State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
MEETING

Location of Meeting
Juneau-Haines Room
Anchorage Marriott Downtown Hotel
820 W. 7th Avenue
Anchorage, Alaska

MINUTES OF
December 1-2, 2011

Thursday, December 1, 2011

CALL TO ORDER

CHAIR GAIL SCHUBERT called the meeting of the Alaska Retirement Management Board (ARMB) to order at 9:05 a.m.

ROLL CALL

Eight ARMB trustees were present at roll call to form a quorum. Commissioner Hultberg was delayed due to weather and joined the meeting after lunch.

Board Members Present
Gail Schubert, *Chair*
Sam Trivette, *Vice Chair*
Gayle Harbo, *Secretary*
Kristin Erchinger
Commissioner Becky Hultberg
Commissioner Bryan Butcher
Martin Pihl
Tom Richards
Mike Williams

Board Members Absent - None

Investment Advisory Council Members Present
Dr. Jerrold Mitchell

Department of Revenue Staff Present

Angela Rodell, Deputy Commissioner
Gary M. Bader, Chief Investment Officer
Pamela Leary, State Comptroller
Zach Hanna, State Investment Officer
Steve Sikes, State Investment Officer
Scott Jones, Assistant State Comptroller

Department of Administration Staff Present
Mike Barnhill, Deputy Commissioner
Jim Puckett, Director, Division of Retirement & Benefits
Teresa Kesey, Chief Financial Officer, Division of Retirement & Benefits

Consultants, Invited Participants, and Others Present
Robert Johnson, ARMB legal counsel
Michael O'Leary, Callan Associates, Inc.
Gary Robertson, Callan Associates, Inc.
Paul Erlendson, Callan Associates, Inc.
David Slishinsky, Buck Consultants, Inc.
John Boucher, SOA Office of Management & Budget
Michael Hayhurst, KPMG
John Alcantra, NEA Alaska

PUBLIC MEETING NOTICE

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

APPROVAL OF AGENDA

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

Item VIII, Sustainability/Unfunded Liability, scheduled for 9:15 a.m., was moved to the afternoon because some people were delayed due to weather. The Board approved the agenda as amended.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES

JOHN ALCANTRA, Government Relations Director for the National Education Association of Alaska, mentioned the positive comments by Governor Sean Parnell and NEA Alaska Executive Director Lydia Garcia at the Board's September meeting in Fairbanks for everybody to keep an open mind to the options available, given the vast resources Alaska has. Unfortunately, what the press reported of a State Affairs hearing in Fairbanks three weeks after the ARMB meeting, and what he heard on teleconference, did not sound open-minded. It sounded like a crystal ball was necessary to return to a defined benefit plan. He said actuarial analysis is a science, but never a crystal ball, and the ARMB makes decisions based on the best information possible. He hoped that when the Board met again in Juneau [in February] that there would be some good reports of legislative actions happening to allow employees to have an option of a defined benefit plan or a defined contribution plan.

MR. ALCANTRA reported that he attended a conference a couple of weeks ago where 42 of 50 states were represented. Most of the states were unbelieving that Alaska, with its billions of dollars in savings, was the only state in the nation that did not have a defined benefit pension system or a social security plan. He said the Board cannot make legislative policy, but he hoped the open-mindedness that the Governor talked about in September would exist at the administration level, at the legislative level, and at the ARMB level.

APPROVAL OF MINUTES

MS. HARBO moved to approve the minutes of the September 21-23, 2011 meeting. MR. WILLIAMS seconded. The motion passed without objection.

ELECTION OF OFFICERS

MR. PIHL moved that the Board cast a unanimous ballot to re-elect Chair Gail Schubert, Vice Chair Sam Trivette, and Secretary Gayle Harbo for one year. MS. ERCHINGER seconded.

The motion carried without objection, 8-0.

REPORTS

1. Chair Report

CHAIR SCHUBERT said she received very good feedback from the Education Conference held in New York City. She thanked Gary Bader, Judy Hall and other staff for pulling it together, saying that every year the conference gets better, and the Board heard incredible topics delivered by outstanding speakers this year.

CHAIR SCHUBERT reported that she had worked with Mr. Pihl and Deputy Commissioner Barnhill and others on the sustainability and unfunded liability topic slated for discussion later in the meeting. She thanked Mr. Pihl for his work on that.

2. Committee Reports

2(a). Audit Committee

Committee Chair MARTIN PIHL reported on the committee's November 30 meeting, saying that the independent auditor KPMG would give a direct report on the audit to the Board later. The committee heard that the audit process went smoothly and KPMG found very good preparation by staff. KPMG gave clean opinions but did have one significant finding dealing with the National Guard reporting of participants, which did not rise to the level of materiality. Jim Puckett, the Director of the Division of Retirement and Benefits, had informed the committee that the National Guard participants who are paid a benefit are scrutinized very carefully so there is little risk. Mr. Puckett would give a status report to the Board at the February 2012 meeting. He complimented staff in both the Treasury Division and the Division of Retirement and Benefits for their work and preparation for the audits. *[The minutes of the November 30, 2011 committee meeting are on file at the ARMB office.]*

2(b). Real Assets Committee (former Real Estate Committee)

Committee Chair KRIS ERCHINGER said the committee met November 30. One action was to review and recommend to the full Board for approval a revised charter to broaden the scope of the former Real Estate Committee to include timber investments, farmland, energy and TIPS. The committee also heard a presentation by Steve Sikes on the Real Assets Investment Plan for 2012, which would be brought to the full Board in February. *[The minutes of the November 30, 2011 committee meeting are on file at the ARMB office.]*

2(c). Salary Review Committee

Committee Chair MARTIN PIHL said the committee met November 30. Commissioner Becky Hultberg was added to the committee, along with Gail Schubert, Kris Erchinger, and Martin Pihl. The committee did not meet earlier because good progress had been made on the salary administration plan in recent years, and the Budget Committee had addressed a provision for staff salaries in its work. Ms. Leary presented an update on the salary plan, and the committee continues to be pleased with the progress on salary administration. The committee will get an update from the consultant's analysis and other salary comparisons at a future meeting.

MR. PIHL said the Board approved Resolution 2010-18 a year ago, and the committee felt this continuing resolution did the job going forward and there was no need for a new resolution. He reported that Commissioner Hultberg spoke in favor of a less stringent recommendation in the resolution than that the state comptroller position be made exempt. She had said there were other positions in the State system that were somewhat comparable to state comptroller. MR. PIHL said he still supported exempt status for the position; however, the commissioner was not present to speak on the matter. *[The minutes of the November 30, 2011 committee meeting are on file at the ARMB office.]*

3. Retirement & Benefits Division Report

3(a). Membership Statistics

DRB Director JIM PUCKETT mentioned the quarterly retirement system membership statistics included in the meeting packet, and said there was nothing unusual to comment upon. He invited comments on the new format of the report.

3(b). Buck Consulting Invoices

The monthly invoices from the actuary were included in the meeting packet so trustees could review the billings and services provided.

4. Treasury Division Report

Department of Revenue Deputy Commissioner ANGELA RODELL reported that it had been a quiet quarter in the Treasury Division. They continue to work with the Department of Law to qualify a group of law firms to help with foreign representation when it is needed for certain foreign investments.

5. Chief Investment Officer Report

Chief Investment Officer GARY BADER referred to the written report in the packet that listed fund transfers and rebalancings that staff had transacted since the last board meeting, along with several other items. He reported that the allocation to Crestline Advisors was increased by $33.5 million, as part of changes made to Crestline's investment mandate last year.

MR. BADER notified the Board that Jeff Conrad had resigned from Hancock Agricultural Investment Group, and his replacement was Oliver Williams, a person that staff has dealt with for many years at Hancock. He said that the change, by itself, was not enough to place Hancock on the manager watch list. However, staff later became aware that Joe Silviera, of Farmland Management Service — a company contracted by Hancock to run the ARMB's agricultural properties — recently passed away. Given the two leadership changes at the top of Hancock, he said staff recommended placing Hancock on the watch list and the Board directing staff to increase scrutiny of what takes place at the firm.

<u>MS. HARBO moved that the Alaska Retirement Management Board place Hancock Agricultural Investment Group on the Watch List</u>. <u>MR. TRIVETTE seconded</u>. The motion carried unanimously.

MR. BADER mentioned that the Frontier small cap value mandate that the Board approved at the September meeting was funded by transferring money from several other small cap managers, in order to rebalance the investment style bias [in the small cap equity portfolio]. Victory Capital Management had also made a presentation on their small cap value product at the September meeting, and that item would be taken up later under "Investment Actions."

MR. RICHARDS referred to the Treasury Division letters in the packet instructing the custodian bank on fund transfers among the various plans, and asked Mr. Bader to elaborate on the process for rebalancing. MR. BADER said staff first looked at all the defined contribution/defined benefit components because those are not paying benefits now and are accumulating cash. That cash is transferred to get those components back within target bands, and the cash goes into the Public Employees' and Teachers' pension funds and is swapped for investments like private equity and public equity, etc. Then there is a swap between the pension funds and the health funds to get them into balance. At the end of that, all three groups are rebalanced again. He gets a report weekly from his staff informing him of where the funds are relative to the asset allocation bands.

MS. ERCHINGER remarked that the Audit Committee receives monthly compliance reports and sees when any of the accounts are out of compliance with the [asset allocation] bands the Board established. Generally, any non-compliance is only a matter of timing a few days here and there. She could not recall that there had been anything of concern to the Audit Committee over the last year and a half.

6. Fund Financial Report

State Comptroller PAMELA LEARY presented the financial report for the retirement systems for the first quarter of fiscal year 2012. The total ending invested assets as of September 30 were $18.4 billion, a decrease of 7% since the fiscal year end at June 30. The change in invested assets for all the plans in just the month of September was a loss of 5%, and 4.5% of that was due to investment income.

MS. LEARY stated that the financial statements for October were available on the web site. For October there was a 5% increase to the total net assets due to investment income increases of 5.5%. [Unaudited numbers for November show about a 1.5% net decrease of invested assets, leaving the ending invested assets down roughly 4% for the first five months of the fiscal year.]

MS. LEARY showed charts of the monthly changes in invested assets for each retirement plan and health care trust fund, as well as the asset allocations. Each plan was well within its target allocation bands.

MS. KESEY reviewed the Division of Retirement and Benefits supplemental financial report, drawing attention to the details of the net contributions/withdrawals for the three months ended September 30, 2011. A second page showed the same information for just the month of September.

MS. KESEY reported that in October the Division received approximately $27 million for the Early Retiree Reinsurance Program, which would be included in the next set of cash flow statements. The Division was also notified of a $2.9 million Retiree Drug Subsidy (Medicare Part D) payment that was expected within the next week.

MS. HARBO pointed out that approximately $5 million went out in refunds from the PERS and TRS defined contribution plans (DCR) in the three-month period. She asked if that was money to DCR participants who had terminated employment. MS. KESEY confirmed that she was correct.

7. Private Equity Portfolio - Review and Performance Analysis

GARY ROBERTSON, Senior Vice President of Callan Associates Inc., presented an annual review of the retirement fund's private equity portfolio as of June 30, 2011. *[A copy of Callan's slides for this presentation is on file at the ARMB office.]* He began with a timeline of the ARMB private equity program that started with a 3% target allocation when the Board hired Abbott Capital Management in 1998. He noted that the timing of starting initiatives in a private equity program is very important to the performance. The Board hired Pathway Capital Management in 2001. Abbott and Pathway since inception have about 33 partnerships that overlap, and about a one-third of the ARMB's invested capital is in the same partnerships. He said Callan believes that overlap is beneficial because those are the high conviction managers. In 2009, the ARMB investment staff initiated an in-house private equity portfolio. The Board's most recent action was to raise the private equity target allocation to 8%, effective July 1, 2011. The current actual allocation is 9.2%, so private equity is overfunded.

MR. ROBERTSON reviewed the details of the ARMB private equity program's funded position at June 30, 2011 compared to June 2010. The total retirement fund increased 22% in the fiscal year, which increased the private equity target by $210 million. The private equity portfolio also earned 16%, or $208 million, and the 1% increase in the target allocation added almost $400 million to the target. The backlog of uncalled commitments, which will drive the funded status, is only about 55% of the NAV (net asset value) — so there is not a big reservoir, and Callan believes that will help mitigate the program's overfunded status over time.

MR. ROBERTSON next talked about private equity market conditions historically and more recently. He noted that the first money that Abbott put out went into the high-price environment of the tech bubble in the late 1990s. The timing of hiring Pathway in 2001 was perfect; it was right below the bottom of the market, so the first money that Pathway invested was at rock-bottom prices. Pathway also had a larger buyout style, and they rode the buyouts wave up very handsomely. The first few investments of the in-house portfolio got caught in the 2008-2009 down wave, but generally it did not have a big effect because the portfolio is still quite immature.

There was no mergers and acquisitions (M&A) activity in 2009. Good progress in fundraising began in 2010 when bank lending became available again, and 2011 through September was actually quite good. However, the decreased market liquidity since late July, due to more economic uncertainty and market volatility, will hurt the private equity market.

MR. ROBERTSON stated that the market has been very receptive for IPOs (initial public offerings) and M&A over the last year. There have been record numbers of buyout IPOs and a bit of a mini bubble in the venture capital area for the social media types of companies. The general partners are very focused on getting capital back to their investors at this point because there is a big backlog of companies that are aging. And to raise new funds, general partners have to show progress on their last funds.

Currently, new deals are fairly solid; prices are not low, but they are equitable. The general partners are pricing the deals for a low-growth environment. The companies that made it through the recession are now very lean and should fare well in the future. Callan believes that even if the recovery is sluggish, private equity will still hold its own as an equity strategy. Private equity has now outperforming public equity over all periods except the three-year period.

MR. ROBERTSON highlighted the following points about the ARMB portfolio performance for the 12 months ended June 30, 2011:

- Commitments went up 10%. Private equity funds typically have about 5-6 years to invest their capital, so in a normal, healthy market environment the rate of replacement by the managers should be about 30%. The ARMB portfolio is a little below average at this point because the market is not liquid. However, commitments were up from 4% last year, so the managers were finding more good funds compared to FY 2010.
- Paid-in capital increased 12%. The normal expected turnover rate is 15%-20%.
- Because the ARMB portfolio committed more than was paid in, the uncalled commitment went up 4%, versus going down 5% last year.
- The portfolio had a 22% cash yield. The ARMB took $45 million out of the portfolio on a net cash flow basis, meaning distributions were more than what was paid into the portfolio.
- The true unrealized appreciation was actually 20%, illustrating that there was good write-ups in the portfolio companies.
- Using the total wealth creation measurement, the ARMB has $1.34 for every dollar it has paid into private equity. That places the ARMB portfolio performance high in the second quartile compared to an opportunity set database.
- The portfolio is mature at 73% paid in. Fully mature would be when all the capital has been returned.

MR. ROBERTSON also presented the portfolio diversification by private equity strategy, industry type, and geographic location. He said the 32% international exposure is very similar to other institutional portfolios.

MR. ROBERTSON next talked about Abbott and Pathway individually, describing the portfolio activity and performance in fiscal year 2011 and since each manager started investing on the ARMB's behalf. *[See Callan report, slides 10 through 17, for details]*

He also gave an overview of the private equity portfolio that is managed in-house. *[For details see Callan report, slides 18 and 19]* Lastly, he briefly reviewed the corporate governance portfolio, a closed-end fund called Blum Strategic Partners III.

MR. ROBERTSON stated that the ARMB's two private equity managers are very complementary, with a focus on venture capital from Abbott and distressed debt at Pathway. The in-house portfolio is overcoming early liquidity, but the results are good, and the manager picks seem to be doing quite well. He said Callan sees all the partnerships in the industry and knows the reputation and performance of each. The ARMB is invested in the very best general partners in the industry, and the total portfolio diversification is good.

Fiscal year 2011 was the second year of good liquidity, and net cash flows and valuations went up in the portfolio. The portfolio is over its 8% target allocation, but there is a good balance between uncalled capital and the NAV. Hopefully, over the next three to four years that will mitigate the actual allocation number downward. A lot of it will depend on how the overall retirement fund portfolio performs.

There has been an illiquid period after July 2011, but Callan believes that even if it is a rocky economy, it is a good buying opportunity for the uncalled capital. The good news is that the economy is not in a bubble. The general partners are clearly focused on distributions back to their investors.

MR. TRIVETTE asked if Callan had any suggestions for what to do with Blum Strategic Partners III. MR. ROBERTSON replied that since the June 30 report Blum had some very bad news in the portfolio, and he did not know if they would be able to raise a next fund. The ARMB would be staying static with Blum, and hopefully their portfolio will recover. He pointed out that the corporate governance fund was not private equity, and he would not re-up with Blum in a private equity portfolio.

MR. BADER stated that the Board made the decision to terminate Blum. The remaining investment with Blum is not scheduled to be re-initiated; it is a fund that has a determined life to it, so the ARMB would incur significant penalties to terminate early. Blum is a winding-down account.

DR. MITCHELL said he had been involved in the initiation of the ARMB private equity program in 1998. Some of the questions raised at that time were whether a fund as large as this retirement fund could do what endowments at Yale, MIT and Harvard had done in the private equity sphere: Could they overcome the high fees and the employment of gatekeepers? Could a public fund deal with the opaque nature of private equity? Could it beat the public markets from which a lot of the funds came? And could the ARMB staff handle the complexities of private equity? He said that from this presentation he would have to say yes to all those questions raised. He thought the program had been remarkably successful.

MR. O'LEARY indicated he wanted to highlight some important lessons learned for some board members and attendees who did not have much background in private equity. First, to the extent possible, it is always better to know the ultimate target allocation at the outset. The Board's initial target allocation was 3% of the total retirement fund, and the consequence was that the planned pace of investment was driven by that 3% target. Then the target was raised and then raised again. At this stage, the Board does not have to worry about the target, because the actual private equity allocation is at 9.2% of the total retirement fund, or over target.

MR. O'LEARY said his second point was that the Board should not directly compare the internal rates of return (IRRs) for Pathway and Abbott. The IRR is very heavily influenced by the specific start time of a portfolio, as well as by the strategy tilt in the portfolio. Venture capital has a bigger tilt in Abbott's portfolio than in Pathway's portfolio, so there is a bit of an apples-and-oranges comparison. The same point applies to the internally managed portfolio, because its history is short, and there is no venture capital orientation to speak of.

Referring to Blum, the corporate governance portfolio that is part of private equity, MR. O'LEARY mentioned that Relational Investors was another corporate activist manager the Board hired that was never a part of the ARMB's private equity portfolio. He said he was very happy with the private equity program. He was also grateful for Mr. Bader's assistance in identifying Abbott and Pathway as gatekeepers, as well as for the Board's decisions to hire them.

MS. HARBO inquired about when the Board should start looking for an exit strategy for what are illiquid investments, given that the defined benefit plans are closed and will need the income at some point.

MR. BADER responded that staff had looked at the liquidity of the defined benefit plans, and the actuary has schedules for when assets under management will increase and when they will start to decline. Staff feels that there is at least ten more years before reaching that point.

MR. O'LEARY remarked that a great aspect of private equity is that every fund the ARMB invests in has its own life cycle and will go down to zero. Unless there is another major economic event along the way, the orderly shrinkage of the private equity allocation is reasonably straightforward simply by slowing down the pace of new commitments.

CHAIR SCHUBERT called a scheduled break from 10:25 a.m. to 10:39 a.m.

8. Investment Performance Measurement - Periods Ended 9/30/2011

Executive Vice President of Callan Associates Inc., MICHAEL O'LEARY, and Senior Vice President, PAUL ERLENDSON, presented a performance review of the retirement fund portfolio and individual participant plans as of September 30, 2011. *[A copy of Callan's slides for this presentation is on file at the ARMB office.]*

MR. O'LEARY said the economic recovery continued at a slow pace in the third quarter, with a revised 2% GDP growth. Of note in the quarter was the big spike up in year-over-year CPI (consumer price index) and PPI (producer price index), and the significant drop in the consumer sentiment index.

The third quarter was so weak because of several key issues: (1) Greece, Italy and Europe; (2) slowing growth and inflation concerns in the emerging markets, most notably Brazil and China; (3) Super Committee concerns in the U.S. [working on deficit reduction solutions]; (4) the absence of job growth; and (5) people expecting greater economic growth than they should have, given the financial condition.

Interest rates remain at extraordinary low levels. MR. O'LEARY showed a graph of the effective yield over Treasuries for various spread categories ticking upward during the September quarter. He noted that PIMCO had a negative return in their Total Return Fund in the quarter because of credit risk exposure: they were significantly underweight Treasuries and had emerging market debt.

MR. O'LEARY reviewed Callan's periodic table of asset class performance for the third quarter, and the last 1-year, 3-year, 5-year, and 10-year periods. The weakness in emerging markets persisted in the quarter and over one year. Bonds were the best performers out to five years. The Russell 3000 Index was up 0.5% for the year through the end of September, while the MSCI EAFE Index was down almost 9.5%. The EAFE is a developed market index, and Europe is a big part of it, but currency was a detractor for the year.

MR. O'LEARY commented that people are moving increasingly toward a global equity benchmark for their equity allocation. Only 40-some percent of a global benchmark is the U.S. So if one had had a global benchmark for their equities, they would have done significantly worse in recent periods — because of the dollar strength — than if they had had a domestic equity benchmark. It can clearly work the other way as well, where one gets the currency advantage by not being in the United States.

Showing two slides that were discussed at the Education Conference in New York City in October, MR. O'LEARY drew attention to the high level of company earnings and the low level of price/earnings ratios. The market decline in the third quarter took equity valuations to levels that do not seem to be justified by the level of earnings, suggesting that people are expecting that earnings are going to decline. That is not evident in analysts' estimates, nor in the earnings reports that came out subsequent to September 30. A comparison of the number of credit upgrades and downgrades indicates that in 2010 and thus far in 2011 upgrades have outnumbered downgrades.

MR. O'LEARY mentioned that Callan has been explaining that some disappointing relative performance was largely from timing issues related to both real estate and private equity valuations. The positive side of that valuation timing issue has now come through, and private equity has been carrying the burden of boosting ARMB performance thus far in calendar 2011. Real estate has helped as well. The NCREIF Property Index was up 16% for the year ended September 30, 2011. REITs at 1.9% were well behind that but still positive. Real estate has caught up with the improvement in equity markets, and private equity appears to have done so as well.

At September 30, the retirement fund had an over-allocation in private equity relative to what was then a 7% target, and an under-allocation to domestic and global equities. Much of the public equity under-allocation was due to the equity markets declining while other asset classes went up. Compared to other public funds, the retirement fund had a slightly greater allocation to international equity and a significantly lower allocation to fixed income. There is a big allocation to alternative investments, which includes both private equity and absolute return. The Board places its TIPS investments in the real assets category; however, the TIPS exposure mitigated some of the low allocation to fixed income because these inflation-protected securities have acted a lot like U.S. government bonds so far in the year.

MR. O'LEARY reported that the retirement fund was down 8.84% in the September quarter but did better than the target asset allocation return of -9.27%. For the trailing 12 months, the fund had a positive 2.52% return that beat the target return of 0.96%. He noted that the fund's private equity portfolio made 24.5% over the 12 months ended 9/30/11; where timing differences in valuing illiquid investments had been a drag on total fund performance in prior periods, those timing differences contributed to performance in the most current year. Real assets had a positive 13.3% return for 12 months, and it was the same story — largely timing differences reflecting the appraisal process for valuations. The one-year and two-year total retirement fund returns are now better than the median return.

MR. O'LEARY next reviewed the performance of each asset category in the ARMB portfolio:

- The U.S. Treasury fixed income pool, managed internally, did three basis points better for the year than the benchmark Barclays Capital Intermediate Treasury Index, 3.97% compared to 3.94%. For the quarter, the in-house portfolio was slightly behind the benchmark, but 3.36% was an attractive return and right in line with expectations.

- The non-dollar fixed income had a negative return for the September quarter and was below the unhedged benchmark. Mondrian historically has done a wonderful job for the ARMB.
- High yield bond returns were negative in the quarter, but manager MacKay Shields did better than the target. Their relative performance over the past year has improved such that their five-year return is now above median.
- Total domestic equity did worse than the Russell 3000 Index for the quarter.
- The large cap domestic equity pool return was slightly positive over the last year. For the quarter it was worse than the benchmark but above median.
- The small cap equity pool is made up of two index funds plus several active managers. The pool return was better than the benchmark for the 1-year and 2-year periods, and a tad below benchmark for the 3-year, 5-year, and 7-year periods. The three active managers — Luther King, Lord Abbett, and Jennison — have added significant value. The impact of hiring new active small cap managers is not reflected in performance yet.
- The convertible bond portfolio managed by Advent is part of the ARMB equity pool. The Board is seeing one side of the expected performance pattern, as Advent was down less than the equity market decline in the September quarter. This type of portfolio is expected to lag rising equity markets and do better than equities when the market is declining.
- International equity performance for three years and longer has been very competitive compared with other public funds. It was not grand during the last 12 months, and did slightly better than the benchmark in the September quarter.
- While the returns for the international ex-emerging markets portfolio have been negative for all periods out to five years, they have been better than the EAFE Index.
- The emerging markets equity pool in aggregate has underperformed the index over the last two years. The pool has a value tilt.

MR. BADER explained that when the retirement fund changed to individual health trusts for PERS and TRS, emerging markets manager Eaton Vance required that the ARMB exit from one of their products and go into another product. The expensive transaction costs to go from one fund to another severely damaged Eaton Vance's returns. It was not the manager's fault, but it influenced the performance record a lot.

MR. O'LEARY continued his review of performance by asset class:

- Lazard, the ARMB's one global equity manager, seems to have recovered nicely from a performance "ripple," such that the 3-year, 5-year and 7-year numbers have beat the MSCI World Index.
- The real assets portfolio return of 13.30% for the fiscal year exceeded its target of

12.81%. It lagged in the September quarter.
- The internally managed REIT portfolio had good results relative to market over the quarter and for the 1-year and 2-year periods.
- The TIPS portfolio managed in-house has done well.
- In the absolute return composite, the best recent performer was Crestline. GAM had a good quarter. For Mariner, one has to go out to three years to find competitive returns. Mariner has more of a fixed income focus, and it has been very difficult to navigate in the fixed income area. Prisma looks okay on a since-inception basis, but its recent performance has not been outstanding.
- The two buy-write programs are in the early days and are performing in line with expectations.

MR. O'LEARY indicated that the Callan report also had two pages that highlighted which investment managers had been doing well for both 1-year and 5-year periods, and which managers had disappointing performance.

MR. ERLENDSON reported on the individual investment funds that retirement plan participants can invest in. He said there is a message with participant-directed monies, in terms of how they react to the markets, and it shows the importance of the diversified array of investment options the Board has in place for participants to invest in. Nearly half of the 27 options are multi-asset strategies, either target date funds or balanced funds. Nearly two-thirds of all the money in the participant-directed plans is invested in the multi-asset pools, while about one-third of the participant money is in the single asset strategies.

Through the end of November, the U.S. stock market has been negative in six of the last seven months. It is not surprising that some of the cash flows Callan has observed reflect the risky sense of the market. The Alaska Balanced Fund and the Long-Term Balanced Fund account for over 56% of the assets. Taking into account the Stable Value Option, the third largest fund in terms of capital deployed by the participants, 70% of the assets are in those top three funds. Those are risk-based strategies, where the managers are trying to diversify or retain capital.

The third quarter of the year was negative for the stock market, and the largest amount of net positive cash flow was into the Stable Value Fund (over $10 million). Long-term, high quality bonds have had a phenomenal year so far, and the Long-Term Treasury Fund was the second largest recipient of capital from participants shifting money. Of concern is that with talk of inflation fears, long-term Treasuries would be the last thing an investor would want to own if that were going to happen. The third largest fund receiving flows was the Long-Term Balanced Fund. So the flows of capital seem to suggest that participants are paying attention to the market, and they are reacting by either chasing high returns (long-term Treasuries) or deploying capital into capital preservation strategies.

MR. ERLENDSON said the largest source of capital for moving money was the Alaska Balanced Fund, with about $12 million taken out. It is also the largest single fund, so that was not surprising. Small cap equity has had a very difficult year, and that was the second largest source of flows of funds, at about $4.7 million. Then the S&P 500 Index Fund was the third largest source of capital being moved. So people were taking money out of the equity markets or the more aggressively positioned balanced funds.

MR. ERLENDSON stated that, on a risk-adjusted basis, the balanced and target date funds have been beating their benchmarks or are equivalent to benchmark.

Over the quarter, the last year and the last three years, almost all of the passively invested single-strategy type funds are meeting their benchmark and are doing better than the typical funds in these arenas.

MR. ERLENDSON gave the Board some details about the annual Callan client conference scheduled for January 30 through February 1 in San Francisco.

MR. TRIVETTE asked Mr. Erlendson to give the Board a written summary of his comments about the behavior of participant-directed money over the last year. MR. ERLENDSON said he would do that. MR. TRIVETTE said the knowledge could lead the Board to make some changes in the education provided to the defined contribution plan participants.

CHAIR SCHUBERT mentioned an article she had read that it was becoming in vogue to talk about the economic collapse of China. She asked for Mr. O'Leary's thoughts on that.

MR. O'LEARY said that much of China's extraordinary growth is attributable to the huge investment in infrastructure, which has driven job creation and the conversion of much of the population from agrarian to city dwellers. So infrastructure has been an important contributor to growth, but at some point that has to begin to change to citizens spending money. Many believe that that transition will be more difficult for the government to dictate and control than it has been for it to control the pace of new fixed investments. He does not share at all the view that China will go off the deep end. China has been preemptive in tightening to try to deal with inflation, and in the last week or two has shown signs of relaxing that as their economy has slowed some. It is important for the global stage for the emerging economies — not just China — to be contributing very positively to growth, because it is not going to come from Europe. He was keeping an eye on this and would let the Board know if he detected any change.

9. KPMG Audit Report

MICHAEL HAYHURST introduced himself as Managing Partner of KPMG's Anchorage Office and the engagement partner on the 2011 audits performed over the Division of Retirement & Benefits in the Alaska Department of Administration and the Treasury

Division in the Department of Revenue. *[The 2011 audit results had been presented in more detail to the Audit Committee at its prior meetings, and the minutes of those committee meetings are on file at the ARMB office, along with the KPMG slide presentation.]*

MR. HAYHURST touched briefly on the separate responsibilities of the Board, management, and the independent auditor in an audit. He also reviewed the list of reports KPMG issues, as well as the opinions on reports that KPMG issues as part of the audit engagement.

He explained three critical areas that KPMG looks at because they require estimations:

- Funded status of the retirement systems and progress on funding future benefit obligations, as well as related disclosures in the financial statements.
- Claims payable incurred but not reported. KPMG reviewed the Group Health and Life Fund, Retiree Health Fund, and the Alaska Retirement Healthcare Trust this year, and did not find any significant issues.
- Investments - checking the assessment of value of alternative or hard-to-value investments that are not traded on a regular basis. This year KPMG involved a financial risk management specialist to look specifically at alternative investments. The focus was on the policies, processes and controls that the department has in place, and what management does to identify what they are comfortable with as the fair value that gets recorded in the financial statements. KPMG was comfortable with the robustness of the process in place. KPMG also checked the allocation of investments to the various retirement plans.

MR. HAYHURST reported that no items were identified as adjustments to the financial statements. One item related to the lag period used to record the value of alternative investments is identified as an unadjusted audit difference almost every year. By the time the financial statements are issued and KPMG issues its opinion, updated valuation information is received as of June 30. KPMG makes an assessment at a detailed level as to what the amount would be if they recorded it in the financial statements and made an adjustment. Historically, that has not been material, but it is large enough to go over KPMG's listing scope.

MR. HAYHURST said there were no deficiencies identified in internal controls that would rise to the level of a material weakness.

There was one significant deficiency identified in the National Guard Naval Militia Retirement System (NGNMRS) not providing data on a regular basis to the Division of Retirement and Benefits that would be used to determine plan benefits. That branch does not have established policies for locating and ensuring that it gives DRB the appropriate data, and the Division has to do a lot of verifying work. This has been an ongoing and unremediated deficiency and something that management mutually agreed with KPMG on. It is more an efficiency item than it is about any errors that might be in the financial statements, although it is reasonably possible that it could get to be more than inconsequential. KPMG did additional analysis and procedures, and the NGNMRS is a fairly straightforward plan. Ultimately, agencies that are feeding information into the system should have consistent policies on how they are doing that.

MR. HAYHURST stated that no new significant accounting policies were required to be implemented in the current year. Further, there were no significant or unusual transactions. He reviewed a list of other matters and stated that KPMG did not encounter any significant difficulties; they had full cooperation from staff, full access to the books and records, and follow-up on any questions. There were no disagreements with management.

MS. ERCHINGER asked if members made employee contributions to the National Guard retirement system. MR. PUCKETT said it was employer-only contributions.

MR. JOHNSON asked if KPMG knew of any anticipated changes in the accounting standards that could create major auditing efforts in the coming year. He also asked at what point KPMG had to disclose that there had been a conversation about alternative accounting treatments with management.

Answering the second question first, MR. HAYHURST said that FASB, GASB or some standard-setting body can come out with new accounting standards or interpretations, or a different transaction can come up within an entity. There is divergence in practice out there, and practice allows for an agency to pick different ways to do something. Through interpretations of the various standard-setting bodies that have been built up, a preferred method is adopted. It is those types of conversations where KPMG may say there are acceptable alternatives related to recording a particular transaction and indicate what alternative is being adopted by an entity. A lot of times in the conversations with management there really are not acceptable alternatives; there is really one GAAP and understanding the facts and circumstances to determine which literature applies and drives to what accounting treatment to use.

Regarding Mr. Johnson's first question, MR. HAYHURST said the most significant impending change is the convergence between U.S. accounting standards and international financial reporting standards. It is not necessarily pulling in GASB at this point; however, it is not atypical when there is a major significant change in convergence in standards that that feeds back to the various standard-setting bodies. A couple of the key things they are working on are revenue recognition and financial instruments. He was not aware of anything that could significantly impact what KPMG would be looking at in the next year.

CHAIR SCHUBERT called a lunch recess at 11:58 a.m. and reconvened the meeting at 1:18 p.m. Commissioner Becky Hultberg and Deputy Commissioner Mike Barnhill joined the meeting following lunch.

10. Investment Actions

10(a). Victory Capital Management

MR. BADER stated that the Board interviewed Victory at the September 2011 meeting. He read an excerpt of the minutes to the effect that staff had advised the Board to defer any hiring decision until staff could get a higher level of comfort with the returns that Victory Capital Management reported at the meeting. He explained that the apparent discrepancy was between the returns reported at the presentation and the annual returns that were provided separately. Upon review, it was found that one set of returns were calendar year returns and another set of returns were based on fiscal year returns. From staff's perspective, that issue was set aside.

Subsequent to that, another issue arose. The risk/reward chart that Victory had presented showed returns based on 9-1/2 years of data, which appeared to be a convenient way of avoiding the tenth year investment returns that were very poor. ARMB staff talked to Victory about that report and learned that the 9-1/2 years were the returns associated with when the portfolio manager began his service at Victory. MR. BADER said he, Steve Sikes and Sean Howard spoke to Victory about all this several times. Callan's report on Victory that was provided to staff showed the returns over seven years at 408 basis points above the index, for five years at 515 basis points over the index, for three years at 371 basis points, and last year at 321 basis points outperformance. Victory has been a top-quartile performer in terms of alpha, information ratio, and Sharpe ratio.

MR. BADER said that, having addressed the issues, staff continued to support the selection of Victory for a small cap equity mandate.

<u>MR. TRIVETTE moved that the Alaska Retirement Management Board hire Victory Capital Management to manage a U.S. domestic small cap value portfolio up to an initial funding of $100 million, subject to contract and fee negotiations</u>. <u>MS. HARBO seconded</u>.

MR. TRIVETTE thanked staff for their additional due diligence and said he was totally comfortable with the explanations.

The motion passed unanimously, 9-0.

10(b). Equity Guidelines - International Small Cap Equity Resolution 2011-21

MR. BADER reviewed the staff report in the packet. He recommended changing the investment guidelines to allow the Board's two international small cap managers to have a small exposure to emerging market stocks.

MS. HARBO moved that the Alaska Retirement Management Board approve Resolution 2011-21 amending the Investment Guidelines for Domestic and International Equities, limiting the weight of investment in emerging markets to ten percent of the portfolio weight for managers that are benchmarked against the MSCI Small Cap Index. MR. PIHL seconded. The motion carried unanimously, 9-0.

10(c). Investment Advisory Council Contract

MR. BADER briefly covered the staff report included in the meeting packet and asked that a committee of the board review the applications for the Investment Advisory Council position currently held by Dr. Mitchell and make a recommendation.

MS. HARBO moved that the Board authorize an extension of Dr. Mitchell's contract through February 29, 2012, and that the Board Chair appoint a committee to review the submitted applications and complete the selection process for the position on the Investment Advisory Council. MR. TRIVETTE seconded. The motion passed unanimously.

CHAIR SCHUBERT solicited volunteers to serve on the selection committee and came up with Ms. Harbo, Mr. Richards, and Mr. Trivette.

10(d). Real Assets Committee Charter

Committee Chair MS. ERCHINGER explained the charter revision to change the Real Estate Committee to the Real Assets Committee. The Real Assets Committee met November 30 and recommended approval of the charter to the full Board.

MR. PIHL moved that the ARMB approve the Real Assets Committee Charter, which reflects the renaming of the Real Estate Committee and expands the scope of this committee to include all real assets. MS. HARBO seconded. The motion carried unanimously. 9-0.

10(e). LaSalle - Budget Variance

MR. BADER reviewed the staff report in the meeting packet. He said LaSalle Investment Management has asked for approval for an estimated $1.36 million roof replacement project on an industrial property located in Sumner, Washington. ARMB staff's authority is limited to $300,000 for line item variances of capital expenditure budgets, and so Board authority was needed.

MS. ERCHINGER stated that the Real Assets Committee discussed the request at its November 30 meeting and recommended forwarding it to the Board.

MS. ERCHINGER moved that the ARM Board approve the fiscal year 2012 line item budget variance to proceed with the estimated $1.36 million roof replacement project at the Rainier Industrial Park. MR. PIHL seconded.

MR. WILLIAMS observed that the building was built seven years ago, and asked if there was any recourse against the contractors that the ARMB could pursue. MR. BADER replied that staff had reviewed the due diligence the investment manager did. He said it is customary in situations like this that the investment manager look into the engineers that did the buyoff on their due diligence of the building. The manager has not indicated to staff that they will go after that at this early point.

COMMISSIONER BUTCHER asked what the original purchase price of the building was. MR. SIKES did not have that number but said the current value is just over $13 million.

The motion passed unanimously, 9-0.

11. IFS Action Item

MR. BADER reviewed the staff report in the meeting packet that addressed one recommendation in the Independent Fiduciary Services (IFS) audit report regarding the fixed income portfolios.

> **B.1.b #11 - Specify minimum credit ratings in TIPS guidelines**
> IFS report recommendation #11, page 49, states:
> *Treat internally managed portfolios the same as externally managed portfolios in terms of setting appropriate investment guidelines, as well as for ongoing monitoring and performance measurement.*

MR. BADER explained that in February 2011 the Board had approved staff's recommendation to alter the investment guidelines so that instead of laying out the investment criteria in each investment manager contract, it would say in each contract that the manager is subject to the investment guidelines passed by the Board. That way, the investment guidelines could be updated without amending the manager contracts.

MR. BADER said the internally managed portfolios are subject to the investment guidelines. In addition, Callan does performance measurement, and the internal compliance officers monitor the performance of internal staff the same way they do the external managers. He said staff believed the ARMB was already doing what the IFS report had recommended, based on previous Board action. He recommended, therefore, that the Board affirm the existing policies and processes with respect to investment guidelines, monitoring and reporting activities.

MR. RICHARDS moved that the Alaska Retirement Management Board affirm the existing policies and processes with respect to investment guidelines, monitoring and reporting activities. MS. HARBO seconded. The motion carried unanimously, 9-0.

12. T. Rowe Price Guidelines

MR. BADER explained a list of investment guideline revisions that staff was proceeding on for T. Rowe Price Associates:

- Removing T. Rowe Price's ability to invest in hybrid and non-investment grade bonds;
- Reducing allowable foreign security holdings from 10% to 5%; Adding convertibles, rights, and warrants up to 5% in the U.S. Small Cap Trust;
- Prohibiting securities lending;
- Remove cash holdings "for temporary defensive purposes" from the guidelines.

SUSTAINABILITY/UNFUNDED LIABILITY

1. Legal Analysis: Statutory Responsibility of ARMB

Board legal counsel ROB JOHNSON said it was appropriate as the Board considered various options for funding the retirement systems to have a refresher on the fiduciary obligations that were imposed on the ARMB and that trustees assumed by being members of the ARMB.

MR. JOHNSON referred to a supplemental handout of slides entitled "Fiduciary Concepts - SB 141 and SB 125" *[on file at the ARMB office]*. He said the fiduciary obligations are formed as a consequence of the law. What is paramount through a lot of case law analysis is that the duty that a fiduciary owes to the beneficiaries of a particular trust is that of "the highest standard of care." To apply all the analysis requires turning to the ARMB statutes, the source of the Board's authority and responsibility.

MR. JOHNSON read a sentence from AS 37.10.210(a): "Consistent with standards of prudence, the board has the fiduciary obligation to manage and invest these assets in a manner that is sufficient to meet the liabilities and pension obligations of the systems, plan, program, and trusts." He explained that the Board owes its duty of loyalty and obligation to the *"obligations of the systems, plan, program, and trusts."* Who the Board owes its obligations to is also emphasized in a significantly important way in AS 37.10.071(c): "In exercising investment, custodial, or depository powers or duties under this section, the fiduciary of a state fund shall apply the prudent investor rule and exercise the fiduciary duty in the sole financial best interest of the fund entrusted to the fiduciary. Among beneficiaries of a fund, the fiduciaries shall treat beneficiaries with impartiality."

MR. JOHNSON drew attention to a list of verbs, direct objects, and objects of propositions in AS 370.10.220, and their meaning to the ARMB's duties and obligations. He noted that one section states that by the first day of each regular legislative session the Board is to report to the Governor, the Legislature, and the individual employers on various and sundry issues related to the financial condition of the systems. So the statute certainly gives the Board a bully pulpit and, in fact, gives the Board an obligation to tender certain things. The Board is also to submit quarterly updates of the investment performance to the Legislative Budget and Audit Committee. So the ARMB's role is linked to other entities in government.

MR. JOHNSON also reviewed a list of verbs and direct objects in AS 37.10.071 that placed a mandatory obligation on the Board to do certain things. He noted one provision that the Board will exercise the powers of an owner with respect to the assets — a fairly broad-based declaration. The following provision in the statute is that the Board shall perform all acts not prohibited by the section, whether or not expressly authorized, that the fiduciary considers necessary or proper in administering the assets. That is broad-based language, but it has to be put in the context of the Board's described role under the provisions that created ARMB.

MR. JOHNSON said this creates a dynamic tension between trustees and others. The Department of Administration has the authority and responsibilities over PERS and TRS to act as an administrator, by law. There is a statutory role of the Department of Revenue to provide staff to the Board. The ARMB's provisions require that there be assistance, coordination, submission of reports, and the like. So there is an inter-relationship between all these parties. Then there is the statutory and constitutional role of the Legislature. The Legislature by law adopts budgets, it expects the ARMB to tender certain reports, and only the Legislature has the capacity to enact legislation.

MR. JOHNSON said there was no question that recommendations were expected from the Board. He drew attention to language from various committee meetings on SB 141 (that adopted the defined contribution plan and ARMB). Senator Stedman gave very clear statements that he assumed that the ARMB would be making and providing recommendations. There is almost a supposition that Senator Stedman believed the ARMB would solve a lot of the problems that were facing the Legislature at the time of SB 141 being implemented.

Legislative history, as reviewed by the courts, is used selectively. Generally speaking, the courts will have to conclude that there is some sort of void to be filled in how a statute is interpreted or a way to clarify what was meant by the Legislature, and so on, before they really even get to looking at legislative intent. But the courts, in reviewing legislative intent, generally speaking will presume that the law as written and as adopted by the body that is the legislature is paramount, as opposed to the desires and indicators of a particular legislator, however important that legislator may have been in the process. But nevertheless, what Senator Stedman's comments are, along with other remarks recorded in committee minutes, indicate a supposition by the Legislature that, in fact, there would be a bully pulpit for the Board to make recommendations on things that it thought were important with respect to the health and well-being of the system that they are the fiduciary for.

MR. JOHNSON discussed what kind of recommendations the Board could make and what kind of things the Legislature could do to change the existing world. With respect to the funds and the funded status, the Legislature can ultimately pass laws that would assist in maybe addressing the issue. The Legislature can listen to the ARMB's recommendations and consider those. Whether the ARMB recommendations are the type of things that require legislation depends on what the Board proposes to say. A choice among amortization schedules or a change of direction in the actuarial valuation of a system are the types of things that are left more to the Board than are necessarily ingredients of legislation. By the same token, if there are goals that require statutory changes, while the Board can make recommendations, ultimately the Legislature adopts and has the choice of appropriating funds that the Board might even be recommending that they provide.

MR. JOHNSON referred to the *Gallion* case in Alaska, a retirement case that came out of the Municipality of Anchorage and was ultimately considered by the supreme court. The Municipality of Anchorage concluded that it was in the municipality's interest to combine into one fund three retirement funds with different funded levels. The police and fire unions sued, claiming that combining and aggregating the various funds constituted a diminution of benefits. The Alaska supreme court agreed with a California decision that even though an employee may not suffer out-of-pocket expenses, the interest of the employee at issue is in the security and integrity of the funds available to pay future benefits. As the *Gallion* court concluded, there is a vested right in the actuarial soundness of the plan to which a claimant is the beneficiary.

MR. JOHNSON stated that case law in a number of jurisdictions has recognized that adequate research and explanation may justify changes in funded status and how to go about funding things. Some courts have held that there is a clear analytical distinction, however, between the rights that beneficiaries have to receive benefits and the rights to control how those benefit payments are to be funded.

Taking those determinations and applying them in Alaska, however, there are situations where changes may not stand, such as the blending of funds which do not have a factual basis other than the desire to reduce employer costs (the *Gallion* court). Even though projections into the future are uncertain, a beneficiary may be entitled to a particular entitlement notwithstanding an intent or practice to change factors used in calculating that entitlement (*Sheffield vs. APEA*). In the latter case, the State had long presumed that it could change the mortality schedules for its beneficiaries because everybody presumed that the law fairly clearly provided that those mortality tables could be changed for any one individual. But the court concluded that a person is entitled to have the mortality table that is most advantageous to that person fixed and constitute the basis upon which their retirement benefits might be calculated.

MR. JOHNSON said that changes in how a benefit is paid and how it is calculated need to take into account the proscription against diminution of benefits. Throughout this, even in the *Gallion* case, is the issue suggesting that beneficiaries have an entitlement to security on the actuarial soundness of the system. Unfortunately, there is no definition of that. The closest is some case law. The Washington supreme court adopted a Pennsylvania court's footnote definition that "for a public retirement system, actuarial soundness requires that the municipality contribute a sum of money each year sufficient to cover the 'normal cost' for the year plus interest on the system's unfunded accrued liability." It is sort of a broad-ranging concept, but actuarial soundness, at least in the view of those courts, constitutes something along those lines.

MR. JOHNSON said his point to the ARMB is that within the context of fiduciary obligations, the Board's recommendations certainly should take into account the notion that employees and beneficiaries have, under apparently applicable case law, a right to expect something other than challenges to the integrity and security of the system that exists for them. He suggested that trustees keep that sort of thing in mind as they made recommendations. On balance though, there appears to be no question but that the Board has the authority and the ability — and, in fact, it probably falls within the scope of what the Board should be doing — to be making appropriate recommendations, recognizing at the same time that at the end of the day it is the Legislature that adopts legislation and that appropriates funds that the Board might recommend are most appropriate.

2. Historical Perspective

MR. BADER stated that the Board Chair and Trustee Pihl had requested an historical perspective, and that certain records be included in the meeting packet: November 2010 meeting minutes and materials, the September 19, 2011 letter from Mr. Pihl, and the Governor's presentation at the September 21-23, 2011 meeting. *[The slide summary and other materials referred to are on file at the ARMB office.]*

3. Scenarios to Address Retirement of Unfunded Liability of Defined Benefit Retirement Plans - Spreadsheets

MIKE BARNHILL, Deputy Commissioner of the Department of Administration (DOA), said he heard loud and clear from some trustees at the last board meeting that they wanted to have a meaningful engagement in the process that DOA was going through in looking at various options to address the unfunded liability. He said that after receiving a letter from Chair Schubert, he had started talking to each trustee individually about what scenarios they would like to have modeled by Buck Consultants, and how they would like to be engaged in the process of developing recommendations for the Governor and the Legislature.

MR. BARNHILL thanked Trustee Pihl for the spreadsheet format and his input on the data points for Buck to model the scenarios provided in the meeting packet *[on file at the ARMB office, along with the Buck detailed spreadsheets as backup]*. He explained in detail what each of the summary scenario spreadsheets depicted as run under the level percentage of pay amortization methodology and then run under a level dollar amortization, and for payoff periods of 25 years, 30 years, and 40 years. He pointed out the results for the State contribution amount in each scenario and what percentage the State assistance represented of the projected General Fund balance.

MR. PIHL circulated a copy of the PERS scenario with three additional columns showing the contributions required by the State and others after FY20 to reach fully funded status by certain dates *[on file at ARMB office]*. He spent a few minutes explaining what his penciled numbers were meant to portray. He thought the Board should make some findings from the data outputs and possibly choose to advance a recommendation.

MR. BARNHILL said the scenarios were useful in showing what happens to the unfunded liability and the payment for it when four different levers were adjusted. The levers were: (1) changing the method of amortization between level percentage of pay and level dollar; (2) changing the term of amortization from 25 years to 30 to 40; (3) adding in various levels of additional cash up front through appropriations: and (4) changing the employer contribution rate. Based on the comments Governor Parnell made at the September meeting, DOA also had some other mechanisms that could be employed to help address the unfunded liability, including a cash-out for retirees or some incentive to help employees retire early, or an incentive for people to move from the defined benefit plan to the defined contribution plan. Another mechanism was a retirement reserve account where money would be deposited instead of into the trust fund, which could enhance budgeting flexibility down the line. He said there are a variety of mechanisms and levers, and there are a number of different ways that the State, the ARMB, the Legislature and the Governor can address this issue.

Trustees had initial comments and questions on the summary scenarios. Then JOHN BOUCHER from the Office of Management & Budget (OMB) in the Governor's Office explained the revenue forecasts that go out to 10 years and how any revenue data beyond that falls dramatically with the [oil] production curve.

CHAIR SCHUBERT remarked that it was an extremely complicated issue. The benefit was set in stone because it was constitutionally protected, so Alaska cannot reduce benefits to deal with the unfunded liability crisis, as Commissioner Hultberg said other states are doing with their pension plans as a way to help balance their budgets. The public does not have a good understanding of the problem, and it might be helpful to have some public education about the demands that it will create on the General Fund and other services.

COMMISSIONER HULTBERG said it was important to consider the impact on the General Fund because it is a classic example of if we pay more now, we will pay less later. But if we pay more now and ramp up the percentage of the General Fund that is going toward the unfunded pension liability issue, then it really crowds out other services. The health care liability is another one that is growing very rapidly. That is the situation that has to be managed carefully, because the more oxygen taken out of the General Fund, the more pressure there will be. That is not a conversation anyone is ready to have.

MR. PIHL spoke in favor of the level dollar amortization methodology, saying it costs less over time, it reduces State assistance, and it avoids the crisis of annual assistance payments that are projected to grow to over a billion dollars a year.

MR. TRIVETTE recalled that when the systems switched from using the level dollar amortization to level percentage of pay around 2006 people were concerned about municipalities not being able to pay their share — and switching certainly lowered their contribution amounts. He thought that SB 125 ameliorated that problem partially or in whole. His readings, and talking to pension trustees at other funds and to actuaries, have led him to believe that level dollar amortization is the right methodology to use for a closed retirement system. He supported making some recommendations now because the issue would not get any easier down the line. The Board could still look at other options as they arise in the future.

MR. RICHARDS said it was important to keep the retirements safe for public employees who have done their work. He had thought at the time that SB 141 was a knee-jerk reaction to a difficult time, and little did he know that 2008 would come along and make the economic problem seem like it was going to happen all the time. He said he believed in Alaska and in the United States to get things back on track to more prosperous times eventually. Therefore, he was reluctant to believe the doomsday view that things are going to be difficult for the future. Being a math person, the numbers said to him that it was either pay now or pay later, and the State and the public have to cough up some money. There would be a small benefit to going to a 30-year amortization, but it would also add on money in the form of interest that he believed was a waste of the state dollars and would be harder to justify. The 25-year amortization was a good decision, and the Administration could carry on with that and get some relief from realizing that the status quo is a good thing. He thanked everyone who put the numbers together because it helped him make a better decision. There is oil in the pipeline now, and the State does have money in the bank. It would not be wise to make some adjustments and add a burden to later administrations, so he favored a quicker resolution in 25 or 30 years.

COMMISSIONER HULTBERG agreed that there was oil revenue today, but over the last decade the oil production has declined 37.8% while the spending has gone up 90%. That presents long-term concerns that if the State does not turn that trend around there could be some years of having to make some very difficult decisions.

MS. ERCHINGER commented that she was surprised at the results of the status quo scenario. She said she still agreed with her statement at an earlier meeting about needing to do something because the State assistance payments nearing $1.4 billion a year down the road are not sustainable. Yet the scenarios demonstrate that the status quo is not as bad as she originally thought. She had thought a lot about the Governor's request that the Board not make a recommendation that would limit the flexibility of the Administration and the Legislature. In her role as fiduciary of the Board, she could not in good conscience consider a scenario that leaves the retirement system never fully funded. With that in mind, she proposed that any Board recommendation state which scenarios definitely should not be considered.

COMMISSIONER BUTCHER raised the idea of providing education on the unfunded liability issues for the large number of freshman or newer members of the Legislature so they were prepared to make the best decisions possible. Several people expressed support for the idea, and Mr. Barnhill said he would be happy to join with others in the effort. MR. PIHL said the summary scenarios were easy to understand and should be used.

People spent a few minutes talking about amending the scenarios to include Mr. Pihl's hand-written additions, as well as other information, before the spreadsheets could be handed out to people who would be looking at the funding issue.

The Board took a break from 3:30 p.m. to 3:48 p.m. and resumed to take up the next topic related to sustainability and the unfunded liability.

4. Unfunded Liability - Real or Soft

MR. BARNHILL indicated there were three draft resolutions for the Board's consideration. He and MR. PIHL explained the basic differences between the two resolutions that MR. BARNHILL had drafted and the one that MR. PIHL had drafted.

MR. BARNHILL requested a subcommittee that would work with Mr. Johnson to refine the ideas put on the table into a resolution that the Board could consider more fully tomorrow.

CHAIR SCHUBERT appointed Mr. Trivette, Ms. Erchinger and Mr. Pihl to work as a subcommittee.

MR. PIHL solicited comments from fellow trustees on what they wanted in the body of a resolution relating to the unfunded liability of PERS and TRS.

Regarding the notion of a real or soft unfunded liability, MR. BARNHILL stated that it was real, but it was a soft liability. There are a variety of ways that the Board, the Legislature, and the Governor can address it, including extending the amortization period, which is why it is referred to as a soft liability. He said that in past presentations he has referred to the benefit payments, which by constitution the retirement systems must make, as the hard liabilities. That is why in the past he has drawn attention to the benefit payment projection that Buck Consultants produces.

5. Legislative Intent: SB 125 and SB 141

MR. JOHNSON said he had talked about the legislative intent of SB 141 in his earlier presentation. SB 125 that was enacted in 2008 provides the employer contribution rate cap of 22% for municipalities and other employers, with the remainder being picked up by the State. To the extent that the ARMB is still involved in setting contribution rates, the same principles apply regarding the Board's obligations.

MR. JOHNSON said the SB 125 legislative history is relatively sparse regarding changes to the Board's fiduciary obligations or suggestions that it ought to be different. An example of where what the Legislature did on the rate cap issue was not abundantly clear related to the true-up controversies (if later information coming in suggested that there be a true-up mechanism to reallocate liabilities between the State and the municipality). The Department of Law did analysis on it, and he and Mr. Barnhill looked to see if the provisions held some definitive statement of intent regarding this. The Division of Retirement and Benefits analyzed and computed a particular methodology, and all the reviewers had to conclude was one of several possible reasonable conclusions. Legislative history did not particularly help in the solution on that. That is an example of where legislative history might be helpful, if it existed, but it did not exist on that point.

MR. JOHNSON said the statements by the senators or representatives and so on are helpful in perhaps the sense of what the Legislature was endeavoring to do, but the language of the law is what applies. The provisions that control the ARMB's fiduciary obligations are written in the law, and that includes issues such as the target audience of the ARMB, the objectives, and what the Board can and cannot do.

MR. PIHL indicated that he had the presentation that David Teal made to PERS and TRS on April 27, 2007, and a similar presentation made to Senate Finance on April 23. He said it contained fairly clear intent behind what ultimately became SB 125.

MR. PIHL expressed his belief that the unfunded liability was a real liability that should be funded over the remaining service life of the defined benefit plan group of employees. Whatever is required actuarially at the end of an employee's service life is part of the pay that the employer agreed with that employee to set aside in a trust for him. Therefore, he could not think of it as a soft liability.

DAVID SLISHINSKY of Buck Consultants explained how the remaining service life of employees is calculated in normal actuarial practice. He noted that GASB is going through a process of examining the current standards under GASB 25 and 27 and has issued an exposure draft that will be followed up by a final draft that all governmental employers will have to follow. In that, they use a remaining service life for purposes of amortizing a part of the unfunded liability. For a plan, that is basically the average service life that is remaining for those who are currently active in the plan. That period is generally anywhere between seven and 14 years. Typical practice for amortizing unfunded liabilities for an ongoing plan is anywhere between 20 and 30 years (that represents the service life, not the remaining service life but the service life for employees from date of hire). The ARMB is using 25 years; other systems use 30 years and some use 20 years. But generally that is for the entire service life of a new entrant.

MR. BARNHILL mentioned that the soft versus hard liability jargon comes from the pension obligation bond context. A distinction is made between the unfunded liability as a soft liability, and it being a hard liability if the bonds are issued because the payments come due regularly and have to be paid.

MR. TRIVETTE asked if he got it right that there was nothing in SB 125 that overruled the ARMB's responsibilities as set forth in SB 141. MR. JOHNSON said he was correct.

6. Investment Earnings Over Time

MR. BADER stated that a chart showing annualized returns for PERS and TRS was included in the packet *[on file at the ARMB office]*.

7. Options

MR. BARNHILL stated that a summary of options to address the unfunded liability, plus some additional variations that could be combined with the options, was included in the packet *[on file at the ARMB office]*.

8. Resolutions

At this point, Board trustees spent a half hour discussing the three draft resolutions that Mr. Barnhill mentioned earlier and what history and recommendations they wished a final resolution to contain.

The Liability Subcommittee made note of the suggestions to consider when they met later with board counsel and the staffs of both departments to draft an inclusive version of a resolution.

RECESS FOR THE DAY

CHAIR SCHUBERT recessed the meeting for the day at 4:40 p.m.

Friday, December 2, 2011

CALL BACK TO ORDER

CHAIR SCHUBERT called the meeting back to order at 10:00 a.m. All nine trustees were present.

SUSTAINABILITY/UNFUNDED LIABILITY (Continued)

A new draft Resolution 2011-23 was distributed to everyone prior to the meeting start.

8. Resolutions (Continued)

<u>MS. HARBO moved that the Alaska Retirement Management Board adopt Resolution 2011-23 relating to the unfunded liability of the PERS and TRS systems</u>. <u>MS. ERCHINGER seconded</u>.

CHAIR SCHUBERT thanked everyone who worked on the resolution.

MS. ERCHINGER summarized what the subcommittee did, saying the resolution contained the bulk of the points that Mr. Pihl had made. A few items were not included, and some items were pared down fairly significantly but the meaning was kept. What was materially different from the resolutions that were originally presented yesterday was two sections that specifically laid out what funding scenarios the ARMB did not support and the reasoning behind those conclusions, and one section recommending that the Governor and the Legislature give consideration to a number of scenarios that provide a range of feasible options for responsibly addressing the unfunded liability.

MS. ERCHINGER said the resolution stated that the Board did not support any scenario that failed to amortize the unfunded liability over a reasonable time frame, and it did not support extending the amortization period to 40 years. The scenarios the Board asked be given further consideration were the 25-year amortization and the 30-year amortization under both the level percentage of pay and level dollar methodologies, as well as the option that provided a one-time $1.0 billion infusion into the PERS system and continued State support going forward.

Trustees next spent approximately 45 minutes asking questions of the actuary for clarification, discussing points and wording in the resolution that they either objected to in varying degrees or were in support of, and making several revisions for clarity. *[A digital recording of the complete discussion is available at the ARMB office.]*

MR. SLISHINSKY presented an additional scenario that had been requested the day before. That was for a $500 million appropriation to PERS and an equal $500 million appropriation to TRS, after which the State's contribution would be capped at $250 million to each. The scenario was added to Attachment A.

COMMISSIONER BUTCHER raised the question of whether the Board would be doing any proactive follow-through on the resolution and, if so, what form that would take. MR. BARNHILL said he would be attending hearings on the issue and he anticipated that Mr. Bader and others would also be there. COMMISSIONER BUTCHER said he planned to discuss it with the House Finance Committee.

There was also a brief exchange on how to transmit the resolution to the Legislature and if it should be embedded in the Department of Revenue's annual report to the Legislature.

MR. BOUCHER spoke about the General Fund unrestricted revenue number for FY13 to FY20 and the focus on the oil-related portion. He explained that state revenue forecasts are eight years and that the Legislature is generally trying to think three to five years out. He felt that showing funding scenarios that go beyond a 10-year horizon on the spreadsheets would be very speculative because revenue becomes more uncertain further out, and the slope of the oil production line heads downward.

CHAIR SCHUBERT suggested, when first referring to Attachment A in the resolution, adding the phrase "...attached hereto and made a part hereof...". The purpose was to make sure that people understood that they could not read Attachment A in isolation. MR. JOHNSON said it was a good idea.

<u>Roll call vote on Resolution 2011-23 as amended</u>

Ayes:	Erchinger, Butcher, Harbo, Hultberg, Pihl, Richards, Trivette, Williams, Schubert
Nays:	None

The motion carried unanimously, 9-0.

UNFINISHED BUSINESS

1. Calendar/Action Items

MS. HALL indicated that the 2012 meeting calendar was included, and there were no changes since the last meeting. She had also included a prototype of an action list, as requested by several trustees. Trustees were invited to contact her after the meeting with items for the list.

2. Disclosure Reports

MS. HALL stated that the disclosure memo listing financial disclosures submitted since the last meeting was included in the packet, and there was nothing unusual to report.

3. Legal Report

MR. JOHNSON said he did not have a separate legal report.

ACTION ITEMS - NEW BUSINESS - None.

OTHER MATTERS TO PROPERLY COME BEFORE THE BOARD - None.

PUBLIC/MEMBER COMMENTS - None.

INVESTMENT ADVISORY COUNCIL COMMENTS

DR. MITCHELL said that as he listened over the past two days to the extremely responsible and informative liabilities discussion he found his thoughts turning to what the investment implications might be for a fund that was dealing with the possibilities of a 25-year, 30- or 40-year amortization schedule and scenarios that went all the way out to the year 2071. In an investment world, where performance is measured daily, where hiring and firing decisions are often based on a one-year or shorter track record, and where computer program trades are made in milliseconds, how hard it is to match the very long-term thinking about liabilities with the short-term pressures on the assets investment side. Yet, the Board must do that.

DR. MITCHELL said that Charlie Ellis — the founder of the consulting firm Greenwich Associates, who is also an author, a professor, and a member of the investment committees of organizations ranging from the Vanguard Group to Yale University — has written that successful investing takes a long time; it does not get chopped up into months or years or even decades; investing is a long wavelength activity. So if a board can focus on liabilities of 25, 30, 40 years' duration, shouldn't it also focus on supporting those liabilities with an investment program of equal longevity and stability? For example, how often should you change your asset allocation? Every six months? Every year? Every five years? Every decade? Even less often?

Ellis argues that the major changes in asset allocation, changes that have some real significance, should not take place more often than once every ten years. DR. MITCHELL said he did not think Ellis was talking about tweaks in the asset allocation or small adjustments or rebalancing, which can always take place as needed. But major moves only once in a decade.

And what about manager changes? Ellis proposes that boards should be spending their time finding managers they can stay with for a long, long, long time — or as he puts it, for richer, for poorer, in sickness and in health. He believes that marriages — and he uses the word marriages — should be more common than they are in the investment firm/client relationship, and that hiring decisions should be based on long-term factors such as character, capacity, talent, and commitment, rather than on short-term numbers. Boards that insist on chasing managers based on recent performance numbers, Ellis writes, are just making trouble for themselves, since every manager has bad periods, and they often follow the exceptionally good periods.

DR. MITCHELL said he personally did not agree with Ellis on everything he has written, but the idea of a long-term-oriented investment program to deal with long-term liabilities does have an agreeable symmetry and a certain attraction. And everyone should be thinking about it.

TRUSTEE COMMENTS

MR. RICHARDS wished everyone Happy Holidays and said he appreciated all the hard work people had done over the last two days. He said it did his heart good to see all the effort put forth on behalf of the State of Alaska in general and the retirees.

MR. TRIVETTE stated that the Board was incredibly blessed to have the staff it has on both sides of the table [Administration and Revenue Departments], who have tremendous commitment. He thanked Mr. Puckett for his commitment and his staff's commitment, and mentioned that he has said the same about Mr. Bader and his staff for a long time. Alaska has a reputation for being one of the best-run pension boards in the country. The news media, people from other pension systems, and retirees and active members listen to the board meetings by telephone, and people read the minutes online. He said he was proud to be involved with the Board, and he felt it was a lot of work but the Board was making good progress.

MS. ERCHINGER thanked Judy Hall for the action items listed in the meeting packet. She also thanked Trustee Pihl, who served on the Unfunded Liability Committee, and said she appreciated his positive spirit of trying to move the Board forward in a positive direction. The fact that the Board was able to move fairly quickly to consensus on a recommendation to the Governor and the Legislature, and follow the Governor's request to provide some information before the legislative session this year, was a real testament in large part to Deputy Commissioner Barnhill's and Trustee Pihl's efforts on behalf of the Board. Had it not been for them, the Board might still be spinning its wheels trying to get its hands around this huge issue.

CHAIR SCHUBERT also thanked Trustee Pihl, who has been talking about the unfunded liability "snowball" growing for many years. Hopefully by taking the action the Board did today, it will start to melt that snowball. It was important that Trustee Pihl kept the issue in front of the Board, and she thanked him for championing the issue. In closing, she wished everyone Merry Christmas.

COMMISSIONER HULTBERG commented that the Board trustees come from very different backgrounds and bring their different perspectives to the table, but they worked together incredibly well. It might not result in immediate consensus, and in many cases that was a good thing because they had to go through the work of arriving at that consensus. She thought that was the culmination of the process at this meeting, and she found it a great process to participate in and watch. She thanked everyone for that.

FUTURE AGENDA ITEMS - None.

ADJOURNMENT

There being no objection and no further business to come before the board, the meeting was adjourned at 11:05 a.m. on December 2, 2011, on a motion made by Ms. Harbo and seconded by Mr. Trivette.

Chair of the Board of Trustees
Alaska Retirement Management Board

ATTEST:

Corporate Secretary

Note: An outside contractor recorded the meeting and prepared the summary minutes. For in-depth discussion and more presentation details, please refer to the recording of the meeting and presentation materials on file at the ARMB office.

Confidential Office Services
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