leverage as a positive combination.

MR. HANNA gave a brief overview of the ARMB private equity program that started in 1998. The allocation to private equity is now 6% of the total fund assets. Both private equity gatekeepers — Abbott and Pathway — have discretion within their annual allocation to make investments on the ARMB's behalf. Private equity has been quite volatile since the ARMB entered the asset class, but the portfolio is high quality and well diversified. For five of the past seven years, the portfolio has been a top quartile performer, one year was in the second quartile, and one year was in the third quartile. Time-weighted returns for 2005 were 30.3% versus 4.9% for the S&P 500 Index and 6.1% for the Russell 3000 Index. The internal rate of return through the end of 2005 was 8.2%, which compares favorably with market equivalent returns. The ARMB portfolio has well exceeded the expectation of 350 basis points over public market returns.

MR. HANNA stated that the commitment target for 2005 was $300 million, with a $330 million maximum. $326.5 million was committed to 27 partnerships, split roughly equally between Abbott and Pathway. These commitments were roughly balanced by strategy, but the bulk went to buyout and special situations funds. It is notable that venture capital commitments by both managers were particularly strong compared to the past several years.

MR. HANNA reviewed a graph showing the actual contributions (capital calls) to private equity funds, which can take four to five years to absorb after the money has been committed. It then takes about five to eight years until the partnerships harvest the investments and start returning money to investors like ARMB. Distributions in 2005 were up 61% over 2004 in the ARMB private equity portfolio because the exit markets were generally favorable.

MR. O'LEARY said that understanding the cash flow patterns in the private equity area of investing is not intuitive.

MR. HANNA said that through 2005 the ARMB had $1.5 billion in total commitments, $905 million of that had been paid into partnerships, and the total value at the end of 2005 was $1.1 billion (this is 1.2 times the invested capital).

MR. HANNA briefly reviewed diversification within the portfolio before moving on to discuss the 2006 outlook. Venture capital fundraising is expected to be stable, with buyout fundraising expected to decrease from an all-time high in 2005. A reasonably high distribution pace is envisioned for 2006, however, at some point during the year or beyond, higher interest rates and increasing defaults may slow these distributions. Portfolio company pricing is likely to continue an upward trend due to high competition for deals and increasing leverage. The strong demand for top-tier partnerships will continue, and the ARMB will continue to focus on access. Finally, keeping sensitive information confidential will remain an issue for access to venture capital in particular.

MR. HANNA presented the tactical plan for private equity in 2006. Staff is recommending a commitment target of $250 million split equally between Abbott and Pathway. Both managers should continue to build well diversified portfolios over the long term. Private equity is expected to reach the target of 6% of fund assets over the next few years. Due to the volatility of overall fund asset levels and private equity cash flows, total fund exposure to private equity may fluctuate materially above and below the 6% target.

MR. SEMMENS asked how the valuations of private equity companies are determined. THAD GRAY of Abbott Capital Management explained how the book value method is used for venture capital — the value is cost until someone else pays a higher price for the same class of securities. For buyouts, it tends to also be the book value method for a certain period of time, and then they compare the performance to comparable companies in the public markets to get a total enterprise value for that company, which is converted to an equity value for their position. AL CLERC of Pathway Capital Management stated that valuations generally tend to be conservative, even when the general partners do write up their portfolio companies.

MR. SEMMENS asked what incentive general partners have to be conservative. MR. O'LEARY replied that asset-based fees are based on the contributions as opposed to the value of the portfolio companies.

IAC member BILL JENNINGS inquired of staff if there have been cases where different partnerships in which the ARMB is invested are bidding against each other in buyout situations. MR. HANNA stated that, in part, club deals were a way to work together to get away from some of that bidding and to control the pricing to a certain extent. MR. CLERC added that another development arising from club deals is that the buyout funds can do much larger deals than they have been able to do individually in the past.

DR. JENNINGS asked if staff believed that Abbott and Pathway were still getting access to the same quality partnerships as they have in the past. MR. HANNA said yes.

7. Abbott Capital Management, LLC

THAD GRAY and MEREDITH RERISI gave an annual review of the private equity portfolio their firm manages on behalf of the Alaska Retirement Management Board. *[The details of their report are included in an Abbott Capital booklet dated February 16, 2006, on file at the ARMB office.]*

MR. GRAY first reviewed the highlights of 2005, in which Abbott generated $144 million of distributions and an annual return of 33.5%. There had been $98 million in distributions in 2004 and a return of 20.4%. Abbott slightly exceeded the target commitment level for 2005, due to a wealth of opportunities in the private equity market for new investment. By the end of 2005, Abbott had committed $161.7 million to 14 new partnerships (six buyout funds, seven venture capital, and one special situations fund). He also briefly described the market conditions in 2005.

MS. RERISI covered details of the ARMB's portfolio, commenting on the partnership investments and the underlying portfolio companies.

MR. O'LEARY inquired about the absence of private equity investments in the Pacific Rim. MR. GRAY said it has been a difficult place to make money in the last ten-plus years. Abbott invested in one Pacific Rim fund, which was formed in 1996, and does not expect a full return on their capital. Alaska is not invested in that fund. Abbott was able to watch development of the Pacific Rim market through its investment, and it has not been a pleasant experience. In China in particular, it is difficult to become a control investor in a company. Companies are typically family controlled and operate several sets of books. India is a slightly different situation, and Warburg Pincus in particular has been successful in making some very large, control-oriented investments there and has exited some of those. But until Abbott can see a pattern of successful investments being made in China that are getting exited, they are probably going to watch it from the sidelines.

MR. BADER drew attention to some blank columns on Abbott's statement of investments and asked for an explanation. MS. RERISI said it was because of the increased sensitivity of the underlying portfolio information. She added that the private equity industry has come to grips with disclosing the top level information. But Abbott has chosen to leave out of its presentation reports the distributions and individual portfolio company internal rates of return (IRR) because the investment partners do not want their IRRs to be part of the public record.

MR. BADER stated that if there were a desire for the board to publish its private equity portfolio information on a partnership level, a possible consequence is that the ARMB would not be invited to participate in future partnerships.

MR. GRAY confirmed the accuracy of that statement. He added that in spite of all the protective steps that Abbott takes, one venture capital fund has already indicated they do not want any public funds subject to the Freedom of Information Act in their new partnership. To avoid this type of situation as much as possible in the future, Abbott has chosen to handle its public reporting the way the board sees it in this report.

MR. JOHNSON said that prior to SB 141 there were statutory provisions that allowed an exception to the general production of public documents. Pursuant to that, the board adopted regulations and provided terms in various contracts, etc. that allow maintaining some information as confidential. With the passage of SB 141, there is a further statutory enhancement that actually allows the board to be more closed in terms of delivering information if the board concludes that it has a potential effect upon the finances of the investments. That is an area where the board might need to adopt regulations going forward, but it is operating under the old regulations and provisions in place now.

MR. O'LEARY commented that this is a very sensitive area for the board because it is investing in a high risk area where money is locked up for a decade, and the question may be why can't we know what we are doing. He said it may take a little work, but trustees can know in great detail what the board is investing in. Every time money flows to or from one of the partnerships, it goes through the ARMB's custodian bank, so the board has the independent flexibility to calculate an IRR for any partnership. The oversight managers have a great deal of detail, which can be shown to staff and the trustees if they visit their offices. He said trustees should not hesitate to raise a question at any time, because the answers may take a little time but they are available.

MR. GRAY stated that Abbott will show the ARMB and staff any information they want to look at in the Abbott office, as long as they leave it there.

MS. RERISI added that Abbott has regularly scheduled monthly conference calls with staff, and also speaks with them in the interim as needed, to make sure that staff has all the information they need.

MS. RERISI briefly reviewed the top ten portfolio companies that have generated significant value in 2005. MR. GRAY noted that many of the companies will be distributing cash in the next quarter or two and will not be in the top ten six months from now.

In summary, MR. GRAY said the ARMB portfolio is in very good shape, deal flow continues to be strong, and there are a number of partnerships in the pipeline in 2006 that represent very good opportunities for the board. Liquidity remains strong, and although Abbott does not know how long that will remain the case, they expect conditions to hold up well in the first half of 2006. Abbott plans to maintain diversification across all segments of private equity, as it is a long-term asset class, and they do not plan to make short-term changes to the portfolio in response to short-term trends.

DR. MITCHELL asked if it would cause a problem for Abbott if the staff had recommended $250 million or $375 million as the commitment target for 2006 [the staff recommendation is $125 million]. MR. GRAY said tripling the $125 million allocation would be a stretch and would also lead to some imbalance in Abbott's client base. He added that $125 million is a good number for Abbott to get committed in 2006.

MR. O'LEARY said Abbott would not necessarily increase the number of partnerships it would invest the retirement fund's money in, but Abbott would try to get more money to work in existing partnerships.

MS. RERISI added that another aspect of doubling or tripling an allocation in one year is that investing more money with existing partnerships would create an unequal weighting to a given vintage period that would impact the diversification of the portfolio over time.

MR. GRAY said there is no issue getting money to work; the issue is getting it to work in a consistent and balanced way.

8. Pathway Capital Management, LLC

ALBERT CLERC and JAMES CHAMBLISS presented an update on the private equity portfolio their firm has managed for the Alaska Retirement Management Board for four years. *[The details of their report are included in a portfolio review booklet dated February 16, 2006, on file at the ARMB office.]*

MR. CLERC began with an overview of the firm. MR. CHAMBLISS reviewed Pathway's investment philosophy and process for selecting partnerships.

MR. CHAMBLISS reported that Pathway used the additional 10% allocation provided for in the board's policies and procedures and committed $164.7 million to 13 partnerships in 2005. He said at last year's tactical plan review Pathway had stated they would be trying to increase exposure to high quality venture capital funds. They were successful in finding six venture capital partnerships to invest in on the ARMB's behalf.

MR. CLERC reviewed the portfolio's diversification by investment strategy, pointing out that the biggest change from 2004 was that venture capital rose from 7% of the portfolio to 15% in 2005. The non-U.S. portion of the portfolio increased to 23%, and the majority of that is invested in Western Europe. He also reviewed the industry and geographic diversification.

MR. CHAMBLISS stated that since the portfolio's inception in 2002 the board has committed $501 million to 33 partnerships; $154 million of that has been invested by those partnerships. The portfolio was valued at $201 million as of September 30, 2005, resulting in a 31.1% net IRR.

MR. CLERC stated that the buyout investments were the main reason that the ARMB's portfolio at Pathway performed so well over the last year. The buyout funds were able to take advantage of the liquidity in the debt markets and restructure and provide dividends back, or they actually took some significant companies public in the portfolio. Three investment strategies — acquisitions, distressed debt, and special situations partnerships — have performed well since inception of the portfolio. It is still early for the venture capital strategy, as a large portion of it was committed in the last six to twelve months.

MR. CHAMBLISS briefly drew attention to a list of partnerships that drove the strong performance for the one-year period ended September 30, 2005.

Turning to the 2006 tactical plan, MR. CHAMBLISS said Pathway's goal is to commit $125 million in up to 12 partnerships. He stressed that they do not feel compelled to invest the $125 million: they will only invest that money if they find suitable investments for the ARMB portfolio. Pathway will continue to emphasize bringing the venture capital exposure up to the long-term target level but will only invest when they can identify suitable investments.

In summary, MR. CLERC stated that the one-year return was 45.3%, increasing the internal rate of return to 31.1% at September 30, 2005. He said the outlook for high-quality private equity partnerships is good for 2006, and Pathway does not believe it will have any trouble putting out $125 million.

DR. MITCHELL asked if Pathway would be able to achieve the commitment target for 2006 if the staff had recommended double or triple the $125 million allocation. MR. CLERC replied that Pathway could do it, but they have already started allocating and asking partnerships for what they need out to 2007. Because of the increased demand to get into private equity funds, gatekeepers have to be planning a year in advance how much they need. If the ARMB wished to increase the allocation beyond $125 million for 2006, Pathway could make it happen but there would be a delay in getting the money committed.

MR. O'LEARY commented that if Pathway were successful in getting a much larger allocation committed to prime partnerships this year for the ARMB, there would be an undue concentration in this particular class year.

MR. CLERC agreed, adding that there is a plan to achieve the board's allocation to private equity over a certain period of time. The best way to do that is to be a consistent investor and not put too many dollars in any one vintage year.

MR. O'LEARY stated that if the board changes the policy target, the board is accountable for perhaps great or poor performance, depending on the luck of the draw with regard to the timing of that change. In Pathway's case, there was an initial target of 3% of the total fund assets, and the early results were so attractive that the previous board made a decision to increase the target. The decision was made right before the private equity asset class peaked. So there was X amount of money being invested per year for a couple of years, and then 2X amount of money into funds that were making their investments in the bubble. The manager was not responsible for the board's policy decision to go from X to 2X; the manager was responsible for getting into good partnerships that were available in that year.

MS. HARBO pointed out that of the seven U.S. partnerships Pathway invested in for 2005, five of them were in software and technology. While it must have been a good opportunity, she wondered if that was too much concentration by industry.

MR. CLERC explained that no investments have been made from the 2005 commitments to partnerships. Because Pathway did a lot of venture capital funds in the past year, the board will start seeing an increase in the portfolio in the software and technology area.

Referring to Pathway's report of $500 million committed and $154 million contributed to date, MR. SEMMENS asked if that meant there was still $350 million to invest. MR. CLERC replied that the partnerships that Pathway has committed to have only drawn down $154 million. The partnerships still have to draw down an additional $350 million, which generally takes five to six years.

6. Private Equity 2006 Tactical Plan (Continued)

A. Resolution 2006-04 - Private Equity Plan

MR. ROSES moved that the Alaska Retirement Management Board adopt Resolution 2006-04, which approves the 2006 Annual Tactical Plan for Private Equity. MS. HARBO seconded.

At MR. SEMMENS's request, MR. BADER summarized how staff calculates the investment pace that will reach the 6% target allocation to private equity over several years.

MR. O'LEARY stated that Mr. Hanna provided a draft of the 2006 tactical plan to Callan's internal expert, Gary Robertson. They had some give and take about what is a reasonable investment pace assumption, but Mr. Robertson is very comfortable with staff's plan.

DR. JENNINGS informed the board that he asked some technical questions of staff about the draft plan and was satisfied with the answers.

MR. O'BRIEN and DR. MITCHELL both indicated that they supported staff's recommendation.

There was no objection to the motion, and it passed 7-0.

B. Resolution 2006-05 - Private Equity Policies & Procedures

MR. BADER made a correction to the description of the board of trustees at the top of page 6, which he said Ms. Harbo had drawn to his attention.

MS. HARBO moved that the Board approve Resolution 2006-05, adopting the Private Equity Partnerships Portfolio Policies and Procedures, subject to the correction made by Mr. Bader. MR. ROSES seconded.

CHAIR TRIVETTE asked if there were any significant changes made to the private equity guidelines. MR. BADER said no, that the policy was merely updated to reflect the ARMB's oversight.

Without objection, the motion was approved, 7-0.

For the record, MR. BADER stated that Mr. Corbus was the first chair of the alternative investments committee.

The Chair recessed the meeting for lunch at 12:10 p.m. and called the meeting back to order at 1:15 p.m.

9. State Street Report

SUSAN TAYLOR introduced KIM CHAN, Director of Client Services in the Public Funds Division of State Street Bank in Boston. She said Ms. Chan has a long experience in various aspects of the custodial business and insight into complex client operations. Ms. Chan has assured the asset accounting staff in the Treasury Division that she can assist in gaining efficiencies in the state's operation.

[State Street provided a paper copy of their slide presentation, dated February 16, 2006, which is on file at the ARMB office. The following State Street presentations took an hour and 45 minutes. Please refer to the materials on file for more details than appear in these minutes.]

A. State Street Overview

MS. CHAN introduced her colleagues, who work with Treasury Division staff on a regular basis: Lisa Tyrrell, Kirti Patel, Rajiv Mathur, Kevin Roy, Henry Disano, Adele Kohler, Neil Tremblay, and David Beach.

MS. CHAN first reviewed the history and organizational structure of State Street, a corporation that services institutional investors worldwide. It's major lines of business are investment servicing, investment management (State Street Global Advisors), and investment research and trading. She said State Street recently spent almost $900 million in technology, including enhancing the core infrastructure, investing in value-added services like compliance monitoring, client interfacing technology, and in business continuity programs.

B. Service Structure

LISA TYRRELL said she works closely with the asset accounting and portfolio management staff in the Treasury Division. She described the key services that State Street's Public Fund Division provides to Alaska's retirement fund operation on a daily basis. She serves the role of liaison for Ms. Taylor and Mr. Bader to assist them with all the services at State Street. For example, when the board hires a new investment manager, State Street sets up individual accounts so the manager can trade on the ARMB's behalf. She also serves in a project management role, and an example of that is implementing the new defined contribution plan the State of Alaska has starting on July 1. She said process improvement is very important to the Treasury Division, taking less time to get the same or even more in-depth information. In the last two days some of State Street's information technology staff have been in the Treasury offices rolling up a new on-line information delivery system.

C. Accounting Services

MS. TYRRELL also gave an overview of State Street's Financial Information Services unit. This group provides customized services for the ARMB because no two public funds are alike. One tailored service is the weekly asset allocation reporting so that portfolio management staff can make sure investments are in line with the board's policy and make any necessary adjustments. Another is the monthly manager reconciliation process for the asset accounting staff, whereby State Street acts as an independent third-party check of activities reported by the ARMB's investment managers. Because of its public fund client base, State Street is able to offer consulting advice on the best practices of all the public funds. Finally, State Street does a lot of data exchange with the board's other service providers.

In closing, MS. TYRRELL encouraged the ARMB and its staff to take advantage of State Street's knowledge and expertise to implement new processes, etc.

D. Performance and Analytic Services

KEVIN ROY said that he and Rajiv Mathur are part of State Street Analytics and lead the core team, located in Alameda, California, that is responsible for providing performance measurement and analytic services to the State of Alaska. The Performance and Analytic group primarily does performance analysis (where the majority of services are provided to the ARMB), risk analysis and strategic analysis. They deliver monthly performance reports to staff on about 146 portfolios/ aggregates/breakouts, characteristics and attribution reports on the portfolios, and the State Street universe quarterly reports and trade execution reports.

MR. ROY said they are currently working with staff on investment compliance monitoring. They are taking information from both the accounting side and the performance side and blending it together with the board's investment guidelines to create a set of rules to continually test that the portfolios are adhering to those guidelines.

MR. ROY briefly listed some new products that State Street Analytics is launching: plan attribution, corporate governance metrics, investment compliance (project underway with the Treasury Division), Mystatestreet.com, and evaluation of risk management platforms.

MR. ROY and MR. MATHUR held an exchange with DR. MITCHELL about the corporate governance metrics product, which they explained is a quantitative tool to measure another characteristic of a company that can give insight and forecast into what that stock might do. MR. TREMBLAY added that State Street Global Advisors is working with the advance research center to see if this type of analysis can add value in an active portfolio.

MR. JOHNSON stated that recently companies have tried to develop programs that would assist entities engaged in securities litigation to calculate their losses. He asked if State Street has done any of that type of loss calculation for litigation support.

MR. ROY said that State Street is looking to partner with Algorithmics, a company that can do that type of multi-myriad risk analysis — projecting how a market event or non-market event will play out through the markets and what its impact on a portfolio might be.

E. Securities Finance

HENRY DISANO explained the securities lending process, which he said is a low-risk way to generate incremental income for lending participants. He said that State Street has on average $700-$800 million of ARMB's securities on loan, although it has reached as high as $1 billion.

MR. O'LEARY observed that with the securities lending program, in addition to the index funds and other products that State Street manages for the retirement system, State Street is probably the ARM Board's largest investment manager.

MR. BADER stated that the previous board at times struggled with the idea of securities lending. He asked Mr. Disano to describe what happens if the rebate rate is either greater or less than in the lending transaction example on page 29 of State Street's presentation material, which showed 50 basis points of difference between the rebate rate and the yield from the Navigator Prime Fund where the collateral is invested.

MR. DISANO said the rebate rates adjust as short-term interest rates change. There can be situations, especially in a rising interest rate environment, where the rebate rate could exceed the yield of the Navigator Prime Fund. State Street has a unique agreement with the State of Alaska to protect Alaska against negative loans. So in the event the rebate exceeds the yield of the fund, State Street makes up that difference.

MR. O'LEARY said that State Street also indemnifies Alaska's portfolio against loss arising from operational issues and borrower default.

MR. BADER stated that the cash collateral is invested very conservatively in the Prime Navigator Fund. He asked what would happen if the fund lost money. MR. DISANO replied that that is the risk that clients should focus on the most. The Navigator Prime Fund is a money market fund that invests only in A1-P1 securities. State Street Global Advisors has never even had a security that has missed an interest payment, so it is a high credit quality shop.

MR. O'LEARY noted that in the industry over ten or fifteen years there were one or two instances where somebody else's fund used for the investment of collateral has had a small interest in a troubled company.

MR. O'LEARY stated that the ARMB always has the right to recall a security from loan. Securities lending should always be transparent to the investment manager, so if the manager wants to sell a security today, they can do that.

Responding to MR. SEMMENS, MR. DISANO said the Federal Reserve Bank has been fairly transparent in giving the market an indication of whether interest rates will move. So State Street has a good idea of which loans could potentially become negative and which ones are going to be profitable, and would avoid making any risky loans.

MR. DISANO stated that there have been no losses since the ARMB entered State Street's securities lending program in January 2001. Back in 1994, there were many losses in securities lending industry wide, but at State Street the losses were very minimal and a result of rapidly rising interest rates. The securities lending industry is much more transparent to clients now.

MR. DISANO reported that the securities lending program has generated $17.5 million in revenue since 2001. The last couple of years have been more challenging because of rising interest rates, but the program managed to generate $2.4 million for the Alaska retirement fund last year.

Prompted by MR. O'LEARY's comment that there are more securities to lend than there is demand to borrow, MR. DISANO described State Street's sophisticated queuing system that insures that the ARMB's portfolio gets its share of securities lending opportunities. MR. O'LEARY said this is important because different clients have different splits of income with the lending agent. The queuing system insures that each client has a reasonable shot at lending its securities, regardless of the income split.

MR. DISANO stated that State Street was the first firm to develop a reporting system that looks at the returns in a securities lending program on a risk-adjusted basis. State Street has worked to make the program more transparent by hiring a consultant to provide a benchmarking service so clients can go on line and look at a universe of over seven trillion lendable assets and compare their performance with the overall universe. Another initiative is to eliminate some of the interest rate exposure by matching the liability (rebate) and the asset. Finally, there are other potential ways to generate more revenue in the program by moving to more aggressive collateral vehicles and through expansion of non-cash collateral. So if the ARMB's risk parameter for its securities lending program was to change, State Street could generate more revenue.

F. State Street Global Advisors Overview

NEIL TREMBLAY and ADELE KOHLER made a 20-minute presentation on State Street Global Advisors (SSGA), which has $1.4 trillion in assets under management in various asset classes. The ARMB makes use of SSGA's passive equity asset management, enhanced assets, and active management. Of note is that Bill Hunt became chairman and CEO of SSGA in 2005.

MS. KOHLER conducted a review of the portfolio in 2005, followed by comments on some trends in investing that SSGA sees in other public funds. She said U.S. investors are fully saturated into the passive investment world, and most of the new growth comes from outside the U.S., where institutions are just now understanding the benefits of having a core index-like portfolio as part of their overall plan. U.S. passive investors are becoming more creative about the benchmarks they are using. In this environment of very low expected returns, dividends have become a lot more important, so passive portfolios are being tilted towards higher-dividend-paying stocks. Another large trend is towards indexes that screen out socially irresponsible securities, going beyond tobacco and alcohol into tilting toward positive attributes like corporate governance and environmental sustainability. Some states are passing legislation requiring that their public entities divest investments in specific countries or to stay away from companies that do business in countries that have some kinds of terrorist relationships. These socially responsible investment restrictions are being implemented to some degree in the active strategies as well.

MS. KOHLER said that SSGA saw growth in the enhanced indexing area, which many clients view as a great way to move slightly up the risk curve with some reliable incremental returns over time. Another great area of growth was the active quantitative strategies, primarily in the international alpha strategy that the ARMB is now invested in, as well as in the small cap active strategies. The demand for these strategies are driven by two things: clients are looking for new areas to gain excess return above the benchmarks, and SSGA provides this excess return in a consistent and incremental way over time. SSGA has significantly increased its focus on research in the last couple of years. One of the primary functions of the research center is to do "maintenance" on the existing strategies to make sure they will continue to work.

MS. KOHLER stated that assets in certain SSGA strategies have grown so quickly that they have had to stop accepting new assets. A big area of focus for 2006 is to evaluate how large they can grow in each strategy and still be able to deliver the consistency of excess return that they have been able to deliver up to this point. It is important that growth not disadvantage existing clients, and that if SSGA has to close a strategy that existing investors can still contribute to that strategy. There will be a proliferation of new types of strategies in 2006, both extensions of existing strategies and brand-new ones. One example is an active commodities strategy.

MR. SEMMENS referred to page 41 of the State Street report that listed "focus on liability matching" in the 2006 outlook. Because there is interest in liability matching in Alaska, he asked for more information on it.

MS. KOHLER said there is significant interest in liability-driven investing, where liabilities are part of the equation. Most of that interest is from continental European and U.K. clients whose pension laws have dictated that they mark their liabilities and assets to market. To the extent that U.S. investors start to focus on similar ways of accounting for their pension liabilities and assets, there may be a greater need to focus more directly on liabilities. Some U.S. funds are asking SSGA to devise a liability-driven solution which allows their assets to be similarly structured as their liabilities. But because many public funds are finding themselves in an underfunded pension situation, it is not feasible to simply lock in that loss. SSGA is tilting portfolios with longer-duration fixed income solutions and then overlaying that with some active strategies to help the funds make up some of that shortfall. It is certainly redirecting the benchmarks of the assets from S&P 500 plus EAFE to "what is the liability payment that I need to be paying out, and do my assets reflect the duration and the stream of those liabilities over time."

MR. SEMMENS asked about the typical current return of a strategy like that. MS. KOHLER replied that SSGA has three clients that have taken that liability-driven solution to the fullest extent and done both the liability side plus the alpha overlay. But the portfolios are still fairly new, and she did not want to speculate on what the total return objective is.

MR. SEMMENS asked if a liability-driven strategy is expected to return less than the ARMB's current asset allocation. He added that people are telling the board that it must match the investments to the liabilities, and that is great as long as the board can earn the 8.25% that the actuary thinks it should.

MR. O'LEARY explained that if the board wanted to perfectly match the assets to the liabilities (if mathematically possible), there has to be certainty in calculating the duration of both the liabilities and the assets. Theoretically, using Treasuries and some derivatives thereof to get a duration of 20 years, the board could have a pool of assets that could match that liability. However, there is no free lunch. If someone is going to overlay a strategy on top of that duration match, by definition, alpha does not have to be positive. Callan Associates sees in the corporate sector a greater willingness to consider having a longer duration bond portfolio to match the liability. He has one corporate client that has a duration-matched bond portfolio in lieu of the Aggregate Index, and it is benchmarked to the Lehman Government Credit Index plus 30% of the duration of the Lehman Government Credit Index. Their logic is that the portfolio will not really help in the total fund, but at least with respect to a segment of the assets the duration of the liabilities and the duration of the assets are a match. It is a deep subject that cannot be fully explored today.

G. Transition Management and Commission Recapture

DAVID BEACH spoke about State Street's transition management services that a plan sponsor uses to move assets from one investment manager to another manager. There are a lot of moving parts in a transition that create portfolio risk. State Street steps in and coordinates the process and acts as the fiduciary for the plan. The only fees they make are pure commissions from the underlying open-market transactions.

MR. BEACH reviewed State Street's history in the transition management business, their industry rankings, and activity and performance by asset class in 2004. State Street did several transitions in the last year for the ARMB.

MR. BEACH next reviewed the retirement fund's commission recapture program that State Street has managed since 2003. He explained that commission recapture is a contractual arrangement that ARMB has to direct its investment managers to trade with certain brokers, subject to best execution. In turn, the brokers agree to rebate a portion of the commissions back to the ARMB. About 25-30% of the commissions get rebated to the retirement fund, for a total of $728,000 in 2005.

MR. O'LEARY said often asked questions are why don't the managers just trade at a lower commission rate, and why not just direct 100% of the trades. He said commissions have come down slowly, and managers are now typically trading a fair amount of their turnover through systems that have lower transaction costs. But the typical manager is also trading for all their clients simultaneously. If the manager wants to sell a stock to add value to portfolios, the board would never want to put the retirement fund's assets second in line to be sold after the discretionary accounts. He said he has been very supportive of the commission recapture program, but there are a lot of dynamics to understand in deciding what is a reasonable target for different types of managers.

When queried by the Chair, MR. O'LEARY said State Street has done a nice job for the board. There was an internally managed commission recapture program prior to 2003 that took a lot of staff time because of the administration involved.

MR. BADER said he was pleased with State Street's oversight of the commission recapture program.

MR. BEACH stated that he calls the investment managers quarterly to touch base with them and discuss any exceptions, etc.

MR. PIHL asked why the ARMB's December 2005 commission recapture activity was so high. MR. BEACH offered to check on that, but investment managers do a lot of trading towards the end of a quarter. MR. BADER added that the board changed its asset allocation to put more towards equities, and that could account for some of the increased commission recapture activity in December.

In closing, MS. TYRRELL said State Street has enjoyed a 15-year relationship with Alaska, and she extended an open invitation to trustees and staff to visit them in Boston to see the operations.

The agenda was reordered to take up securitizing cash next.

10. Cash Securitization - State Street Global Advisors

NEIL TREMBLAY and ADELE KOHLER of State Street Global Advisors made a presentation about the effects of excess and frictional cash in the retirement fund's portfolios and how that cash can be equitized to maximize the returns that are earned on uninvested cash. *[SSGA's slide materials include charts and other details that are not in the minutes, and this information is on file at the ARMB office.]*

MR. TREMBLAY said equitizing cash is a core business for SSGA. He said that prior to becoming the head of product engineering at SSGA, Ms. Kohler was a member of the global asset allocation group.

MS. KOHLER stated that most plan sponsors are focused on the asset allocation of their portfolio to be able to meet the requirements of the liabilities down the road. But there are things going on inside the portfolio that detract from meeting that ultimate goal, and one of those is leakage. Leakage is all the little things that happen in the plan that tend to draw down the return. It can take the form of explicit cost like the cost of transitioning one portfolio to another without going through an efficient transition manager. It can relate to manager fees, transaction costs, and opportunities that are missed — such as securities lending, commission recapture, and leaving cash balances in the portfolio idle. These cash balances can be part of an equity portfolio, for example, and are not meant to be exposed to cash returns only.

MR. O'LEARY clarified that any residual cash in the retirement fund portfolios is invested in a short-term fund. What SSGA is speaking about is that the cash is not invested in equities.

MS. KOHLER said the focus on these lost opportunities has become much greater in recent years because investors are no longer experiencing the bull market of the 1990s.

SSGA has an investment process that could help the board extract more value from the overall retirement fund. Cash balances are being held in the active equity portfolios so managers can buy securities when they see opportunities. The aggregate of the cash held in the board's U.S. equity portfolios averages $59 million. If one assumes that the U.S. equity market over the long term will provide an average 9% return, and cash only delivers around a 3% return, the ARMB is missing out on about 6% return for that particular cash balance, or about $3.5 million in a single year. A similar calculation applied to the non-U.S. equity portfolio results in about $2.7 million of lost revenue. Added together, the potential one-year gain from exposing that cash to the equity markets is roughly $6 million.

MS. KOHLER explained how exposure to the equity markets is achieved without actually physically taking the cash away from the portfolio managers. There are many tools available, but SSGA is recommending the use of equity index futures contracts, currency forwards for the non-U.S. part of the portfolio, and equity swaps as an alternative to futures. Futures are cheap, they trade intra-day, and they track the benchmark you are trying to get exposure to. There is currently no way to buy a MSCI EAFE Index future, but there will be in about a month when the Chicago Mercantile Exchange rolls out a brand-new MSCI EAFE futures contract.

MS. KOHLER said the risks of futures are pretty much the same risks incurred by buying the stocks themselves: the overall risk is the risk that the market goes down. The second major risk of futures is that the futures themselves do not behave exactly like the underlying index. That risk is minimal for the S&P 500 because the benchmark and the contract itself behave similarly and rarely veer in price from one another. The risk is slightly greater with a basket of index futures used to invest in an EAFE portfolio because the basket does not look exactly like the original benchmark. But that problem will be eliminated once the MSCI EAFE Index contract is rolled out next month. The biggest risk is that futures are somehow scary and dangerous — what SSGA is doing with futures is a very straightforward and unleveraged way to use this particular financial vehicle.

MS. KOHLER reviewed an example of investing $100 of cash in a futures contract. She also discussed the global team of portfolio managers at SSGA that would be doing this on the ARMB's behalf. Because the team of nine cash equitization managers is located globally, SSGA has redundancies and therefore backup systems if something disrupted operations in any one location.

MS. KOHLER stated that SSGA's goal would be to look at the retirement fund's manager cash balances every day, aggregate them, and make sure that SSGA owns the right amount of futures to equitize those cash balances. If the retirement fund has cash flows coming into the portfolios, SSGA will buy more futures, and if the fund has cash flows going out of the portfolios, SSGA will sell futures contracts. SSGA will also monitor that the good faith deposit is at the right level. There are four different groups at SSGA that look at the trades daily, which is part of the risk control process. The futures position is marked to market every day, so the risk of the futures that you hold is limited to one day's market move.

Regarding currency forwards, MS. KOHLER said SSGA has an extensive counterparty risk group that analyzes every single broker and counterparty that SSGA would enter into a transaction with. There are a series of other internal reviews of the program as well, from the internal compliance group and the corporate auditing committee.

MS. KOHLER stated that SSGA does this strategy for a lot of clients, both in the index portfolios, and about $70 billion between cash equitization and strategic overlay portfolios.

MR. ROSES asked staff if the Alaska State Pension Investment Board looked at this strategy. MR. BADER replied that he made a brief presentation of this strategy at the January board meeting. The prior board also heard the presentation, but it was near the end of their existence, and they perhaps did not want to add any new programs right before leaving.

MR. SEMMENS asked if Mr. Bader had analyzed the relationship between SSGA's futures products and was satisfied that the market moves that happen in futures contracts are essentially the same as the index. MR. BADER said essentially the same, and the contracts would be arbitraged back if the market moves were not the same. MS. KOHLER referred to page 6 of the presentation material and described how the futures are priced through arbitrage to behave like the benchmark.

DR. JENNINGS said he thought the $6 million return projection for the ARMB's portfolio was a little on the high side, but there are a number of reasons to like the proposal. Not only does it take care of the current problem with cash, but it lays the ground work for some future strategies like manager overlay, currency overlay, portable alpha, etc. Also, the fact that the comptroller's office in the Treasury Division is adding a compliance person should give the board more comfort with this type of presentation. The large risk is if stocks underperform, and another is tracking error risk.

MS. KOHLER said the other big risk is if the retirement fund's money manager does not look at the portfolio for a week. The board needs a manager that is diligent about looking at the cash positions every day and making sure the futures adjustment is made. SSGA has clients that when they first enter into a relationship where futures are being used want daily communications for a while until they are comfortable that SSGA is monitoring the cash positions closely.

MS. HARBO asked if other public pension funds are securitizing cash. MR. TREMBLAY said the strategy has come into vogue lately, but CalPERS and CalTRS have been doing it for a long time.

MR. O'LEARY added that the funds have to be big to have enough residual cash to make it administratively practical. He also pointed out that from the managers' perspective the cash still remains in their portfolios and they earn a cash rate on that. The ARMB will receive separate reporting for the cash securitization program. There is some complexity, because if SSGA needs to get additional cash to support the futures position, cash would have to be transferred to them. If the board had had this program in place in 2000, 2001 and 2002, there would have been a lower total fund return because the equity return was obviously negative and cash returns were positive. The strategy should work over the long run, provided that equities return more than cash.

MR. O'BRIEN said he supported staff's recommendation to equitize the frictional cash in the manager portfolios. He added that it was consistent with the ASPIB board's action a few years ago to limit an investment manager's cash position to no more than 3% of the portfolio, and if the manager was over 3% the cash was taken away and invested. This is a reasonable way to take that cash and equitize it.

MR. BADER stated that staff has found that 3% is not enough cash in the portfolios for the small cap equity managers. If there is a program for equitizing cash in place, staff feels the cash limit could be raised to 5% for small cap managers without putting a drag on the returns because the cash would be equitized anyway. Staff's written recommendation in the packet includes a resolution to amend the equity guidelines to allow for up to 5% cash holdings by small cap and international equity managers. Staff believes that from a compliance standpoint and just for ease of operation, it makes sense to use the ARMB's custodian to manage a cash securitization program. Staff is looking down the road, as Dr. Jennings mentioned, to becoming familiar with this strategy and perhaps using it for other areas that the board may eventually become involved in. It is possible that staff will come back to the board in the future with a recommendation to bring the program in-house in steps.

MR. PIHL <u>moved that the Alaska Retirement Management Board adopt Resolution 2006-06 approving a cash securitization program and direct staff to negotiate a contract with State Street Global Advisors to implement the program</u>.
MR. ROSES <u>seconded</u>.

The motion passed without objection, 7-0.

At MR. SEMMENS's request, MR. BADER explained that Resolution 2006-07 rescinds

Resolution 2006-02 and changes the 3% cash holding guideline to 5% for small cap and international equity managers.

MS. HARBO moved that the Alaska Retirement Management Board adopt Resolution 2006-07 amending the equity guidelines to allow for up to 5% cash holdings by small capitalization and international equity managers. MR. PIHL seconded.

The motion passed without objection, 7-0.

11. SB 141 Housekeeping Measures (continued from the CIO Report)

Assistant Attorney General VIRGINIA RAGLE returned to answer questions from trustees on the 12-page discussion document prepared by the Department of Law and the Department of Administration describing proposed changes as follow-up to SB 141. MS. MILLHORN and MS. CARPENTER were also available to answer questions.

MS. HARBO said she had received questions from nonvested employees in the PERS system about the repeal of certain reinstatement provisions in 2010. She was also contacted about employer contributions to a nonvested employee's health reimbursement account (HRA) for major medical when they enter the defined contribution program.

MS. MILLHORN said there is no requirement that the employer retroactively make a contribution to the HRA. The conversion provision allows that after the employer has made that policy decision that the employee's account balance will be matched by the employer. There is language in the 12-page discussion document clarifying what membership service is for the purpose of the HRA.

MS. CARPENTER stated that June 30, 2010 is the expiration date for former members to reinstate service by repaying their refunded member account contributions under PERS and TRS.

MR. JOHNSON referred Ms. Harbo to Section 133 on page 118 of SB 141 and Section 149, which address provisions that take effect on June 30, 2010.

MS. MILLHORN offered to research Ms. Harbo's questions and get back to the board later. *[The next day she provided the board with a written response from the Division of Retirement and Benefits, dated February 17, 2006, which is on file at the ARMB office.]*

CHAIR TRIVETTE asked if the provisions required by July 1, 2006 have been put into a draft bill. MS. RAGLE replied that a few simple provisions have been put into a bill that has been introduced. COMMISSIONER NORDSTRAND added that Representative

Seaton introduced a bill as a placeholder to have a vehicle that could be used later to make changes via the amendment process.

MR. SEMMENS inquired if there was a cleanup measure that answered the question of whether the payroll attributable to defined contribution plan members is applied to the whole consolidated rate. MS. MILLHORN said there was. MR. SEMMENS asked what would happen if legislation does not pass. MS. MILLHORN said the Division will still have the normal cost rate for the employers and the past service cost together will be the employer rate going forward. She explained that Mercer, the prior actuary, determined how the employers would pay off the unfunded liability. But when the bill was drafted, it was not recognized that when the change was made between the definition of plan and system that caused the Division of Retirement and Benefits to be unable to include the defined contribution payroll along with the defined benefit payroll. So there is a provision on page 5, item #3, that would correct that. It is in the second category for possible action after July 1, 2006 because it would become more essential because of the valuation as of June 30, 2007 that would set the employer rate for 2010. So there will be no impact to employers in the short term, but it needs to be corrected.

COMMISSIONER NORDSTRAND stated that it has to do with what universe of payroll to apply the employer contribution rate to. That will have a consequence on July 1, 2006, when the first defined contribution plan employee shows up. The employer is either charged the 21% rate on that employee or it is not. The consequences are limited because there will be very few employees the first year. He understood it was always the intent of the legislature that it apply to the entire payroll base because there is a closed system and a shrinking number of employees. And the rate at some point to cover the unfunded liability would be so large against the shrinking employee group that it would become completely untenable. At the end of the day, this is simply a methodology for PERS employers to pay what they owe. There is an unfunded liability amount for each of the PERS employers — some are funded at a higher ratio than others, and a few of them are even 100% funded. If an employer chooses to terminate out of PERS and they have an unfunded liability, they will get a bill.

MR. SEMMENS remarked that this item was not in the category to be done right away, although he believed it should be. Also, employers will need an accounting system that can manage more than two PERS employer contribution rates, and that will be a problem for some employers.

Referring to item #4, which would allow a lower contribution rate for employers that are overfunded, MR. SEMMENS questioned the wisdom of "fixing" an overfunding problem. That was where the whole system was a few years ago when contribution rates were lowered — and now the system is $6 billion in the hole.

MR. BROOKS indicated this issue would have to be resolved through the legislative process, but in brief, it may ultimately have to do with the size of the overfunding.

MR. SEMMENS had a brief exchange with MS. CARPENTER about the normal cost rate to the defined benefit plan level, the consolidated rate that is above the normal cost rate, and where variability comes in based on the particulars of each individual employee. She also clarified that item #10 was deleted as not needed.

MR. SEMMENS drew attention to item #12, asking for an explanation of why the PERS board had regulatory authority for the Supplemental Benefits that the ARM Board does not have now.

MS. CARPENTER stated that in drafting SB 141 the regulatory authority for PERS and TRS was given to the Commissioner of Administration, as opposed to the PERS and TRS boards. It was an oversight in drafting SB 141 that regulatory authority for the Supplemental Benefits System (SBS) was given to the ARM Board. The SBS, from the Department of Administration's point of view, is a plan that the department administers just like the other systems, so it seemed logical that the regulatory authority should stay with the department.

MR. SEMMENS asked what regulatory authority the ARM Board does have.

MR. JOHNSON said the word regulatory in this sense means the authority to enact regulations, and does not mean an oversight role.

MR. SEMMENS asked if the PERS and TRS boards had the authority to write regulations for the retirement systems.

MR. BADER said he recalled that the PERS and TRS boards wrote regulations, but they had to be approved by the Commissioner of Administration. It was a joint relationship.

MR. SEMMENS stated that if he were presenting a fix to SB 141 it would be to re-establish the ARM Board's part in adopting regulations, not clarifying that the ARMB does not have regulatory authority.

Referring to item #3 under "Cosmetic Changes," MR. SEMMENS asked about deleting the requirement to distribute individual account balances of less than $1,000. MS. CARPENTER said there is no longer any statutory requirement to automatically refund those balances, but the member may request it.

MS. HARBO inquired about how many appeals are pending for PERS and TRS at the

Office of Administrative Hearings. MS. MILLHORN said she could provide those statistics tomorrow. She added that attorneys at the Department of Law reviewed the appeals and reduced the caseload considerably. MS. HARBO asked if any decisions have defaulted to the appellants because the timeline was not met. MS. MILLHORN said no.

12. Relational Investors LLC.

JAMES HEARTY and SANDI CHRISTIAN made a presentation about the portfolio they have managed for the ARMB since May 2005. *[A copy of Relational Investors slide presentation is on file at the ARMB office.]*

MR. HEARTY briefly gave an overview of Relational. Their investment style is characterized as proactive governance and concentrated in a portfolio of between eight to twelve stocks. The current market value of the account is about $300 million. The return goal is to outperform the S&P 500 Total Return Index, although they do not correlate much with the S&P. Although outperformance has been very good since inception of the product in 1996, Relational has only outperformed the S&P 500 Index 57% of the time. The ARMB portfolio is underperforming the index by 1.85%, but it is early in the game.

MR. HEARTY said he is surprised and pleased that there are as many stocks in Alaska's portfolio as there are, a sign that Relational has made more than the normal number of purchasing decisions this year. The portfolio is also heavily invested as a percentage of the total $400 million allocation to Relational. Lastly, over 75% of the portfolio's value is invested in just four stocks: Prudential Financial, Baxter International, Computer Associates, and Sovereign Bancorp. Prudential has been in Relational's portfolio for three years and has done extremely well for all their clients. The ARMB portfolio caught the tail end of that performance, and Relational believes it can improve a little bit more and is a very good stock for the long run.

MR. HEARTY stated that Baxter, Computer Associates and Sovereign are relatively new initiatives that are doing exactly what the stocks that Relational gets involved with tend to do — not much happens for a year or two while Relational gets engaged with a company and tries to improve performance.

MR. HEARTY next spent some time discussing details of the four largest stocks in the ARMB portfolio, with the greatest focus on Sovereign Bancorp, Inc., a $60 billion bank that has been in the news lately.

Turning to the strategic plan, MR. HEARTY said their portfolio is closed to new clients, and they plan to maintain a concentrated portfolio and active investment style. He noted that four of the firm's senior management are 50-55 years old, and they are working on a transition plan.

MR. O'LEARY asked Mr. Hearty to explain the portfolio structure. MR. HEARTY said the ARM Board has a separate account with Relational. They have amalgamated some of the smaller clients into groups to buy shares of individual partnerships, but larger clients have their own accounts.

RECESS

CHAIR TRIVETTE recessed the meeting for the day at 5:00 p.m.

Friday, February 17, 2006

CHAIR TRIVETTE called the meeting back to order at 9:00 a.m. Trustees Trivette, Pihl, Harbo, Williams, Semmens, Nordstrand, Roses and Corbus were present.

REPORTS (Continued)

13. 2006 Capital Market Assumptions - Callan Associates, Inc.

[Michael O'Leary's slide presentation of the new capital market projections that Callan Associates will use in the ARMB asset/liability modeling is on file at the ARMB office.]

MR. O'LEARY began by explaining how Callan Associates develops its five-year capital market projections. Callan does not purport to have any market timing ability whatsoever. As a consequence, Callan's projections change only modestly from one five-year projection to the next five-year projection. They study historic returns and inter-relationships and use that as the base upon which to build. Callan has a capital markets research group that each year begins the process by developing a recommendation that eventually goes to Callan's client policy review committee. After numerous questions and further research, the committee officially adopts the projections.

MR. O'LEARY explained that a lot of reverse engineering takes place because Callan does not want the analysis to result in wild shifts in asset allocation. There is not much meaningful historic data for many subasset categories. Even TIPS (Treasury inflation protected securities) are comparatively new, the character of the market has changed quite a bit, and they are very complex to measure. Another example is the data on emerging markets is very new, and the character of the data series has changed wildly as the composition of emerging markets has changed.

MR. O'LEARY stated that Callan spends a lot of time trying to determine what inflation will be. Short-term interest rates and inflation over the long term are very close to one another. Generally, short-term interest rates have provided little, if any, real return, although most of the time it is slightly positive. The second thing in building projections is looking at what the investment-grade bond market provides today. The current yield on the investment-grade bond market is a terrific, naive predictor of bond market return over the next five years. Callan always assumes that the mid point of the distribution of stock market returns will exceed the mid point of the distribution of bond market returns. Callan also distinguishes between the expected return for domestic stocks and for international stocks. Over the very long term, one should expect domestic stocks and international stocks to produce essentially the same level of return. Another factor is currency, which over the super long term is probably equal to differentiated inflation rates. However, over meaningful periods — like five years — currency can be an important factor, either as a contributor or a detractor from return to the base currency. The dollar going down is good for return for the U.S.-based investor in international stocks.

MR. O'LEARY explained that after the big asset categories of stocks, bonds, and cash, everything else is a segment. The more granular the segments, the more difficult it is to develop reliable projections. There is a big enough distinction between large capitalization stocks and small cap stocks that it is worth the effort to make that distinction. There is also a uniqueness to real estate. Ultimately, you can either be a lender or an owner — everything else is some derivative of being a lender or an owner. From the perspective of the typical institutional fund, real estate is really equity real estate. You do not observe a lot of volatility in the value of privately held real estate. The NCREIF Index is the best real estate index around, but the return volatility of the NCREIF Index appears to be less than that for investment-grade bonds. Does anybody think that owning a real estate asset is less risky than owning an investment-grade bond? Anybody in Alaska in the 1980s can recall some incredible changes in real estate values. The reason the volatility appears to be so low for real estate is because appraisal values are used to calculate the returns, but properties in the index are not appraised every day. An appraisal is a longer-term assessment of value, so they tend to be much milder in changes of value, even when there have been some big spikes. So Callan arbitrarily creates a volatility estimate and a correlation estimate that lets real estate work in an optimizer without dominating it. The purpose is so clients recognize that equity real estate is illiquid equity that typically has a fairly high income component to return.

MR. O'LEARY stated that real estate is a fairly easy asset class to model compared to little segments of the market like international small cap stocks, emerging market debt, and absolute return strategies. The cautionary note is that when looking at the projections they are not all created equal. The smaller an asset category becomes, the more you have to intellectually not assign great precision to the expected return or the risk. He asked the IAC members for their comments.

DR. JENNINGS said he thought the most important relationship for capital market expectations that Mr. O'Leary just described is the equity risk premium, because opinions on that will drive the decision process the most as the board considers whether it can meet the liabilities. Callan uses about a 4% equity risk premium, which is within the range of what other consulting firms use.

MR. O'BRIEN stated that the asset allocation decision is the most important decision that the board will make. Studies show that 80-90% of the return is based on the asset allocation decision.

DR. MITCHELL said that Callan's is an excellent approach and he agrees with it as far as it goes. He believes that the future will hold more on the private side of investing and less on the public side, and Callan's estimates are based on public market returns. The board heard during yesterday's presentations that while public market managers and public market results all huddle around the average return, private market returns are very diverse, ranging from absurdly high returns to losing all your money — which is hard to factor into capital market assumptions. The second thing is what other asset classes will exist five years from now that we don't know about today.

MR. O'LEARY drew attention to a chart of major market returns over the last six years, which included the bear market of 2001-2002 and the recovery that followed. Over ten years, stocks outperformed bonds by a reasonable margin, and importantly, inflation was comparatively tame.

MR. O'LEARY said the U.S. economy has been very good. Despite inflation being over 3%, core inflation has been around 2%. Callan tends to focus on core inflation rather than broader measures of inflation like the total CPI (Consumer Price Index). Everyone has read about the impending slow-down in consumer spending. Savings rates are low to actually being negative, tax cut effects are basically behind us, interest rates are rising, the housing market seems to be cooling, and higher energy costs are still something that people seem to be adjusting to. In order for the economy to continue to grow, employment growth has to continue, which means business investment has to begin to pick up. Corporate balance sheets are a source for great optimism because corporations are not going to sit on the cash. They will either spend it on improving their productive capability, or they will clean up their balance sheets and further pay down debt, or they will buy back stock, or they will raise dividends — or some combination of all of the above. All the economic data since the hurricanes has been quirky, so Callan had not put a lot of stress on any short-term data.

MR. O'LEARY reviewed the economic forecast on page 10 of the presentation booklet: (1) U.S. and China will continue to be the primary engines of growth; (2) oil prices will slide but gradually; (3) the Federal Reserve may tighten the short-term lending rate to 4.75%; and (4) the U.S. current account deficit is heading to $900 billion in 2006 and the dollar will weaken. As lower interest rates outside the United States rise to close the gap, people will be less inclined to buy U.S.-dollar-denominated instruments.

MR. O'LEARY briefly reviewed the U.S. economic growth by sector. He also discussed consumer spending being funded through the cashing out of increased values in homes, and how housing affordability is starting to deteriorate as interest rates go up.

Turning to inflation risk, MR. O'LEARY said 2-1/2 years ago there was real concern about the possibility of deflation. Now there is beginning to be talk about a significant increase in inflation. Callan is firmly in the middle and has raised its five-year inflation expectation to 2.75% (from 2.60%). The caveats to that projection are scary macro events like something affecting the price of energy, or a financial market blowup, etc. He referred to a graph from Western Asset Management showing inflation history since 1960, noting that inflation has been bouncing around since 2000 and will probably continue for the intermediate future.

DR. JENNINGS stated that even in a low inflation period for the foreseeable future, prices double about every 20 years, even with about 3% inflation. The ARMB is a long horizon investor, so even if there is no expected short-term spike up in inflation, the board needs to be concerned about inflation when structuring the investment program because of the long horizon.

MR. O'LEARY added that if there is a risk of the forecast being wrong, Callan would worry about inflation being higher rather than lower.

MR. SEMMENS asked what action the board should be taking if inflation is a concern. DR. JENNINGS said there are inflation sensitive asset classes, such as TIPS, real estate and commodities, that sort of insure against the surprise on the upside risk.

MR. O'LEARY stated that over the super long term being an owner of anything is an inflation hedge, because if inflation is there the value of that thing in nominal dollars will be greater. In that context, equity is a good inflation hedge. All financial investments stink when there is an unexpected acceleration in inflation, with the possible exception of vehicles like TIPS.

MR. O'LEARY said that historically a portfolio of 60% stocks and 40% bonds could be expected to earn about 8%, but those days have passed, largely because of lower inflation. He next discussed each of the major asset categories, beginning with domestic equities. A graph of the price to earnings (P/E) ratio for the S&P 500 from 1954 to 2005 indicates that stocks do not look overly valued or cheap by that measure. Another graph contrasted the earnings yield on the S&P 500 with the 10-year Treasury yield. That one measure of relative valuation could make the case that stocks are undervalued relative to bonds.

Using a graph of history since 1981, MR. O'LEARY stated that the current yield on the Lehman Aggregate Index is a strong predictor of bond market returns. At the end of 2005 the yield to worst for the Lehman Aggregate Index was slightly over 5%. So based on that, the best guess of bond returns for the next five years would be 5%. That makes sense because the duration (the interest rate sensitivity) for the bond index is about 4-1/2 years. Although the current yield is not a perfect predictor, Callan has consistently used it as a beginning point when developing bond index return estimates.

MR. O'LEARY reviewed the 2006 capital market projections:

- Inflation was increased by 15 basis points, from 2.60% to 2.75%.
- Cash returns were raised to 4%, a level that returns are currently above. The real return would be 1.25% (4% minus 2.75%), which is a high real return for cash.
- Bond returns were set at 5%, up 25 basis points from 2005.
- Domestic equity returns were left unchanged at 9%, a little lower for large cap and a little higher than 9% for small cap.
- Real estate return was held at 7.6%.
- Private equity return was held at 12%, a 33% premium to the public markets.
- International equity return was reduced by five basis points (to reflect what happened to relative returns last year).
- High yield bonds stayed the same as 2005.
- Absolute return stayed the same.

MR. O'LEARY explained that while Callan increased the inflation projection by 15 basis points, they left most of the equity return projections essentially the same. This has lowered the expected real return from equities by about the 15 basis-point increase in inflation. The bond real return has increased. The spread between stocks and bonds, in terms of real return, has narrowed a little bit.

MR. O'LEARY drew attention to a chart of 2006 asset mix alternatives and explained some of the differences. He said if anyone proposes something significantly below mix 1 or significantly above mix 5, they must have some very weird capital market projections. On balance, Callan's projections for the last three years have been higher than the norm, and the results have been better than they expected. Callan is less of an outlier now, but they are still toward the higher end of a range of expectations.

MR. O'LEARY stated that this presentation was to give the board the assumptions, and staff would come back at the next meeting with a recommendation to either maintain the current policy or make specific changes. The ARMB's current asset allocation policy is between mix 3 and mix 4 and essentially on the efficient frontier. He noted that the "other" category includes farmland and energy related investments.

MR. BADER commented that the ARMB currently includes emerging market equity as part of the international equity class for modeling purposes. He asked if there would be any advantage to further delineating the asset classes when modeling.

MR. O'LEARY replied that if staff asked Callan to use a broad measure of international, explicitly including emerging markets, they would use the MSCI All World ex-U.S. Index. The expected return and risk would be a weighted combination of EAFE and the emerging markets, so slightly greater than the EAFE Index. The weighting to emerging markets would be that index's proportion in emerging markets, which is roughly 10%. He added that Callan used the EAFE Index and not the broad index, so the ARMB return would be a tad greater.

MR. SEMMENS asked if Mr. O'Leary could guide the trustees in what to focus their thinking on during the month before the March meeting. He said the actuary thinks the ARMB is going to earn 8.25%, and anything different than that is going to have an impact.

MR. O'LEARY said Callan's projections were developed using an expected inflation number of 2.75%. Most actuaries, when developing their projections of liabilities, are using a higher rate of inflation because they are looking at a much longer period. As a frame of reference, inflation in the post World War II period has exceeded 4% per year. So there is a full percentage point of difference between the long run inflation expectation built into the development of the liabilities and what Callan sees in the capital markets over the next five years. There are not many people who expect 3.75% inflation over the next five years. The financial markets are priced on their expectations, not on the actuary's expectations.

MR. O'LEARY said this is always a challenge. He encouraged trustees to think about what is a reasonable real return target for a well-diversified portfolio. The expected real return from the ARM Board's current policy is in excess of 5%. The actuary is looking for 8.25% less 3.75% inflation, so that should theoretically work. The board could increase the risk of the portfolio, but then the risk of bad things happening is going to increase as well. The actuary will eventually do an asset/liability study, and that will help the board understand the consequences of different policy alternatives. From his perspective, he sees an expected real return that exceeds what is built into the actuarial analysis. Given that this is a shrinking pool of participants, at some point the policy should become more conservative. Maybe the asset/liability study will help define when that should be. Obviously, the more conservative the policy becomes, the lower the expected return is going to be.

MR. O'LEARY commented that the board later will be looking at pension obligation bonds, and a question there is what is the cash flow to the system going to look like. Given the changes in expected contributions, that should be explicitly considered. He said he did not think the board was in a position yet to make those decisions, although it was a super high priority that the board would likely address during calendar 2006.

MR. BADER suggested that at the March meeting Callan provide some tables that take the standard deviation number and measure the likelihood of earning the expected return over a longer period of time than just one year.

MR. O'LEARY explained that the expected return of the current policy mix is 7.89% plus or minus 11.89% - the range of what could happen in one year. Over longer periods the range clusters closer to the median, but there is still a lot of variation in expected return.

COMMISSIONER CORBUS asked what Callan was using as the proxy for volatility for private equity and absolute return. MR. O'LEARY stated that the observed volatility for private equity is very low because of the accounting conventions. For asset allocation modeling purposes, Callan uses 34% standard deviation, so more than twice the volatility of the S&P 500. This is to err on the side of being conservative, particularly when talking about the esoteric asset classes.

MR. O'LEARY said that most of the hedge fund activity at the ARMB and the Alaska Permanent Fund is toward the more conservative end of the spectrum, so that the observed volatility of the funds of funds has actually been the same or lower than the volatility of bonds. But other types of hedge fund strategies have had greater volatility. Callan used 10% as the projected standard deviation for absolute return strategies. Callan believes that if the building blocks of an absolute return strategy are stocks, bonds, etc. and they are using complex strategies and leverage to modify the pattern of returns, then the basic asset class return should define the upper limit for that. Within the absolute return category, there can be more conservative or more aggressive strategies. The 10% volatility number is needed in the optimizer to keep the allocations within reasonable bounds. A lower standard deviation would result in the optimizer selecting 20% of absolute return.

MR. O'LEARY reported that Goldman Sachs is in the process of launching a new alternative strategies product, and the press yesterday reported that it is targeting a 10-12% return with an expected volatility of 10%. On the way in, that is a common expectation, but he believes it is inconsistent with Callan's capital market assumptions. He added that a National Association of College and University Business Offices (NACUBO) study was released recently which reported that it is very common for the major endowments to have close to 50% of their assets in the non-traditional categories. These endowments make extensive use of private equity and absolute return strategies, typically in the form of hedge funds.

DR. MITCHELL mentioned not looking at the volatility measure of asset classes in isolation but along with the correlation numbers, because it is possible to put two volatile — but uncorrelated — assets together to create a portfolio with a lower volatility.

COMMISSIONER CORBUS noted that on page 45 of Callan's presentation, the ARMB's 2006 policy has a total of 23% in what used to be considered non-liquid investments (real estate, private equity, absolute return, high yield, and other).

MR. O'LEARY said Callan limited the absolute return to 5% in the optimizer. He added that the board's policy to have 2% in high yield bonds, which are publicly traded, augments the 24% in domestic fixed income. The ARMB's total of 23% in the categories that Commissioner Corbus listed is not out of line, and much of it has been funded from the bond portfolios.

MR. PIHL questioned if the actuary using an 8.25% expected return was pushing the envelope. MR. O'LEARY said, in today's market, yes. MR. PIHL asked if there should be a confidence factor built into the actuarial assumptions so the outcome was more conservative. MR. O'LEARY replied that if one believes that inflation will be 4% in the long run, then 8.25% is a very reasonable return expectation. The private sector is a lot different than the public sector in the series of numbers that they use. The most frequently used return number in the public sector is still probably 8%, as opposed to 8.25%. There are some systems that are well above 8%, while many are now at 7.75%, but they are the types of systems that are more likely to change that expected return number frequently. In a multi-participant system such as Alaska's, the predictability of the future contribution levels is critical. However, that is a question to put to the actuary. He said that from a financial perspective, when bonds are yielding 5%, it is tough to see a diversified portfolio earning 8.25%.

MR. PIHL inquired if the board can tell the actuary it wants to be more conservative. MR. O'LEARY said the actuary has to develop a consistent set of assumptions. So if the board told the actuary it was uncomfortable with an inflation expectation as high as it is, the actuary would probably be comfortable in reducing the discount rate. However, the board has to keep in mind that the liability is discounted at whatever the discount rate is. So the lower the discount rate, the greater the liability. MR. PIHL remarked that the board probably would not want to do that while things are in the hole.

MR. O'BRIEN related that the State of Colorado's pension fund was 8% fixed income at the height of the market in 2000, and they are now in trouble with the legislature. Their funding ratio went from being overfunded to being about 70% funded.

MR. O'LEARY added that Colorado's pension fund does not include health care and also has a smoothed market value, so it is worse than Alaska's retirement fund.

MR. O'BRIEN said the point about the volatility is that the fixed income component does an enormous amount to mitigate volatility. For a public fund, that is an important aspect of what the board is charged with monitoring.

The Chair called a short break from 10:40 to 10:47 a.m.

14. TCW - Strategic Mortgage Presentation

MR. BADER introduced STEPHEN McDONALD and JEFFREY GUNDLACH of Trust Company of the West, who appeared to make a presentation about TCW's Strategic MBS (mortgage-backed securities) strategy. *[The details of the TCW presentation are included in a booklet, dated February 17, 2006, on file at the ARMB office.]*

MR. GUNDLACH, the chief investment officer, said that TCW manages about $58 billion in U.S. fixed income, and the vast majority of the assets are in mortgage and asset-backed securities. The strategy being presented to the ARMB is Strategic MBS, which was founded in 1991. Over that 15-year time period, TCW's product has been one of the top-five performing, unleveraged fixed income strategies in the world in dollar-denominated assets, and many times has been number one. Relative to most bond strategies, this strategy is largely free of restrictions to manage the maturity structure, the security choices, and the mix of securities, to use the best ideas to develop extraordinarily high risk-adjusted returns in the mortgage markets. The objective is to earn 500 basis points more a year than traditional bond investments over a full market cycle net of fees, and TCW has done that over all five-year rolling time periods.

MR. GUNDLACH said the mortgage-related securities market is very big and has many pockets of inefficiency. The philosophy is that exploiting market inefficiencies is a reliable source of enhanced return. People believe the mortgage market is very complex, and most investors, including most very large bond managers, do not have the resources to analyze the complexity. TCW has about 50 people working in the mortgage and asset-backed securities market. While there are 300 fixed income managers in the manager universe, there are only 10 managers focused on mortgages. Even the median manager in the mortgage area has significant excess return, which reinforces the idea that there are pockets of inefficiencies in the market.

MR. GUNDLACH stated that the volatility of TCW's Strategic MBS is similar to long-term Treasuries, which have about half the volatility of most equity strategies. There is no leverage in this strategy. Investments are focused in CMOs (collateralized mortgage obligations), a subset of the mortgage market that is about one trillion dollars of capitalization. It is the area of most complexity and most inefficiency, which is why it is TCW's field to explore inefficiencies. TCW also invests in CBOs (structured finance), mortgage REITs (real estate investment trusts), and a bit of puts and cash. This is one of the only value-added bond activities that is not just taking credit risk: it is a AAA-rated portfolio.

MR. GUNDLACH reviewed the yield of the portfolio, which historically has averaged about 600 basis points higher than standard mortgage indices — similar to the yield for high yield bonds and emerging markets. He said that while growth has been fairly stable, there are periods of negative returns. The worst outcome in this strategy generally happens when the bond market is on the defensive with the Federal Reserve tightening — an environment that has happened three or four times since inception of this strategy. An example was negative 20% returns in 1994 as a result of market dislocation caused by significant Fed tightening. The next two times of Fed tightening, 1999 and 2000, the market was not so distressed and they had a flat return. The most recent example is the last 18 months, where TCW has had about a 10% return while the Fed tightened interest rates. The good news is that the Fed has already raised rates 350 basis points and is probably getting near the end of that cycle.

MR. GUNDLACH next reviewed a return-versus-volatility chart for the last five years. The TCW Strategic MBS fund has had lower volatility than long-term Treasuries and much lower volatility than the S&P 500 Index.

MR. GUNDLACH said one of the most attractive attributes of the strategy is true diversification. So many ways of trying to enhance returns through alternative investments or higher return bond strategies really involve downgrading and taking default risk. Because TCW does not take that risk, it is a uniquely diversified high return strategy in fixed income.

MR. GUNDLACH reviewed several other aspects: (1) the average performance of different asset classes in rising and declining equity markets; (2) the efficient frontier to show the potentially valuable role of strategic MBS in a balanced portfolio; (3) the historical return and risk with a standard deviation of about 9, similar to longer-term bonds; (4) TCW's record compared to the universe of other managers; and (5) graphs of historical information ratio.

MR. GUNDLACH presented the annualized returns for TCW Strategic MBS since its inception in 1992, noting that their 1.5% return last year was a little behind the bond market's 2.4%. He reminded the board that when the Federal Reserve is tightening aggressively, it is typically a hostile environment for TCW, and they just try to be positive. They tend to do better in a more neutral interest rate environment.

MR. GUNDLACH concluded the formal presentation by briefly reviewing the MBS department organization chart.

MR. O'BRIEN said he found TCW's track record impressive, but he wondered why other investment managers are not diving into this market where the returns are super normal. MR. GUNDLACH replied that it is a combination of the resources that it takes, and the fact that what TCW does is not really an asset class but more of a pure play on manager skill. He said it is hard to prove the manager's skill without having a long record, which presents a high barrier to entry. Even with TCW's combination of organizational stability, track record, risk-adjusted returns, and tremendous tenure of experience, they do not have the world pounding on their door to do this strategy.

MR. O'LEARY surmised that part of the answer to Mr. O'Brien's question is that others use the mortgage strategy as a component in managing a broader bond portfolio but do not market a stand-alone product focused on the area.

MR. O'LEARY recalled that 1994 was a period when many local governmental units got burned badly in mortgage derivatives. He asked Mr. Gundlach to talk about the type of structured instruments that TCW uses.

MR. GUNDLACH said the strategy invests in a wide array of securities, like interest-only strips, that have volatility and periods of very poor returns and periods of very high returns. They invest in all manner of other types of CMOs — some are principal only, something they have been doing in recent years. Some are complex combinations of floating rate and reverse floating rate types of securities. The individual items in the portfolio are esoteric and potentially volatile and risky. It is a question of risk management. It is true that naive approaches and perpetual allocations, indifferent to market valuation and market conditions, have led historically to negative experiences in various line items or subsectors. The real purpose for TCW's management in this area is to provide risk management services to the client.

MR. O'LEARY remarked that this is not something that one could remotely consider doing passively: you have to have confidence that the manager has skill in the area.

MR. O'LEARY asked if the opportunities for complexity have diminished as the market has gotten bigger and the number of players looking for those little exceptional advantages has increased, like hedge funds.

MR. GUNDLACH responded that some opportunities come and go with the interest rate environment and the flows into hedge funds and other things. Other opportunities come about because of new innovations. TCW's activities in the CBO (collateralized bond obligation) market are relatively recent, and that area has been exploding and developing. Other opportunities have been unfolding in the credit side of things, which TCW has not been involved in in recent years. There can be tremendous opportunities in mezzanine credit tranches when there is a weak housing market, and TCW has 37 people dedicated to that type of activity. So while opportunities change, the strategy has a lot of potential given the evolution of mortgage finance and structured finance in the bond market.

MR. O'LEARY said he was struck by TCW's growth in assets in the last three or four years. He asked what level of assets TCW could manage and still be effective in adding value.

MR. GUNDLACH stated that TCW was slow to start growing this product. They add a couple of clients a year and turn down investors that do not appear to be committed to a long-term program, because the strategy can have volatility and anxious moments. TCW recognizes that the strategy has limited capacity, but they expect they could manage $2.5 to $3 billion. There is $1.5 billion today, but they are more interested in growing slowly and maintaining their credibility and track record.

MR. O'LEARY asked if people raise the issue of how the investments are priced. MR. GUNDLACH said there are two solutions, and TCW offers both. They can have the whole thing priced by a third-party, and many of their clients do that. The problem is the third party can be off by a few percent on a snapshot basis, but TCW is willing to live with that. The other alternative is for TCW to be involved in the process, and that has the obvious conflict-of-interest connotations.

DR. MITCHELL asked what percentage of their total fixed income the Strategic MBS comprises for those clients who use it. MR. GUNDLACH said one use is as a fixed income allocation, and in those cases it is never more than 20% and usually around 10%. Ten percent seems to be a prudent idea because the extra volatility does not really show up very much, yet the allocation adds meaningfully to risk-adjusted returns. The second use is as an alternative allocation, and about one-third of their clients use it that way, particularly in the college endowment area.

When MR. O'LEARY inquired about the size of the largest single account, MR. GUNDLACH said it was $180 million.

Noting that there have been high flying products out there that eventually hit the skids, MR. PIHL asked for further comment about the risk in the mortgage strategy.

MR. GUNDLACH stated that the biggest risk imbedded in this strategy is you can invest in servicing rights and get a good fee for servicing mortgages. But mortgages are refinancable, in most cases for no penalty and very low cost. So if you buy servicing rights (which are also packaged as interest-only strip securities in the CMO market) and pay a lot for them thinking they will be around for a very long time, and everyone refinances the next day, you have basically lost all your money. It is like a default with no recovery. So TCW has very high hurdles of what they require from those securities, and they generally only buy them when they have already factored a fast refinancing condition into the price.

Staff Recommendation to Board:

MR. BADER referred to page 19 of TCW's presentation booklet and said the lack of correlation of the Strategic MBS strategy with the equity markets was what attracted he and Bob Mitchell to this type of investment. This, while it still is able to earn a return that is in line with the actuary's and the ARM Board's expectations. He had mentioned this investment strategy to the prior board and also brought it forward to this board as part of future planning.

MR. BADER said he discussed with the Investment Advisory Council members and Mr. O'Leary that because of the characteristics of return for the strategic mortgage strategy a typical manager search does not seem like the best way to assess whether this is an appropriate investment. So staff is suggesting that the board assign Callan Associates the responsibility to review the TCW Strategic MBS strategy and report back to the board at the next meeting whether it is a suitable investment for the ARMB.

MR. SEMMENS <u>moved that the ARM Board contract with Callan & Associates to evaluate TCW's Strategic MBS strategy and present its findings at the March board meeting</u>.
MR. ROSES <u>seconded</u>.

MR. SEMMENS asked how the board would decide the amount of money to allocate to a mortgage strategy. MR. BADER replied that if Callan returns with a favorable review of this product that staff has in mind something in the area of $100 million as part of the fixed income allocation. If the volatility dictates that the investment should be less, then staff's recommendation would reflect that.

MR. PIHL asked if Callan's study would also review other managers and include a look at the up side and the down side of mortgage strategies. He had in mind Columbia Management in Portland, which at one time was touted as a stellar firm.

MR. O'LEARY said Callan's research specialists would look at all the aspects, including other managers that offer similar products, even those firms that have disappeared.

The roll was called, and the motion passed unanimously, 8-0.

15. Japan: Proactive Governance - SPARX Securities USA, LLC

SHOICHI MIYASAKA, MIKIO SHIMIZU, and YOKO MATSUOKA appeared before the board to talk about their activist approach to investing in Japanese companies. *[The SPARX Securities presentation took approximately 45 minutes, and details are included* *in their booklet on file at the ARMB office.]*

MS. MATSUOKA described the Japan Value Creation Strategy's beginning as a joint venture with CalPERS and Relational Investors in 2003. The strategy has about $1.5 billion under management. SPARX's approach is pure bottom-up based on disciplined research of over 3,000 public companies by 33 investment professionals in Japan.

MS. MATSUOKA said SPARX has been grateful to witness the acceleration of structural changes in Japanese companies over the last 15 years of a sluggish economy in Japan. Many companies have made the shift from a traditional bureaucratic model, where Japanese banks had governing power over corporations, to a modern market-driven model.

MR. MIYASAKA, executive officer and head of the value creation investment strategy team in Tokyo, described how the old model was based on a business relationship where the crossholders, which owned about 50% of companies, did not require a profit. Currently, about 90% of Japanese public companies are owned by investors that require a return on their investment. Companies know they have to deal with the new stakeholders, and since they have never done this until recently, they are very interested in what SPARX has to say.

MR. MIYASAKA related how SPARX held a huge investors conference three years ago and invited CalPERS and Relational to speak about the activist strategy. Surprisingly, a large number of company senior managers attended the conference to listen, although it was intended for investors. He stressed that SPARX is known for its non-hostile approach to activism and has established a good performance track record.

MR. MIYASAKA described how the return on equity is improving because the fundamentals of the companies are improving, but at about 10% it is still too low by global standards. He related how companies have never had to pay attention to how they manage their balance sheet, and this is one of SPARX's main focuses when they talk with company managements. The educational process for how to maximize the shareholders' value is very important to the SPARX proactive process. He reviewed what they tell Japanese companies about how they should allocate their increasing free cash flow: one is to return the excess cash in dividends, and the other is to reinvest the money in capital expenditures.

MR. MIYASAKA explained that CalPERS owns 20% of the Japan Value Creation Strategy, Relational Investors owns a 10% stake, and 70% is owned by SPARX. He said SPARX can learn a lot from the experience of Relational and CalPERS in the United States. The Japanese corporate governance improvement unfortunately is far behind what the U.S. has experienced.

MR. MIYASAKA reviewed the performance of the Japan Value Creation Strategy over the past three years. It is a concentrated strategy that has invested in 13 companies so far and has exited from four of those. That leaves a portfolio of about $1.5 billion invested in nine companies.

MR. O'LEARY noted that a dollar invested in the strategy at inception three years ago is now worth $1.45 in U.S. dollar terms. The Japanese public market was up about 31% for the same period, mainly because of the significant shift away from the old business model.

MR. MIYASAKA explained that a hostile activist approach to Japanese public companies is difficult. But SPARX has been focusing on Japanese equity investments for the past 17 years and has developed good access to managements, so they do not have to be hostile to get things done. They do not make an investment decision without letting the company senior management know ahead of time what they should do and giving them the opportunity to welcome SPARX as a partner to change the company and maximize shareholder value. SPARX is one of the top ten shareholders in the nine companies in the portfolio. They are prepared in case management changes it attitude or suddenly stops the communication effort with SPARX. They have retained lawyers and a top management consultant for that possibility, but they have not had to use them over the past three years and merely keep them updated on the progress.

MR. MIYASAKA reviewed the stock selection criteria, saying that the SPARX portfolio is considered a mid to large cap strategy in Japan, with an average market capitalization of $3.5 billion. He said most activist managers are focusing on small cap companies, but SPARX focuses on the mid to large cap segment of the market and seldom encounters any competition in that space. It typically takes three to six months to make an investment decision, after they have identified several companies as potential targets. SPARX limits itself to being a minority shareholder to control risk in the portfolio, with positions ranging from 2% to 19%. They need a catalyst to adjust the value gap, but they want to be that catalyst by providing their stewardship to a company's management to change the way they manage the company to unlock the hidden value.

COMMISSIONER CORBUS asked how SPARX is received when they call on the managements of the companies. MR. MIYASAKA said one of SPARX's strengths is that they are already known in Japan because they have been doing company research for the past 17 years. Even though they make known their objective to maximize shareholder value through proactive involvement, they never encounter resistance from management, and in fact, managements have shown eagerness to learn what they should do.

MR. O'LEARY stated that one of the challenges for U.S. investors is to understand what is the norm in other markets. He said SPARX has affiliations with brokers and other entities, and he asked if SPARX typically uses the services of those entities for management of the portfolio.

MR. MIYASAKA said SPARX is a totally independent asset management company. MS. MATSUOKA explained that SPARX Securities operates in Japan and in the U.S., but those brokerage firms are solely for the distribution of SPARX Asset Management products and do not trade Japanese equities for the Japan Value Creation Strategy.

MR. O'LEARY made the observation that 33 investment professionals did not seem like very many to research 3,000 companies. MR. MIYASAKA replied that visitors to their offices would never see all 33 research professionals in a day. They are out visiting four to five companies a day, and they conduct their research very efficiently.

In response to MR. O'LEARY's question about research, MR. MIYASAKA explained the SPARX research structure further and how it serves other products up to a point.

DR. JENNINGS inquired about fees. MS. MATSUOKA said the management fee is 2% and the performance incentive fee is 20%.

DR. MITCHELL asked for a stock in the current portfolio that was an example of the type of company SPARX would buy. MR. MIYASAKA described a bicycle parts company that also makes fishing tackle and how, after three years, the company has bought back close to 30% of the outstanding shares.

The Chair called a recess for lunch at 12:16 p.m. and reconvened the meeting at 1:30 p.m.

REPORTS (Continued)

16. Implementation Update

MELANIE MILLHORN referenced a February 7, 2006 letter to Representative Bruce Weyhrauch from Judge Terry Thurbon responding to some questions raised at a February 3rd House Ways & Means Committee meeting. Trustee Semmens presented the unfunded liability report at that meeting, and Gary Bader also attended. She said the letter answers the questions that Trustee Harbo raised yesterday about the status of pending appeals at the Office of Administrative Hearings. *[The letter from Judge Thurbon is on file at the ARMB office.]*

MR. PIHL drew attention to a sentence in the first paragraph of the letter: "The committee seemed to be working from somewhat inaccurate case data, perhaps taken from the preliminary report of the ARM Board."

MS. MILLHORN explained that the Division of Retirement and Benefits prepared some information that was incorporated into the unfunded liability report from the ARM Board, however, this preliminary information was not detailed. Judge Thurbon prepared the letter based on the most recent status of the appeals that are pending before the Office of Administrative Hearings.

MR. PIHL commented that the letter implies that somewhat inaccurate case data came from the ARM Board.

MS. MILLHORN and MS. CARPENTER reviewed the following items:

- PERS/TRS defined contribution plan employee handbook - final draft under review at the Department of Law and will be finalized by March 1.
- Medical plan document - staff is working with Buck Consultants and Deloitte on several issues, including indexing the deductible, and DC plan employees paying a percentage of prescription drug cost with a cap.
- Employer conversion election - there is a web page where employers can find out how many nonvested employees they have and the impact if they were to allow the employees to convert to the defined contribution plan.
- Employee choice kit is almost ready.
- RFP issued for recordkeeping, financial advice and educational services for the defined contribution plan. An evaluation committee has been selected to look at the responses.

MR. SEMMENS initiated a discussion about why a new recordkeeper was necessary and where the money would come from to pay for these services. MS. MILLHORN explained the need for a contractor with expertise in a core defined contribution plan.

COMMISSIONER NORDSTRAND said the RFP includes the existing plans as well so that by January 2007 there will be combined, uniform web-based access to all the plans where participants can get a collective picture of all their investments. There may also be an opportunity to reduce the fee structure for participants by having a uniform recordkeeping system for all the plans. He said there are some general funds available for this project. Besides having the contractor's people actually in Alaska to give seminars and advice, the state may be able to use the extra advice and education component that will be necessary for the defined contribution plan to help the 20,000 people in SBS get more financial advice and planning assistance.

MS. MILLHORN and MS. CARPENTER continued reviewing items for implementing SB 141:

- Combined retirement system upgrades for employers to enter payroll data. Phase I of a new project will be an electronic web-based reporting system. Phase II will be a more interactive product that will check for problems at the time the payroll data is entered.
- Notification to participants affected by the change to refunded indebtedness.
- Employer's Edge - monthly newsletter outreach to employers.
- Training sessions on benefits and e-reporting for employers in Anchorage, Juneau and Fairbanks. A web seminar will also be available, as well as videotapes of the training sessions.
- Plan qualification for people who are not vested - Deloitte requested to do that part.
- John Gaguine is working on a major regulation package for the existing PERS and TRS statutes and the new defined contribution plan. Staff will make a presentation on that package at the next board meeting.
- SB 141 information available on a web site, as well as news about various initiatives underway.
- Marketing section has been developing information for employers.

MR. ROSES said that when the board first met it discussed its responsibilities. One thing was that the board was supposed to be managing the assets and the liabilities. He considers a health plan as part of the liabilities, but he did not recall any board discussion about the health plan for the employees in the new defined contribution plan. He said he was feeling left out of the planning and asked if someone could clarify the board's role.

MS. MILLHORN replied that when the defined contribution plan was first developed Mercer conducted an analysis and looked at key areas for the new medical plan: the deductible, prescription drug costs, coordination with Medicare, and the out-of-pocket amount. Mercer's November 2004 report is on the Division of Retirement and Benefits web page. That was the core plan that was used for the defined contribution medical plan that the legislature adopted. The cost associated with that plan was approximately 1.75%, which is in SB 141. The ARM Board is charged with looking at the cost and medical trends on an annual basis. Medical is recognized as a very high cost area, and it is the only portion of the defined contribution plan that is a defined benefit. There is some volatility associated with it, and that is where the parties that worked on the report to the legislature wanted to explore the option of indexing the deductible. When Mercer designed that medical plan, the deductible dollar amount was $250, the family deductible was $750, and the out-of-pocket was $2,000.

MR. ROSES said he was not asking about the particulars, but he wanted to know at what point in time the ARM Board would be involved in the medical plan — only when it comes to the volatility part of it? Only beyond a certain date but nothing in the imminent future?

MS. MILLHORN replied that the Division will be looking at those other areas and will be bringing that information to the ARM Board.

MR. SEMMENS said that it sounds like the legislature was considering a sample medical plan when it adopted SB 141, but that the plan is not cast in concrete at this point. He said the board is interested in whether it has any responsibility in finalizing that medical plan. Or the question could be, does this fall under the auspices of administering the plan.

MS. MILLHORN stated that because some of the details were not initially identified, there is additional work to do, and she believes that it comes back to the ARMB.

MR. SEMMENS asked if the legislature has to be involved in actually identifying the medical plan. MS. MILLHORN said no.

COMMISSIONER NORDSTRAND stated that he understood that in a general sense the plan administrator, who is the Commissioner of Administration, establishes what the benefits are and can change the benefits within the plan. There are limits constitutionally on what can be changed in vested interests in existing retirement plans, even health provisions. The plan administrator would consult with the ARM Board about the benefits in recognition of establishing liabilities. But he did not think that the ARMB actually establishes and "approves" plan provisions for the health plan. He said the board could research it further with legal counsel to see what the statute says.

MR. JOHNSON said there is no question that the statute refers to the administrator administering the plan, and there are the new provisions in SB 141 that talk about the role of the ARMB in investing and managing the assets. Somewhere in there is regrettably probably not a perfect, bright line on exactly how involved the board gets versus what is meant by specifically the administration. Under the statutes as they exist right now, it is a work in progress that needs to identify as best as possible the roles of the board and the administration.

MR. SEMMENS said he would like to get a clear, bright line and an understanding of who is ultimately responsible and who has the authority for these matters related to the pension system. He suggested that the board request that staff work out a document that clarifies responsibilities and authority.

MR. ROSES said he understood that the board cannot be involved in all the day-to-day decisions, and he appreciated all the time and effort that staff puts forth. He said the fiduciary responsibility session at the Callan conference scared him, and ever since then when he picks up a document that involves the ARMB he becomes even more concerned than he was before. He sees all these decisions being made over which the board is supposed to have some fiduciary responsibility, according to the information at the Callan conference, yet the board has very little decision-making or oversight on what is done. At this point, he said he is feeling that the only time he serves a position on the ARMB is when somebody wants to use him for a scapegoat — and that is not a feeling he is comfortable with. He agreed with Trustee Semmens that he, too, would like clearer delineation as to the role and expectations of the board. He said he has no problem living up to the expectations of him as a trustee if he knows what they are.

CHAIR TRIVETTE agreed that not knowing exactly what the board's authority is puts trustees in a difficult spot. He asked staff for any ideas.

MR. BADER stated that the Department of Revenue is not the best resource to divine the intent of the legislature. But if the board had specific questions to submit to staff, he would compile those and submit a request to the Attorney General's Office for guidance because it is their responsibility to interpret the statutes on behalf of the board. Some of the questions may require a review of the record as SB 141 went through the legislative process.

CHAIR TRIVETTE requested that trustees submit their questions to staff to forward to the Department of Law. *[Mr. Bader later sought and received clarification that questions would be submitted to him by February 28 so there would be time to get responses back from the AG's office by the March 23-24 meeting.]*

MR. SEMMENS thanked the Division of Retirement and Benefit staff for the details of the SB 141 implementation plan and all their hard work.

Return to SPARX Proactive Governance Approach

MR. ROSES stated that he would like more information about the Japan active management approach that the SPARX people presented.

MR. ROSES <u>moved that the ARMB direct the portfolio management staff at the Treasury Division, in conjunction with the Investment Advisory Council, to explore the options for an investment strategy similar to what SPARX presented</u>. MS. HARBO <u>seconded</u>.

MR. BADER suggested that Callan Associates be included in that direction. The first and second on the motion agreed.

When queried by the Chair, MR. ROSES said a report at the next meeting or as soon as possible would be fine.

The motion passed without objection, 8-0.

[Commissioner Corbus was excused at 2:08 p.m.]

17. Second Actuary RFP - Update and Selection

CHAIR TRIVETTE read the following statement: "Upon notice of intent to award a contract, statutory provisions governing state procurement prohibit the discussion of proposals in public. The proposal evaluation committee must make this recommendation to the Alaska Retirement Management Board in executive session."

MR. ROSES moved that the ARMB go into executive session for the purpose of discussing responses to a request for proposal, as the chair just described, because the discussion involves the finances of the retirement system and could possibly deal with the reputations of the firms involved.

The motion passed without objection, 7-0.

The board went into executive session at 2:15 p.m. and reconvened in regular session at 2:38 p.m.

MR. SEMMENS stated that the board considered one or more responses to an RFP for actuarial services.

MR. SEMMENS moved that the ARM Board direct the staff to issue the notice of intent to award. MS. HARBO seconded.

Roll call vote
Ayes: Harbo, Nordstrand, Pihl, Roses, Semmens, Williams, Trivette
Nays: None

The motion passed unanimously, 7-0.

18. LaSalle Investment Management - Medical Office Investment

MR. BADER stated that the board currently has a relationship with LaSalle to run a core real estate investment portfolio. Part of their mandate allows investment in medical office complexes. Staff became aware of a fund that LaSalle is offering that might fit the needs of the ARMB and be consistent with the mandate that already exists, except for its form of governance. With that in mind, staff invited LaSalle representatives to speak to the board about this type of real estate investment.

[The LaSalle people provided a booklet containing their slide presentation and other details of the LaSalle Medical Office Fund II, which is on file at the ARMB office.]

STEVEN BOLEN, president of the LaSalle Medical Office Fund II, and MATTHEW WALLEY of client services made a presentation on the benefits of investing in the medical office sector.

MR. BOLEN stated that LaSalle Medical Office Fund II is being created to acquire on-campus medical office buildings, or near a hospital campus, and in some cases in off-campus locations. The portfolio, at the end of the investment period, will be broadly diversified in multiple U.S. cities.

MR. BOLEN said the booklet provides details on why the ARMB should be considering this investment, but he wanted to focus on a few of the main reasons. He said the opportunity in medical office investing centers around very favorable supply/demand fundamentals. He reviewed statistics showing the growing number of patient visits to office-based physicians as people get older, and how the greatest population growth is in the 55+ age group. Another factor is the rapid advances in medical technology that make it possible for health care providers to deliver health care services outside of the hospital setting.

MR. BOLEN said the supply factor is that there is a more disciplined introduction of new medical office buildings in the marketplace compared to regular office buildings. The primary reason is that the tenant spaces in medical office buildings are typically small, and it is harder to aggregate enough tenants together to meet the minimum preleasing requirements to obtain a loan. The decision to build most medical office space on or near a hospital campus often comes from a hospital administrator who is looking to accommodate new doctors. Finally, medical professionals are a loyal tenant base with high lease renewals. A couple of reasons are the referral relationships with other colleagues in the building and the risk of confusing patients by moving to another location. This is important because replacing a tenant is the single biggest cost of managing a property. So medical office building tenants generate stable and predictable income streams for the owners.

MR. BOLEN stated that LaSalle sees an opportunity to aggregate a large portfolio of small office buildings that can be offered to a large conventional investor in office properties for a premium in about five to ten years. The medical office sector is stable and does not operate in lock-step with conventional real estate cycles or economic cycles.

MR. BADER asked for a brief explanation of the fund structure and exit strategy.

MR. BOLEN said the fund is structured as a private real estate investment trust (REIT). LaSalle is raising $300 million of gross equity that will be leveraged 65%. They will acquire medical office buildings, and up to 25% of the fund can be used for development activities. There are many more investors interested in medical office properties now, and LaSalle sees the opportunity to fetch a portfolio premium in the future. The REIT has a nine-year investment period, with the ability to extend the life of the fund for two two-year terms, with advisory board approval. The advisory board consists of a majority of shareholders, and the ARMB may be interested in taking a seat on that board.

MR. BROOKS remarked that the growth of medical costs dominates the board's liability discussions, and this investment in medical office buildings is an opportunity for the ARM Board to make some money on the other side of the equation.

MR. PIHL said he thought doctors were interested in owning their own buildings. MR. BOLEN replied that some physicians really believe that ownership of their space is the way to go regardless of where interest rates are. He added that another school of thought is that physicians want flexibility to grow their practices and expand their space over time, and that is easier to do in a rental model. He has purchased buildings from physician syndicates.

Staff Recommendation to Board and Real Estate Consultant Input

JEANNINE BALSAMO of the Townsend Group and STEVE SIKES, a staff investment officer in the real estate section of portfolio management, appeared before the board to discuss the LaSalle medical office fund proposal.

[Ms. Balsamo provided a detailed written report to the board, and staff handed out a one-page staff summary and recommendation, both of which are on file at the ARMB office.]

MS. BALSAMO stated that when Townsend looks at investments for recommendation, they look at a number of factors: the strategy, the manager's ability to execute the strategy, and the fit within the ARM Board's portfolio. Townsend agrees with LaSalle that the demographics for medical office are very compelling in terms of the aging population and the use of this type of building. LaSalle is also the manager that has been doing this type of strategy the longest in the industry, although the strategy has not been around a long time.

MS. BALSAMO said that as far as the fit for Alaska, this type of product is lower risk and offers stable income - what an institutional investor typically likes in a portfolio. About a year and a half ago Townsend had done a search for some higher-returning type investments, and those had quite a bit of office properties. The ARM Board was trying to gain from the recovery in the office market and get a spike in return. The medical office fund does not do that, but it will help stabilize the risk in the office portfolio.

MS. BALSAMO addressed how an investment in medical office will fit in the board's annual real estate plan for 2006. LaSalle is an existing manager, and typically the board has preferred to have fewer managers to keep track of than more. This fund will be the exclusive vehicle for LaSalle to invest in medical office. That means that they will not be able to do that for the separate account, whereas last year in the annual plan one of the property types that the board approved LaSalle to invest in was medical office properties. So it will be a different vehicle than the separate account, but the board is still gaining access to the property type and more of the properties. If the ARMB were to have done medical office in the separate account at a $30 million investment, that would have been one property. Now the board will gain access to many properties diversified across the country through the fund vehicle. The down side is that the ARMB does not have the control to sell: the board is in it for the life of the fund and then it is done.

MS. BALSAMO said Townsend concurs with staff's recommendation to invest $30 million in this fund vehicle, subject to legal review because LaSalle's fund documents have just been released.

MR. PIHL inquired about the fee structure. MS. BALSAMO replied that day one the ARMB pays 1.5% on the full committed capital through the investment period. That is something that she wants to talk to the manager about. Then there is a 20% incentive fee above a hurdle of 9% internal rate of return. While fee structures all differ and can be very complicated, LaSalle's fee structure is in line with where an enhanced fund fee structure would be.

DR. MITCHELL asked Ms. Balsamo to discuss the sources of the target total net return and how secure those sources are, because some return will come from leverage, some from development, etc.

MS. BALSAMO stated that LaSalle's fund is a leveraged core investment, and leverage is contributing quite a bit to the return. Medical office has recently come more into favor in the investment universe, so as a property type there is a debate whether it should be core or enhanced. There has been a lot of capital that is targeted to this property type right now. The risk is that if cap rates were to drop more than they have been, LaSalle would be buying at higher pricing. If cap rates do not rise for LaSalle to sell into that, then they could be at risk of not hitting their net return target.

DR. MITCHELL asked how much of the net return target the rental income would be. MS. BALSAMO said 6-7%.

MR. O'BRIEN observed that with such high leverage on a $300 million pool of capital LaSalle will have $900 million to deploy. He wondered if that was reasonable to expect.

MS. BALSAMO said one of Townsend's concerns with this fund is the amount of properties LaSalle will have to invest in, based on what LaSalle has done in the past and the amount of capital that Townsend knows is targeting to this property type. That is one of the reasons that the investment management fee based on committed capital is a concern. LaSalle has the relationships and has been able to buy three large portfolios in the last two years, but it is a concern whether they are going to be able to find adequate deal flow for this fund. They certainly cannot do it by buying buildings one at a time; it is too many buildings to acquire.

MS. BALSAMO made it clear that when Townsend writes its recommendations and does fund reviews, the ability to deploy capital always seems to be a concern. There are so many managers targeting certain real estate property types that concern about a manager's ability to find the deals is a common theme. What to look for are the managers that the ARM Board believes have the relationships and the ability to deploy capital. So far, LaSalle has demonstrated that ability.

MR. SIKES drew attention to staff's memorandum that was handed out and asked for the board's authorization to move forward on this real estate investment.

COMMISSIONER NORDSTRAND <u>moved that the Alaska Retirement Management Board authorize staff to invest up to $30 million in Medical Office Fund II, subject to staff and legal counsel satisfaction with the final legal documents</u>.
MR. WILLIAMS <u>seconded</u>.

<u>Roll call vote</u>
Ayes: Williams, Semmens, Roses, Pihl, Nordstrand, Harbo, Trivette
Nays: None

The motion passed unanimously, 7-0.

The Chair called a scheduled break from 3:15 to 3:30 p.m.

19. Adoption of Investment Policies:

MR. BADER reported that at its first board meeting the ARMB accepted all the investment policies of the Alaska State Pension Investment Board, with the understanding that staff would bring the individual policies to the board on a systematic basis for approval.

A. Absolute Return Guidelines - Resolution 2006-08

MR. BADER stated that the policy is unchanged from what was adopted previously. He offered to answer any questions about the investment policy guidelines.

MR. ROSES moved that the ARM Board adopt Resolution 2006-08, establishing absolute return investment guidelines.
MR. SEMMENS seconded.

When queried by the Chair, Mr. O'Leary and the IAC members indicated they were comfortable with the absolute return policy guidelines adopted by the previous board and had no objections to this reaffirmation.

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

B. Fixed Income High Yield Guidelines - Resolution 2006-09

MR. BADER said this policy was also unchanged from when the previous board adopted the guidelines, followed by the ARM Board's adoption at its first meeting in October 2005.

The IAC members and Mr. O'Leary all said they had no comments.

MS. HARBO moved that the ARM Board adopt Resolution 2006-09, establishing high yield fixed income investment guidelines.
MR. ROSES seconded.

The roll was called, and the motion passed unanimously, 7-0.

20. Pension Obligation Bonds - Resolution 2006-10

MR. BADER reported that at the January meeting the board heard presentations on pension obligation bonds from four different perspectives. After the presentations, the board asked questions of the presenters. Some members of the legislature have indicated a desire to know if the ARMB supports pension obligation bonds. Staff drafted a resolution for the board to consider and vote upon. He said, for the record, that the Department of Revenue does not favor using pension obligation bonds to address retirement funding issues, however, some legislators do.

MR. SEMMENS moved that the Alaska Retirement Management Board approve Resolution 2006-10, related to pension obligation bonds.
CHAIR TRIVETTE seconded.

MR. SEMMENS stated that the resolution merely says that the ARM Board is in favor of employers, particularly municipal employers, having all tools available to them to fund their pension obligations. The resolution does not push pension obligation bonds on any employer or issuer.

MR. SEMMENS said the resolution lays out some of the risks and other considerations that employers would have to understand before issuing pension obligation bonds. The bonds have been successful in other areas. He noted that the board heard a presentation in January from Jeff Sinz, the chief fiscal officer for the Municipality of Anchorage, who said he did not know if Anchorage would issue pension obligation bonds or not, but he wanted the ability to do it.

MR. SEMMENS stated that if the ARM Board is not willing to say, with respect to political subdivisions of the State of Alaska, that POBs constitute a concept worthy of fair and further consideration, then the board is saying to municipalities that they have very limited tools they should be able to use. Without the resolution, the board's message will be that the tool available is for the state to raise the employer contribution rates until they are 30% of payroll. He thought that was a poor message to send to municipalities. The correct message would be that the board recognizes that its fiduciary responsibility is to get assets into the retirement system to be invested. And it is up to the individual employer member to determine what is best for them to come up with those assets.

MR. SEMMENS said that the fact that the state's bond rating might be impacted if municipalities issue pension obligation bonds should not be the board's concern. The fact that the Municipality of Anchorage's bond rating would be impacted by them issuing pension obligation bonds is not the board's concern. Anchorage will have to assess that. If the State of Alaska does not think that POBs are good for the state, he said he has an idea that the legislative process will make it very difficult for pension obligation bonds to be issued. But for the board to say that POBs are not a good option is the wrong message to send. He said he supported adopting the resolution.

MS. HARBO indicated she would vote for the resolution because of the word "may" and because POBs are a tool, although only available to the large municipalities and cities. She said she did not know what tools small communities would have. The opinion she expressed at the January meeting still holds true: it is like borrowing on your home to pay off your credit card — it is still a debt.

MR. WILLIAMS asked if the Treasury Division envisioned that issuance of POBs by municipal entities would adversely affect the state's credit rating.

MR. BOUTIN related that the Department of Revenue has been told by the sponsor of HB 278 that the bill would not be pursued this session. That bill would have allowed municipalities to take their unfunded pension liability and turn it into state moral obligation debt. Department of Revenue opposes the use of POBs to pay for unfunded pension liability. The state's moral obligation debt capacity is limited, and the Department believes that a few larger municipalities would use up the capacity. Using the state's moral obligation pledge in that way would negatively impact the state's credit ratings.

MR. BOUTIN said that if the board approves the resolution he hoped it would not be used by investment bankers and their lobbyists to say that the ARM Board supports pension obligation bonds. He said to his knowledge this board is the only entity in Alaska that has had a presentation on pension obligation bonds done by anyone other than investment bankers. Investment bankers get a payday the day the bonds close, and then they walk away. The cost of pension obligation bonds is 200 basis points right off the top on the date of closing.

MR. SEMMENS reiterated that this board's interest is different than the interest of the Department of Revenue in this case. By state law, the board's interest is to match the assets with the liabilities — in this case, to get $5.7 billion more into the retirement system.

MS. HARBO asked who would pay the debt if a municipality defaulted on its pension obligation bonds.

MR. BOUTIN said that under HB 278, as the Department of Revenue, its advisors and bond counsel understood it, a municipality would be pledging the state's moral obligation, so the state would pay. There may be other scenarios that would not use the state's credit and where the responsibility to pay would fall on the taxpayers of a particular municipality.

COMMISSIONER NORDSTRAND stated that he did not support Resolution 2006-10. He drew attention to the last whereas clause that uses the language "..., POBs may offer an appropriate mechanism..." One could easily add a friendly amendment in the preamble that POBs may or may not offer an appropriate mechanism. Frankly, there is a debate going on in the document. His interest as a member of the board is to insure that the pension systems are fully funded. The use of POBs may make the problem worse, not better — it's a 50/50 proposition, given the arguments being made. In the absence of more information, his interest is to not make a bad problem worse. The board is charged with coming up with suggestions to the legislature on how to deal with the unfunded liability, and he is a uncomfortable with taking one potential suggestion and pushing that out in front first without dealing with the other options.

MR. ROSES asked how quickly a municipality could issue POBs if this option was made available to employers.

MR. SEMMENS replied that the analysis would be time-consuming to find out if a municipality could even issue pension obligation debt.

MR. ROSES said he did not want the board to limit the tools that any municipality might be able to use to cover their pension debt. But just as important, he was not sure this was the right time to put municipalities in a position where they have to decide whether to use the POB funding tool or not. There is different legislation pending, including a discussion about whether the state is going to infuse any money into the system to help fix the underfunding problem. Also, the board is waiting for an actuarial report to say whether the unfunded liability is $5.7 billion or something higher or lower than that. He said he did not want to vote against the resolution, but he did not think now was the time to move it forward either. He said he was going to make a motion to postpone any action on the resolution until June.

MR. PIHL stated that he had mixed feelings. He has wrestled with question of why the retirement system is where it is now and has concluded that the State of Alaska has substantial responsibility. He said he feels the state has an attitude of "wait and see," and he is frustrated. The board ought to be looking at ways to find funding. There is a long list that everyone has talked about, so the board should polish that list and rate it. He said he was waiting for leadership from the state to look at the funding options and was sorry the resolution was pushed on the board so soon. He said he agreed with the suggestion to defer action on this item.

MR. ROSES moved that the ARM Board postpone the pension obligation bond discussion until the June meeting. MS. HARBO seconded.

In support of the motion, MR. ROSES referenced his earlier comments. He said he agreed with Trustee Pihl about exploring some of the other funding options. Also, the board needs to wait until it gets the actuarial report and until after the legislative session is over.

MS. HARBO expressed her support for waiting until the board has heard from the first actuary and maybe the second actuary, so everyone has a good handle on what the liability really is.

MR. PIHL commented that of the $3.4 billion unfunded liability in the public sector, the State of Alaska is two of the employers. He said he would like to hear what the state's plans are and what the state might provide as incentives for other employers around the state to do their part. The State of Alaska, through the actuarial process and setting employer contribution rates, has a significant responsibility for why the retirement system is where it is.

<u>Roll call vote</u>
Ayes: Harbo, Nordstrand, Pihl, Roses, Williams, Trivette
Nays: Semmens

The motion to table passed on a 6-1 vote.

UNFINISHED BUSINESS

JUDY HALL, ARMB liaison, briefly reviewed the following items:

1. **Action List** - in the board packet.

2. **Disclosure Reports** - in the packet.

3. **Committee Assignments** - in the packet.

4. **Meeting Schedule** - an updated calendar was passed out.

5. **Legal Report** - Legal counsel had nothing to report.

NEW BUSINESS - None.

PUBLIC/MEMBER COMMENTS

MS. TAYLOR thanked the board for meeting in Juneau where the Treasury Division staff can attend and take advantage of the educational presentations.

MR. BOUTIN added his thanks for meeting in Juneau. He said it provides an opportunity for legislators and/or their staffers to attend, see the board process, and interact with the trustees.

OTHER MATTERS TO PROPERLY COME BEFORE THE BOARD

MR. ROSES moved that staff provide the Alaska Retirement Management Board with a list of possible options by which the state may be able to address the unfunded liability of the retirement system.
MS. HARBO seconded.

MR. WILLIAMS asked which part of the state Mr. Roses was referring to. MR. ROSES said probably the area of the state where most of the dollars are being moved around - the Treasury Division and anyone they need to include in developing that list.

MR. BADER indicated he would be happy to act as a conduit for anyone who would like to provide ideas.

COMMISSIONER NORDSTRAND asked if the intent of the motion was to identify sources of funds. He said there are basically only a few ways to deal with the unfunded liability: (1) increase contribution rates over time (and who pays that increased rate is the subject of political discussions); (2) drop large amounts of money into the retirement fund; or (3) borrow money and drop large amounts into the retirement fund. The next question is simply whose money to use for those possible processes — the Amerada Hess fund, the Permanent Fund, the budget reserve fund, etc. — and how much.

MR. PIHL said those funding sources are certainly included. An example is that the state projects a budget based on $57.50 oil next year. If oil prices average $67.50, part of the difference could be committed toward the unfunded liability problem. Other examples are a certain amount of production from a gas field could be committed, or the state could provide a match incentive to municipalities that put in another 5%.

MR. ROSES stated that some of this may be obvious to those people who work in this arena every day. But when the board is charged with the responsibility of trying to manage the assets and the liabilities and bring those two into alignment, it has to see all the options available and be able to prioritize them in order to make a recommendation to the legislature.

MR. BADER clarified that staff would make the list of options and strategies and organize the material so the board could get its arms around it and be able to rank the options at the March meeting. He added that the board might not want to get involved in trying to identify the funding sources.

COMMISSIONER NORDSTRAND said he was okay with the motion if it was not asking the Department of Administration to come up with specific funding sources to fund these options.

MR. SEMMENS remarked that he was certain the legislature is looking to the ARM Board to come up with exactly the kind of recommendations that Commissioner Nordstrand does not want the department to come up with.

Roll call vote
Ayes: Harbo, Nordstrand, Pihl, Roses, Semmens, Williams, Trivette
Nays: None

The motion carried unanimously, 7-0.

INVESTMENT ADVISORY COUNCIL COMMENTS

DR. MITCHELL said he would speak about alternative investments - private investments, such as venture capital, buyouts, real estate, timber, commodities, energy, absolute return and probably a dozen other potential investments that we haven't even heard of yet. The most important constant in the investment business is change. A well-crafted institutional portfolio in the 1950s would have been hopelessly out of date by the 1970s. And a 1970s portfolio would have looked antique by the 1990s. And a 1990s portfolio will look old fashioned and sub optimal by 2010, which is only four years from now.

DR. MITCHELL guessed that the biggest change between now and 2010 will occur in the ratio of private to public market investments. That ratio, which for most plans today is overwhelming weighted toward publicly traded stocks and bonds, will probably be turned on its head by 2010 so that 50% or 60% of a good institutional portfolio will be invested privately in partnerships and other like vehicles. As Mr. O'Leary pointed out this morning, the leading edge endowments, like Yale or MIT, are already past that point. And the two funds that he is most closely associated with, the Massachusetts pension plan and Boston Foundation, are 30% and 42% private, respectively, and they are both moving north.

DR. MITCHELL stated that the ARM Board is about 21% in alternatives, counting real estate. So what advantages might an increase in the ARMB's commitments to alternative investments offer? Some of the advantages are higher returns, lower correlations, greater diversification, the ability to use leverage, to go short, greater exploitation of market inefficiencies in mispricings, maybe smarter managers, maybe tighter alignment of interests, and certainly the ability to access new investment ideas and techniques before they become commonplace.

He said the board has a good asset allocation right now, and he applauds it and does not for a moment advocate in March moving from 21% alternative investments to 50% or 60% in alternatives. That would be not professional, not responsible, and not prudent. He does advocate that the board next month consider increasing the allocation to private investments broadly defined by a modest amount, maybe 4-5%. Second, to continue to open the door wide to presentations from firms and from gatekeepers that do things differently and that operate in the alternative space. He congratulated the board and the staff and the consultant for moving as far as the retirement fund has already moved and encouraged the ARMB to keep on moving.

DR. JENNINGS stated that he wanted to revisit his theme about the board's role as governing fiduciaries as opposed to managing fiduciaries. When the fund was smaller it was perhaps appropriate to get into the details of smaller investment allocations. For example, the board heard a presentation today on a $30 million allocation that is less than a quarter of a percent (of the fund's total assets). He encouraged the board, as it thinks about its roles, to think about some threshold to delegate to staff or a committee below which they would be able to operate on the board's behalf and report back to either the full board or to a committee. This would separate the governing fiduciary role and the managing fiduciary role.

DR. JENNINGS noted that the revised meeting calendar just handed out looks like this board is going down a path that is very similar to the routine that the ASPIB operated under. He encouraged the board to take time at either the education conference, a retreat or a regular meeting to discuss how the trustees feel about the idea of delegation.

COMMISSIONER NORDSTRAND asked if boards of similar-sized pension funds do things differently in terms of how much detail the board gets into and what level the board is engaged at on investment options, as opposed to delegating to the department staff to make the choices.

DR. JENNINGS replied that it doesn't necessarily correlate to fund size; it correlates to the confidence the board has in a committee or a staff mechanism. The most sophisticated program that he is involved with is actually one of the smallest ones, and most of the responsibility is delegated down two layers to a subcommittee with reporting back up through.

MR. O'BRIEN agreed, saying that he is familiar with public plans where the medical office fund transaction that the board took up earlier today probably would have been handled at the staff level, with some reporting up to a real estate committee or the full board. That way, the investment operation keeps moving and is not dependent upon a board meeting. This requires setting thresholds and parameters for the authority that is delegated.

DR. MITCHELL said he agreed with both his colleagues. If the board buys into the asset allocation and sets parameters, it could leave a lot of things to the staff.

COMMISSIONER NORDSTRAND stated that he thought this board was overwhelming itself — and maybe necessarily so at the outset. Meeting two full days a month for the foreseeable future is a lot, especially considering all the staff preparation involved. That might change once the board is fully saturated with basic information. Maybe it is possible to shrink some of the presentations to less information so there is more time for the board to discuss how it can function more efficiently. There is a point at which it all becomes information overload.

MR. WILLIAMS asked staff if there was still time available at the education conference for a governance discussion. MR. BADER replied that it was an important item that could be best covered in an educational setting.

Responding to the Chair, MR. O'BRIEN said a lot of work can be done at the committee level. He agreed with Commissioner Nordstrand that right now the board is dealing with a lot of the basics — like trying to take a drink from a fire hydrant. The board has to feel comfortable with all parts of the portfolio before it starts delegating tasks to the various committees. He stressed that he was not being critical of the agenda for this meeting, but looking back, maybe it would have been helpful on the first day to have a 30-minute discussion from Mr. O'Leary and the staff about the basics of private equity. The private equity portfolio is doing very well, and the board heard a lot of good things from the presenters. But they did not talk about the J-curve, and the board would have heard about the J-curve if the portfolio was not doing well.

DR. MITCHELL said he agreed that a lot can be done at the committee level. It is a good idea to make sure trustees know they can attend any committee meetings they are interested in.

MR. O'LEARY indicated he agreed with the IAC comments that a key element is having confidence in staff and its capabilities. Eight or nine years ago, the number of investment staff was very limited, and the prime focus was the internal management of a huge portion of the assets. He urged the board to look at the agendas and see how many hours of the limited meeting time will be spent listening to managers make presentations. It has to be done but maybe not by the full board. When the ARMB board was created and charged with responsibility on both sides of the equation, not just the investment side, he thought then that the board would have to change how it spends its time. The amount of very important work has increased significantly. But first it is important for the board to get a flavor for the issues, in order to be comfortable.

Delegating more authority to staff to implement in some way is reasonable. He encouraged the board to speak with the Permanent Fund board and staff about how they are changing. For example, the APFC has a program with small cap managers where staff has the authority to hire and fire managers in that area. Those managers typically have small allocations, so it is an effective use of Permanent Fund time. The APFC insists on making all major manager hire and fire decisions and wants to speak with those managers that are in charge of very big portfolios. The ARM Board should eventually be spending time overseeing what staff is doing, but the board has to define the lines.

MR. BOUTIN mentioned that, unlike the Permanent Fund board, this board always meets off site and does not see the investment operations at the Treasury Division. He encouraged the board, as part of its due diligence, to reschedule its tour of the operations at the Department of Revenue and the Department of Administration that was cancelled in January because of flight issues.

TRUSTEE COMMENTS

MS. HARBO thanked the IAC members and Mr. O'Leary for their opinions on matters before the board and for educating the trustees. She also thanked the Department of Revenue for the opportunity to attend the Callan conference, which she found informative, especially learning about the changing opportunities for investing in different asset classes.

CHAIR TRIVETTE offered his thanks to the Division of Retirement and Benefits staff and the Treasury Division staff for their support to the board.

FUTURE AGENDA ITEMS

COMMISSIONER NORDSTRAND suggested rescheduling the tour of the state departments in March because it's the board's last meeting in Juneau this year.

MR. ROSES mentioned receiving an invitation to a UBS client conference in San Diego. He said he would like more information about this kind of thing.

MR. BADER said that over several years he has observed many of these invitations in almost every asset class. Although there is some value to them, there is greater value in going to a conference that addresses an asset class broadly, as opposed to going to one specific manager's presentation about the asset class.

ADJOURNMENT

There being no objection and no further business to come before the board, the meeting was adjourned at 4:34 p.m. on February 17, 2006, on a motion made by MS. HARBO and seconded by MR. ROSES.

Chair of the Board of Trustees
Alaska Retirement Management Board

ATTEST:

Gayle W. Harbo

Corporate Secretary

Note: The summary minutes are prepared from a tape recording of the meeting and are written by an outside contractor. 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
Karen Pearce Brown
Juneau, Alaska