State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
SPECIAL MEETING

Location of Meeting
Teleconference

MINUTES OF
October 15, 2008

CALL TO ORDER

CHAIR GAIL SCHUBERT called the teleconference meeting of the Alaska Retirement Management Board (ARMB) to order at 9:03 a.m.

ROLL CALL

Seven ARMB trustees were present at roll call to form a quorum. Mr. Richards joined the meeting shortly after it started, and Mr. Semmens announced his presence on line about 9:30 a.m.

ARMB Board Members Present
Gail Schubert, *Chair*
Sam Trivette, *Vice Chair*
Gayle Harbo, *Secretary*
Commissioner Patrick Galvin
Commissioner Annette Kreitzer
Martin Pihl
Tom Richards
Larry Semmens (joined about 9:30 a.m.)
Mike Williams

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

Consultants Present
Robert Johnson, outside legal counsel
Mike Barnhill, AK Department of Law legal counsel
Anne Johnson, AK Department of Law legal counsel
Michael O'Leary, Callan Associates, Inc.

Department of Revenue Staff Present
Jerry Burnett, Acting Deputy Commissioner
Gary M. Bader, Chief Investment Officer
Bob Mitchell, Senior Investment Officer
Zachary Hanna, State Investment Officer
Steve Sikes, State Investment Officer
Judy Hall, Liaison Officer
Bree Simpson, Asst. State Investment Officer

Department of Administration Staff Present
Patrick Shier, Director, Division of Retirement and Benefits
Jim Puckett, Deputy Director, Div. of Retirement and Benefits
Kevin Worley, Chief Finance Officer

Others Present
Pat Forgey, Juneau Empire

PUBLIC MEETING NOTICE

JUDY HALL confirmed that public meeting notice requirements had been met.

APPROVAL OF AGENDA

GAYLE HARBO <u>moved to approve the agenda</u>. MIKE WILLIAMS <u>seconded</u>.

The agenda was approved without objection.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES

There was no one who wished to speak to the Board.

REPORTS

CHAIR SCHUBERT informed the Board that she had asked Mr. Bader to schedule this meeting because of the extraordinary financial times we are experiencing, and it was appropriate to discuss a number of items.

MR. BADER said he had requested the Investment Advisory Council (IAC) members to give their perspectives: George Wilson on what he has seen as an endowment fund manager and what people are saying about the markets; Jerrold Mitchell as a manager of a private wealth firm; and Williams Jennings on historic severe market declines and what the Board should take into account going forward. He said Mr. O'Leary would provide Callan's perspective. He said the Department of Administration has been on top of the market turmoil, and he had asked Retirement & Benefits

Director Pat Shier to share some of the communications from participants.

A. Update on Defined Benefit Plan Funds

MR. BADER related that during the past six weeks the government has taken over the nation's two biggest mortgage finance firms (Fannie Mae and Freddie Mac), has rescued American International Group - the world's biggest insurance company, and has won Congressional approval for up to a $700 billion dollar rescue package of the financial system. As the bailout rushed through Congress, Treasury Secretary Henry Paulson stressed that a major aim was to buy bad assets, primarily mortgage-backed securities, from financial institutions. Now, part of the package is being used to invest in bank preferred stocks in order to encourage lending to borrowers. Credit to the economy is what oil is to a car — you can run without it for a very short time and then everything will freeze up. The longer this credit crisis persists the more difficulty is expected down the road. There has been a large sell-off in the markets recently. The coordinated efforts by the U.S. Treasury and the European Central Bank have brought a measure of relief to the markets, but sustainable gains may be more elusive in the future.

MR. BADER outlined what the retirement plan portfolio has been experiencing. There is a hoarding of short-term paper, and a very thin market for Treasury bills inside of three months. The annual yield on a three-month Treasury bill is around 0.3%. This is important because, as Mr. Pihl has emphasized several times in board meetings, the retirement fund has a net outflow of cash each month as payments to participants are greater than contributions received. So when the fund receives money from the employers, investment staff wants to invest it short term and make a reasonable return on it, but that is difficult right now. Staff has been leaving those funds with State Street Bank that has a short-term investment fund with an annual yield of about 0.7%.

MR. BADER stated that nobody has an appetite for commercial paper. Last week commercial paper outstanding fell $56.4 billion. The Fed announced last Tuesday (Oct. 7) that a new facility for purchasing high grade commercial paper would be put in place. Corporate debt issuance has been light since its high last May. As of September 2008, net issuance totaled only about $13 billion versus $103 billion last May. So the credit markets are still tight and still a challenge to the retirement fund.

MR. BADER said the Dow Jones Industrial Average has dropped 28% since January 1, and has fallen 19% since last August. The ARMB's active domestic equity managers have provided a small performance consolation by outperforming indexes: 149 basis points for large cap stocks, and 219 basis points for small cap. But that is relative performance, not absolute performance. In private equity, distributions have slowed to a crawl as markets are no longer available for leverage recapitalization activity and there is little or no acquisition and initial public offering activity. In absolute return space fund redemptions, deleveraging, the Lehman Brothers failure, increased correlations, and increases in margin requirement are forcing some security holders to sell at discounts and therefore drive market prices lower, and mark-to-market is creating losses for other holders.

MR. BADER stated that the ARMB's non-core real estate portfolio is 29.5% of the private real estate portfolio. The non-core portfolio uses a high degree of leverage, sometimes in the area of 65% to 80%. Many of the funds are faced with refinancing properties down the road, and in the current environment, if unsuccessful, this could lead to turning property over to the lender or additional capital calls. No such circumstance exists right now that would create that situation. But if this market persists, the ARMB's portfolio could be faced with that possibility. Some of the non-core funds have started to take contingency measures to prepare for the worst-case liquidity scenarios. BlackRock Diamond Fund has drawn down $110 million of their credit facility in order to be liquid in the event that they cannot borrow money in the future. ING Clarion Development Ventures II has put investors on notice that it may exercise fund recall of capital drawn down to pay debt if ING is unable to refinance. That means that investments returned to ARMB through sales in the fund could be called back because there is a callback period available to the fund. So liquidity continues to be an issue. Many of the non-core funds do not have near-term maturity challenges but all will have problems if the credit crisis is not resolved.

MR. BADER said the preliminary quarterly returns for the farmland portfolio are positive, up about 1.0%. But farmers can also be affected during the credit seizure. The ARMB has about $480 million invested in farmland, and the portfolio does not use any leverage. But farmland is an asset class that typically has low leverage, so the portfolio is not liable to experience any calls to meet borrowing costs in farmland. Finally, the ARMB has not made any timber investments yet.

MR. BADER estimated that the retirement fund is down about 13% since the beginning of the fiscal year, July 1. Volatility in the markets makes it difficult to pin that number down. Investment staff cannot control the markets but they can control the response to what happens in the markets. Staff's response is adhering to the board-adopted strategic plan, and they believe it is the best route to use to protect the retirement fund during these turbulent times.

B. IAC Perspectives on the Markets

GEORGE WILSON commented that Mr. Bader ended his overview with what he called "staying the course," which is the message in his peer group. His endowment fund has spent a lot of time working on its asset allocation over the last couple of years, similar to the ARMB. They believe that their asset allocation policy is the appropriate way to manage money on a very long-term basis. The endowment fund is focused on understanding how the portfolio has moved over the last couple of weeks, and is spending a lot of time thinking about how to rebalance in markets that are very illiquid. Based on assumptions that the endowment has made relevant to the illiquid part of the portfolio relative to returns from private equity and real estate and the like, it is highly unlikely that people will be selling assets over the next couple of years. So the endowment is in the process of re-doing those assumptions so that they can manage as close to the asset allocation overall as they can. They are also focusing on housekeeping issues, similar to what the ARMB has done over the last year: they are not in securities lending and are focused on being sure the cash balances are invested at safe rates and not stretching for yield. So the big picture in the endowment world is staying the course. Most endowments and foundations do not have significant inflows of cash when times get tough, so they are making sure they have appropriate amounts of liquidity to deal with near-term challenges.

JERRY MITCHELL said his comments followed along Mr. Bader's and Mr. Wilson's. The private wealth fund he manages has been proactive in calling the clients, who are asking what they should be doing in this disruptive and difficult financial environment. He said he found a quotation from one of the great twentieth century investors, John Templeton: "Profitable investing is mainly common sense. Don't get carried away by enthusiasm, don't get carried away by despondency. Don't buy things you don't understand. Always study what you buy in advance. Make long-range plans. Know in advance that you are going to have to live through bear markets. Just use plain common sense and the chances are that you'll have superior long-term investment performance." His fund has basically 25% fixed income investments and 75% in equity and equity-like investments. Taking that quotation to heart, they have made sure that the 25% in fixed income is absolutely safe, meaning they moved six or seven months ago from a mixed fixed income portfolio to one that is basically all Treasuries. So the clients can live off those Treasuries, even if the fund has to endure difficult times. As for the 75% in stocks, the fund managers will be buying stocks as they rebalance. While they know they won't be getting the absolute bottom prices for some of the names, the fund will be buying companies with real products, with real assets or real intellectual property — names like Schlumberger, Pfizer, General Electric and some of the oil companies — little by little, and with the expectation that even if the fund has to survive one or two more years of difficulties, those will be good investments for the clients long term.

DR. WILLIAM JENNINGS stated that most people have heard the "talking heads" speak about the very long horizon and how long it took markets to reach new highs after 1929 or 1973. After 1929, 1957 is mentioned as the recovery period; 1982 is mentioned for the oil embargo. The point of these reports is that the time line is measured in decades, not years. His belief is that the pundits are focusing on index levels. When they do that they are excluding dividends and not focusing on total returns. Focusing on total returns, those recovery periods are basically twice as fast. In short, history is less dire than some of the pundits claim. Secondly, today's environment has a lot more buybacks as part of the equation. We are already starting to see cash-rich companies act to initiate buyback programs. So that might lean towards a quicker recovery period. Lastly, the pundits tend to focus more on breaking even rather than on what forward-looking returns look like. While it makes good headlines to talk about multiple decades, the peak is behind us, and there was plenty of opportunity in each of these periods to generate returns. Looking at the 1930s as an example, only two rolling five-year periods in the 1930s had negative returns, the other eight were positive five-year returns. So looking forward the Board should take comfort that risk premiums are now much more attractive than they were not too long ago. Long horizon investors need an equity bias, and today that means they should be focused on rebalancing.

C. Callan Perspective

MICHAEL O'LEARY mentioned that he and the Board discussed many of the market issues at the

Fairbanks meeting a couple of weeks ago, so he would not repeat that discussion but focus on what people are doing right now. The first reaction is to review all the investments: Where are we? What are our exposures? Do we have anything at risk that we can change? He said the ARMB has been ahead of the game in that analysis. Fortunately, the sense from being in Boston to review all the managers is that things seem to be in reasonably good stead. Mr. Bader earlier identified some of the more aggressive real estate strategies as something one could focus on. But they are also focusing on whether the organizations are sound, are people bailing out, or are people being terminated. The answer to those questions is no, that the ARMB is with strong, stable managers.

MR. O'LEARY said the second thing Callan clients are figuring out is how the markets have changed their actual asset allocation relative to their target. Given the tremendous drop in the stock market, the basic stability in the real estate market, and positive returns in high quality fixed income, the retirement fund is out of balance. So developing a plan to move the total portfolio back within targeted ranges is something that is front and center on everybody's mind. The vast majority of Callan's clients are attempting to implement their rebalancing. There are some variations in the pace at which they do it, but they are all moving in that direction.

MR. O'LEARY said the third issue that people are addressing is if they should be doing something differently - given that the market events were not anticipated, or should they be altering their policy because of what they have learned in the last three or four months particularly, but also over the last year. It seems that most funds are reasonably comfortable with where their strategic plans are. At the margin, they may be rethinking things but recognizing areas of emphasis, but they are not making substantial changes. The more opaque types of investment products are facing the toughest scrutiny.

MR. O'LEARY said the final consideration is what happens during a recession (if we are, in fact, in one) and what does that mean for the market. A JP Morgan publication defines the last recessions in the post-World War II period. On average, during the recession, the stock market is actually up fractionally. Typically what happens is the market goes down in the early parts of a recession and then begins to recover before the economy actually begins to recover. Then six months after the recovery, on average, the market has been up more than 10%. That is where the focus has to be in terms of the outlook. How deep and protracted will the recession be, if we are in one. With the stock market down as much as it is since June 30, there is a long way to go to get back to zero before the recession end.

MR. O'LEARY told Board members he had in front of him a histogram that shows annual stock market returns for the S&P 500 for 217 years. There are four years where, on a calendar year basis, the return for the S&P 500 was worse than a 30% decline. Through October 7, 2008, the market is down over 31% this year. There have been other periods of substantial decline, and people have gotten through them, but in terms of order of magnitude, this is certainly up there with the big ones.

MR. O'LEARY said that for those people interested in watching the credit market, looking at yield spreads is a good way to test the progress of the relief programs and the collective global policy actions. For example, the yield difference between commercial paper and government-issued paper, or the yield difference between corporate bonds and Treasury bonds. These are a good barometer of whether the programs are working and what Callan continues to focus on.

D. Defined Contribution Plan Returns

MR. BADER stated that the ARMB is also responsible for investing defined contribution plan assets. Staff believes the defined benefit components of those defined contribution plans have return characteristics very similar to what he outlined earlier for the Public Employees' Retirement System and the Teachers' Retirement System. Staff attempted to give the Board some measure of how they think participants are doing with their defined contribution accounts by taking the SBS and Deferred Compensation Plan balances in each of the investment options and providing a weighted average return. By using the weighted averages of the gains and losses in the various investment options, staff estimated that defined contribution plan participants have lost about 15% fiscal year to date. The Board needs to be congratulated for holding a special meeting and approving new investment options for the defined contribution plan, which were implemented just slightly before the most severe part of the market down turns. Staff's review shows that plan participants used the new options by making net transfers of about $23 million into more conservative investment alternatives. Participants who used those options are probably happy that the Board made those available to them.

MR. BADER explained that, calendar year to date, the worst performing fund in the defined contribution plan menu was the Brandes International Fund, which was down 41% as of October 9. The next worst performer was the S&P 500 Fund, which was down 37.7%. Some investment options in the defined contribution plan were positive during this period: Intermediate Bond Fund up 4.6%; T. Rowe Price Interest Income Fund (Deferred Comp Plan) up about 3.5%; and the T. Rowe Price Stable Value Fund (SBS Plan) was up about 3.6%. So as money transferred into those funds, they turned out to be a safe haven, and those funds did what they were put in the investment options menu to do.

MR. BADER said the Division of Retirement & Benefits (DRB) has been in the front line for talking to participants who have been calling with concerns and questions.

E. Participant Communications

PAT SHIER reported that when the Division started getting phone calls the leadership team decided to get together to make sure they had the information they needed in advance. Some frequently asked questions (FAQs) and answers were prepared, and they put together a stuffer for the retiree pay checks that briefly answered the most common question about if they would still receive their checks. The Department of Revenue, Great-West, and others submitted suggestions for the FAQs based on what they were hearing from their members as well. The DRB team also put together a doomsday scenario for what to do if the phones all lit up with calls about the market issue. They have not had to use that plan, and call volume seems to be dropping off. DRB also asked Great-West what would happen if the banks through which the firm handled some direct deposits were to fail. Great-West made arrangements for a paper check solution.

JIM PUCKETT confirmed that the phone call volume has been very low lately. There was a spike in calls from participants concerned about their retirement funds when the market troubles first began.

F. Trustee Questions

MR. TRIVETTE asked if DRB had been getting more calls from the defined contribution plan participants than from retirees.

MR. SHIER said the highest volume of calls was from individuals concerned that they may not receive their retirement check.

MS. HARBO referred to Mr. Bader's report of a calculated 15% loss in accounts of defined contribution plan participants so far in the fiscal year. She said her concern was that in the first two years of the defined contribution plan people that had the third party administrator handle their accounts were invested in the Brandes International Fund, the S&P 500 Fund, small cap stocks, and the Citizens Core Fund. They were not in the same plans that the SBS participants default into. She felt sure their losses would be higher than 15%.

MR. BADER agreed that would be the case, if those participants did not exercise control over their accounts in the same fashion that SBS participants did. He said the same would be true for some of the Alaska Target Funds as well, which all assume that people with longer-term investment horizons should be 90%-100% invested in equities. That is a problem when the markets decline as this one has. Fortunately, those people have very long investment horizons to hopefully recover these losses and even show bigger gains. He said Ms. Harbo's was a great observation.

MS. HARBO thanked Chair Schubert for calling this meeting. She also expressed appreciation to staff for keeping on top of things and keeping the Board informed.

CHAIR SCHUBERT stated that the ARMB restricts its equity managers to holding no more than 3% of their portfolios in cash. She said she was a big proponent of limiting manager cash back in the Alaska State Pension Investment Board days, because it did not make sense that a manager could hold up to 15% cash and still get paid their investment manager fees on the cash. She asked if the Board should revisit the cash policy.

MR. BADER replied that staff has already prepared an action memo for the next board meeting that proposes to change the cash requirement to an average over ten days. This would give a manager more time to invest the proceeds of a stock sale. He noted that many times when markets recover they bounce back strongly, and much of the recovery takes place in one or two days. The Board's strategic plan gets frustrated a bit when managers decide on their own to go heavily into cash. However, to the extent that managers were in cash, it probably benefited the portfolio recently. The Board will be able to discuss the cash policy at the next meeting.

CHAIR SCHUBERT inquired if the Board should be concerned about the solvency of any firms that currently manage retirement plan assets. MR. BADER stated that Lehman has a real estate fund, but staff does not know of any problems with any other managers.

MR. O'LEARY said there are situations in the industry where a substantial decline in assets might raise questions about a management firm's viability because their fees are tied to the asset value of the portfolios under management. Managers for the ARMB typically are comparatively large. Those that are not large are well diversified in terms of their product offerings and also seem to be doing comparatively well. With the exception of a manager such as Lehman that had the misfortune of having a parent that had a problem — and to the best of his knowledge, that is the only one in the ARMB's roster — the Board seems to be in good stead. Cadogan is a part of the Fortis Group; fortunately, in both of those cases the investment operations seem to be pretty solid. The Lehman bankruptcy has already sold Neuberger & Berman, which has been a very successful money manager. The Board's real estate consultant, Townsend Group, will be monitoring with the ARMB staff the progress of the Lehman real estate operation.

Regarding monitoring the Lehman matter, ROB JOHNSON mentioned that there is a bankruptcy court proceeding on Friday involving an assessment of various and sundry affiliations and inter-relationships along the lines of what the Board discussed in executive session in Fairbanks. The Board's legal counsel will be listening to that proceeding for any clues that would suggest that the Lehman divisions the ARMB is involved with are impacted in any way.

MR. BADER stated that most of the accounts in the defined benefit program are separate accounts. So if for some reason a manager were to go dark overnight, the assets are actually held by the custodian bank (State Street), and the Treasury investment staff can direct that another manager take over those accounts. The separate account structure insulates the retirement portfolio fairly well against manager insolvency, at least as it relates to public equities.

MR. O'LEARY mentioned that State Street Bank is one of the nine institutions that the U.S. Treasury Department selected to receive an injection of capital. Bank of New York was the other custodial entity.

CHAIR SCHUBERT asked if the lack of liquidity in some assets would impact the Board's asset allocation. MR. BADER responded that the liquidity issue makes it more difficult to accomplish the rebalancing. Staff is currently working on freeing up fixed income investments to accomplish the rebalancing, even though the portfolio may take a loss on some of them. However, staff believes it is important to stay the course with the rebalancing program.

MR. PIHL remarked that the country's economy has lost so much of its manufacturing and industrial base that he wondered how that bodes in the stock market's recovery ahead. MR. O'LEARY said it was ironic in that the manufacturing sector, which had been a real dark spot in the U.S. economy for the last seven or eight years, had actually been enjoying substantial recovery. That was reflected in the improvements in the country's competitive position brought about because of the decline in the value of the dollar. Exports were helping support the economy in 2007 and the early part of 2008. Most economists are expressing the view that the United States confronted the possibility of this slow down a little bit ahead of its global trading partners. So they expect that the U.S. may begin to emerge from the slow down more quickly than other countries. He said Mr. Pihl's point is valid about what to expect the shape of the future recovery to be. He has not heard anyone anticipate a sharp recovery but rather a flattening in economic activity and then a more modest recovery that hopefully would gain real strength in the early part of 2010.

COMMISSIONER GALVIN requested that staff inform the Board about moves on the Department of Revenue side to make sure there is enough liquidity to meet obligations. MR. BADER explained that for the funds over which the Revenue Commissioner has sole fiduciary responsibility staff approached him a few weeks ago to talk about the liquidity issues. The Commissioner opted to relax the constraints on fixed income holdings and allowed staff internally to consider cash to be essentially some of the fixed income holdings in the strategic allocations for the various funds he is charged with. Staff has been attempting to increase liquidity as much as possible. Those opportunities are when the state receives large tax payments or other sources of revenue. For the ARMB funds the challenge is slightly different in that the money outflows are greater than what comes in every month. Senior investment officer Bob Mitchell attempts to raise liquidity whenever he can, and staff tries to be as aggressive with the ARMB portfolio as they are with the other state funds.

MR. TRIVETTE asked Mr. Bader if he anticipated the Board needing to hold another special meeting in the next month. MR. BADER said staff was preparing for the worst and hoping for the best. The hope for the best is that the markets start to recover. Because of the Board's responsibility, and because trustees get calls from constituents, if similar markets persist next month staff will confer with the chair and decide if another meeting like this would be beneficial.

MR. TRIVETTE requested that DRB provide ARM Board members with a copy of anything that the Division sends out to plan participants, such as the stuffer that Mr. Shier mentioned went out to retirees recently. It is better for trustees to get these things as soon as possible.

MR. SHIER said DRB strives to send everything to Judy Hall on the Revenue side so she can pass it on to ARMB members. COMMISSIONER KREITZER said that makes for a consistent process, and everyone hears the message that the information has to be passed on to trustees.

G. Adjustments to Strategic Plan

MR. BADER indicated that staff had no adjustments to recommend.

OTHER MATTERS TO PROPERLY COME BEFORE THE BOARD - None.

PUBLIC/MEMBER COMMENTS - None.

ADJOURNMENT

THERE BEING NO OBJECTION AND NO FURTHER BUSINESS TO COME BEFORE THE BOARD, THE MEETING WAS ADJOURNED AT 9:56 A.M., ON A MOTION MADE BY MS. HARBO AND SECONDED BY MR. TRIVETTE.

Chair of the Board of Trustees
Alaska Retirement Management Board

ATTEST:

Gayle W. Harbo
Corporate Secretary

Note: An outside contractor prepared the summary minutes from a tape recording that staff made. Please refer to the recording of the meeting on file at the ARMB office for more detail.

Confidential Office Services
Karen Pearce Brown
Juneau, Alaska