**State of Alaska**
**ALASKA RETIREMENT MANAGEMENT BOARD**
**MEETING**

**Location of Meeting**
Kenai/Denali Room
Anchorage Marriott Hotel
820 W. 7th Avenue, Anchorage, Alaska

**MINUTES OF**
**December 3-4, 2009**

**Thursday, December 3, 2009**

## CALL TO ORDER

VICE CHAIR SAM TRIVETTE assumed the role of Chair in the absence of Chair Gail Schubert and called the meeting of the Alaska Retirement Management Board (ARMB) to order at 9:00 a.m.

## ROLL CALL

**ARMB Board Members Present**
Gail Schubert, *Chair* (arrived at 1:23 p.m.)
Sam Trivette, *Vice Chair*
Gayle Harbo, *Secretary*
Kristin Erchinger
Commissioner Annette Kreitzer
Martin Pihl
Tom Richards

**ARMB Board Members Absent**
Commissioner Patrick Galvin (on vacation)
Mike Williams

Six ARMB trustees were present at roll call to form a quorum.

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

**Consultants Present**

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

**Department of Revenue Staff Present**
Jerry Burnett, Deputy Commissioner
Gary M. Bader, Chief Investment Officer
Pamela Green, State Comptroller
Bob Mitchell, Senior Investment Officer
Zachary Hanna, State Investment Officer
Steve Sikes, State Investment Officer
Scott Jones, Assistant State Comptroller
Judy Hall, Liaison Officer

**Department of Administration Staff Present**
Patrick Shier, Director, Division of Retirement and Benefits

**Invited Participants and Others Present**
Mike Barnhill, Department of Law
David Slishinsky and Michelle DeLange, Buck Consultants, Inc.
Mike Hayhurst and Corinne Fiedler, KPMG
David Wakefield and Todd Rittenhouse, Mondrian Investment Partners
Janet Becker-Wold and Gary Robertson, Callan Associates, Inc.
Ray Edelman, Todd Hawthorne, and Melody McDonald, RCM
Jeffrey Conrad and Stephen Kenny, Hancock Agricultural Investment Group
James McCandless and Brian Webb, UBS AgriVest, LLC
Chris Ryder and Paula Pretlow, Capital Guardian
Lee Wanie and Marco Merz, BlackRock, Inc.
Jay Dulaney, Retired Public Employees of Alaska (RPEA)
Jeff Pantages, Chris Brechbuhler, and Julie Duhrsen, Alaska Permanent Capital Management
Peggy Wilcox, Alaska Public Employees of Alaska (APEA)

## PUBLIC MEETING NOTICE

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

## APPROVAL OF AGENDA

MR. BADER changed the firm name on report #13 from Barclay Global Investors to BlackRock, Inc., to reflect the recent name change. He also noted that the Legal Report toward the end of the agenda would include an executive session.

MR. PIHL suggested moving the Election of Officers from the beginning of the meeting to the afternoon of the first day (#13-B) when more board members would be present.

MS. HARBO moved to approve the agenda as amended. MR. RICHARDS seconded. The agenda was approved without objection.

## PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES

There was no one present or on line who wished to speak to the board.

## APPROVAL OF MINUTES - October 1-2, 2009

MS. HARBO made a correction to the first line of page 12, where it should have said "...the ARMB Real Estate Committee heard the full presentation..." instead of the Audit Committee.

MS. HARBO moved to approve the minutes of the October 1-2, 2009 meeting as amended. MS. ERCHINGER seconded. The motion passed unanimously.

## REPORTS

### 1. Chair Report

Chair Gail Schubert was absent in the morning and this report was deferred until her arrival.

### 2. Committee Reports

#### 2(a). Audit Committee

Committee chair MARTIN PIHL reported that the committee met with independent auditor KPMG on September 30 and reviewed the Treasury Division audit. The committee met again on December 2 after KPMG had completed the audits of the Department of Administration and the Treasury Division. KPMG was scheduled to give a report to the Board tomorrow. MR. PIHL complimented KPMG managing partner Mike Hayhurst for a comprehensive discussion of the audit, especially focusing on sensitive areas, and in answering questions. The audit results were clean, and there were no adjustments. Staff of both the Department of Administration and the Treasury Division are to be complimented for the improved work-up they did and for the timely assistance to complete the audit.

MR. PIHL reported on the committee's due diligence visit with the ARMB custodian, State Street Bank, following the board's education conference in October. State Street mentioned that the ARMB committee was probably the first public pension fund group that had visited, which he took as a compliment to Alaska. It was informative to learn the extensive scope of State Street's custodial services. The committee was impressed with the bank's commitment to security and excellence. He thanked state comptroller Pamela Green for coordinating that visit.

## 3. Retirement & Benefits Division Report

COMMISSIONER KREITZER reported that the governor would be rolling out the fiscal year 2011 budget around December 14-15. She said she enjoyed the education conference in New York City, and several of the sessions were directly on point for her. She felt the interaction between the Alaska Permanent Fund board of trustees, the ARMB trustees, and the University of Alaska representatives was very helpful. She expressed appreciation for the work that went into organizing the conference.

### 3(a). Membership Statistics

PATRICK SHIER, Director of the Division of Retirement and Benefits (DRB), drew attention to the quarterly and cumulative membership statistics for the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS). *[These reports are on file at the ARMB office.]* He noted the negative numbers on the quarterly TRS report under the "terminated" column and said it is a feature of school districts not renewing teacher contracts in the spring and then deciding that they can afford to hire teachers back.

MR. SHIER reported that DRB has been dispatching people from the benefits unit to hold regular training on behalf of PERS and TRS employers at Anchorage, Fairbanks, Juneau, and remote communities. The training has been very well attended. People are not only happy to have a retirement counselor but also a health plan expert in the room. DRB has been holding benefit fairs on weekends to match the schedule of the membership, and those have been well attended.

MR. SHIER stated that the repricing with State Street Bank, assisted by Great-West (the third party administrator), DRB and the Treasury Division, went off without a hitch and drew few phone inquiries from plan members. *[The Board received a detailed report on a fund manager trading error and a State Street custodial error at the October 1-2, 2009 meeting.]*

MR. SHIER mentioned that DRB continues to monitor the national health care debate, and they have not seen anything yet that would indicate how the legislation would treat retiree health care. They have concerns that it may create a tax burden if the trust funds are considered an employer for the purposes of national health care reform. DRB will continue to monitor that and make recommendations for action as it becomes appropriate.

MR. RICHARDS asked if DRB calculated what the annual premium would be for retired PERS or TRS members. MR. SHIER said DRB calculates that number and uses it as a method of arriving at some of the actuarial predictions for the future, as well as for billing retired individuals who are not eligible for paid health care coverage. But they no longer use it as a method of pulling a per capita figure out of the retirement funds and putting the money in the retiree health fund. Claims are now paid directly out of the 115 health trust. However, if DRB were to use the annual premium number (close to $12,000), and an individual retiree paid the premium to have themselves covered, the retiree would be in taxable territory under a proposed provision for national health care reform. Having to calculate that number exactly would create some fiscal complications.

Board legal counsel ROB JOHNSON asked if any organized groups were advocating issues in Washington, D.C. on behalf of public pensions or if public pensions were being ignored in the debate. MR. SHIER said his sense from certain groups and from the state's actuary was that groups were advocating to leave public pensions alone.

COMMISSIONER KREITZER stated that the Department of Administration has been providing information to the Alaska congressional delegation through the governor's D.C. office to ensure that they know what the impact would be should an action like that happen.

MR. SHIER told trustees that DRB representatives have been attending meetings with retiree representative groups, as travel conditions permit. It is a good venue to talk about health plan design and use.

MR. SHIER reported that two days ago DRB completed the end of several hundred extension accounts in the Supplemental Benefit Plan (SBS) and consolidated participants' accounts under different employers. It was considered a misuse for participants to be able to move to a new SBS-participating employer, open a new SBS account, and then withdraw funds from an existing SBS account after the 60-day waiting period. Those funds are for retirement and should remain locked away for that purpose, somewhat like Social Security. A second part is that Great-West is now directly handling the administration of all distributions out of the defined contribution products for people who decide to terminate and take their money. DRB must approve the distributions. This is expected to be the last hurdle in the way of on-line Deferred Compensation Plan enrollment.

MR. SHIER stated that the division hired Theresa Kesey as the new chief financial officer. Ms. Kesey has been with the division for a number of years and was an assistant to Kevin Worley.

**4. Treasury Division Report**

Department of Revenue Deputy Commissioner JERRY BURNETT said he had nothing to report and would yield his time to the chief investment officer report.

**5. Chief Investment Officer Report**

MICHAEL O'LEARY of Callan Associates, Inc. introduced JANET BECKER-WOLD, his team mate on the ARMB assignment, who was scheduled to make a presentation on international small cap equities later in the day.

Chief Investment Officer GARY BADER reported on a list of items, as follows:

- The protest of the Board's decision to award a contract for services to conduct an independent audit of state performance consultants and evaluation of investment policies has been appealed. There was also a challenge to Mr. Bader's authority to write the Decision on Protest, and that is one of the items on appeal. A copy of the Decision on Protest 09-0020 was included in the board packet.

- There were several reports on rebalancing actions that took place within the retirement systems since the last meeting. These were done to stay at the asset allocations for the retirement funds.
- There were also two reports on rebalancing across the pension plans and health plans. The objective was to get at the strategic asset allocation.
- There were four cancellations of directions to real estate fund managers to send the dividends back to the retirement funds, as opposed to reinvesting the dividends. The asset allocation for real estate is slightly below target, so staff believes it is appropriate to rescind the direction to repatriate the dividends.
- Notifications of making $25 million allocations to Lazard Emerging Markets and Capital Guardian Emerging Markets, with the goal of getting back to the asset allocation in international equities.
- Communication from a Deferred Compensation Plan participant who is unhappy with the menu of investment options in the defined contribution plans. State investment officer Ryan Bigelow's response was also provided, inviting the participant to contact staff again with specific recommendations so those options could be reviewed. Another participant wrote to request safer investment options, illustrating the interest in expanding the menu of investment opportunities available to participants.
- Staff requested that the board remove Brandes international equities and Mariner absolute return from the watch list because they no longer meet the criteria for being on the watch list. Staff also requested removing State Street Global Advisors international equity because the board terminated that mandate at the April meeting.

<u>MS. HARBO moved that the board remove Brandes international equities and Mariner absolute return from the watch list because they no longer meet the criteria for being on the watch list, and remove State Street Global Advisors international equity because they were terminated</u>. <u>MR. RICHARDS seconded</u>.

The motion passed without objection, 6-0.

- State investment officer Ryan Bigelow has been given additional responsibilities and will now be the primary contact for the defined contribution plans and have a role in equity management. This will more evenly divide the responsibilities which were formerly all under state investment officer Zachary Hanna. Also, assistant state investment officer Bree Simpson has resigned and will be returning to school. State investment officer Andy Wink is transferring from the fixed income unit to the real estate unit to work with Mr. Sikes. The Treasury Division is recruiting for an assistant investment officer in the fixed income unit.
- The board's policy for equity investments requires that stocks have to be listed on a recognized stock exchange. Sometimes when a company is dissolved or in a bankruptcy proceeding securities are issued that have little or no value, and the stocks are virtually not going to trade. The retirement fund is in technical violation of the equity

policy by holding these stocks, but staff believes the stocks have some option value even as they are held at zero value in the portfolio. The compliance unit has reported these stocks as a compliance violation. Staff requested that the board exempt these stocks from a violation of the policy until they could present a revised policy at the next board meeting.

MR. PIHL moved that the Alaska Retirement Management Board exempt from the equity investment policy guidelines stocks not listed on a recognized stock exchange that are issued when a company dissolves or as part of a bankruptcy proceeding. MS. HARBO seconded.

The motion passed without objection, 6-0.

MR. BADER reported that he wrote a letter to the international investment managers to ask if they were taking into account the potential for a movement to divest portfolios of companies doing business in Iran. There was no effort to coerce managers to do so; it was just an inquiry to find out if they had considered it. Manager responses so far are that these securities are a small percentage of their portfolios and most of them have considered the potential of divesting these companies.

MS. ERCHINGER inquired if the person who appealed the decision on RFP 09-0020 had done so to the commissioner of the Department of Administration. COMMISSIONER KREITZER said the person appealed to the office of the commissioner of the Department of Administration. She noted that she had asked at the October meeting, when the board authorized staff to publish a Notice of Intent to award the contract, whether the decision could be appealed to the DOA commissioner. She had considered excusing herself from the discussion and vote at that time. When it was clarified later, and an appeal was received, she recused herself and delegated the responsibility for reviewing the appeal to Deputy Commissioner Kevin Brooks. She has taken steps to ensure that she has no knowledge of the appeal and protest at this point.

MS. ERCHINGER referred to the November 4, 2009 letter to State Street and questioned why the rebalancing of the TRS retirement health pool and the TRS pension pool did not balance to zero, as she would expect. MR. BADER replied that he would check on it and respond later.

**6. Mondrian Investment Partners - International Fixed Income**

DAVID WAKEFIELD, Senior Portfolio Manager, and TODD RITTENHOUSE, Senior Vice President of client services, appeared before the board to give a report on the global fixed income portfolio that Mondrian manages for the Alaska Retirement Management Board. *[A copy of the presentation slides is on file at the ARMB office.]*

MR. RITTENHOUSE spoke briefly on the organization, its investment products, and its client relationships and assets under management. He said Mondrian is debt free and has not laid off a single person during the market down turn. New business generation has been very solid across the board, and they will be hiring this year. There have been no changes to the global fixed income team.

MR. WAKEFIELD went directly to the performance record for the ARMB portfolio valued at $205 million. Year to date the fund was up 11.5%, which came from two components. The non-US government bond benchmark itself was up 6.8%, helped by a solid rise in foreign currencies or a fallen US dollar over the past year. Mondrian added 4.3% return year to date on top of the benchmark return. At the height of the global financial crisis, around the fourth quarter of 2008 and the first quarter of 2009, they made a number of changes, including making a modest allocation to corporate bonds. They added to a number of non-core sovereign markets — Italy, Ireland, Australia, Mexico, Poland — where they thought markets sold off indiscriminately because of general attitudes toward risk. If anything, the fundamentals of those markets, and in particular the inflation outlook, improved, so Mondrian saw value. With recovery stories gathering pace and risk aversion largely going away, those non-core markets have performed exceptionally well, which is what lies behind the 4.3% outperformance so far in 2009. Mondrian was able to pick up value in the financial crisis by sticking to their disciplines, which is often the case in times of turmoil. Relative to their peer group, Mondrian's strong performance over the past year has made them top decile over the longer-term periods, and they are top quartile in the current year up to September.

In terms of global inflation trends, MR. WAKEFIELD said there is a lot of polarity in the marketplace between those who think there will be deflation in time and those who think there will be certain inflation with all the quantitative easing and governments priming the economies. Mondrian has a two-year horizon for prospective real yields, and they do not see the developed markets and most emerging markets having an inflation problem over the next two years. They have a quantitative approach to forecasting inflation, and unequivocally the factors that go into the model are pointing to low inflation. Spare capacity is really a feature around the world, and economies have just started to grow again. Mondrian sees that spare capacity remaining potentially for a few years. They are still fairly negative on the outlook for the world economy — not another recession on the back of the one just experienced, but they believe that the recovery will be stop-start and fairly fitful. The key drivers of GDP are consumer spending and investment, making up 80% of GDP in the U.S. and many other countries. Mondrian thinks that the factors driving those are not positive: wages, employment, house prices, and even financial wealth are off their peaks of two years ago. Credit constraints have eased a little bit but are still quite tight by historical standards. There are good reasons to be cautious still about the world economy. If above-trend growth does not happen, that spare capacity will not be used up. So this could be a feature for a good few years yet, and that is very much the story from their economic models.

Looking forward, MR. WAKEFIELD reviewed the prospective real yields by country, saying they want to overweight markets that have a high prospective real yield. He pointed out that the portfolio has no currency hedges. They see value in Australia where the central bank there has been raising interest rates but Mondrian sees a fairly benign outlook for inflation there. About a third of Australia's economy is very open to international trade (by comparison the U.S. is about 10%). Australia has not had a recession, although growth has been below trend over the last year, and they have spare capacity that will keep inflation down. While not a key point, Australia will benefit from a secular rise in commodity prices seen over the past year and that is expected to continue.

MR. WAKEFIELD stated that Mexico is another market where Mondrian sees value, with a prospective real yield of over 4%, higher than most other countries. Direct trade links with the United States are very pertinent, and Mexico's economy has been in recession. Worker remittances from the U.S., which have a direct impact on the economy, are down over 20%. So a weak outlook for the economy and a benign outlook for inflation. Poland is another country where Mondrian sees value, although they have pared back from an 8% allocation there to a 4% allocation. Poland, like everywhere else, has the situation of spare capacity. However, unique to Poland, about 10% of the labor force had migrated out of Poland to find work, which led to labor shortages and higher wages. With lower job opportunities in the world economy, some Poles have gone back to Poland to work and wages have fallen. Unit labor cost is a key driver of inflation, so that is one specific factor unique to Poland. Mondrian took profits from Poland over the past year, but they still see some value. They redeployed those profits to Sweden. Sweden has a good prospective real yield for a very developed market. Sweden has a very open economy, and the collapse in world trade hit that country hard. Inflation is declining, and Mondrian sees that continuing, supporting the prospective real yield of 2.5%. Although not a key criteria for Mondrian, it is worthy of note that Sweden, Australia, Mexico and Poland all have good debt situations at the moment relative to a number of the other OECD countries, like the U.S. and the U.K.

MR. O'LEARY asked for confirmation that Ireland was the largest debtor nation in Europe, or in some respects the world. MR. WAKEFIELD said Ireland was one of the biggest debtor nations in the Euro zone. That is relevant because Mondrian owns Irish bonds, which have benefited the portfolio despite the rise in debt over the past year. While the debt situation has picked up sharply in Ireland, the risk of a default is still negligible because it started from an extremely low debt situation and has increased only to the Euro zone average.

MR. WAKEFIELD stated that Mondrian sees value in the U.K. The prospective real yield is so-so at around 2%, but they sometimes overlay that with a qualitative judgment or a quantitative underpinning in terms of currency. U.K. sterling has been weak following the global financial crisis and particularly weak versus the euro currency. Part of Mondrian's overweight in the U.K. is ostensibly a currency situation, much like they had a position in Japan a couple of years ago when the prospective real yield was so-so but the yen was extremely undervalued. The Japan position came to fruition, so sometimes if there is a particularly strong signal on the currency Mondrian cannot ignore that.

MR. WAKEFIELD mentioned that Mondrian does not see value in the euro zone and so are underweight there by over 20%. That is partly because of the highly valued euro and partly because of the low prospective real yield. The U.S. has had a very flexible response to the global financial crisis, and unit labor costs are falling at their fastest annual rate ever — not good from a growth perspective but good from an inflation perspective. The euro zone, unfortunately and predictably, has had a fairly sluggish and inflexible response to the global financial crisis. In sharp contrast, unit labor costs in the euro zone — countries like Germany, France, and the key markets — are actually rising, and that is a key driver of inflation. That is depressing the prospective real yield, so on a medium-term perspective Mondrian does not see value in bonds there. Plus, the currency is getting very much on the overvalued side.

JANET BECKER-WOLD asked what Mondrian's outlook was for the yen, given the euro's dramatic move relative to the dollar recently. MR. WAKEFIELD referred to a chart of prospective real yields of bond markets that take into account the exchange rates by relative inflation. He pointed out that although the yen has been a beneficiary of the global financial crisis and has risen, it has actually risen from an undervalued position only now to around fair value. So, surprisingly, it is not overvalued versus the U.S. dollar. The euro is close to being extremely overvalued versus the U.S. dollar. U.K. sterling is fair value versus the U.S. dollar. It might surprise people that given the secular fall in the U.S. dollar almost uninterrupted since February 2002 (barring a minor rally in 2005), the U.S. dollar is still not extremely undervalued against the broad range of currencies. It is fair value versus the yen and fair value versus U.K. sterling, but undervalued versus the euro currency. Mondrian is broadly neutral to the Japanese market — the prospective real yield is about average, and the currency is about fair value. Nevertheless, Japan is still quite a big absolute weight in the portfolio because it is a big weight in the index.

MR. WAKEFIELD drew attention to a list of individual securities in the international fixed income portfolio. He stated that the bonds Mondrian buys for the ARMB portfolio are sovereign bonds or the government equivalent. However, Mondrian still sees value in some corporate bonds, particularly the European banks. In aggregate, corporate bond spreads have now fallen back in line with their long-run averages and are back to fair value from where they were. It would not be a surprise if Mondrian started to pare back those corporate positions in the near future if the recovery stories continue to gather pace. Corporate bonds is an area that has outperformed sovereigns this year and benefited the portfolio, and Mondrian still sees more to play for within corporates to an extent.

MR. O'LEARY asked Mr. Wakefield to address two issues: the long-term outlook for the dollar, and concern about the size and direction of deficits. He mentioned that Mr. Wakefield had indicated that Mondrian was not worried about inflation in the next two years, and he wondered if that was really the correct time frame given the dollar and deficits or if those were not factors to be worried about.

MR. WAKEFIELD stated that Mondrian is not concerned about the long-term outlook for the U.S. dollar. Some of the factors that have driven the U.S. dollar lower, such as the current account and imbalances in the U.S. economy, have gone away. The current account, which is very pertinent for the U.S. dollar, and something that Mondrian had real concerns about, is now very much on a sustainable path. They do not feel that the U.S. dollar will lose its reserve currency status any time soon. The U.S. dollar has been weak this year because of global attitudes to risk, and perhaps more risky currencies elsewhere have benefited, like the Australian dollar. Mondrian does not see a viable alternative to the U.S. dollar as reserve currency. It certainly will not be the Chinese currency: it is not fully tradable, and it is still an emerging market. It will not be the yen: the yen has had decades to prove itself. Mondrian does not believe it will be the euro currency: the euro zone is a very disparate mix of economies, and more economies are going to join and make policy management there even more difficult. The only way the U.S. dollar would lose it lustre long term is if it lost that reserve currency status, and Mondrian does not see that.

In terms of the inflation horizon that Mondrian looks at, MR. WAKEFIELD said that if they had a five- or 10-year forecast for inflation he thought it would inevitably become very stylized and not provide a huge amount of information. It is clear that financial market participants have a much shorter view. Mondrian has a very open mind on the outlook for inflation beyond two years. They believe there are fairly equally balanced risks of deflation and a return to a rise in inflation after two years. The slack in economies, which deficits are a part of, could well have a disinflationary force for many, many years to come. But equally, there are up-side risks in terms of the potential output in the U.S. and elsewhere being eroded by the deficits, falling labor supply, higher unemployment, and low investment. That could make economies more inflation prone for a given level of GDP. Also, there could be higher food costs and a secular rise in oil prices. So Mondrian has a very open mind in terms of equally balanced risks beyond the two years. The key thing is not so much what deficits and government pump-priming will mean for GDP: if anything, it will be negative for GDP as governments try to wrestle with how to cut those deficits. Everything being equal, that will tend to sit on inflation.

VICE CHAIR TRIVETTE thanked the Mondrian gentlemen for the presentation and remarked that the material about the outlook for the coming year was very helpful. He said he appreciated Mondrian's work for the ARMB.

**7. Fund Financial Presentation and Cash Flow Update**

State Comptroller PAM GREEN gave the regular financial report as of September 30, 2009 *[financial statements included in the meeting packet]*. She reviewed the changes in value (all increases) for the invested assets of each retirement plan for the month of September and for the fiscal year to date.

Responding to MR. PIHL, MS. GREEN confirmed that the State of Alaska appropriation came in during the quarter (August). MR. SHIER said the total appropriation was $282,965,000. MR. PIHL said he wanted the board to realize that without the State appropriations the outflows from the retirement funds probably exceed the contributions on an annual basis.

MS. GREEN displayed graphs of total invested assets, investment income, and asset allocation in the Public Employees' Retirement Trust Fund over the past 12 months. She pointed out that all the asset allocations were within their target bands at September 30. The fixed income allocation was on the low side. The same comments regarding asset allocation pertained to the PERS Retiree Health Care Trust Fund as well.

MS. GREEN displayed graphs of activity in the Teachers' Retirement Trust Fund over the past 12 months and pointed out that income has been increasing in the fund. The asset allocations were within their target bands at September 30, with fixed income on the low side but within the bands. The Teachers' Retiree Health Care Trust Fund also had all asset allocations within the target bands.

The Judicial Retirement Trust Fund and the Retiree Health Care Trust Fund graphs illustrated total invested assets, cumulative investment income, and the actual asset allocation versus the target allocation. MS. GREEN also showed graphs of the Military Retirement Trust Fund investment asset growth, etc., and noted that asset allocation was well within target bands.

MR. RICHARDS asked that since Ms. Green always provided the percentage change in assets for the month verbally if she could add a percentage column on the Schedule of Investment Income and Changes in Invested Assets by Fund. It would save the trustees having to write the percentages in next to each retirement fund. MS. GREEN said she would do that.

MS. GREEN referred to the reporting of funds by manager included in the meeting packet and said the invested assets reported were for all the non-participant directed plans. The reporting did not include SBS and the Deferred Compensation Plan, or the defined contribution retirement plans. She said that all the asset categories increased except for real estate, which had about 6.7% of losses from the June 30 quarter that were now being reflected in the financial statements.

VICE CHAIR TRIVETTE commented that separating the non-participant directed plans reporting made it a lot easier to keep track of, and he appreciated the asset accounting staff doing that.

MR. O'LEARY mentioned that Callan's performance reporting was using preliminary real estate returns through the end of September.

MR. PIHL observed that the Tishman Speyer Real Estate Venture funds showed large losses, and he asked if staff could explain that. VICE CHAIR TRIVETTE indicated that Mr. Sikes would provide comment on that later.

MR. SHIER presented the ARMB financial report supplement to the Treasury Division report, prepared by the Division of Retirement and Benefits. Page 1 showed the cash flows of the various retirement funds for the first three months of the fiscal year, and page 2 was the same information for the month of September.

VICE CHAIR TRIVETTE called a scheduled break at 10:15 a.m. and reconvened the meeting at 10:30 a.m.

**8. International Small Cap Equity Presentation**

MR. O'LEARY introduced JANET BECKER-WOLD of Callan Associates, Inc. and briefly reviewed her professional background. He said that he hoped to get Ms. Becker-Wold on the ARMB agenda again over the next 12 months to share her thoughts on currency, which is an area that everyone needs to be more aware of. The topic at today's meeting was international small cap equities as a separate allocation, as requested by Mr. Bader.
*[A copy of the Callan slide presentation is on file at the ARMB office.]*

MS. BECKER-WOLD stated that the weighted median market capitalization of the EAFE Index, which is the benchmark for the ARMB's four active international equity managers, is $33.6 billion. The weighted median market cap of the EAFE Small Cap Index is $1.24 billion, which is vastly different. One question might be whether the ARMB is getting any small or mid cap exposure in the existing international equity structure. If trustees look at the characteristics that Callan provides in the supplemental quarterly reports, the international composite of Brandes, Capital Guardian, Lazard and McKinley is only slightly smaller in market cap than the EAFE Index. Looking at the managers individually, Brandes does dip down into some mid cap, but the other managers not so much. So the ARMB is not getting the international small cap exposure through its existing active managers.

MS. BECKER-WOLD listed reasons why the board might want to consider international small cap as a separate allocation within the international structure: (1) there is some performance potential; (2) this is a good area to deploy active risk; and (3) there are some diversification benefits, both for the international equity structure and for the total equity structure. However, implementation issues can counter-weight some of the potential benefits.

MS. BECKER-WOLD showed graphs of large cap versus small cap equity performance for both U.S. and international equities. She noted that there are similar but not coincident performance cycles within both large and small cap. So an investor can get some diversification if they have exposure to both of these markets.

Displaying a graph of cumulative 10-year performance, MS. BECKER-WOLD stated that there is a small cap premium in international small cap equities, just like there is in U.S. small cap. She also explained a risk/reward scatter chart showing that over 10 years international small cap has added a 4% premium over the EAFE Index per year with an increase in risk of 9%. By contrast, the U.S. small cap has added an annualized premium of about 4.4% over the Russell 1000 Index with a 25% increase in risk. The international small cap appears to have a good tradeoff.

MS. BECKER-WOLD next explored the question of whether to implement an international small cap portfolio actively or passively. Callan data shows that the median active international small cap manager consistently beats the EAFE Small Cap Index. Active small cap management is successful in adding value because the international small cap stocks are under-researched. Also, there is a lot of intra-stock volatility that allows managers to pick stocks among a universe where they can add value.

VICE CHAIR TRIVETTE asked what premium a top quartile small cap international manager could be expected to provide, if the median manager in Callan's database averaged 1.02% excess return per year. MS. BECKER-WOLD said a reasonable return expectation for active international small cap management would be between 100 and 200 basis points net of fees.

MR. O'LEARY pointed out the incredible spread in manager excess returns on the chart — from 8% over the EAFE Small Cap Index return to 10% under the index return. One of the challenges of realizing the average return is to stick around for it, and on a year-to-year basis a manager can have a huge variation from peers and from a benchmark.

MR. PIHL remarked that what worried him was the dramatic downward trend of returns on the graphs since mid-2007. He asked if that was a flight to quality. MS. BECKER-WOLD explained that the decline in active management alpha is one that Callan has seen across a lot of actively managed asset classes. In the international small cap area, she thought it had a lot to do with Morgan Stanley's huge revamp of the indices. For example, the MSCI EAFE Small Cap Index prior to 2007 had half the number of stocks it has now. The more inclusive index may make it harder for managers to beat it. However, there are some fundamental reasons why active managers should be able to continue to beat the index but maybe not at the same magnitude that they were able to before the benchmark reconstruction.

MS. BECKER-WOLD explained a periodic chart of investment returns for a 10-year period ended September 30, 2009. She noted that emerging markets have been the top performer in five of those years, the Russell 2000 Index was the top performer in two of the years, and the EAFE Small Cap Index was the leader in two of the years. The Russell 1000 Index and the EAFE Index were not a top performer in the 10-year period but did appear in second place. It is another reason to think about the way that international small cap equity could potentially diversify the ARMB portfolio's international structure, which already contains a dedicated exposure to emerging markets.

MS. BECKER-WOLD spent some time describing the correlation of international small cap to the S&P 500 and other indices. She offered the conclusion that emerging markets and small cap would appear to be not only good diversifiers within an international structure but in an equity structure in general, relative to the S&P 500. She also reviewed how sector exposure differs across indices. International small cap brings a different sector mix than the EAFE index, picking up more consumer discretionary stocks and industrials. International small cap stocks tend to be more heavily geared to the local economies, thus they tend to provide better diversification relative to large cap stocks that are often geared to the global economy.

MS. BECKER-WOLD reviewed how the three commonly used international small cap indices are constructed, and said all the indices have been expanded and improved in the last two years. Most of the small cap managers that Callan talks to are not trying to replicate the benchmarks, but the benchmarks are their starting point. As the indices become more inclusive to represent the actual universe in which managers invest, it becomes more difficult for managers to hold stocks outside the benchmark that can create the value added.

Using an efficient frontier graph, MS. BECKER-WOLD provided a risk/return framework for the board to think about how much international small cap equity to add to the portfolio. She pointed out that going from 100% the EAFE Index to 100% the EAFE Small Cap Index moves the risk up significantly. But there is a place where the [efficient frontier] line is relatively vertical, where small cap equity can be added to potentially improve the return of the total international equity portfolio without necessarily increasing the risk.

DR. JENNINGS noted that small cap indices are constructed to be about 15% of the market cap in each country. He asked if there was a mid cap segment that was not represented, and if 15% was another useful benchmark to bring to the table when looking at how much of the portfolio to invest in international small cap.

MS. BECKER-WOLD said the EAFE Small Cap Index has a mid cap gap. The EAFE managers would be more likely to buy larger mid caps than they would be to ever buy small caps. The MSCI has developed an investable or all-cap index and carved out a mid cap component: the bottom 15% is small, the next 15% is mid cap, and the top 70% is large cap.

DR. JENNINGS said that would suggest that a prospective small cap allocation would be filling in for the roughly 30% that active international managers are not doing. He noted that people tend to think of the international equity allocation as global ex-US, so that would also roll in emerging markets as part of the decision-making. He asked how thinking about emerging markets would interact as part of the developed large cap and international small cap.

MS. BECKER-WOLD responded that emerging markets would have been an interesting element to add to the efficient frontier graph of EAFE and EAFE Small Cap. Emerging markets are clearly much more volatile than small cap companies in developed markets.

These small caps tend to be less volatile, and she guessed they would be a little more highly correlated. So a mix of 10% and 10%, or even 15% and 15% if the board wanted to get more aggressive within a structure.

MR. O'LEARY related that a client has two international small cap managers, one that includes emerging markets and one that does not. The management style also has to be consistent with the marketplace. Callan can provide statistics of the distribution of emerging market securities by capitalization, and a decent portion is small cap. Some managers do not want to take a risk of emerging markets and a risk of small companies, because, given the volatility, there is exponentially a management challenge.

DR. JENNINGS said he was just thinking of all three of those asset classes together and not advocating for emerging markets small cap equity. MS. BECKER-WOLD agreed there was a good case for having exposure to all three if a fund has enough assets to sufficiently diversify them. She has a client that has had dedicated small cap for a very long time. They are looking at what would be the appropriate weights to both small cap and emerging markets within their international structure because they think that both are good places for returns, albeit at higher volatility.

MR. BADER stated that staff would put it on the to-do list to run simulations using the indices of all three asset classes, in order to respond to Dr. Jennings' question at the next meeting.

MS. BECKER-WOLD moved on to review the implementation challenges of international small cap. Callan's database includes 98 international small cap strategies, although if the ARMB were to look at hiring, the number would be substantially smaller. There can be capacity problems because very good managers fill up and close their products. As with some other small cap strategies in the U.S., international small cap managers found themselves with available capacity recently and have re-opened some of their products. It is just a smaller universe than an investor would normally be looking at in the developed markets. Finally, it is difficult for a manager to stay in the top 30th or 40th percentile because their ranking moves around. So international small cap is an area where the board would want to have more than one manager to help dampen some of the manager-specific risk.

DR. MITCHELL inquired if the managers that Callan might recommend in a search would be new names that only manage international small cap equities or if they would be international small cap products of larger firms. MS. BECKER-WOLD said they would be both.

In conclusion, MS. BECKER-WOLD stated that Callan believes it makes sense for plans that have sufficient assets to diversify to pursue international small cap. The ARMB has exposure to U.S. small cap equity with the same return premium. The board could structure the portfolio to take advantage of the diversification benefits of international small cap without duly increasing the volatility. It is a good area to explore active management in order to capture the higher return potential. The negative aspects are greater liquidity risk, fees tend to be higher, and looked at in isolation small cap stocks can be extremely volatile. However, some of that volatility can be mitigated if the portfolio is structured appropriately.

VICE CHAIR TRIVETTE said he wanted to see a return chart for some of the top international small cap equity managers to see how their returns bounced around in the last few years. He was also curious to see if any of those were managers with whom the ARMB already had a relationship.

**9. Buy-Write Strategy - RCM**

MR. BADER noted that the education conference had a presentation on this area, and he invited RCM to talk to the board about their strategy that is not identical but has many common elements to what trustees heard about at the conference.

MELODY McDONALD, RAY EDELMAN, and TODD HAWTHORNE of RCM Capital Management joined the meeting to speak on the RCM Redwood product, a strategy of buying stocks and writing in the money calls, commonly referred to as an equity buy-write strategy. *[A copy of the presentation slides is on file at the ARMB office.]* MS. McDONALD mentioned that RCM has been doing a lot of listening over the last year, and one thing they came away with is that clients are looking for more stable performance and more protection on the down side. They have been doing the buy-write strategy for a year with seed money, and they are beginning to talk to some clients about it now.

MR. EDELMAN stated that for nearly 40 years RCM has used their own internal fundamental research effort to generate and exploit what they call an information advantage to drive superior and consistent returns for their clients. They recognized that clients were moving beyond long-only strategies in the last decade, and they wanted to evolve into new products that used their internal research foundation. He said the RCM Redwood product is a team effort headed by Todd Hawthorne and himself.

MR. HAWTHORNE explained that RCM decided to seek the performance with stability that clients were asking for by setting three distinct goals: (1) to deliver an absolute return of between 8% and 12% over a full market cycle; (2) to deliver those returns with significantly lower volatility - half that of the S&P 500 Index; and (3) to deliver a high amount of down-side protection so clients can hold onto returns over time. The mechanism RCM chose to achieve those goals was an equity buy-write strategy. Simply, it is buying stocks and selling in-the-money calls against those stocks to create a buy-write. The approach allows RCM to leverage their two core competencies: the dual research platform, and the equity derivatives expertise.

MR. HAWTHORNE stated that academic studies of buy-write strategies say that (1) the returns are equal to, or in many cases better than, the indices upon which they are compared; (2) that those returns are achieved at a lower volatility of returns; and (3) they provide a small amount of down side protection. RCM improved upon that formula by applying market intelligence from their dual research platform to optimize the risk-adjusted returns. The research platform analyzes the positive and negative stock drivers for each stock, they quantify its current and future valuation, and they define its potential down-side volatility. They then roll that all up into a stock's intrinsic value, or the level at which they believe the stock has a lot of valuation support. They use equity derivatives to customize a payout profile that gives RCM protection down to a stock's intrinsic value level and at the same time gives an adequate or better return for the amount of risk being taken.

MR. HAWTHORNE walked through a simple example of a buy-write transaction, where RCM purchases a stock and sells a one-year call against the stock, essentially buying low and selling high simultaneously. He explained that there is a lot of down-side protection and a high probability of realizing a full return at expiration. He also compared the RCM Redwood strategy to a traditional buy-write strategy and highlighted the major differences *[slide 13]*.

DR. JENNINGS asked if there was a leverage aspect to the RCM approach. MR. HAWTHORNE replied that there is inherent deleveraging in all buy-write strategies, and he explained how that takes place.

MR. O'LEARY remarked that earning 8% to 12% average return says that there is risk. He asked what the risks were that would result in the ARMB not earning 8%-12%. MR. HAWTHORNE responded that the risks are primarily twofold. The first risk has to do with research - picking the wrong stocks can impair the return profile. While they try to correctly identify the potential down-side volatility, if they do that incorrectly, then they have stock risk. In that case, they do a risk assessment to see (1) if there is another buy-write they can put on; (2) if the intrinsic value assessment has changed; (3) if they need to modify that position so that its risk can be appropriately compensated for going forward; or (4) if they have made a mistake and should take that position off. The other major risk is a prolonged period of very low market volatility, where the returns are not good enough for the amount of risk they are taking.

Further responding to MR. O'LEARY about the value of a stock in the holding period, MR. HAWTHORNE conceded that the return numbers he outlined were at expiration of the call. He added that he and Mr. Edelman designed the product in an 18 VIX environment — certainly lower than the current market volatility — and they still had hundreds of potential investments that met their hurdle rate. So they feel confident that the great majority of the time will be a volatility environment where the Redwood strategy will still give adequate returns.

MR. EDELMAN stated that over the long term the broader market (S&P 500) returns have been about 8%. RCM's goal for the Redwood strategy is to be market-like to better, which is where they get the return objective of 8% to 12% over a market cycle. For example, they will not get absolutely 8% if the market is -10%.

MR. O'LEARY remarked that Mr. Edelman's explanation was clear but it begged the question of a reasonable and reliable expectation about the market. He did not disagree with the view that 8% is reasonable, but over the last decade the return on the market has been negative.

MR. EDELMAN said one of the goals is to cut volatility, and over the last year the portfolio had positive absolute returns while the S&P 500 return was negative for much of that time.

At DR. MITCHELL's request, MR. HAWTHORNE described the call market or the other side of the buy-write trade, which he said are listed markets, very active, and highly liquid. Real money is changing hands, and it is driven by people's expectations of where a stock is going to be in the future and the volatility in the marketplace.

MR. O'LEARY mentioned that this period has been highly unusual and the volatility level extraordinary. He commended RCM for looking for ways to improve the clients' lot. He could understand RCM's focus on this strategy as the market began a disastrous decline: they have avoided or reduced the magnitude of the loss in the first part of the period and benefiting from the still-high volatility in the initial market recovery. His question was what the longer-term environment was likely to be, because if this pattern could be counted upon, presumably everybody would want to do it. That would likely change the volatility premium.

MR. HAWTHORNE stated that there is an interesting hedge built into the strategy in that they are not systematically selling calls on a very rote basis. Theirs is a very flexible strategy: they can actually take advantage of changes in the volatility environment because the portfolio is active and they are always putting on brand-new buy-writes. When RCM first began the Redwood fund, the environment was closer to a 20 VIX, but as the world deteriorated the volatility went up and RCM was able to take advantage of that. When the market is trending up and volatility comes in, the returns are definitely going to be less, and the strategy could potentially underperform versus a long index. Presumably, the ARMB's other assets would be doing quite well in that environment.

MR. HAWTHORNE displayed the Redwood fund's performance by month over 2009, noting that the period covered almost every kind of market imaginable and was a good testing ground for the strategy. He specifically drew attention to when the S&P 500 Index was down 23% — the buy-write strategy was actually down a little over 3%. That demonstrates the ability that RCM has to take advantage of a changing volatility environment and to provide the protection when it is needed. He noted that since inception the fund has had well over 30% down side protection in aggregate throughout all the market environments. Also, when the strategy was down to -3%, they still had contained within the portfolio approximately a 15% potential return that they would collect at expiration. He also pointed out on a graph that the volatility of the strategy has remained stable at about half that of the S&P 500 Index.

MR. HAWTHORNE spent a few minutes describing the Redwood buy-write process in more detail, starting with idea generation, through stock selection and portfolio construction, and finally monitoring and risk management.

MR. O'LEARY asked what RCM would do if the screening process was unable to identify opportunities that satisfied the return hurdle rate. MR. HAWTHORNE said that if it was an extremely low volatility environment, they would be on the sidelines and not break the investment process.

Concluding the presentation material, MR. HAWTHORNE stated that buy-writes as an asset class have a value in most asset allocations because they can, and typically do, provide equity like returns at a lower volatility of returns. RCM believes that by applying their version of market intelligence they can improve upon the standard buy-write strategy.

MR. EDELMAN stressed that the ARMB should view the buy-write strategy as a complement to the retirement fund's other strategies.

MR. BADER asked if there were any issues with brokers and custody. MR. HAWTHORNE said there are two approaches. The simplest is to have a prime broker where the longs and the calls are housed at the same place. Another way is where the longs need to be custodied at a custodian bank, a tri-party agreement is created, and the calls stay at the prime broker.

VICE CHAIR TRIVETTE asked what percentage of the RCM Redwood fund had both components at the same location. MR. HAWTHORNE said 100%, and they currently are prime brokered at UBS.

MR. PIHL inquired if RCM was the only firm offering this buy-write approach and what the fee structure was. MR. HAWTHORNE replied that most of what he has seen angle more toward the traditional buy-write fund where there is some kind of indexing, the calls are more systematic in nature, and the calls are slightly out of the money. He could not guarantee that RCM was the only firm that was combining a buy-write strategy with fundamental research, but he had not come across any others. The theoretical fee structure that RCM will offer the fund at is 75 basis points for up to a $100 million investment.

MS. McDONALD mentioned that one advantage RCM has is that Mr. Hawthorne is part of the organization and communicates with Mr. Edelman constantly. Some firms offering a buy-write option will sub-advise that particular derivatives approach.

VICE CHAIR TRIVETTE thanked RCM for the presentation before calling a lunch recess at 11:54 a.m. When the meeting reconvened at 1:15 p.m., trustees Erchinger, Harbo, Pihl, Richards, and Trivette were present. Chair Gail Schubert arrived at 1:23 p.m.

**REPORTS (Continued)**

**10. Private Equity Evaluation**

GARY ROBERTSON of Callan Associates, Inc. conducted an annual review and performance analysis of the ARMB private equity portfolio. *[A copy of the slide presentation is on file at the ARMB office.]* He said that his report last fiscal year was very positive for the private equity portfolio, and he had emphasized then that things would be very different this time around. The past year has been awful for all asset classes except treasuries — especially equities, including private equity. The key theme for the coming year is cautious optimism, recognizing that there is little visibility in the markets right now and that we could bump along the bottom for a while before there is a sustainable recovery.

MR. ROBERTSON stated that the ARMB is invested in a broad market portfolio that covers the full spectrum of corporate finance investments, from small startup companies, through large cash-flowing companies, to companies that have fallen on hard times and need to get restarted. He briefly reviewed how the ARMB invests money with two oversight managers (or "manager of managers"), who invest in private equity partnerships that in turn make commitments to various companies. He noted that these positions are long term and can last from 12 to 15 or more years, so it is important to measure twice and cut once with the asset class because you cannot really trade out of positions if you are not happy.

The ARMB private equity program started 11 years ago with the hiring of Abbott Capital Management, and the board hired Pathway Capital Management eight years ago. Blum Capital was hired in 2005, and that portfolio is getting wound down now. The in-house program was started two years ago. The managers overlap a bit in their investments, providing the ARMB with bigger commitments in what both managers have a high conviction are good investments.

MR. ROBERTSON reported that the ARMB total fund declined about 18% from June 30, 2008 to June 30, 2009. That, coupled with the restructuring of the health care funds this year, resulted in the private equity target declining by $240 million. The longest tenured gatekeeper, Abbott, has the most assets, followed by Pathway. The in-house program and Blum Capital program are much smaller. The Blum program is largely public stocks and not technically private equity. Private equity as a percentage of the ARMB total fund is 8.7%, well within the asset allocation band.

MR. ROBERTSON showed a graph of private equity market commitments since 1996, noting there has been a fair amount of volatility in the size of the market over time, depending on the economic cycle. When the board hired Abbott in 1998, they invested into a high-priced environment at the top of the tech bubble, and that gave the portfolio a bit of a headwind. Pathway was hired in 2001 in a recession, and they were able to invest a fair amount of money into very low-priced deals at the bottom of the market and ride the next buyout boom up. Pathway has a buyout style, which was very favorable to them. The in-house portfolio was started a year before the new recession. Today, following the great recession after the fourth quarter of 2008, plan sponsor commitments into the private equity market have come down a lot. That will probably continue into the next year as well.

MR. ROBERTSON stated that corporate earnings and revenues are continuing to suffer. That makes it very hard to value companies and for companies to get loans. When this happens, private equity goes pretty much completely illiquid. The general partners are focusing on triaging the portfolio companies, cutting costs, and renegotiating their debt agreements. Very little deal activity is announced quarter to quarter. Since there is no transaction activity, not much capital is being called, and the ARMB is not getting much back in distributions. Because the general partners know that plan sponsors do not have a lot of capital to commit to private equity now, they are not coming to market for fear that they might not be successful. So things are very static at this point. The market is going to stay frozen until lending returns, because most of the private equity market relies on buyouts which require debt. The mood is cautiously optimistic, and it should be a good time to invest in private equity. But if the economy is foundering for several quarters, private equity returns are not going to pick up.

MR. ROBERTSON said that based on history now should be a good time to invest in private equity. The key factors are low prices, capital structures are conservative because debt is unavailable, the general partners are chastened and have found investment discipline again, and investments made now should eventually take advantage of a sustained upswing in the economy and hopefully a long economic expansion. Callan still believes strongly that over the next market cycle private equity will maintain its return spread, once things pick up again. They believe that the factors that make private equity more profitable than public equity have not gone away. In the short term and until the market does turn up, it will be hard to see the benefits of those characteristics in quarter-to-quarter returns.

MR. ROBERTSON presented private equity industry returns by strategy over one- to 20-year periods. Total private equity returns were -24.4% for the one-year period through March 31, 2009. By comparison, the one-year return in the first quarter of 2008 was 12.9%. He explained that FAS 157 was implemented by the accounting industry in the fourth quarter of 2008. The private equity industry had to move from valuations that were somewhat cost-based to mark-to-market, or largely comparing to public stock valuations. Shifting to this valuation methodology created the perfect storm right when equities had a huge drop, and the down draft for private equity in that quarter was 18%.

MR. ROBERTSON next discussed the state of the ARMB private equity portfolio for the one-year period ended June 30, 2009 and compared it to the numbers one year ago. He highlighted the following points:

- 25 partnerships were added to the portfolio this year, for a total of 214 partnerships.
- Commitments grew by 11% off the base, versus 18% last year. So commitments have slowed, but the ARMB has been disciplined in continuing to put money out.

- Uncalled capital grew 11% this year, up from 9% last year. So general partners are calling dollars much more slowly than the ARMB is committing them.
- Distributions were $82 million in fiscal year 2009, a big change from the $225 million in distributions received last year. That translates into a 6% cash yield this year versus a 27% cash yield last year. 2% of the 6% cash yield this year was the liquidation of one of the corporate finance portfolios, so the private equity portfolio really only yielded about 4%.
- The net asset value of the portfolio was down $213 million, a 17% decline. However, the ARMB put an additional $101 million in during the year that was absorbed in that loss. So the unrealized depreciation was really about 25% when adding those two together. That compares to a 10% unrealized appreciation last year. Callan does not believe that kind of dramatic change will happen again in the next year, but they also do not expect to see a lot of movement up or down in the portfolio, unless something exogenous happens.

MR. ROBERTSON also presented the 12-month changes for the individual private equity manager portfolios compared to the prior fiscal year. He started by highlighting certain elements in the Abbott portfolio, as follows:

- This portfolio is older and more mature, therefore less volatile.
- Commitments increased by 9% during the fiscal year.
- Uncalled capital increased as capital calls slowed more than commitments.
- Total portfolio is about 72% paid in (mature). It will probably stay at that level going forward.
- Cash yield was 4% on the distributions.
- There was a 25% unrealized depreciation.
- The internal rate of return decreased 4% this year.

Referring to a graph of the Abbott portfolio's internal rate of return compared to the VentureXpert Vintage Year Peer Group Benchmark, DR. MITCHELL asked if the information indicated that Abbott was good or bad. MR. ROBERTSON replied that Abbott has a return multiple of $1.23, while the median is slightly negative. The upper quartile of the database is 1.32 times, and Abbott is high in the second quartile. The graph shows that in the years that Abbott is in the second quartile they are high in the second quartile, and in the years they are upper quartile they are quite high there. Callan expects that Abbott will approximate the top quartile, although this portfolio had some initial head winds when it started in 1998.

MR. ROBERTSON next drew attention to some of the 12-month changes for the Pathway portfolio, as follows:

- The commitments, portfolio paid in, and uncalled capital all increased between 13% and 16%. These are higher than Abbott's portfolio because Pathway's is a younger portfolio.
- The distribution was a 4% yield versus 23% last year.
- The unrealized depreciation was 25%, similar to Abbott.

- At -18.8%, they had a more dramatic drop in internal rate of return, which has to do with the time frame.
- They have a buyout-oriented portfolio. Pathway very much outperformed on the way up and very much underperformed when the buyout bubble exploded. Abbott has more venture capital in their portfolio, which gives them a little dampening effect.

Looking at the graph of the Pathway portfolio's internal rate of return compared to the VentureXpert Vintage Year Peer Group Benchmark, MR. ROBERTSON said there is a shorter time period to evaluate them, and they are first quartile in every year.

MR. O'LEARY said he believed that the accounting standard FAS 157 may have had more impact on buyouts than on the venture capital strategy. MR. ROBERTSON agreed, especially on the larger buyouts, which tend to be more Pathway's style.

MR. RICHARDS asked if there was a way of looking at the data that would show what year partnerships that are entered into this year would come to fruition. MR. ROBERTSON said there is an average distribution pattern of partnerships, but the actual distribution is very market dependent. Some partnerships can mature very early in a good economic cycle right afterwards, or the partnerships can be very protracted if they have to hold on for a long time.

MR. O'LEARY added that the ARMB staff's modeling process used to develop the annual plan for how much to invest in private equity makes assumptions about the pace at which the money that is committed in the coming year will be drawn down. Staff is also making estimates of the rate at which those investments will mature. It is easy to play with the model to see what would happen if the liquidations of the underlying companies got stretched out or were accelerated so capital was returned very quickly. It is not atypical to see the expected life of a buyout investment in the five-year area. But if a buyout investment were made five years ago, today harvesting that investment is probably being deferred a couple of years because of the severe economic climate. Staff does an excellent job of thoughtfully considering the sensitivity.

MR. ROBERTSON stated that the ARMB private equity portfolio is well diversified from a strategy standpoint, especially for a large public fund. The portfolio has a lot of venture capital, less than 50% buyouts, good exposure to special situations, and some debt-related investments. The portfolio is about 3% over the venture capital target, about 6% over in buyout, and about 10% under in special situations. However, special situations and buyouts are very similar so the portfolio is well positioned for strategy diversification.

Regarding the ARMB in-house portfolio started two years ago, MR. ROBERTSON said there are currently three partnership investments. He reported that ARMB staff and Callan evaluated secondary funds this year, and staff is in the process of closing on a secondary investment. The in-house investments are not seasoned enough to make a meaningful evaluation. The distressed debt fund draws down quickly and is 90% called, and at March

31 valuations updated for June cash flows it was just a bit underwater. That is a good outcome for a fund that started to invest before the fourth quarter of 2008. Callan expects the fund to go up from there. The other two funds in the in-house portfolio combined are less than 23% called.

MR. ROBERTSON stated that the corporate governance portfolio was initiated in May 2005 and largely focused on publicly traded small cap companies. Of the two direct partnership investments, one is an open-end vehicle investing in publicly listed securities, and one is a closed-end vehicle that invests in public companies and can also do some private investments. The public vehicle was completely liquidated this year, and the ARMB is waiting for the other partnership to liquidate. The performance of the liquidated fund was not good but it was not a disaster either, outperforming the S&P 500 Index for the 12-month period. There was just no reason to continue the program.

In summary, MR. ROBERTSON stated that both private equity managers are approximating top quartile performance. The portfolio overall is high in the second quartile of the benchmark database at this point. The portfolio is getting a lot of venture capital exposure from Abbott, and Pathway's buyout-oriented style has stood the ARMB in good stead during the boom and helped the return. The commitment activity was muted this fiscal year, and Callan expects it to be muted next year as well. The Abbott portfolio is 72% paid in, and when Pathway reaches that level in the near future the portfolio will be fairly mature.

Looking forward, MR. ROBERTSON said he was optimistic but there could be a lengthy bumpy period, depending upon when the economy swings up and private equity outperforms again. The good news is that Callan thinks valuations are bottoming and will move up with some volatility — but private equity valuations will not move up and respond as quickly as public markets will. The ARMB portfolio has a moderate backlog of uncalled commitments, so a good amount of capital to go to work in the marketplace when valuations are low.

## 11. Farmland Update and Review

### 11(a). Summary of Farmland Portfolio

State Investment Officer STEVE SIKES stated that farmland is part of the real assets portfolio, along with timber, energy, and treasury inflation protected securities. As of June 30, 2009, farmland represented 3.9% of the retirement fund assets. He briefly reviewed the history of the farmland program that was started in June 2004. The board selected two advisors, Hancock Agricultural Investment Group and UBS AgriVest LLC, both of whom would be making presentations later in the afternoon. The total farmland allocation is approximately $560 million, with $114 million of that remaining to be invested in future farmland investments. The allocation was briefly suspended last year when the real assets allocation exceeded its target, but that suspension was lifted in July 2009 and both advisors can now make new farmland investments. With each property averaging $5 million in size, the investment pace has been relatively slow. Roughly half of the portfolio is made up of a single acquisition of 41 properties that was made in June 2008 for $215 million.

MR. SIKES said the farmland investment program strategy and structure is similar to the real estate program separate account program. The advisors have complete discretion to make investments within the allocation and investment constraints. Farmland is a lease strategy investment structure, so the advisors buy the farmland and then lease it to farmers to operate. The portfolio crop type target weights are 80% row crops and 20% permanent crops. There are no development properties and no leverage in the portfolio. Each advisor prepares an annual plan that they present to ARMB staff for review. There are annual audits and annual appraisals. Lastly, a registration system ensures that the advisors are not competing for the same farmland asset and bidding up the price.

MR. SIKES stated that the rationale for the farmland investment program at the time the board approved the program was: (1) attractive total return with high cash distributions; (2) low volatility; (3) overall portfolio diversification; and (4) an inflation hedge. In the recent credit crisis and recession, farmland investments maintained positive returns with low volatility throughout the entire period.

MR. SIKES said the foundation of the farmland investment return is an attractive income return that is generated from the rents that farmers pay to operate the land. The total value of the 82 properties in the portfolio is $480 million. It represents over 150,000 acres in 15 states. The actual crop mix is 82% row crops and 18% permanent crops. The portfolio has grown to be fairly well diversified across crop types and NCREIF farmland regions. Inception to date (4-1/2 years), the ARMB composite net return is 9.37% annualized. A goal when the program started was to produce a 5% net real return, and for this period the actual real return is 6.72%.

MR. SIKES said the only negative is the performance comparison to the benchmark: for the same 4-1/2 year period, the NCREIF custom benchmark returned 16%. The benchmark is customized to reflect the ARMB portfolio's 80%/20% crop type weights. Staff attributes the underperformance to the benchmark to the performance of the permanent crops early on when the ARMB portfolio was not invested in those crops yet. There are also regional differences where the portfolio was underweight over time. It is challenging to produce index returns in the NCREIF world because the constituents of the index are so unique. Now that the portfolio has been built up, staff expects the return to be much closer to the custom benchmark in future years.

Regarding the farmland investment outlook, MR. SIKES said he did not expect the farmland sector to be immune from what is happening in the economy, and he did not expect 9%-plus returns over the short term. Some crop prices have fallen over the past year, and a driver of rents is how much the farmer expects to sell the crops for. So there may be some constraints on the ability to raise rents. However, very low leverage in the farmland sector overall and ownership primarily in local and private hands make the sector structurally strong. Forced selling as a result of falling values is not expected to be a component of performance. The long-term drivers in terms of alternative energy and demand for protein coming from improving economies should still be in place. At this time, staff does not believe there is any reason to change the farmland strategy, and recommends that the advisors should continue to invest the remaining allocation.

**11(b). Timberland Investment Update**
MR. SIKES reported that the timberland investment program that began in September 2007 is still ramping up. Timberland Investment Resources made its first investment in December 2008. Hancock Timber Resource Group made its first investment in June 2009. The total allocation to the timberland program is $240 million, with just over half invested. Although very early in the program, Timberland's performance has been good but much of that is attributed to the attractive purchase price compared to the appraised value. The NCREIF timberland index performance suggests that the sector has been impacted by the economy and the reduced demand for wood products. Staff believes this is still an attractive place to be over the long term. A little less than half the allocation remains to be invested at a time when prices should be declining, while the assets in the portfolio should continue to grow.

**11(c). Farmland Investment Policies, Procedures and Guidelines Update**
MR. SIKES explained that a December 2008 revision to the farmland investment guidelines inaccurately stated a requirement related to Unrelated Business Tax Income. Staff was bringing the correct language back to the board for approval by resolution.

<u>MS. HARBO moved that the ARM Board adopt Resolution 2009-29 adopting the revised Farmland Investment Policies, Procedures and Guidelines</u>. <u>MR. TRIVETTE seconded</u>.

Referring to page 7 of the guidelines, MR. TRIVETTE said the managers are supposed to investigate whether the ARMB should be entitled to any property tax exemptions. He asked if the managers are supposed to tell staff the results of their inquiry. MR. SIKES said he thought that was understood.

The motion passed unanimously, 7-0. *[Trustees Galvin and Williams were absent]*

**11(d). Hancock Agricultural Investment Group**
JEFFREY CONRAD, the President of Hancock Agricultural Investment Group, and

STEPHEN KENNY, Senior Investment Analyst, had been invited to review the farmland portfolio the firm manages for the ARMB. *[A copy of the Hancock slide presentation is on file at the ARMB office.]*

MR. CONRAD first presented some information about the Hancock Agricultural Investment Group before talking about the U.S. farm economy outlook. Crop revenue in 2008 was wonderful, and 2009 is still fairly good in the most difficult period since the Great Depression. Net farm income reached a record in 2008, and although it has fallen off some, it is close to a 10-year average for the sector. In the context of the general economy, the farmland sector is still performing relatively well. A lot of people expect the U.S. dollar to continue to be weak, and the farmland sector benefits greatly from that because a lot of agricultural commodities are exported. Another positive fundamental in the agricultural economy is the low debt-to-equity ratios. Lastly, it should give the board comfort that the sector should be able to take an income shock without seeing values hugely decrease.

MR. CONRAD said that clients have been asking why agricultural land values are holding up when they see pressure on commercial real estate and other assets. The answer is that the strong income returns are supporting land values. Hancock represents about 44% of the NCREIF Farmland Index, and they expect 6% to 6.5% income for 2009, even as commodity prices have gone down.

MR. BADER asked Mr. Conrad to comment on the potential for income from other uses of the land, which staff has been hearing about. MR. CONRAD said that beyond agricultural production, there can be hunting rights and leasing for wind electrical production. There generally are higher and better use pressures that Hancock expects will continue to impact the portfolio long term as the population grows, but these demands have diminished somewhat in the short term.

MR. KENNY reviewed the ARMB farmland portfolio, starting with the goals of diversification by geography and crop type, getting the optimum income return, prudent risk levels, and a passive lease structure for the portfolio. The three key portfolio benchmarks are total return over a five-year rolling period, income return for the portfolio and also individual properties, and a minimum going-in yield for individual properties. The portfolio is weighted more in the Pacific West region because of the Sonoma 12 wine grape asset in California.

MR. KENNY reported that at September 30, 2009, Hancock's current allocation was $205.25 million. Properties owned totaled $145.5 million and $23.2 million was for three properties that are either under contract or in a queue. They expect to have the remaining balance of $36.6 million invested in 2010. The portfolio is structured with six limited liability companies and is made up of 19 farmland assets located in 10 states. The ARMB portfolio's income returns have been consistent for 1-year, 2-year, 3-year, and since inception, and the portfolio has outperformed the customized NCREIF Farmland Index before and after fees for those time periods.

CHAIR SCHUBERT mentioned having read an article about the benefits of omega-3 oil from certain fish and the concern that at some point the fish stocks could diminish because of the demand for omega-3. The article suggested that soybeans might be genetically altered to create omega-3. She asked if the farming sector was reactive to a report like soybeans possibly being genetically altered to produce omega-3.

MR. CONRAD replied that Hancock does see a lot of research and development reports, and scientists are always looking at tweaking the genes, etc. for different reasons. In a larger context it is sort of noise on the side because they cannot adjust their strategy to capitalize on it, not knowing how viable something will be. However, it is fair to say that in the U.S. there are many genetically modified products out there, and Hancock does keep track of the trends.

MR. KENNY stated that the properties in the ARMB portfolio are cash leased to local operators. For example, the portfolio has a few properties in Illinois, and if an operator wants to grow high oil soybeans it is his prerogative. Hancock does not make the calls on what type of crop the operator is going to grow.

MR. BADER asked if Hancock provided any stewardship of a property so that operators are not continuously growing the same crop and depleted the soil. MR. CONRAD said that is critical from a property management standpoint, and they have that oversight responsibility. They try not to dictate what a tenant can do, but if the operator is not taking care of the asset — such as maintaining the irrigation system, crop rotation, etc. — obviously they would address that. The ultimate redress is to not re-lease the asset.

MR. JOHNSON inquired about the length of the typical farmland lease. MR. KENNY replied that it is usually one to three years for row crop properties. When leases end they go out for bid, and usually it is the same tenant who would get it. Things have changed dramatically in the last few years: a lot of larger farmers have bid aggressively, and Hancock may sign them up for a one- to two-year lease. But if they are happy with the current tenant, and the tenant is happy with the increased cash rent, then Hancock will re-sign with them. MR. CONRAD added that there are other considerations besides getting the highest dollar per acre.

CHAIR SCHUBERT asked if any of the tenants on the ARMB properties had defaulted on their lease obligations in the economic down turn. MR. CONRAD said no, that things were fine at this point. He said that the farm sector has maintained average earnings during the down turn in the general economy, and Hancock is comfortable with the tenant pool.

While waiting for the next presenters to get set up, CHAIR SCHUBERT suggested taking up the election of officers that was deferred from earlier on the agenda.

**ELECTION OF OFFICERS**

MS. HARBO nominated Gail Schubert for the office of board chair [for one year]. MR. PIHL seconded.

There were no other nominations, and MR. PIHL moved for unanimous consent. The motion passed without objection.

MS. HARBO nominated Sam Trivette for the office of board vice chair [for one year]. MR. PIHL seconded.

There were no other nominations, and the motion carried unanimously.

MR. PIHL nominated Gayle Harbo for the office of board secretary [for one year]. MR. TRIVETTE seconded.

There were no other nominations, and the motion passed without objection.

Ms. Schubert, Mr. Trivette and Ms. Harbo were present and accepted the offices to which they had been elected.

**REPORTS (Continued)**

**11(e). UBS AgriVest LLC**
BRIAN WEBB, Managing Director of UBS AgriVest, and JAMES McCANDLESS, Executive Director, addressed the board about the farmland investments the firm manages for the ARMB. *[A copy of the UBS AgriVest slide presentation is on file at the ARMB office.]* MR. WEBB reported one change in their regional offices: George Schwab, who covered the southern region for several years, retired, and Cullum Jeffries was hired to take his spot. Mr. Jeffries has 10 years of experience with GE Capital on the commercial property side, in both asset management and acquisition, as well as an agricultural economics degree from Texas A&M.

MR. WEBB stated that since inception UBS AgriVest in aggregate has been able to provide a 5% real (above inflation) return. They still believe that is an appropriate long-term benchmark for returns on farmland. The aggregate portfolio has underperformed the NCREIF farmland benchmark over the past year. It is difficult to not have some swings in performance over short periods of time. They are pleased with the way the portfolios for ARMB and other clients are positioned, and they feel good about what things look like going forward.

MR. WEBB said some macro forces have been in play for the past few years that have helped farmland generate the overall returns. Those forces include a dwindling amount of farmland and water resources globally, due to urbanization and some soil erosion. Farm commodity inventories have been at historically low levels for the last couple of years. The farm debt-to-equity ratios have been declining and are at historic lows, so there is plenty of capital in the farmland sector, particularly in the U.S.

MR. WEBB said the global demand for farm commodities is on the rise, which is the underlying source for returns from the farmland itself. The demand is coming from improving incomes in developing countries and from biofuels. The global economy has put a little pause on this macro force, and there has been a pause in excess appreciation that farmland has been enjoying for the past few years. But there does not appear to be a point in time where farmland will have to give back some of those returns. Things are at a plateau, and as the economy starts to come back in the U.S. and globally, they think the macro forces will kick back in and be positive for farmland.

MR. WEBB said the increasing supply of farm commodities in response to improving demand can only come at higher commodity prices. It means bringing less fertile soils into play or producing commodities in areas where the transportation costs to get those commodities to market are higher. They believe that higher commodity prices will continue into the future, particularly as the global economy starts to pick up some steam again. Finally, the higher commodity prices certainly support higher farmland rents on properties in the ARMB portfolio and also support higher farmland values.

MR. WEBB showed a graph of farm commodity prices since 1994 and remarked that UBS AgriVest never viewed the very peak of commodity prices in the middle of 2008 as sustainable. Neither did the farmland tenants, and UBS was never able to negotiate rents that reflected those very high commodity prices. Prices have pulled back to sustainable levels at this point, and UBS AgriVest believes the rents and the farmland values are well supported by the current commodity prices.

A graph of U.S. farm income showed an inflationary trend line through the years that has picked up in the past few years. The U.S. Department of Agriculture is forecasting the inflationary trend line to continue at this higher level. UBS AgriVest does not think that the USDA forecast reflects the macro forces described earlier, and they believe there is more room for farm income to grow. The *Wall Street Journal* has reported that farm income is going to be significantly off this year from the past couple of years. But the measure is a very macro measure of farm income that includes cattle operations, hog operations, and dairies — things that UBS AgriVest is not investing in on the ARMB's behalf. It is those areas that have taken the hardest hit. Annual and permanent crop land has actually held up quite well, even this year, and they think it will bounce back in coming years.

MR. WEBB showed a chart of US farmland annual returns from 1970 to 2008 compared to inflation, the bond market, the stock market, and commercial real estate. He stressed that farmland has been able to cover the 5% real total return goal over long periods and with a strong correlation to inflation. Farmland has also been a good diversifier for overall portfolios because of the negative correlation with the bond market in particular, but even with the stock market. Nevertheless, the returns over the past two or three years have been in excess of what UBS AgriVest believes an investor can expect over the long run.

MR. WEBB reported that over the past three or four years permanent cropland has done very well. The ARMB portfolio underperformed relative to the benchmark, and a large part of that came from under-exposure to permanent crops. As UBS AgriVest built the portfolio they were not finding buying opportunities on the permanent crop side. But the portfolio is very well diversified at this time and has appropriate exposures to both permanent and annual cropland. There is tactical under-exposure to permanent cropland from this point forward because they do not think that permanent cropland can continue to outperform, given where pricing is of the relative two sectors. Since inception in 1991, permanent cropland on an absolute return basis has not been able to keep up with the annual cropland. And on a risk-adjusted basis, the standard deviation of permanent cropland returns is much higher than for annual cropland.

MR. McCANDLESS reviewed specifics of the Midnight Sun (ARMB) portfolio, which at September 30, 2009 held 63 farms in 13 states. The cost basis of those properties was $302 million, and the market value was $322 million. The remaining allocation to invest was about $52.6 million. The highest percentage of investments are in the Pacific West region (California), reflecting the state's larger properties and larger operators that are more attractive as investments.

MR. O'LEARY mentioned the publicity about environmental issues having an impact on water access in California. He asked how UBS AgriVest thinks about that, and if any ARMB investments were impacted in any way.

MR. McCANDLESS replied that the water situation is a primary concern when underwriting an acquisition in any western state that has irrigation. Large areas of California are essentially off limits, as far as UBS AgriVest is concerned, because the long-term outlook for water is so much in question. The areas where the ARMB portfolio holds properties have excellent water and have not been affected by the "political drought," which has probably enhanced the value of those properties quite a bit.

MR. McCANDLESS reviewed the portfolio characteristics compared to the constraints established in the ARMB farmland investment guidelines. He also explained for CHAIR SCHUBERT that Midnight Sun, Inc. is a title holding entity that is a tax-exempt corporation. There are six Midnight Sun entities that are either regional or by state so that all the properties are not in one basket.

MR. McCANDLESS showed graphs of total return and cash income return for the Midnight Sun portfolio. He said the portfolio does not have quite five years of history yet, but since inception the income return has been 4.37%, beating the expected 4% return over a rolling five-year period. He noted that not all the income was reflected in the September 30 numbers because a lot of the payments are received in December. The permanent crop properties are leased on a participating lease basis where the rent is a percentage of the gross income from the property. That number is not tallied up until about this time of the year. UBS AgriVest expects significantly more income to come in before the end of the year, and they will probably be making two distributions this month.

MR. McCANDLESS reported that UBS AgriVest rented two ARMB properties (6,000 acres) along the Gulf Coast of Texas to Duke Energy for a wind generation project that will consist of about 80 towers. Those properties are still being farmed and will continue to be leased as farms. Duke is in the process of doing meteorological testing and getting permits, etc. The lease is set up to provide fixed payments for the footprint of each tower and roads, etc. and a percentage of the power sales. Those leases have a 25-year term, and the percentages are escalated up every five years. This was not an intended use for these properties, but UBS AgriVest was able to negotiate those leases.

MR. TRIVETTE asked if UBS AgriVest had an estimate of the income the ARMB portfolio would get from power generation. MR. McCANDLESS said the farm rent is about $160,000, and they expect the percentage of power sales will be $500,000 to $600,000.

MR. PIHL asked if the ARMB has approval authority for a long-term lease commitment of the property like that. MR. McCANDLESS said no, that it is part of UBS AgriVest's discretion to manage the portfolio. MR. PIHL responded that an encumbrance of the property outside of growing row crops or permanent crops should come to the attention of the staff and the Real Estate Committee for approval, as a matter of practice.

MR. BADER said that Mr. Pihl had raised a good point. He said this information was not a surprise to staff, who have been well aware of the incremental income coming from the Texas properties. Beyond that, he bore the responsibility regarding the long-term encumbrance of the property being a change in the nature of the underlying asset. He said staff saw it as a tremendous opportunity to add incremental value, however, he should have informed the trustees.

Regarding the title holding companies that the chair asked about earlier, MR. O'LEARY said he understood the logic of it to minimize overall risk because of isolated circumstances on a property. He asked how UBS AgriVest determined what number of holding companies was the right number.

MR. McCANDLESS said they simply approached it by region or by state. The mandate is that the assets in each entity cannot exceed $50 million, and when the asset value reaches that point UBS AgriVest would structure a new entity to take additional properties. The only exception is the original Midnight Sun portfolio that was already in place and had exceeded $50 million.

MR. RICHARDS asked if UBS AgriVest felt that the Texas farmland properties would be easier to sell or harder to sell with the windmills on them. MR. McCANDLESS said he thought the properties would be very easy to sell with that kind of income stream.

MR. BADER stated that when the board approved the acquisition of the Winding Brook portfolio there were certain exceptions that had to be made to the ARMB's standard practices. The portfolio was viewed as a single asset at the time, and the understanding was that properties that did not meet the investment guidelines would have to be sold off at some point. He asked if all the properties in that portfolio now meet the individual property criteria laid out in the investment guidelines or if some properties need to be sold.

MR. McCANDLESS said that UBS AgriVest has not identified any properties that need to be sold. However, they do a hold-sell analysis on all the properties at the end of the year. At that time, the team will be able to identify if any Winding Brook properties do not fit the guidelines.

CHAIR SCHUBERT thanked the gentlemen from UBS for their presentation and called a scheduled break from 2:59 p.m. to 3:15 p.m.

**12. Capital Guardian - Non-U.S. Equity Review**

PAULA PRETLOW with Client Services and CHRIS RYDER, an investment specialist with Capital Guardian, spoke on the Alaska retirement fund's international equity portfolio valued at $527 million. *[A copy of the Capital Guardian presentation material is on file at the ARMB office.]* She said they would offer periodic comments about the emerging markets equity portfolio as well, although it was not the focus of this presentation.

MS. PRETLOW briefly covered the investment philosophy, business approach, and investment process at Capital Guardian. She said they had layoffs and redundancy reductions across the board because of poor markets. Those are finished, and they have adjusted to a reduced number of overall employees within the Capital Group to serve both their retail and institutional clients. The multiple portfolio manager system remains the cornerstone of the investment process that is built on research. As Capital encountered performance issues, they made changes to the non-U.S. equity team, the U.S. equity team, and the fixed income team. There have been no changes to the emerging markets equity team. They want their managers and analysts to be able to focus, so now there are fewer managers per mandate. The non-U.S. equity team has seven managers, where last year at this time there were nine managers. Richard Hovis, a global EAFE manager, moved to the mutual fund side of the business. Rudolf Staehelin took the global EAFE slot on the non-U.S. equity team, and Sun Kwat moved off the team to focus exclusively on Japan. The styles of the seven managers currently on the team reflect the core EAFE portfolio.

MR. RYDER mentioned that Capital believes it is very important to cross fertilize the culture between the institutional business and the mutual fund business. Richard Hovis's transition to the mutual fund side occurred at the same time as another senior portfolio manager from the mutual fund side moved to the institutional business (but not part of the international equity portfolio). MS. PRETLOW advised that clients may see more of that cross fertilization between the mutual fund side and the institutional side going forward.

MR. RYDER stated that a key benefit to having a multiple manager team is not relying on any one individual and being able to plan for generational change. One announcement in the last couple of months was that Nilly Sikorksy, who has been with Capital for 42 years, plans to retire at the end of 2010. That is a slow and steady transition that Capital has been anticipating for some time and which they can accommodate while still retaining the core mandate that Alaska hired them for.

Turning to the investment results, MS. PRETLOW said last year was tumultuous but Capital Guardian did protect the international equity portfolio on the down side. Part of their style will also see them trailing in rapidly rising markets, which is what has occurred since the first quarter of 2009. However, on an absolute basis, Capital has participated quite handsomely in that market run-up. She noted that the same general trend was true for the ARMB's emerging markets portfolio as well. MR. RYDER stated that the ARMB's emerging markets portfolio was up over 70% year to date.

*[Mr. O'Leary pointed out that the heading on the investment results page was incorrect and should have read "Results as of October 31, 2009."]*

MR. RYDER said that while the economic data has not been getting any worse, it is still in the fairly latent period of improvement. The biggest reason behind improvement in market performance globally is that the stimulus packages around the world have been so important in changing investor sentiment towards risk. The monetary growth in China in the first half of this year was in the mid-20%. That is bound to have had an impact on investor perception of the systemic risk that existed at the beginning of March 2009. The EAFE team managers believe that while the good news has mitigated the worst aspects of the recession, nevertheless there is still an underlying concern that end demand, particularly from the consumer in the developed world, is still somewhat muted. So managers have adopted a fairly cautious view of the world. They think that things like consumer deleveraging in North America will take several years. As a result, the majority of the managers feel that the underlying economic recovery story might be more muted than in past cycles. That plays into their stock selection in the international portfolio.

MR. RYDER stated that the portfolio has performed well in absolute terms but has lagged a bit in relative terms because Capital was positioned more defensively at the end of 2008 and going into the first quarter of 2009. Cash was the largest single detractor from returns as the market was strongly rallying. The second important characteristic was an underweight to financial stocks, something they have continued. Capital also had disappointing stock selection within financials. Progressing through March, they recognized that the systemic risk to the financial system had gone away. However, they are still very concerned that the bank earnings in the coming decade will not be the same as they were in the previous decade. There are still a number of uncertainties out there, particularly related to regulations. That is why Capital has been very selective in the banks and insurance companies they have added to the portfolio. They have cherry-picked what they think are the long-term winners in the industry as opposed to buying the stocks that have risen the most from March to date, which tend to be the banks that were just about to go bust in March and got a bailout. Capital does not believe that is an investment thesis on a three- to five-year time horizon, but nevertheless it has paid off for investors who took that risk in this interim period.

MR. RYDER said the third major factor that detracted from performance was Capital's disappointing stock selection in materials. While Capital was overweight the materials sector, the stock selection was more defensively oriented towards gold as opposed to the industrial commodities that have run the most as people have been taking the prospects of global growth back on board and "re-risking" their portfolios. Gold has traditionally been seen as a hedge against both inflation and systemic risk that the market was experiencing in the first couple of months of 2009. Despite the fact that the price of the commodity has been fairly strong, the gold stocks have been laggards compared to the industrial commodities during this period. Also, Barrick Gold Corp. has a hedge book that it has been unwinding, and that has impacted the performance of that stock. Nevertheless, the comments he made about gold are also true in the ARMB's emerging markets portfolio at Capital, and that portfolio does not have Barrick Gold in it. It has all been about gearing into economic recovery, so the industrial commodities have done well.

MR. RYDER stated that gold is seen as an inflation hedge and a defensive asset and has underperformed. Capital has maintained a sizeable gold exposure in the ARMB's non-U.S. equity and emerging markets portfolios. While that is very much driven on an individual company basis, it perhaps suggests a couple of things. There is still some concern that the global recovery is not going to be the straight line that people have been talking about of late. Secondly, there is still a concern about inflation 18 months to two years out. The stimulus packages enacted around the world have mitigated the worst of the recession, but nobody has quite figured out how to pay for it all. The prospect of unintended consequences of these stimulus packages could be very significant. So some managers have chosen to hedge themselves to a certain degree by retaining some gold exposure.

MR. RYDER reviewed the 20 largest holdings in the non-U.S. equity portfolio to highlight what Capital has been finding attractive in the world today. There is still a lot of uncertainty about the global economy, and Capital remains a little bit cautious. In the market correction they have focused the portfolio on what they think are very sustainable, high quality business models, and companies with strong balance sheets that can see them through the tough times. They want companies that have a strategic vision of where they want to be, and in particular companies that are able to gain market share from their weaker competitors. Capital is not looking for the stocks that are going to bounce the most in this market rally because they have concerns about the strength of economic growth and the strength of markets over the coming couple of years. The top 20 holdings in the portfolio are the large global players in their industries that are going to gain market share from the weaker players. That is important because if they can sustain growth during a period of generally low economic growth, they are going to attract a premium rating. An example is HSBC, the global bank that has the most exposure to Asia, which Capital believes is a relatively high growth area in the coming years. In fact, the chief executive of HSBC has moved back to Hong Kong from London, because obviously China is a huge growth opportunity for them. There are two truly global commercial banks in the world: HSBC and Citigroup. With the difficulties that Citi is having, the opportunity for HSBC to gain market share is the other part of the investment thesis.

MR. RYDER also talked about the top holdings by sector, pointing out that Capital has moved from 13.5% to 19.5% in financials, although they are still very underweight relative to the index. They have been taking money off the table in the traditionally more defensive parts of the market that held up relatively well in the dislocation at the end of last year — so consumer staples, and second-line companies in energy. However, they have kept a reasonable weighting to emerging market energy companies where the valuations are more attractive than some of the oil majors in the west.

MR. RYDER next addressed diversification by country, making it clear that Capital is very much bottom-up stock pickers. They are underweight Japan: the political and social inertia in Japan continues despite the change in government there, and it is hard to get excited about the prospect for many Japanese companies. The stocks in the portfolio tend to be more the export-oriented companies, like Toyota. Europe can be broken down into core Europe and the periphery of Europe. The periphery is the U.K., Ireland, Spain, and Iceland. These are countries that have similar problems to the U.S. in terms of consumer leverage and a financial system that has been somewhat dysfunctional. Capital believes that the workout for those countries is going to take several years. Conversely, the economic recovery in continental Europe (France, Germany and Italy) is probably going to be more of a normal recovery. Those countries have had less consumer leverage and less exposure

to housing booms and busts.
While companies that are very international may be domiciled in one country or another, Capital nevertheless feels that perhaps continental Europe might see some better growth or a more normal recovery rate than in the periphery of Europe.

MR. RYDER said that what is very different in this market cycle is the relative importance of emerging markets to the developed world. Capital has been very constructive on emerging markets on a secular view for a very long time, and they have been able to participate in this portfolio in a limited way because the ARMB's limit for emerging market exposure is up to 10%. At the beginning of 2009, they added significantly to China, after the Chinese market fell 66% last year. It proved to be very fortuitous and the biggest single contributor to emerging market growth funds. Prospects for China are still very positive on a secular view. Short term there is some concern about signs of bubble activity. After the big election change in India in the early part of the year, Capital continues to remain positive on the secular story, in particular for the development of the financial system in India.

DR. MITCHELL asked if a different benchmark than the MSCI EAFE Index would be fairer, given that Capital can invest up to 10% of the international equity portfolio in emerging markets. MR. RYDER said the All Country World Index ex-US is a greater representation of the emerging markets. He stressed that Capital is not really buying emerging market companies; they are buying large cap, internationally exposed, liquid companies — so a relatively limited list. Splitting the index to reflect 10% emerging markets would be slightly apples-and-oranges in terms of the emerging markets exposure that this portfolio is getting.

## 13. BlackRock, Inc. – Portfolio Update

MR. BADER introduced LEE WANIE and MARCO MERZ, formerly of Barclays Global Investors, who were now representing BlackRock as a result of that firm recently acquiring BGI. MR. WANIE explained that he has been the client relationship manager on the ARMB account at Barclays for five years, and Mr. Merz has been there for four years as a senior index strategist.
*[Mr. Wanie distributed a replacement presentation booklet that reflected the change to BlackRock, which is on file at the ARMB office.]*

MR. WANIE said the ARMB had about $218 million invested with BlackRock at October 31, spread across equity assets and fixed income. BlackRock is recognized as a fixed income expert, and the former Barclays Global Investors was recognized as an equity expert. Pre-merger the talk was that they were complementary businesses with complementary products, and so far the different units of the businesses are fitting together very well. There was a small head count reduction at Barclays pre-merger, and it will be interesting to see how the two businesses come together in mid-2010. As a client, ARMB can expect business as usual. BGI is a very scientifically driven firm, and the leadership traditionally has been comprised of investment people who have gained senior management positions. BlackRock has a more client-focused leadership, and their senior leaders are often spending time with clients throughout the size and commitment range. So this board could expect to see senior BlackRock personnel sometime soon.

MR. WANIE stated that other benefits of the new larger firm are better pricing for clients, reduced transaction costs, breadth of products, and custom solutions for things like risk management. BlackRock is currently in the process of reviewing the client coverage model. He has spoken to his BlackRock counterpart in Alaska, and they intend to have a team approach in terms of staying in touch with the ARMB.

Drawing attention to an executive summary, MR. WANIE mentioned that the total assets at November 30 were closer to $227 million as a result of good returns in the equity markets. He noted that the inception dates of all the ARMB strategies with BlackRock were listed as March 31, 2009 because that was when they implemented the retirement system's direction to move away from funds that engaged in securities lending and into the non-lending strategies. It was a complicated process to get the new funds up and running, but it was done on schedule and with a minimum of transaction costs. The equity index fund has been closely tracking the S&P 500 Index. The intermediate government bond fund is down 14 basis points from the index, net of fees, so within expectations. BlackRock has had some trouble sticking to the benchmark in the government/credit bond fund, largely due to unprecedented and massive volatility in credit markets. The bond portfolios are put together using a subset sample of securities and not on a fully replicating basis.

MR. O'LEARY inquired about the size of the government/credit non-lending fund. MR. WANIE said it was several hundred million dollars versus billions of dollars for the lending version of the fund.

MR. MERZ mentioned that the equity index non-lending fund has substantially grown in size over time and is now about $40 billion. Size matters in indexing. So the fact that this fund is so large is why they were actually able to match the benchmark return with zero basis points deviation.

MR. WANIE stated that as transaction costs have come down in fixed income since the beginning of this year, they expect tracking to pick up and be a lot better in the government/credit fund going forward.

MR. O'LEARY asked if it was accurate to assume that, in general, active fixed income would be managed by the old BlackRock and that passive fixed income would continue with the old Barclays Global Investors, or if there would be some further delineation.

MR. WANIE replied that if there is going to be further delineation, it has not happened yet. Currently, the most senior leadership of the active and passive fixed income funds is staffed with two BlackRock personnel. There are a number of very senior BGI personnel who will continue to lead the quantitative fixed income effort. There was concern about what would happen to the scientific fixed income business, however, BlackRock saw that

BGI was doing some creative things in terms of quantitative fixed income, and that they could add value consistently. Also, BGI's performance throughout the financial crisis going back to the summer of 2007 was much better than BlackRock's, so they have decided for the time being to leave it as is. They have a large customer base that is interested in low-risk active fixed income management and that has seen success with it. That customer base has also grown as other fixed income managers struggled through the mortgage crisis.

MR. O'LEARY said he assumed that for the time being clients would be serviced by the same people that have been doing the job. He asked how Mr. Wanie anticipated that would be handled in the future. MR. WANIE said that impacted his job, and earlier this year he was flying all over the country to meet clients. He thought the first cut would be to look at geographical assignments, but customer relationships are critical and he expected any trims to be more at the margin for the first pass.

MR. O'LEARY asked if Mr. Wanie could guess the timing of when everything would be pretty much in place. MR. WANIE thought things would be 80%-90% of the way done by the end of 2010. Some people were made redundant in the client service area and those clients reassigned, and some client relationships will change if it results in improvements. A refined client assignment list would likely come out in the next few weeks, and then another step would occur probably around mid-2010.

MR. MERZ first spoke about the implications of the merger to the equity indexing business. The leadership team will be intact at the new BlackRock entity, and the portfolio manager will continue to be stationed out of the San Francisco office. There have been no personnel changes on the equity indexing side. Barclay's legacy indexing is about 10 times larger than the business at BlackRock, so they will integrate residual BlackRock business on the equity index side into the San Francisco production facility. The good news for existing clients, such as ARMB, is that there will be no changes to the organizational structure. Beyond that, there will be no changes to the investment philosophy for managing equity index funds. It will continue to be total performance management, focusing on risk/return and costs. The S&P 500 Index fund is currently fully replicating and that will not change. Cost is the biggest hurdle for an indexer to overcome because the benchmark itself assumes zero transaction costs for all changes to the benchmark. Almost $1 trillion of the $3 trillion of assets under management are indexed assets. That is the hunting ground to reduce transaction costs through crossing. They cross on average between 40% to 60% annually, so only the residual has to be traded on the open equity market. All equity and fixed income trades are done on a best-execution basis, and that goes for all foreign exchange trades they do on behalf of clients. Because of the firm's footprint, they are able to deliver wafer-thin commissions on behalf of clients.

MR. BADER commented that BlackRock runs both index funds and exchange traded funds (ETFs), and many of them have similar mandates. He asked if institutions are using ETFs. Also whether emerging market index funds, for example, lend securities, and if the ETFs in those markets lend securities.

MR. MERZ replied that institutions do use iShares or ETFs. Emerging markets is a perfect example: the reason why institutions use ETFs as a tactical investment in emerging markets is that the liquidity is substantially higher in ETFs than in a commingled fund that has to transact the buys and sells on the local market. Both commingled emerging market index funds and ETFs lend securities. On the ETF side they are able to lend the securities within the ETF and then the ETF itself, so it is a two-layered lending process. Historically, BlackRock has seen a substantial increase in lending demand on the ETF side, and therefore substantially higher lending yields on ETFs. That has 7
diminished over time, and from the returns that emerging markets have yielded over the last year it is clear that shorting is not a winning strategy in emerging markets currently. As of right now, the lending yield between an ETF and a CTF is identical.

MR. O'LEARY commented that if there is a lot of demand for ETFs, at some point new shares are issued. He asked Mr. Merz to explain that for the board, which he did.

MR. WANIE stated that the use of ETFs by institutional investors is still largely for marginal exercises, such as short-term exposure or short-term liquidity. For investors of hundreds of millions of dollars, who do not need the liquidity that an emerging market ETF would provide, it makes more sense to be in institutional commingled funds that are much cheaper and typically provide enough liquidity for foreseen future payments.

Returning to the presentation slides, MR. MERZ said that operational risk control is paramount at BlackRock. He briefly reviewed the portfolio management process where there is a clear separation of duties between the portfolio management team and the trading team. Within each team there is a rigorous peer review process for trades, and the larger the trade the more senior the reviewing portfolio manager needs to be.

MR. O'LEARY mentioned the controversy regarding currency transactions and said he gathered that the new BlackRock was not trading currency, as Barclays historically had not. He asked if that would continue. MR. MERZ stated that they do not trade foreign exchange internally and do not make any money off foreign exchange trades.

MR. MERZ spent a couple of minutes talking about trends in indexing. The overarching theme that BlackRock has heard from clients about investing has been broader, more diversified exposure. That is nowhere truer than in international investing. Over the last five years they have seen a steady increase in emerging market investing. Today most of their clients have dedicated emerging market exposure, driven by the fact that emerging markets are too large to ignore and are now over 20% of the international equity markets. A more recent trend is the ACWI ex-US Investable Market Index for the inclusion of small cap international investing. Clients are trying to mimic what they have been doing in the U.S. with the Russell 3000 Index exposure or a dedicated small cap active manager. About 30% of BlackRock's asset base has moved to the Investable Market Index strategies. For clients that already have large cap exposure internationally, they also offer a dedicated small cap international vehicle to complement the existing holdings. They believe that over the next five years clients will embrace broad cap investing, and the IMI indices will become the gold standard of international investing. BlackRock has seen steady demand for frontier or pre-emerging market countries — especially Eastern Europe, Middle East, and Africa — which complete the international investment set. Clients are seeking the diversification benefits and the low correlation to U.S. and international equities.

## 14. Investment Actions

### 14(a). Buy-Write Strategy

*[A written staff report was included in the meeting packet.]*

MR. BADER commented that plenty of institutional funds are talking about how to reduce risk in their portfolios and safeguard more of their assets but few are doing anything about it. He reminded trustees that at the October 1-2, 2009 meeting they hired Advent Capital Management LLC to manage a convertible bond mandate. The premise behind the decision was to seek equity-like returns from a convertible fund with some of the down-side protection that bonds offer. The board heard a presentation from Eaton Vance Investment Managers at the 2009 education conference about a buy-write strategy. In 2006, Callan did a study on the buy-write strategy and concluded among other things that the buy-write index could get higher returns with lower volatility than the S&P 500 Index and the Russell 2000 Index. Today RCM Capital Management made a presentation on a buy-write strategy. Staff believes there is potential in the buy-write strategy to improve the performance of the retirement funds, and so recommended authorizing a search for one or more buy-write managers. Staff would report back to the board at the next meeting, possibly with a recommendation.

<u>MR. TRIVETTE moved that the Alaska Retirement Management Board direct Callan Associates, Inc. and ARMB staff to initiate a search for one or more buy-write strategy managers</u>. <u>MS. HARBO seconded</u>.

MR. TRIVETTE inquired if the results of Callan's 2006 study had changed in the ensuing period. MR. O'LEARY said he tracked down the author, Jim VanHuet, who did the study for the Chicago Board Options Exchange (CBOE). It was an update of a study that had been done by another consulting firm, Ennis Knupp & Associates. He asked Mr. VanHuet if he thought the study findings were still accurate, and his opinion was that they were still valid.

MR. RICHARDS made the comment that the return statistics he heard from RCM today were not stellar, although he recognized the volatility aspect. He asked if the board would get the opportunity to discuss whether the buy-write strategy was a good investment strategy for the retirement fund.

MR. BADER stated that the return numbers that RCM presented have to be viewed in the context of the market experience over the last two years. Accepting the fact that the retirement fund is invested in equity markets, the board has to accept that at times there will be losses. Staff is trying to minimize those losses and level out the returns with the buy-write strategy. The return numbers presented by Eaton Vance and RCM, as well as in the Callan study, are relatively good returns. The buy-write studies that were referenced in the Callan report go back several years. RCM has back-tested their approach, and it was successful over a long period of time: what they presented today were the real returns from their seed portfolio. Regardless of what candidates come out of the manager search, the return history will be for a limited period of time. He said staff would provide copies of the Callan buy-write study to trustees.

MR. O'LEARY stated that there are two levels of decision. First is to find out what strategies are out there and then decide what strategy or strategies the board is comfortable with. The Eaton Vance buy-write strategy and the RCM buy-write strategy the board heard about so far are very different, and Callan's manager search is likely to turn up strategies that are somewhere in between those two. The board will have to consider the risks inherent in the strategies and who has the most compelling story in terms of product, history and experience, organization, and fees.

COMMISSIONER KREITZER said she planned to vote yes to move the process forward, but she agreed with Mr. Richards that the board would want to scrutinize the actual strategies and determine if they met what the board wants to do. She will be interested in what Callan learns from the search process and what the managers will have to tell the board in their presentations. She expected questions about the buy-write strategies, whether they do what has been set out, and how that approach looks in the world today with the direction that stocks are going. She tries not to have a short-term view, but it is also hard to ignore right now.

MR. ERCHINGER requested that information given to the board go back far enough to provide a sense of how each of the managers would have performed in various market environments. She also wanted the information presented in an apples-to-apples comparison. For example, RCM's return numbers were presented gross of fees, and the rolling numbers looked great but the individual months did not look so great. Some interpretation of that would help trustees understand the impact of the various strategies from each manager.

MR. TRIVETTE asked for a copy of RCM's back-test results, to the extent that they are available.

On an outcry vote, the motion passed unanimously, 7-0. [Mr. Williams and Commissioner Galvin were absent.]

**14(b). Convertible Bond Guidelines**
*[A written staff report was included in the meeting packet.]*
MR. BADER reported that the board approved Advent Capital Management as a convertible bond fund manager at the last meeting. The investment guidelines for convertible bond managers did not exist, so staff wrote them and was bringing a recommendation to the board. These policies and guidelines have been reviewed by staff and by Advent and are substantially the practices that Advent uses.

<u>MR. RICHARDS moved that the Alaska Retirement Management Board adopt Resolution 2009-28, adopting the convertible fixed income investment guidelines included in the packet</u>. <u>MS. HARBO seconded</u>.

MR. TRIVETTE inquired how staff created new investment guidelines from scratch, and if they consulted with Callan Associates and the investment advisory council members. MR. BADER responded that he and Bob Mitchell did not consult with Mr. O'Leary or the IAC members because they considered the investment guidelines to be quite benign. A convertible bond can be from investment grade to non-investment grade, and the guidelines place certain limitations on the types of investments that can be held. One requirement is that if the manager converts a bond into a stock, that the stock cannot be held longer than 20 days, etc. — guidelines that ensure the manager maintains the character of a convertible bond fund rather than an equity fund.

MS. HARBO asked if an extension for holding a stock beyond 20 days would be indefinitely. MR. BADER said it would not be indefinitely, but there could be liquidity issues in the market that would make it unreasonable to force the 20-day deadline. He added that it would not be in the chief investment officer's interest to override the guidelines set by the board unless there was a compelling reason.

The motion passed unanimously, 7-0. *[Commissioner Galvin and Mr. Williams were absent.]*

**14(c). Cadogan Management Termination**
*[A written staff report was included in the meeting packet.]*
MR. BADER reported that at the last meeting the board granted staff the latitude to terminate Cadogan Management, an absolute return manager for ARMB, based on the news that senior executives had resigned the firm over terms of Fortis repurchasing the firm. The Cadogan management did return and are now in place. Over the ARMB's relationship with Cadogan since 2004 there have been several issues regarding ownership of the firm that have been resolved. However, the unsatisfactory record of performance has been a different issue: since inception, Cadogan has returned 2.8% versus the benchmark at 8.1%. The board recently hired two absolute return managers that hopefully will have a far better record of investment performance. Cadogan has been on the watch list, and staff believes it

is time to terminate this manager.

MR. PIHL moved that the Alaska Retirement Management Board authorize staff to terminate Cadogan Management. MR. TRIVETTE seconded.

MR. TRIVETTE indicated that the Callan performance reports have tracked Cadogan's history, which supported staff's description.

MR. JOHNSON noted that staff's recommendation was to liquidate the Cadogan portfolio and to terminate the contractual relationship with Cadogan when the liquidation was complete. He suggested clarifying if it was meant to be a two-step process, or if a notification of termination would go out even if it was not possible to liquidate all assets in a timely fashion.

MR. BADER stated that the contractual relationship would not end until the Cadogan portfolio was liquidated.

The motion carried unanimously, 7-0. *[Commissioner Galvin and Mr. Williams were absent.]*

**14(d). Brandes Defined Contribution Fund**

*[A written staff report was included in the meeting packet.]*

MR. BADER reported that staff was able to negotiate lower investment management fees for the Brandes Institutional International Equity Fund that has been an investment option for the defined contribution plans since October 2001. Staff worked with Brandes to set up a collective investment trust structure where the fees are lower. The annual savings are estimated to be around $960,000 a year, or roughly $80,000 a month. The board gave staff the direction to do this quite some time ago, but it was not easy to implement.

## RECESS FOR THE DAY

CHAIR SCHUBERT recessed the meeting for the day at 4:35 p.m.

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## Friday, December 4, 2009

## CALL BACK TO ORDER

VICE CHAIR TRIVETTE called the meeting back to order at 9:04 a.m. Trustees Harbo, Erchinger, Kreitzer, Pihl, Richards, and Trivette were present. Chair Schubert arrived at 9:12 a.m.

**REPORTS (Continued)**

**15. KPMG - Audit Report**

MR. PIHL, chair of the Audit Committee, introduced MICHAEL HAYHURST and CORINNE FIEDLER of KPMG to give their fiscal year 2009 audit report to the board. *[A copy of the audit report, the slide presentation, and the minutes of the Audit Committee's December 2, 2009 meeting are on file at the ARMB office.]*

MR. HAYHURST referred to a list of the Treasury Division's and Retirement and Benefits Division's responsibilities. He said essentially it is that management in the divisions are responsible for (1) adopting sound accounting policies, (2) establishing and maintaining internal controls, (3) fairly presenting the financial statements in conformity with generally accepted accounting principles, (4) promoting a culture of integrity and honesty - called "the tone from the top," and (5) establishing controls to prevent, deter and detect fraud.

MR. HAYHURST summarized the list of KPMG's responsibilities as (1) planning, designing and performing an audit of the financial statements of the divisions, and (2) upon completion of that audit, that has been performed in accordance with generally accepted auditing standards, to issue an opinion on the financial statements that they are fairly presented in accordance with generally accepted accounting principles (GAAP).

MR. HAYHURST reported that KPMG had completed the audits on the fiscal year 2009 financial statements of the Treasury Division and the Division of Retirements and Benefits. He provided a list of reports that KPMG issued under those audits. All reports were unqualified opinions, meaning there were no items found and they were clean opinions. KPMG determined that all the financial statements that were being issued over which they had opinions were materially correct in accordance with GAAP.

MR. HAYHURST stated that there was one unadjusted audit difference that represents the time lag between when the market value adjustments get recorded into the financial statements and the fiscal year end. This adjustment occurs every year and, historically as well as this year, is fairly inconsequential relative to the overall value of the financial instruments in the funds.

Addressing procedures around fraud, MR. HAYHURST said that KPMG is responsible for designing tests to identify any material fraud that might exist in the financial statements. KPMG considers various factors when looking at the fraud risk. They go through brainstorming sessions, look at significant estimates and underlying assumptions, and using healthy skepticism consider the potential for misstatement due to fraud. KPMG is required to look at two areas for the risk of fraud because historically these are areas where most of the frauds have occurred. One is in revenue recognition, which does not apply to the sets of financial statements dealt with here, but KPMG still has to consider it because it is a professional standard.

The other area at high risk for fraud that applies a bit more specifically to these financial statements is the risk of management override of controls — specifically around journal entries and adjustments and around significant accounting estimates, the potential for management to weigh in on some of the assumptions, and looking at any unusual transactions. There were no unusual transactions in the year. KPMG did design controls and tests to look at journal entries and adjustments that were recorded throughout the year. Also to look at the significant accounting estimates, especially within the Retirement and Benefits financial statements around the actuarial present value of the obligations represented in those financial statements. As a result of those tests, nothing was identified from the standpoint of any fraud.

MR. HAYHURST listed the other required communications from KPMG:

- Confirm for the ARM Board that KPMG is independent of the Division of Retirement and Benefits and the Treasury Division.
- There were no disagreements with management during the audit steps.
- KPMG received full cooperation from management and had full access to the books and records in the audits.
- KPMG is not aware of any consultation that management had with other accountants looking for potentially a different opinion on a particular accounting matter.
- KPMG did not discuss any major issues prior to the retention of KPMG by management and the ARMB, as it relates to looking for a different answer from another firm on potential accounting issues before retaining KPMG.
- No difficulties encountered in performing the audits.
- Provided to the Audit Committee the significant written communication between KPMG and management, which was the management representation letter and the management letter that KPMG issued as part of the audit of the financial statements, as well as the opinion.

MR. TRIVETTE asked if KPMG audited any of the ancillary funds, such as the long-term care fund or the dental/audio/vision fund.

MR. HAYHURST stated that KPMG does audit the retiree health care fund. He referred trustees to the complete list of audited funds on slide 6. In conclusion, he thanked management for the cooperation KPMG received throughout the audit.

## 16. Investment Performance Measurement - 3rd Quarter 2009

MR. O'LEARY of Callan Associates, Inc. notified trustees that the packet of performance information in the meeting binder was a revised preliminary presentation. It did not contain the final real estate return numbers, but he did not expect a material change when the final report was issued. *[A copy of the Callan slide presentation, containing numerous graphs and charts, is on file at the ARMB office.]*

Starting with a market review, MR. O'LEARY said the September quarter was a great quarter for public financial assets, and the retirement fund participated in that market recovery. The private markets lagged significantly, and private equity was the biggest single contributor to below-target performance. Real estate continued to experience write-downs. To keep things in perspective, the stock market has already discounted a significant profit recovery. It is not enough that profits be up; they have to be up enough so as to not disappoint investors from this point forward. Regarding good news reported this morning about a slow-down in the rate of job losses, there is currently a lot of noise in the economic numbers because of the size of governmental programs and their impact on shifting up demand for things like cars and houses.

MR. O'LEARY stated that the Treasury yield curve at September 30 was extraordinarily steep and across the curve was basically lower than it had been at the beginning of the quarter or a year ago. Any news that economic activity seems to be improving is interpreted as interest rates are going to rise, so from day to day or even within the same day there are big changes in sentiment.

A periodic table of investment returns for major asset classes was interesting because it showed the incredible difference between emerging markets and U.S. large cap stocks over the last 10 years. The ARMB has had meaningful participation in emerging markets, which has helped portfolio performance.

Presenting a chart of the bond index returns, MR. O'LEARY pointed out the reversal in the bond market. The median manager in the high yield fixed income style group had a return of 38.36% for three quarters of 2009. Over the trailing year the return is 16.41%. The Barclays Aggregate Index returned 5.72% for the first three quarters of the year, and the trailing 12-month number is 10.56%. The Barclays Government Bond Index for the three quarters was actually -1.21%, a remarkable change. In 2008, particularly in the fourth quarter, the only asset that was up was government bonds. The reversal in the bond markets has been more spectacular than the changes in the stock markets.

MR. O'LEARY explained that the NCREIF Index for real estate is an unlevered and pre-fee return at the property level and is the most widely used measured of institutional real estate returns. Unfortunately, in many respects it is an unrealistic measure because the vast majority of investors in real estate have some leverage, and it is an inherently high-fee asset category (around 1%). Over the trailing four quarters, the NCREIF Index has been down over 22%, the worst that it has been in the index's history. While vacancy rates are up substantially, there have been prior periods where they have been worse. Going into this recession, real estate was not really overbuilt compared to the late 1980s and early 1990s. Accounting standards for real estate have moved toward market valuation of the assets, and the consequences of significant leverage are in action — plus a very steep recession. MR. O'LEARY also explained the NCREIF Open-End Diversified Core (ODCE) Index for open-end real estate funds that was down more than 28% for the nine months, so worse results than the NCREIF Index. That reflects the higher leverage used in these funds, and the more aggressive valuation because people are trying to withdraw money at those values.

MR. O'LEARY reviewed how anticipated future income from leases plays into the NCREIF values, and said the expectation now is that leases will be signed at lower rates than they were previously. The second factor is that the vacancy expectation is greater today in the valuation of real estate than it was a year or two ago. Also, the capitalization rates are higher than they were. Of note is that the cap rate that is applicable to properties that are actually being bought or sold today is significantly higher than the NCREIF cap rates. Not a lot of transactions are happening so it is difficult to say whether the current cap rates will move higher, or if improved liquidity and economic activity will cause people to think that the current NCREIF cap rates are reasonable. Callan's experience in the real estate business makes them think that cap rates for existing properties will move higher.

When queried for his opinion, MR. WILSON said he agreed with the last statement.

MR. O'LEARY said the bottom line is that it is tough to see significant change in real estate valuations. He shared the view of others that the bottom for real estate will not be apparent for four or five quarters.

CHAIR SCHUBERT mentioned that she had heard there was a second round of loan failures anticipated on commercial properties. MR. O'LEARY said he thought one of the reasons that cap rates for transactions were so high is because of the distress of the equity owner and the legitimate concern about credit availability. That has dissipated a bit because some real estate investment trusts (REITs) were reasonably active in selling new equity during the third quarter. With that equity increase, many owners were able to refinance some of their mortgages, although the situation remains precarious. Maturity schedules of commercial mortgages show a big need for refinancing in calendar 2010 and 2011, hence the general view that the commercial real estate area is not out of the woods yet. What has changed is the expectation about how much that money will cost. With the big improvement in the bond market that occurred, particularly in commercial mortgage-backed securities in the June and September quarters, the environment looks a lot cheerier today than it did just six months ago. Because equity levels in properties are so low, the refinancing rate is critical to the availability of financing.

Addressing private equity, MR. O'LEARY said everyone is aware of the accounting change that forced more market-oriented valuations. Because of the lagged reporting, the December 31, 2008 private equity returns were really based on September 30 valuations. The December 31 valuations showed up during the March quarter and were really negative because they were catching up for what happened in the equity markets in the fourth quarter of 2008. The first quarter of 2009 was a terrible quarter, and that showed up in the second quarter private equity returns. In the third quarter private equity actually posted a slight positive return. That is because the majority of private equity is associated with buyout investments. The ARMB portfolio has a greater-than-average exposure to venture capital, which is affected by the markets but a lot less affected than buyouts. Buyouts are affected in two ways. They have a significant amount of leverage in the structure, so as interest rates rise, it has a much bigger impact on the valuation of the enterprise. Second, buyouts tend to be larger companies for which there is more of a public market comparable, in terms of price/earnings ratios. Also, the general economy made everybody's equity worth less. The decline in private equity looks fairly comparable to the decline in public equity, but the timing of it is off by three to five months. Valuation increases for the buyout types of firms are already beginning to feed through, hence the slightly positive return in the third quarter. But the big changes in valuation will not be apparent until initial public offering (IPO) activity picks up in a meaningful way. IPO activity in the third quarter was actually up but not great.

MR. O'LEARY stated that inflation in the third quarter was -1.3%, and there was a very large decline in the Producer Price Index year-over-year. But a year ago commodity prices tanked and oil was in the thirties per barrel, so from this point forward the year-over-year comparisons will become more challenging. He did not think that the U.S. has negative inflation. The revised real GDP growth for the third quarter was 2.8%.

Referring to graphs of economic indicators put out by JP Morgan, MR. O'LEARY said the economy is still exceedingly weak, but it looks like the housing starts freefall has ended. Inventories have been declining, but even if there is no growth, inventories have to be replenished. Looking at stock valuation measures, MR. O'LEARY said the price to earnings ratio on the S&P 500 Index was over 26x at September 30. That looks high compared to historical averages, but he thought that was because earnings were depressed, and investors obviously think that profits looking ahead will be significantly better. That supports his belief that investors are already anticipating a significant profit recovery. If that does not materialize, then there is vulnerability in the market. The good news is that profits have been comparatively strong: there have been enough job cuts and write-offs that a small change in volume should result in a big change in profits. So the cost-saving gains have already been achieved, but the change in volume is needed now for profits to grow.

MR. O'LEARY mentioned that Mariner Investment Group did a great job talking about future inflation at the October education conference. He obtained permission to reproduce their graph of the 95-year inflation history in the U.S. He said inflation is the biggest issue that this board will face over the next five or six years. Callan shares the standard expectation that inflation is not a concern over the next year or two: the question is if inflation is a real risk beyond that. Mariner's graph illustrates that there have been comparatively few episodes of dangerously high inflation, but when they occur they feed on themselves. A tremendous expansion in the federal balance sheet accompanied the financial collapse in 2008-2009, a result of the government's attempt to provide liquidity. The total net borrowing and lending in the credit markets from households and non-financial corporations, etc. has declined sharply. The contraction would have been huge if governments had not stepped in. Manufacturing capacity and employment are incredibly under-utilized, and hence the optimism about short-run inflation.

MR. O'LEARY commented that nobody knows what the tax bill associated with various government programs will end up being. Interest rates are very low, so it is not costing much for governments to be deeply in debt. The question is what will happen to deficits if interest rates are 2% or 3% or 4% higher. That ultimately is the discipline that gets imposed on the system. If one believes there is any inflation right now, then interest rates are negative. Looking ahead, people will have to be budgeting a lot more in the way of interest expense, and where will the revenue come from to pay that expense. The tightrope that policymakers have to walk, both from a fiscal perspective and from a monetary perspective, is a very challenging type tightrope. If policymakers signal that party time is over, no more negative real interest rates, and short-term rates are going to move up to 2% or 3% (so maybe the rate of inflation), that is a huge change. Depending upon one's political persuasion, you could be optimistic or pessimistic on that.

MR. O'LEARY reviewed the asset allocation of the retirement funds at September 30, using the Public Employees' Retirement System (PERS) as the illustration. Relative to the target, the fund was under allocated to fixed income, primarily because of the strength of the equity market rebound. Staff has subsequently addressed the under allocation.

MR. O'LEARY said the 9.46% September quarter return was attractive in an absolute sense but below the target return. The biggest sector of underperformance was in the private equity arena, where the target is a public market stock index. Private equity was up 3.4% in the quarter. Calendar year to date, the PERS total fund has returned 9.78%, compared to the target return of 16.92%. Again, the underperformance to the target is primarily attributable to private equity. Real assets were also down substantially year to date, but the difference from target was less extreme than for private equity. The trailing 12 months were a different story. Real assets and private equity were equally responsible for the underperformance relative to target. Real assets are comprised of TIPS and farmland that did well and real estate which did poorly. Looking at the longer-term PERS fund performance data, of note was that the return for private equity over seven years was 9.26% annualized and above the target benchmark.

MR. O'LEARY reported that relative to the Callan public fund database, calendar years 2005, 2006 and 2007 were great years for the retirement funds, and in a relative sense 2008 was not a bad year. However, 2009 for three quarters has been an abysmal year in a relative performance sense. That was why he spent time earlier delving into what has been happening in the real estate and private equity asset classes. Private equity made 2008 look better than it really was and is making the 2009 performance look worse than it really is, relative to the public fund database. The PERS fund very long-term return (18 years) is well below the target.

MR. O'LEARY next reviewed the major asset classes in the retirement funds, as follows:

- The total domestic bond pool performance was above the custom index for the last 12 months and was very strong in the September quarter. Although slightly negative last year, the total bond pool did not do poorly compared with other public funds.

- The in-house bond portfolio compared to the Callan core bond style group had an ugly fourth quarter in 2008 but has had three strong quarters of recovery in 2009.
- Large cap equity returned -6.48% for the trailing 12 months, while the Russell 1000 Index was down -6.14% and the S&P 500 Index was -6.91%. A big portion of the retirement portfolio's large cap is passively managed in the S&P 500.
- Small cap equity did a bit better than median in the quarter but did poorly for the trailing 12 months, at -11.23% compared to the index return of -9.55%. The board made significant changes to the structure of the small cap portfolio in 2005. There was market-like performance in 2005, strong relative performance in 2006 but behind the benchmark, and 2007 was a very strong year. Despite being negative, 2008 was strong in a relative sense, and 2009 has been very positive but lagging the index. The managers would say on balance that it is because of the higher quality orientation and less junk exposure.
- For total international equity including emerging markets, performance has been very competitive. The one-year return was 6.26% versus the MSCI ACWI Index at 6.43%, and 22nd percentile when compared with other public funds. Longer-term results are also very good. [Until ARMB increased the allocation to emerging markets, the comparison was focused on the EAFE Index for developed markets.]
- Total international equity excluding the emerging markets has done well compared with a developed market index (EAFE).
- The emerging markets equity pool performance has been competitive as well, 38th percentile over five years and above the benchmark. For the last year, the returns have been better than the median of the Callan emerging markets equity database but a tad below the emerging markets benchmark.
- There is one global equity manager, Lazard, which had a very strong year in a relative performance sense. They have beaten the appropriate benchmark over the long term.
- International bonds (Mondrian) really helped the total portfolio performance with a return of 18.76% over the last 12 months. Part of that was benefiting from the dollar's weakness, and part of it was the government bond benchmark.
- The REIT portfolio, while small now, had a great September quarter, up almost 33% and just slightly behind the NAREIT Equity Index.
- The absolute return composite returned 3.77% for the quarter.
- The high yield bond composite returned 10.18% for the quarter and 14.47% for the trailing 12 months, better than the Barclays Aggregate Index but lower than the high yield index. The high yield managers have more of a quality orientation, so they went down a lot less than the target index in calendar 2008.

MR. O'LEARY brought the performance a few managers to the board's attention, as follows:

- Callan has always compared Cadogan (absolute return) against the long-short hedge fund index, a slightly tougher peer group. But he fully supported the board's decision yesterday to terminate Cadogan.

- Crestline Investors had a decent September quarter relative to the absolute return hedge fund style. However, there was nothing great to say about the 4-3/4 year return of 2.53% annualized.
- Mariner (absolute return) has a fixed-income orientation and has done well compared against the absolute return style group over the last year.

MR. BADER observed that the ARMB's absolute return managers seem to be median managers and yet none of them seemed to be meeting the benchmark of T-bills + 5%. He asked if the benchmark needed to be changed.

MR. O'LEARY replied that from a risk perspective it is reasonable to change the benchmark. He said he and Greg Allen put on a couple of seminar presentations, and his topic was rethinking the policy benchmarks. His thought was why invest in absolute return funds if one do not believe you can attain a T-bills + 5% or LIBOR + 4% return objective. But the challenge is whether it is making life unnecessarily complex by having that as the short-term performance benchmark. There is no asset that produces T-bills + 5% on a consistent year-to-year basis: one has to take risk to do it. If incentive compensation were based on performance against the benchmark and it were paid on an annual basis, you would be livid with T-bills + 5% as the target because there is no way that you could depend on that on a year-to-year basis. If the target were the hedge fund research index or the Callan median for absolute return, that would be a much fairer short-term target. But long term, the ARMB should not be investing in hedge funds unless the asset class is providing the absolute return goal that the board set as the justification for investing in it. The magnitude of the bear market collapse and its focus on fixed income strategies, and the emphasis of being paid for liquidity — or penalized for absence of liquidity, makes this a once-in-a-lifetime type of period to live through. But if three or four years from now, on a cumulative basis, the ARMB has not seen a T-bills + 5% return from the absolute return portfolio's inception, it would be time to question why it was doing this, because the fees are high and the retirement fund was not getting the consistency that the board originally anticipated.

MR. O'LEARY continued highlighting several more managers:

- McKinley Capital is always a volatile manager, and the large cap growth portfolio participated well in the recent quarter relative to other growth managers. Depending on the period, they may look okay or maybe behind. On the international equity side, where McKinley's record is much shorter, staff will have a recommendation to put the firm on the watch list for very poor relative performance.
- Staff will have a recommendation on Turner Investment Partners small cap because of performance.
- Luther King small cap has a growth-at-a-reasonable-price type of strategy. They have done better than the benchmark in the last 12 months but have not participated fully in the market rally because of the quality orientation in their portfolio.
- Lord Abbett's small cap long-term record is very strong, but they have underperformed — again, because of the quality orientation.

- The Jennison Associates small cap has done well.
- Relational large cap has a concentrated portfolio of 10 stocks and has been the problem large cap portfolio for the ARMB. With three stocks representing half the assets in the portfolio, this type of investment approach means that if they get one stock pick right in a big way the picture could change markedly. The concern is when that will happen.
- Emerging markets manager Capital Guardian has done a good job.
- Eaton Vance emerging markets portfolio participated well in the quarter, and it is still early days for this mandate.
- Lazard emerging markets did not do well for the one-year period but beat the index in the September quarter. This mandate has a very limited record.
- The Lazard emerging market debt portfolio had a great quarter, as expected, but also has a very limited record.

MS. ERCHINGER mentioned that at the last meeting the board heard that the in-house bond portfolio is used to provide liquidity to the retirement funds. She asked if Mr. O'Leary had any idea how the performance might have been impacted by that.

MR. O'LEARY stated that the quarter of maximum stress on the in-house bond portfolio was the fourth quarter of 2008 when there was no liquidity anywhere. Yet liquidity was necessary to meet commitments and benefit payments. He recalled staff reporting last year on the extraordinarily wide bid-ask spreads, so that was a negative but he could not say how much of a negative.

MR. BADER said that Treasury Division investment management staff also run an identical mandate for the State of Alaska, which does not have quite the same liquidity requirements as the pension funds. It is an excellent comparison, but he did not know the magnitude of the difference. He planned to report that information to the board on a future agenda, because it is a good comparison of what liquidity costs.

BOB MITCHELL stated that for the fiscal year ended June 30 the difference was about 115 basis points. *[No microphone to pick up this comment, so check accuracy with staff member.]*

MR. O'LEARY commented that some steps have been taken to reduce that risk a little by increasing the fixed income target allocation effective July 1, 2009 and incorporating an explicit cash willingness.

MS. ERCHINGER wondered if it would be appropriate to set aside a portion of the in-house fixed income portfolio for liquidity uses so that the in-house managers are not held accountable against a benchmark for that portion. Her concern was that someone externally looking at the performance numbers might criticize the in-house portfolio for failure to meet its benchmark when in fact the portfolio is not being used the same way that another manager is attempting to meet their benchmark. That should be addressed somewhere so that people viewing the performance information could make a fair comparison.

MR. O'LEARY offered caution about overreacting to a truly extraordinary market environment last year, but the importance of maintaining liquidity was driven home with great force during that time. There are a number of ways to approach it to make sure it is clear to all, and he agreed it should be addressed.

MR. O'LEARY indicated that concluded his presentation. CHAIR SCHUBERT thanked him and called a scheduled break from 10:22 a.m. to 10:32 a.m.

**17. External Manager Review**

*[A staff report on the annual manager review meeting, as well as the background and staff recommendations on Turner Investment Partners and McKinley Capital were included in the meeting packet. These documents are also on file at the ARMB office.]*

MR. BADER reported that each year he directs the board's liaison to send the ARMB's investment managers a questionnaire. He explained the topics covered in the questionnaire and said the responses are provided to the chief investment officer, the general consultant, and members of the Investment Advisory Council. After reviewing the manager responses, they meet to discuss items of particular concern, which took place in September this year. The group agreed to pay close attention to the Turner Investment Partners small cap portfolio, the Capital Guardian large cap equity mandate, and McKinley Capital's domestic large cap and international equity portfolios. As a result of the group's thorough review, they decided to make the following recommendations to the board:

- That the relationship with Turner be terminated and the small cap equity assets invested in index funds for the time being.
- That the Capital Guardian large cap equity portfolio be terminated and the money put into large cap index funds.
- That McKinley Capital's large cap growth mandate and international equity mandate be put on the investment manager watch list. The group closely examined McKinley's returns from inception to date and concluded that McKinley was at what is generally an inflection point in terms of when they could begin to have strong returns. Everyone hopes that McKinley can improve their performance in the coming year so that no additional action is necessary.

MR. BADER asked Dr. Jennings to report on the two topics he brought up during the manager review meeting.

DR. JENNINGS stated that the annual manager review meetings are useful for the IAC members. It allows them to not only look at each manager individually, but the group can consider some more macro issues in an informal setting. He said Mr. Bader had made a presentation to the previous board prior to implementation of Senate Bill 141, and one topic at that time was micro cap as an interesting area of investment. Callan has agreed to review the suitability of a micro cap allocation for a large institutional fund. Return data about small cap stocks is really related to micro cap stocks, and there might be some thought that there is a potential opportunity for outperformance from active management in the most obscure stocks. The group also discussed international small cap as an area to investigate, and the board heard a presentation on that yesterday. The third area the IAC discussed was broad trends in asset allocation, as well as thoughts on suballocations within the real assets and other areas. This will have an impact on the recommendation for asset allocation a year from now. He said that at these meetings he also likes to bring up a look at manager structure and how managers fit within the overall active/passive allocation, etc.

MR. BADER said the group also talked about enhanced indexing and the concept of using futures to get the beta of the S&P 500 Index. Imbedded in the cost of owning a future is the carrying charge of money, which is generally a short-term interest rate. So in order to make more than the index return when buying a future on the S&P 500 an investor would have to be able to earn an income with the uninvested capital equal to or greater than the rate of return of short-term money. The IAC was supportive of staff going a bit in this direction using fixed income as a way of achieving the higher than short-term rate of return. Staff has reviewed that and is not quite ready to proceed in the current interest rate environment. They will be discussing with the IAC a strategy that staff is more enthusiastic about. The manager review group also discussed using exchange traded funds (ETFs) to try and match emerging market returns. Hence, that was part of the question to the BlackRock representatives yesterday about the use of ETFs versus index funds. This would take additional staff, and all that is under review right now.

MR. BADER said that although the group covered a lot of topics at the meeting, the recommendations came down to the three he listed earlier and for which the background information was contained in the written reports.

**17(a). Action: Turner Investment Partners**

<u>MR. PIHL moved that the Alaska Retirement Management Board direct staff to terminate Turner Investment Partners, Inc. as a small cap equity manager and invest the assets in index funds pending staff recommendation to the board</u>. <u>MS. HARBO seconded</u>.

The motion passed unanimously, 7-0. *[Commissioner Galvin and Mr. Williams were absent.]*

**17(b). Action: Capital Guardian Large Cap**

<u>MR. TRIVETTE moved that the Alaska Retirement Management Board direct staff to terminate Capital Guardian Trust Company as a large cap equity manager and invest the assets in index funds</u>. <u>MS. HARBO seconded</u>.

The motion passed unanimously, 7-0. *[Commissioner Galvin and Mr. Williams were* *absent.]*

**17(c). Action: McKinley Capital - Watch List**
COMMISSIONER KREITZER moved that the Alaska Retirement Management Board direct staff to place the domestic large cap growth portfolio and the international equity portfolio managed by McKinley Capital Management on the investment manager watch list. MS. HARBO seconded.

The motion carried unanimously, 7-0. *[Commissioner Galvin and Mr. Williams were absent.]*

MR. BADER stated that following Janet Becker-Wold's presentation yesterday there was a question about how international small cap, emerging markets, and developed international market equities fit together from a portfolio perspective. He said staff intended to present some simulations to help answer that question to the board at the next meeting.

MR. BADER informed the board that he had seen a draft of Callan's review of whether micro cap stocks are a suitable institutional investment, and the final report might be available at the next meeting. He mentioned that Callan had undertaken the study at no cost to the ARMB.

**18. Analysis of Investment Returns, Contribution Rates and Earnings Rate Assumption**
DAVID SLISHINSKY and MICHELLE DELANGE of Buck Consultants were present to give an economic assumption review in response to the board's invitation at the June meeting. There was discussion at that meeting regarding the impact of the recent negative stock market returns on the actuarial results for the retirement systems.

***Overview of Economic Assumptions***
MR. SLISHINSKY stated that when setting economic assumptions Buck looks at an inflation rate that is applied consistently across several elements: (1) investment return assumption; (2) salary increases; (3) cost of living adjustments - the post-retirement pension adjustments (PRPA) for the Alaska retirement systems; (4) interest credit rates; and (5) interest on member contributions.

Studies have indicated that the real rate of return should reflect the asset mix because 92% of return is a result of that asset allocation decision.

The assumptions should reflect the benefit payment period. As actuaries, Buck is looking at a longer period of time than typically the investment consultant looks at. For example, a person hired at age 30 may work to the age of 60 and then may receive benefit payments for 25 years in retirement. The assumptions also should consider recent trends, and certainly there have been a lot of changes in the economy over the past couple of years. Finally, assumptions should take into account future expectations.

MR. SLISHINSKY displayed a chart of historical inflation experience by decades from the 1930s. Over a 50-year period, the inflation has been about 4% per year. Inflation was higher in the 1970s and 1980s, and has been lower than 4% over the past 20 years. Buck uses an assumed inflation rate of 3.5% for the long term.

***Historical PERS Results***

MS. DELANGE referred to a graph of the assets and liabilities of the PERS system from 1989 to 2008. Up through 2001 the market value of assets and the liabilities were following a similar track. Since 2002 liabilities have gone up quite steadily, and assets remained very near flat for a number of years before increasing up through June 30, 2008. So for the last seven years the PERS assets have not been growing at the 8.25% expected return, but the liabilities have been growing at that rate and even higher in some years.

MS. DELANGE next showed a historical summary of the rate of return on the market value of assets for PERS. There have been four years out of the last 21 years where the rate of return was below zero, and 17 years where the rate of return was above zero. The assumed rate of return has been 8.25%. There have been 14 years above an 8.25% return and seven years below 8.25%. Over the 21-year period, the arithmetic mean was 7.7% and the geometric mean was 7.25%. If Buck were to exclude the estimated 2009 return, the arithmetic mean would have been 9.1% and the geometric mean would have been 8.86% — well above the 8.25% expected return. Just the one-year outlier has created a very different scene over the last 21 years.

MR. PIHL asked if the value of assets Buck was using was the real market value or the actuarial recognized market value after spreading (smoothing) gains and losses. MS. DELANGE said the historical summary she just showed was the actual market value based on returns and not the smoothed value.

***Developing the Investment Return Assumption***

MR. SLISHINSKY stated that recent trends are suggesting a low inflation environment, certainly when compared to the long-term history. Inflation over the past two decades has been low, and the U.S. is currently in a very low inflationary environment. The question looking into the future is to what extent the fiscal stimulus going on right now will creep into increased inflation. The asset-liability study that Callan performed a couple of months ago had an inflation assumption of 2.75% over a 10-year period. That is 75 basis points lower than Buck's long-term inflation assumption of 3.25%.

MR. SLISHINSKY said that interest rates have been low and more stable recently. Equity returns have begun to rebound, which is good news. But some economic models predict that it will be a slow recovery and that equity returns will be lower than historical returns over the next five to ten years. Significant investment losses have occurred over the last two years on the actuarial value. It is important to recognize that, using the asset-smoothing method, Buck is now smoothing large significant losses that were created for fiscal year ending 2008, and fiscal year ending 2009 yet to be presented. These losses will dampen the returns over the next five years on the actuarial value of assets. PERS would need significant investment returns to offset those losses to get back to the actuarial assumption.

MR. SLISHINSKY displayed a pie chart of the PERS 2010 asset allocation policy: 30% domestic equity, 22% international equity, 7% private equity, 20% fixed income, 16% real assets, and 5% absolute return. He said there is a lot of exposure to equities and real estate, so there is room in the current policy for upside potential on investment returns. Buck considers this in determining the long-term real rate of return on the PERS portfolio.

MR. SLISHINSKY explained how Buck took a stochastic approach to looking at the expected investment rate of return as well as the level of risk inherent in the portfolio. Using the policy allocation targets, they have determined the arithmetic mean of the real return for each asset class and then used a stochastic projection to basically calculate over a 40-year period what the geometric mean of those results would be, as well as the level of risk. The calculated mean return over 40 years is 4.92%, and the standard deviation (level of risk) is 12.7%. The calculations were based on a 3.5% long-term inflation rate. Expenses were estimated at 30 basis points. They recognized that the ARMB's use of active investment management has higher investment expenses. They calculated the geometric mean return as follows:

| | |
|---|---|
| Real return...................................... | 4.92% |
| Inflation.......................................... | +3.50% |
| Expenses ........................................ | -0.30% |
| Net investment return...................... | 8.12% |

Buck defined a reasonable range for investment return of 20% around the geometric mean of 8.12%. The distribution of expected returns was anywhere from 7.61% to 8.62%. So certainly the 8.25% return assumption is within that range but a bit on the high side of the mean return of 8.12%.

***Impact of Lowering Economic Assumptions***

MS. DELANGE next reviewed the impact of making a change to the inflation rate or the real rate of return.

Lowering the real rate of return assumption would impact the discount rate, which would therefore increase the liabilities. It also affects the amortization rate of the unfunded liability, and by reducing the interest rate will reduce the prior service cost base. Overall, the impact of lowering the real rate of return it to increase the contribution rates.

Lowering the inflation side impacts more things than lowering the real rate of return assumption. It will decrease the discount rate and increase the liabilities. It will decrease the payroll growth assumption because inflation is one of the components of payroll growth. There will be no change to the amortization of the unfunded liability because both the investment return and the payroll growth will be reduced by the same amount. The salary assumption will be reduced because inflation is part of that assumption. Also, the assumption for PRPAs will be reduced because it is based on inflation. So there will be a reduction in liabilities for both the salary assumption and the PRPA assumption. Lastly, lowering the inflation assumption will decrease the assumed investment return and ultimately increase the contribution rates.

MS. DELANGE said Buck assumed that the health care cost trend table adopted last year would not be impacted by a lower inflation rate assumption.

MS. DELANGE showed the results for PERS on reducing the real rate of return assumption by either 0.25% or 0.50%, and not changing the inflation assumption. With each quarter percent reduction in the return assumption, the liabilities increase by about 3%. Normal cost goes up about 5%. Each 0.25% return reduction makes the contribution rate go up a little over 2%. She showed the same analysis for TRS, where the impacts were approximately the same as for PERS. The contribution rate for TRS increases by 2.41% when the real rate of return is reduced by 0.25%. For a 0.50% return reduction, the contribution rate increases by 4.9%.

MS. DELANGE described the same type of analysis for PERS of lowering the inflation rate by 0.25% or 0.50%, and no change to the real rate of return assumption. This does not have as big an impact as the scenarios where the real rate of return assumption was changed because the inflation rate also reduces liabilities because the salary scale and PRPAs are assumed to be lower. With each quarter percent reduction in the inflation assumption, the liabilities increase by about 2% and normal costs increase by about 3.5%. Ultimately, the change in contribution rate is smaller in these scenarios: a 1.73% increase for the 0.25% lower inflation, and a 3.5% increase for the 0.5% lower inflation. She showed the same analysis for TRS, where the impacts are very similar. For TRS, the contribution rate increases by 1.89% for the 0.25% lower inflation, and increases by 3.88% for the 0.5% lower inflation.

MR. SHIER asked if Buck did not change the health care cost assumptions because those costs move independent of any economic factors. MR. SLISHINSKY said Buck discussed this with their health and productivity consultants, who did not think that the level of adjustments on price inflation have had any impact long term on health care inflation. MS. DELANGE added that they also did an analysis to see how much the health care cost trend table changed. There are several inputs that go into that model adopted last year, and changing the inflation assumption did not have a significant impact. Buck decided that it was best at this point not to change the health care cost trend table that was just adopted last year.

MR. O'LEARY requested comment on industry trends with regard to inflation assumptions. MR. SLISHINSKY said he had not seen much movement recently, but over the past five years there has been a downward trend in the inflation assumption used in actuarial valuations.

COMMISSIONER KREITZER said Alaska is not the only pension plan asking these questions. She asked for Buck's observations about other states' experiences. She said she appreciated having the topic of the earnings rate assumptions and the contribution rate on the agenda in order to get the question out in the open.

MR. SLISHINSKY stated that about three years ago South Dakota moved from 8.0% to a 7.75% return assumption. He said he has discussed this with Nebraska, which for state and county employees has a cash balance plan and for school, state patrol and judges they use a traditional defined benefit plan. Nebraska's defined benefit plan has an 8.0% earnings assumption. The cash balance plan is relatively new and a little more conservative, so they are using 7.75% there. A lot of discussion took place there about reducing the assumptions, and Nebraska has taken a wait-and-see attitude to see what happens in the next year or two with regards to an economic rebound and a rebound in the markets before they make any decision. Both he and Ms. DeLange worked on an audit this summer for Colorado Public Employees' Retirement Association (PERA), and that was a big issue there. They were at 8.25%. Their actuary had recommended 8.0% or 8.25%. Buck recommended to PERA that they reduce their assumption, and they ended up adopting the 8.0% assumption.

COMMISSIONER KREITZER asked what happened to the unfunded liabilities for the funds that Mr. Slishinsky mentioned. MR. SLISHINSKY said that as those plans go through the same kind of actuarial analysis and decrease the earnings assumptions, they are increasing their unfunded liabilities, decreasing the funded ratios, and increasing the amount of annual contributions needed to meet those increased liabilities.

MR. PIHL inquired about the starting point for this analysis. He said he was concerned about the huge investment return loss that has been deferred and whether that is recognized at all in the analysis presented today. Also, he wondered if the actuarial world was giving any consideration to the wisdom of spreading losses over five years. He thought it ought to be a shorter period of time. To be conservative, it is fine to spread gains over five years, but it seems ridiculous to spread the losses that are the magnitude they are.

MS. DELANGE stated that the numbers presented today included the actuarial value of assets (smoothed value) up to fiscal year 2008. Buck is in the process of completing the 2009 valuation, and the board could expect that the unfunded numbers are going to be bigger because of the asset losses through fiscal year 2009.

MR. SLISHINSKY explained that Buck showed the historical record going back to 1989 primarily because that information is easily accessible. Buck was providing information for the board to see what the actual experience has been over a long period of time. Twenty years of data for Alaska is one piece of the puzzle. The other piece is looking at what recent trends are and what expected future trends are. When Buck starts looking at the expectations for the future, it has to be a joint effort in having a collective approach to setting those long-term assumptions.

Addressing the second of Mr. Pihl's questions, MR. SLISHINSKY said there is discussion about marking to market value and not smoothing the value of assets at all — thereby recognizing gains and losses immediately. And not only recognizing that on the asset side but also, instead of using the expected long-term rate of return based upon the asset allocation as a discount rate, using something that is more risk-free or tied to a quality bond rate. If that kind of thinking is adopted in the public sector for actuarial valuations, it will be a huge difference in results.

MS. DELANGE stated that most of the systems that Buck sees use some form of smoothing, and five years is the most common with four years as the second most common. So Alaska is in line with all of its peers by smoothing. But with the large losses, the mark to market is a lot to swallow today.

MS. HARBO inquired if Buck has always included the administrative expenses when calculating investment returns, because she did not recall having seen that before. MR. SLISHINSKY said that when they are building the expected rate of return they typically will look at the administrative expenses and a certain element for investment expenses (as if all assets are passively invested, with the assumption that active management pays for itself), or take a more conservative approach and just include all investment expenses, which they did in today's analysis.

MS. HARBO contended that Buck's other presentations used the real return number and the inflation expectation to get the net investment rate of return, but not the administrative expenses as a separate item. MR. SLISHINSKY said they would look back and check.

MS. ERCHINGER asked about what inflation rate assumption other public plans are using. MR. SLISHINSKY stated that generally inflation rates range between 3% and 4%, but there may still be some systems that use rates below 3% or over 4%.

COMMISSIONER KREITZER asked if Buck had any recommendation today for the ARMB. MR. SLISHINSKY said he would give a recommendation if asked. COMMISSIONER KREITZER said she was asking.

MR. SLISHINSKY said he would recommend reducing the investment return assumption. The question is whether it should be reduced to 8.0% or 7.75%, and whether or not the inflation rate should also be reduced. It looks likes most of the difference between Buck's assumptions and the expected returns that Callan has are on the inflation side. So it would make sense to reduce to inflation assumption, whether that be to 3.25% or 3.0%, which would then reduce the investment return assumption as well.

MR. BURNETT inquired if there was anything in Buck's analysis that indicated that the current assumptions are outside the reasonable bounds. Buck has recommended that the assumptions be changed, but they have also shown that the current assumptions are within the reasonable bounds. He asked, based on the ARMB asset allocation, if reasonable people could leave it the same as it is.

MR. SLISHINSKY said the answer is yes, that the result is within the reasonable range. Buck has defined the reasonable range as 20% around the mean return. Others look upon a 50% range around the mean return as being reasonable. Even the 20% reasonable range is still looking at a 1% [return] difference from the low point to the high point of the range. Given that, his perspective is that with the recent market events and because of the economic situation he feels more comfortable being conservative. The question is what the board would want to do.

MS. ERCHINGER commented that the assumption on the rate of return is impacted by the asset allocation, and she asked if the ARMB asset allocation lent itself to using a higher rate of return than what other public funds might be using. MR. SLISHINSKY said yes, that the asset allocation lends itself to a higher expected long-term real rate of return, probably higher than the average retirement system. And the ARMB has had a higher rate of return assumption at 8.25%, where most public systems have been at 8.0%. Some of those systems are now moving from 8.0% down to 7.75% or 7.5%. So because the ARMB is higher does not mean it should not move, but also the analysis results do not indicate that it has to move either.

MR. PIHL stated that this analysis needs to be looked at in tandem with the next valuation report because that will tell the board what the contribution rate has to be to amortize the liability and how much that will increase the state appropriation request.

MS. ERCHINGER said that before making any decision on changing a return assumption she would want to see specifically the wider universe of public pension plans against which the ARMB's asset allocation is compared. It was important to get a better sense of where the ARMB falls on the continuum — conservative or not-so-conservative. That was of more immediate concern to her than the legislative issue. The ARMB has a long-term investment horizon, and it is the board's job to make sure that the retirement plans are fully funded.

CHAIR SCHUBERT thanked the representatives from Buck for the presentation.

**UNFINISHED BUSINESS**

1. **Calendar**
   MS. HALL indicated that the board-approved 2010 meeting calendar was included in the meeting packet.

2. **Disclosure Report**
   MS. HALL stated that the financial disclosures made since the last meeting were

included in the meeting packet.

3. **Legal Report**
MR. JOHNSON said he has been working with Mr. Hanna and Mr. Sikes on new contracts, as needed, and endeavoring to revise other contracts. He indicated that Mike Barnhill from the Attorney General's Office was on teleconference and wished to give a report in executive session.

MS. ERCHINGER moved that the Board go into executive session for consideration of reports regarding pending litigation and attorney-client privileged communication, and for consideration of amendments to investment management contracts, the disclosure of which could have an adverse effect on the finances of the fund. MR. TRIVETTE seconded.

The motion passed unanimously, 7-0, and the board met in executive session starting at 11:25 a.m. When the meeting reconvened in regular session at 11:38 a.m., the board took the following action.

MS. ERCHINGER moved that the Alaska Retirement Management Board authorize the administration to work with managers to negotiate investment management fees and then forward those proposed amendments to the Department of Revenue commissioner and the board chair for approval. MS. HARBO seconded.

The motion carried unanimously, 7-0. *[Commissioner Galvin and Mr. Williams were absent.]*

**NEW BUSINESS** - None.

**OTHER MATTERS TO PROPERLY COME BEFORE THE BOARD**

***Staff Response to Question about Tishman Speyer Real Estate Venture Fund***
MR. BADER said that Mr. Pihl had inquired about the large write-down in the Tishman Speyer Real Estate Venture VI in the September 30, 2009 financial statements. He said both Tishman and BlackRock heavily solicited staff to participate in a real estate venture called Peter Cooper Village, a large apartment complex in New York City. At the time it was the largest single real estate transaction ever. The ARMB declined to participate in those funds, but other large funds that did invest appear to be looking at half a billion dollars of losses. While the ARMB dodged that bullet in a terrible real estate environment, there have been writedowns in other funds in the real estate portfolio. There was heavy leverage in the Tishman Speyer Real Estate Venture VI, and the decline in the fund's value is a result of that heavy leverage. It is symptomatic of what is happening in a number of closed-end funds in the portfolio. Staff hopes the write-downs are at an end. He offered to come back with more details if trustees wished.

MR. PIHL mentioned that leverage is not permitted on the ARMB's direct real estate holdings. MR. BADER confirmed that the separate account core holdings are all unlevered. The open-end funds do have some leverage but nowhere near the amount that the closed-end funds have that are more speculative in nature. The big hits to the ARMB's real estate portfolio are on the speculative side, but the large portion of core assets continue to provide revenues to the retirement fund.

***Response to Question on Rebalancing Memo to State Street***

MR. BADER referred to a rebalance memorandum regarding the TRS retirement plan in the CIO report where Ms. Erchinger yesterday pointed out that one of the columns did not balance. He said staff researched that transaction and determined that what was communicated to the custodian bank, State Street, actually did balance and no accounts need to be adjusted. It was a clerical error in transferring the spreadsheet to the memorandum, where a $3 million high yield line was the difference.

***Follow-up to Education Conference***

MR. BADER said there was a presentation on commodities at the October education conference. He has asked Mr. O'Leary for a presentation at the next meeting on the suitability of commodities in the portfolio, since there is a lot of speculation about the best way to insulate the retirement fund against possible increased inflation.

**PUBLIC/MEMBER COMMENTS** - None.

**INVESTMENT ADVISORY COUNCIL COMMENTS**

DR. JENNINGS said he sensed some trustee concern about the buy-write recommendation yesterday. The closest word he could come up with to characterize his feelings about it was that he was a little more ambivalent about the proposal than Mr. Bader was, and he thought the other IAC members possibly felt the same. He liked it for the reasons put forward, but there are some operational issues. He also wanted to get his brain wrapped around the theory and underlying economic reasons for the specific approach. So he thought it was fair to characterize the IAC as a bit less enthusiastic about the buy-write strategy then staff was. But it was interesting enough to investigate further, even at a cost. He planned to go into the details of any presentations with a fine-toothed comb.

DR. MITCHELL said that he noticed the agenda had presentations about private equity, international bonds, international small cap, buy-write derivatives, and farmland. The rhetorical question has to be why the ARMB is investing in all of these asset classes, subasset classes and sub-subasset classes. The first reason for the diversification is that nobody knows in any given year what asset class will do well the next year. So it stands to reason that the more asset classes the ARMB is invested in, the better chance of at least finding one or two that do perform well in the subsequent year. So performance is one reason. The second is reduction of risk, if risk is measured in terms of volatility (standard deviation). The more asset classes, the greater chance of reducing the risk — it does not always work, but it usually works. The caveat he wanted to propose is the time period. If the board does not stick with these asset classes for a long enough time period, both of the advantages do not have to work. So when the board is considering domestic micro cap or international small cap or farmland, trustees should bear in mind that if they do not really feel they can take staying in those assets for five or ten years, they better not do them.

MR. WILSON commended the board for continuing to look at managers that are not performing and terminating them, as was done at this meeting. He has been involved on the IAC for a little over three years, and there has been a continuing conversation on active versus passive management. He recalled talking to Dr. Mitchell a few years ago about what he thought the standards should be to hire an active manager, and the response stuck with him. Dr. Mitchell had said you should have a very high conviction that somebody over a reasonable period of time would beat the index. If they do not, then you should move to passive management. He followed in Dr. Mitchell's footsteps at the Boston Foundation and has used those words to evaluate managers: in the last 18 months the foundation has gone from seven managers in domestic equities down to three managers, and from roughly 10% passive to 50% passive. The ARMB is at similar numbers. He was struck by the recent trade press over the last week. Dr. Mitchell is chair of the investment committee at the Massachusetts pension plans, and they have actually gone to 100% passive domestically, which he thought was extraordinary. And they moved to 50% passive internationally, including a fairly significant passive allocation to emerging markets, which is pretty rare. The experience at the Boston Foundation is the active managers in emerging markets have significantly underperformed the benchmarks in an area where you would think that people should have an edge. He encouraged the board to continue thinking long and hard about the passive versus active debate because the return numbers the board saw were before manager fees and before the staff time engaged in managing all those asset managers.

**TRUSTEE COMMENTS**

MS. HARBO thanked staff for the very informative education conference, which she found quite productive. She also thanked Ms. Hall for making all the arrangements for those who attended.

MR. TRIVETTE stated that he and Ms. Harbo attended a public pension trustee NCTR conference in October. He intended to type up some notes on what he learned about pension trustee governance and investment-related issues, and share those with the other trustees. He suggested that other trustees might want to consider attending the conference, especially if they were interested in governance and some other issues that the board has to deal with.

CHAIR SCHUBERT mentioned that during the past week or so Dubai World announced that they were having financial problems, and the stock market reacted a bit initially but then basically ignored it. She was not sure what that says about the commercial debt market, whether people are so exhausted dealing with crises that they do not want to face this, or whether the Dubai World situation is the start of another explosive debt problem still to be faced. Or perhaps it was that she worried too much.

COMMISSIONER KREITZER commented that there were others around the table who were worried as well, as she had seen people nodding in agreement at the chair's remarks. She said she appreciated Mr. O'Leary's explanation earlier [about the improved availability of refinancing], but she found there was a great silence on this topic and she shared the chair's concern.

MR. O'LEARY stated that he has wrestled long and hard with the refinancing challenge, and he is still personally concerned about the residential area, where many have pushed it aside. But there are floating rate jumbo mortgages that have yet to refinance. He stressed that his optimism is guarded optimism, and he is optimistic only relative to where he was three or four months ago.

MR. WILSON remarked that this crisis is a fascinating period. Because this debt is public, you can actually see when it matures. So there are lots of charts out there that show a massive amount of refinancing that needs to be done commercially over the next 36 months. From his perspective, the real key will be where interest rates are, because just a modest up tick in interest rates would probably prevent most of those deals from being refinanced. Currently what is going on is "extend and pretend" — lenders are extending the loans and pretending that everything is okay, because the banking system cannot take the shock of actually foreclosing on these loans. His personal outlook is that it will be a very difficult 36 months in the commercial real estate market. But like all opinions, it can be taken with a grain of salt.

**FUTURE AGENDA ITEMS**

MR. BADER said he looked at the buy-write strategy as a form of insurance — it costs to have insurance, it does not always pay to have it, but it is nice to have when you need it. He noted that three trustees and an IAC member spoke against the buy-write strategy, and he did not sense a lot of enthusiasm for it. He did not see any reason to take the board's time and to spend $25,000 on a manager search if he was swimming against a strong current. There are plenty of things that will improve the retirement fund, and it was not his position as CIO to twist arms if people are not enthusiastic about the buy-write approach. He recommended amending the motion that was made and taking the buy-write strategy off the agenda.

CHAIR SCHUBERT stated that she did have an interest in it.

COMMISSIONER KREITZER clarified that she voted in favor of the motion to move forward and look into the buy-write strategy. However, she appreciated Mr. Bader's sensitivity to the board's sentiment.

MR. O'LEARY suggested bifurcating the process and that at the next meeting Callan would make an educational presentation on buy-write. They would survey the market but not present any specific managers. Callan would not charge for that, and if the ARMB decided to proceed with a manager search after getting more information, then Callan's fees would apply.

COMMISSIONER KREITZER indicated she supported Mr. O'Leary's proposal.

CHAIR SCHUBERT ascertained that no one was opposed to the amended course of action on buy-write. With nothing else on the agenda, she wished everyone a Merry Christmas and a good New Year.

**ADJOURNMENT**

There being no objection and no further business to come before the board, the meeting was adjourned at 11:58 a.m. on December 4, 2009, 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 tape-recorded the meeting and prepared the summary minutes. For in-depth discussion and more presentation details, please refer to tapes of the meeting and presentation materials on file at the ARMB office.

Confidential Office Services
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