State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
MEETING

Location
Centennial Hall
Egan Room
Juneau, Alaska

MINUTES OF
February 6-7, 2014

Thursday, February 6, 2014

CALL TO ORDER

VICE-CHAIR SAM TRIVETTE called the meeting of the Alaska Retirement Management Board (ARMB) to order at 9:00 a.m.

ROLL CALL

Seven ARMB trustees were present at roll call to form a quorum. MR. BRICE arrived after roll call was taken, and CHAIR SCHUBERT called in after roll call was taken.

Board Members Present
Gail Schubert, *Chair* (Telephonic)
Sam Trivette, *Vice-Chair*
Gayle Harbo, *Secretary*
Kristin Erchinger
Commissioner Angela Rodell
Commissioner Curtis Thayer
Martin Pihl
Tom Brice
Sandi Ryan

Board Members Absent
None

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

Department of Revenue Staff Present
Gary M. Bader, Chief Investment Officer
Scott Jones, State Comptroller
Bob Mitchell, State Investment Officer
Zachary Hanna, State Investment Officer
Steve Sikes, State Investment Officer
Shane Carson, State Investment Officer
Pamela Leary, Director, Treasury Division
Judy Hall, Board Liaison

Department of Administration Staff Present
Mike Barnhill, Deputy Commissioner
Jim Puckett, Director, Division of Retirement & Benefits
Kevin Worley, CFO, Division of Retirement & Benefits

Consultants, Invited Participants, and Others Present
Robert Johnson, ARMB legal counsel
Michael O'Leary, Callan Associates, Inc.
Paul Erlendson, Callan Associates, Inc.
Kevin Clark, Analytic Investors LLC
George Matthews, Analytic Investors LLC
Glenn Carlson, Brandes Investment Partners
Juan Benito, Brandes Investment Partners
Rob Gillam, McKinley Capital Management
Alex Slivka, McKinley Capital Management
Michael Bowman, Capital Group
Chris Ryder, Capital Group
David Slishinsky, Buck Consultants
Larry Semmens, Chief of Staff to Senator Peter Micciche
Senator Anna Fairclough
Senator Dennis Egan

PUBLIC MEETING NOTICE

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

APPROVAL OF AGENDA

VICE-CHAIR TRIVETTE noted that staff had requested to move Item No. 12, Investment Actions/Procurement, up to before Item No. 8.

<u>MS. HARBO moved to approve the agenda as amended</u>. <u>MS. RYAN seconded the motion</u>.
The agenda was approved as amended.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES

None.

APPROVAL OF MINUTES

MR. BRICE moved to approve the minutes of the December 5 - 6, 2013 meeting of the ARMB. MR. PIHL seconded the motion.

MS. HARBO noted a couple of corrections:

Page 5: It should say Bader instead of Brice in the first and second paragraphs.

Page 13, Paragraph 2: It refers to Ms. Rehfeld and it should say Mr. Boucher.

VICE-CHAIR TRIVETTE noted that on page 9, under Item No. 7, in the second paragraph, it should read, "KPMG issued an unqualified opinion."

The minutes were approved as amended.

REPORTS

1. CHAIR REPORT

None.

2. COMMITTEE REPORTS

A. Audit Committee

MR. PIHL reported that the Audit Committee had a very well-attended meeting in Juneau on February 4, the day before this board meeting. Reports were received from the Division of Retirement and Benefits on the employer audit program and from the Department of Revenue compliance division about their activities and goals.

MR. BARNHILL stated that the Governmental Accounting Standards Board (GASB) issued a 168-page guidance statement this week. MR. BARNHILL also reported that the state has not received any comments on the draft that was put out late last year of the state interpretation.

MR. PIHL added that the committee had been given copies of the RFP for independent audit services, and the committee intends to write a letter to the personnel board in support of what the state is doing, as it is so important to the mission of the ARM Board.

B. Legislative Committee

VICE-CHAIR TRIVETTE reported that the Legislative Committee also met the day before the meeting of the full ARM Board, with eight Trustees participating, as well as John Boucher from OMB and Paulyn Swanson from the Governor's Office. VICE-CHAIR TRIVETTE commented that it was an extremely productive meeting, including an in-depth discussion of Governor Parnell's plan to put an additional $3 billion into the PERS and TRS funds. VICE-CHAIR TRIVETTE noted that Trustee ERCHINGER and Trustee BRICE had met with 11 key legislators about the benefits of Governor Parnell's plan, and had received a list of questions afterwards. MS. ERCHINGER presented a draft of answers to the questions to the Legislative Committee for feedback, and she will send the approved answers to the legislators soon.

VICE-CHAIR TRIVETTE added that the Legislative Committee received a letter from Senator Anna Fairclough, the chair of the Legislative Budget and Audit Committee, indicating she wants to hire GRS, the Board's secondary actuary, to evaluate Buck's analysis of the governor's proposal. VICE-CHAIR TRIVETTE commented that the letter was a courtesy, and that Senator Fairclough had remarked that she wanted the ARM Board to be involved; also, John Boucher and Paulyn Swanson thanked the committee for their work and their willingness to support the Governor's efforts.

3. RETIREMENT & BENEFITS DIVISION REPORT

A. Membership Statistics/Buck Invoices/HRA Rates

DIRECTOR PUCKETT directed board members to the packet, which included membership statistics for September and December of 2013; he commented that the patterns are the same as the previous year, with nothing unusual.

DIRECTOR PUCKETT commented that the Buck Consultants invoices show that they are doing a lot of projects for the Board, and the charges are all standard.

MS. ERCHINGER requested an update on the status of the retiree health plan from the Department of Administration at the April meeting; MR. BARNHILL said that they would be prepared for that.

B. Legislative Update

MR. BARNHILL reviewed the pending bills that are of interest to the ARM Board.

- A new bill has been introduced called the Governor's Veteran's Bill, HB 286 and SB 145, which amends the PERS, TRS, and JRS statutes to bring them into compliance with a 2008 federal law called the HEART Act.

- HB 106 would allow members to elect to have their retiree membership dues deducted from their pension check.

- HB 124 would require in statute that any benefits that are afforded to active employees through the State of Alaska's active health plan would also be afforded to retirees through the retiree health plan.

- Companion bills HB 126 and SB 30 would provide new employees the choice of a defined benefit or a defined contribution plan.

- HB 152 would provide relief to municipalities on termination costs when they discontinue PERS service for a group of employees.

- Companion bills HB 174 and SB 48 would exempt small communities which have had a drop of 25 percent or more in their populations between 2000 and 2010 from the 2008 salary floor for PERS contributions.

- HB 196 and SB 90 would consolidate school district health plans into one plan potentially administered by the state.

- HB 116 would permit police officers and firefighters to use up to five years of military service as credit toward purchasing PERS service credit to qualify for health coverage, which requires five more years of service than the pension does to qualify. This would help even those out and would be paid by taking an actuarial reduction in their pension benefit.

- HB 247 is another new bill which provides for a hybrid variable defined benefit for police and firefighters, which would vary based on actuarial experience.

4. TREASURY DIVISION REPORT

Department of Revenue Commissioner ANGELA RODELL announced that this would be her last Treasury Division report because now the responsibility will pass to the new Treasury Division Director, PAM LEARY.

COMMISSIONER RODELL noted that she met with managers and directors to consider the mission of the department and how to best deploy their assets, and they did some reorganization that she thinks will make the department better and improve service delivery. A new position was created, Deputy Commissioner for Strategic Finance, and filled by MIKE PAWLOWSKI. PAM LEARY is now the Treasury Division Director and State Treasurer, and SCOTT JONES has been promoted to State Comptroller.

COMMISSIONER RODELL responded to a request by the Board to discuss the reserve accounts, which is important to understand as they talk about the Governor's proposal to move $3 billion out of the reserve accounts and into the PERS and TRS trust fund.

The primary reserve account is the Constitutional Budget Reserve Fund, which the legislature can appropriate funds both into and out of by a three-quarter vote. COMMISSIONER RODELL explained that the fund is divided into the main fund and a subaccount that was created in 2000 so that a portion of the funds would have a different asset allocation than the main account, to allow the Department of Revenue and the state to better grow some of the funds. The main fund has about $5.8 billion in it, and the subaccount has about $6.3 billion. The main fund has very moderate risk tolerance, because it is the fund that covers cash flow shortages throughout the year. The subaccount, however, has had tremendous growth from the equity market, providing additional reserve levels to the state. COMMISSIONER RODELL assured the ARM Board that she and GARY BADER and his staff would carefully consider the decisions before moving assets so as not to negatively impact either fund.

The second reserve fund that is very important to the state is the Statutory Budget Reserve, which is excess revenues saved within the general fund. The balance of the SBR on December 31, 2013 was $4.7 billion. The SBR only requires a simple majority vote to move money out, and some was used to balance the FY 13 budget. COMMISSIONER RODELL explained that in July of 2013 with the start of FY 14, they separated this fund into its own separate asset allocation, which has had increasing yields.

COMMISSIONER RODELL stated that the money in the Constitutional Budget Reserve earns less than the money in the PERS and TRS funds, so moving the $3 billion will benefit the state by higher returns. She noted that the Alaska Permanent Fund Corporation has a balance of $49.2 billion, which means she has oversight as Commissioner of over $100 billion. COMMISSIONER RODELL concluded by saying that the state has tremendous financial resources to weather the storms that may be coming.

MS. HARBO thanked COMMISSIONER RODELL for the excellent presentation, noting that she was one who had requested it. VICE-CHAIR TRIVETTE also thanked COMMISSIONER RODELL for the cogent explanation to the Board, and MR. PIHL said kudos to GARY BADER and his staff for the excellent returns.

5. CHIEF INVESTMENT OFFICER REPORT

Chief Investment Officer GARY BADER referred to his report, in which Item No. 1 shows multiple adjustments to the asset allocation. MR. BADER noted that frequent adjustments ensure that they stay within the policy guidelines set by the board.

MR. BADER remarked that Mr. Chambers of Barrow, Hanley is retiring. MR. BADER wished Mr. Chambers well, and stated that a broad team manages the assets so this does not warrant placing Barrow, Hanley on the watch list.

MR. BADER's report included notification of the transfer of $1.2 million to Crestline Investors.

MR. BADER reminded the board that they had approved entering into a contract with Lazard Asset Management to manage an infrastructure fund for the board in a hedged account. However, MR. BADER noted that some issues with hedging had become apparent due to changes in the Dodd-

Frank law and the requirement to put certain assets in reserve when investing in currencies. Thus, they are going to proceed with Lazard with the understanding that at least for the near term, it will be an unhedged mandate.

MR. BADER mentioned two other items that had come up since the board packet was prepared. The first was notification from DePrince, Race & Zollo that their returns have not been up to expectations for the past two years, so they are reducing their fees.

The second is that Western Asset Management, one of two municipal bond managers hired by the board, has been censured by the Securities and Exchange Commission. MR. BADER described the circumstances, which involved a failure to notify clients that an asset was not ERISA-eligible, and indicates a potential for a lack of confidence or trust the manager. MR. BADER noted that this did not affect Alaska and was not a security that Alaska owned, but it raises enough concern that he requests a motion from the board to authorize staff to further investigate and take whatever action it deems appropriate with relation to the WAMCO account.

MS. HARBO moved that the ARM Board staff investigate the Western Asset Management matter relating to the SEC censure and take whatever action the staff deems appropriate. MR. BRICE seconded the motion.

MR. BRICE requested that the board be kept apprised of what actions the staff deems appropriate. MR. BADER replied that of course they would; however, this motion would allow staff to take action before the next board meeting.

A roll call vote was taken, and the motion passed unanimously.

6. FUND FINANCIAL REPORT

State Comptroller SCOTT JONES reviewed the financial statements for the six months ending December 31st, 2013. The ending invested assets were $24.8 billion, with a change in invested assets of 11.93%. This total comprises the PERS system with about $14.6 billion, the TRS system with about $6.1 billion, the JRS with $159 million, and the military with $37 million. MR. JONES stated that the total increase in income was about $2.5 billion, and net contributions were about $194 million.

MR. JONES stated that as of January 31st, the non-participant directed plans totaled about $19.9 billion, down about $400 million from December 31st, and it had dropped further by today's meeting date for a calendar year-to-date change in assets of about -3.1%. MR. JONES then discussed graphs in his report showing asset history, income, and allocations. VICE-CHAIR TRIVETTE thanked MR. JONES for adding the graphs, which he thinks are helpful in getting an overall perspective.

KEVIN WORLEY, CFO of the Division of Retirement and Benefits, went over the supplemental report which shows contributions and withdrawals from the different funds. MS. HARBO commented on the escalating rate of withdrawals from the defined contribution funds. Deputy

Commissioner MIKE BARNHILL replied that this is a pattern seen around the country and may be generational; he described efforts to offer education and counseling to people about how to handle their retirement accounts.

MR. BARNHILL added that they are also working on an auto-escalation feature so that when people receive a raise, the amount deducted from their pay for deferred compensation would automatically increase.

MS. ERCHINGER commented that the contributions and expenditures are getting closer and closer to break-even, portending serious liquidity problems in the next five to eight years, which is one reason why the proposed cash infusion into the retirement systems is so critical.

VICE-CHAIR TRIVETTE recessed the meeting from 10:11 a.m. to 10:25 a.m.

7. CAPITAL MARKETS ASSUMPTIONS

MICHAEL O'LEARY of Callan Associates explained how they do their 10-year projections of return, risk, and correlations. He reminded the board that although the way they reach the numbers is highly quantitative, that is overwhelmed by common sense and reasonable expectations, and developed so that the projections don't result in radical changes in asset allocation in a very short period of time.

MR. O'LEARY went through multiple examples and discussed various asset categories, commenting that the most difficult projection to make is the correlation of one asset class with another. He explained Callan's process of talking about the major asset classes throughout the fourth quarter, coming up with preliminary numbers in January, then adjusting those numbers as they develop more specifics. In February they model the current policy and discuss the likely consequences of various courses of action. MR. O'LEARY said that the results of these discussions would be presented at the next board meeting, then at the subsequent board meeting the Board would be asked to adopt a specific asset allocation for the coming fiscal year.

MS. ERCHINGER asked how to answer the query that "There is no way the ARM Board can hit their 8% earnings assumption." Discussion ensued about the effects of inflation on investment returns, and the fact that inflation rates on medical costs in Alaska are unusually high. MR. BADER commented that the Callan assumption on inflation is a cost price index, which is a good way to measure the real earnings on assets. He suggested putting the question to MR. SLISHINSKY of Buck Consultants about how sensitive Alaska's benefit schedule is to inflation, both medical and CPI, versus just a real rate of return.

MR. O'LEARY discussed tables from Eaton Vance comparing returns from various indexes, and he commented on the wide disparity in returns in various markets. MR. O'LEARY showed graphs of yields for various indices and graphs that compared US stocks to world stocks, and he discussed forecasts.

MR. O'LEARY noted an error in the report in the meeting packet on page 17. The numbers in the "other" box for 2013 to 2022 are the wrong numbers.

MR. ERLENDSON described what clients wrestle with in terms of potential policy changes: trying to decide the best time to make moves to avoid the painful costs of being wrong, and trying to decide which new investment strategies have merit.

MR. O'LEARY commented that Callan really enjoys moderating the capital markets panel, and he likes to take all the question cards home and count them into different categories. MR. O'LEARY said that the category with the highest count last time was the inflation outlook.

DR. MITCHELL remarked that he is a fan of the Callan approach to long-term projections, but he also thinks that the seven-year return forecasts prepared monthly by Grantham Mayo Van Otterloo (GMO) put more emphasis on starting points, valuation, and quality of earnings. DR. MITCHELL commented that GMO would probably find the U.S. earnings in the Callan slides unrepeatable, which is a challenge that everyone should be thinking about. MR. O'LEARY added that he also looks at GMO's forecasts every month because he thinks highly of them, and he would send a copy to ARMB staff.

DR. JENNINGS commented that he thinks Callan is ahead of the game in being more conservative on hedge funds than some other consulting firms. DR. JENNINGS asked the Callan representatives to comment on the private equity numbers and whether there is a risk that their assumptions push the ARM Board too much toward private equity. MR. O'LEARY replied that he thinks not, because they have a very large standard deviation for volatility; also, he thinks there is a huge illiquidity premium opportunity in institutional private equity, predominated by buy-out funds. Managers with no experience in Europe are doing distressed debt funds to buy assets from European banks that are in trouble, and it bears watching to see whether those investments make sense or not.

MS. ERCHINGER stated that she and TOM BRICE were asked a question: Do we know what kind of added risk we would need to take on in order to fund this system if the governor's $3 billion were not added to the retirement plan? MR. O'LEARY responded that the question could be posed as, "If it were really a 10-year horizon, without looking at the valuations on an annual basis, what would you do differently from what you are doing today?" MR. O'LEARY said that his preliminary answer would be that the ARM Board is right at the fringe of aggressiveness with a program that is on its way to zero assets.

MR. ERLENDSON added that they would have to consider whether the incremental value added by a more aggressive strategy would be worth exacerbating the likelihood of a cash flow shortage, and he recommended that board members review the information previously presented by GARY BADER about the cash flow analysis. MR. BADER directed board members to page 17 of the Callan report regarding private equity, reminding them that his previous work had shown that private equity was the highest returning asset class, in excess of 10% over the period measured. MR. BADER stated that without the cash infusion, they might have to try to get additional returns out of private equity for a while.

COMMISSIONER RODELL remarked that the next board meeting falls after the legislative session is done, so the board will know what dialogue occurred and what actions were taken. She noted that it is important during the remainder of the legislative session to be understanding of the tensions that the legislature faces and their decision of how to handle this issue, whether by accepting the Governor's proposal or coming up with a multi-year plan or something else. COMMISSIONER RODELL reminded board members that even if the $3 billion is added, the problem will not be solved, and the conversation about how to allocate assets to hit earnings targets will be ongoing.

MR. PIHL commented that he thinks the ARM Board should have more access to the actuaries and their products, citing an example of a time when the actuarial projection caused damage. MR. PIHL said that projections should reduce state assistance rather than shortening the amortization period, and the Board should have more say in what the actuary produces. VICE-CHAIR TRIVETTE reminded the Board that they did get the actuary to put in writing that every year there is unfunded liability, interest will be added; in 2012, the interest added was $889 million.

VICE-CHAIR TRIVETTE thanked Callan and the Board for an excellent presentation and dialogue, and recessed the meeting from 12:04 p.m. to 1:30 p.m.

8. INVESTMENT ACTIONS/PROCUREMENT

A. CIO Discretionary Authority

CIO GARY BADER explained that the proposal to change the CIO discretionary authority has two objectives: to update the authority to be more in line with the current assets under management, and to provide some symmetry in CIO authority in different areas. MR. BADER summarized the changes, which were included in writing in the meeting packet, and requested approval of Resolutions 2014-01, -02, -03, -04, and -05 implementing the changes.

ROB JOHNSON, legal counsel to the ARM Board, urged the Trustees to consider the proposals carefully and vote with an eye toward maintaining a balance between their responsibility and their ability to delegate.

<u>MS. HARBO moved to adopt Resolutions 2014-01 through 2014-05.</u> <u>MR. PIHL seconded the motion.</u>

VICE-CHAIR TRIVETTE commented that it does take a lot of reading to examine these proposals, but he said that he had gone through every page, and with full knowledge of the authority it gives to staff, he thinks that it is appropriate to adopt these changes. CHAIR SCHUBERT joined the meeting telephonically, and she commented that she thinks these changes acknowledge the excellent staff and how well they have done, and will give them the opportunity to continue to develop and assume more responsibility.

A roll call vote was taken, and <u>Resolutions 2014-01, -02, -03, -04, and -05 were adopted unanimously</u>.

B. Frontier Market Mandate

MR. BADER reminded the board that Everest Capital had done a presentation in New York in October and the board then authorized Callan to do a review of Everest Capital. Callan concluded that Everest Capital is a manager that has the requisite skills, experience, and depth to successfully manage frontier market-oriented funds. ARMB staff intends to visit Everest Capital as part of due diligence, and has requested authority to take action to engage Everest in contract discussions soon, before Everest reaches its full capacity.

MS. HARBO moved to authorize staff to hire Everest Capital to manage a frontier markets portfolio with an initial funding of up to $100 million, subject to staff review and successful contract negotiations. MS. RYAN seconded the motion.

DR. MITCHELL asked if this would come under emerging markets or if there would eventually be a separate category for frontier markets; MR. BADER replied that it would come under the broad category of non-U.S. emerging markets, but they would put it in a fund called "frontier markets".

MR. BRICE expressed some concerns about the risks involved in places with unstable governments, and requested an explanation of the due diligence that would prevent getting into anything they couldn't get out of. MR. BADER explained that there is a three-month lock-up period in the contract, and noted that they are only asking for $100 million, not a very big commitment to an admittedly risky asset class.

MR. BRICE asked the Investment Advisory Council members for their thoughts. DR. MITCHELL said that he thinks it's good to get as much diversification as possible in markets like those considered frontier markets, so adding another manager is a good idea.

MR. O'LEARY commented that he thinks the growth opportunities are tremendous, and the portfolios tend to be well diversified because the managers are well aware of the risks. MR. O'LEARY added that Everest has been around for a pretty long time, and he thinks they are a very viable and worthwhile firm to consider, but staff has a lot of work to do in due diligence.

DR. JENNINGS mentioned a metaphor about small cap stocks being zebras in lion country, with one or two of them having a high potential of being taken down by lions. However, potentially the rest of the portfolio could do great things, and investors would have to go into it knowing the risks.

MS. ERCHINGER asked, if ARMB commits $100 million to a firm that has $2 billion in assets under management, how long would it take Everest to deploy that much in capital? MR. BADER replied that he didn't think it would take very long, because they use swaps to get a lot of exposure, but that is what they intend to find out.

A roll call vote was taken, and the motion passed unanimously.

C. RFP General Consultant

MR. BADER explained that the current Callan and Associates contract for general investment consulting services is effective through June 30, 2014, with no further renewal options. Staff recommended that an RFP be issued for a general consultant in a time frame that will result in a general consultant contract being in place by July 1st, 2014.

MS. HARBO moved for the above RFP to be issued. MS. RYAN seconded the motion.
A roll call vote was taken, and the motion passed unanimously.

D. RFS IAC Position

MR. BADER cited the statute defining the Investment Advisory Council and stated that Dr. Jennings' term expires on June 30, 2014. Staff recommended advertising and soliciting applications from Dr. Jennings and other persons interested in serving as an academic advisor on the Investment Advisory Council.

MS. RYAN moved to solicit applications. MR. BRICE seconded the motion.
A roll call vote was taken, and the motion passed unanimously.

9. INTRODUCTION TO LOW VOLATILITY INVESTING

KEVIN CLARK and GEORGE MATTHEWS of Analytic Investors LLC, which runs the ARMB's Buy-Write program, explained what low volatility equity is, why it works, and how low risk stocks can keep up and even outperform the market. Two points that they emphasized were that low risk does not necessarily mean low return, and high risk doesn't necessarily mean high return; also, the compounding effect of low-risk stocks is very powerful. MR. MATTHEWS noted that the research they were referring to was published in the *Journal of Portfolio Management* in 2006.

MR. MATTHEWS explained that the Buy-Write strategy is designed to get rid of the peaks and valleys and reduce risk, and the long-term results of the low volatility strategy are almost identical to the Buy-Write strategy, with about a 20% risk reduction. However, in a very volatile market, the low volatility strategy would do better, he said. MR. MATTHEWS explained the process of building a low-vol portfolio, and showed an example of a global low-vol portfolio's performance. When the market dropped 40% in '08, this portfolio only dropped 20%. But the next year, the market was up 30% and this fund was up only 8%. The following years showed that the low-volatility portfolio does well in choppy markets.

MR. BADER asked what period they look at when evaluating volatility; MR. MATTHEWS replied that they use Barra's risk model which looks back at the last five years, and they look at fundamentals to assign it a risk rating. They also consider "ES&Gs", environmental, social, and governance factors.

DR. MITCHELL asked how much the ARM Board would have to put into low-vol strategies to make a difference, and whether the recent popularity of this strategy might result in overpricing of low-vol stocks. MR. MATTHEWS replied that initially a board might start with a small amount to understand it, like up to 5%. He also recommended hiring more than one manager to do low volatility because each one will invest in a different way.

VICE-CHAIR TRIVETTE recessed the meeting from 2:51 p.m. to 3:03 p.m.

10. BRANDES INVESTMENT PARTNERS

GLENN CARLSON is the executive director of Brandes Investment Partners, and JUAN BENITO has direct responsibility for the day-to-day management of the ARM Board's international EAFE strategy portfolio. CHRIS CHARD also joined the meeting. MR. BENITO showed graphs and tables of the performance of the defined benefit portfolio, which is about a billion dollars, and noted that he also manages about $150 million for the defined contribution fund. He pointed out that value has performed better than growth most of the time, but not recently; however, they are now crossing the line to the positive side again. MR. BENITO stated that last year was a very good year in which they outperformed the market by over six points.

MR. CARLSON stated that Brandes has been in business for over 40 years, and has over $27 billion in assets under management. They have over 300 employees, most based in San Diego, 54 of whom are investment professionals. MR. CARLSON emphasized that all of their investment strategies are value oriented, and they are an independent firm with absolutely no debt.

MR. O'LEARY inquired about asset losses from clients taking money away. MR. CARLSON stated that the losses peaked in 2009 or 2010, and much of it was high-net-worth individual investors who took their money when the financial crisis hit, with some institutional client relationships also lost later due to a period of underperformance. MR. CARLSON noted that through those hard times, the company lost virtually zero investment professionals, and has actually expanded the partnership; he noted that as owners of the business, the partners could choose to accept low profits to make sure that they do what they have promised for their clients. MR. O'LEARY commented that he wanted to highlight that for people making retention or non-retention decisions. VICE-CHAIR TRIVETTE and MR. CARLSON thanked MR. O'LEARY for bringing it up.

MR. CARLSON referred to page 8 of Brandes' report as he gave an overview of what they are trying to do and what value means to them. He explained how they estimate the value of businesses and industry research teams identify opportunities around the world where they can buy companies at low prices. Those opportunities are presented to Brandes' investment committees, which instruct the portfolio management teams to make decisions on behalf of investors.

MR. BENITO referred to page 14 of their report as he described the portfolio holdings, which are broken down in various ways on subsequent pages. Pages 17 and 18 show what has happened in the portfolio in the last year, resulting in a very concentrated portfolio with about 60 companies. MR. BENITO concluded by thanking the ARM Board for their confidence in Brandes.

MS. ERCHINGER asked what the fees are, and MR. BENITO replied that their fees are low, with a marginal fee rate of 35 basis points for everything over $200 million, resulting in a total fee of about 37 basis points.

VICE-CHAIR TRIVETTE thanked the Brandes representatives for their presentation and for a good year.

11. MCKINLEY CAPITAL MANAGEMENT

MR. BADER introduced ROB GILLAM, chief investment officer of McKinley Capital Management, and ALEX SLIVKA, and noted that McKinley Capital runs two mandates for the ARM Board, a domestic large cap growth and an international.

MR. SLIVKA commented that the firm has not changed much in the past couple of years except for adding some staff, and they had a great year last year as a result of the time, effort, people, and money that they have spent over the past few years. The firm has developed a scientific advisory board comprised of four gentlemen, Harry Markowitz, Ganlin Xu, Rocky Cahan, and Ted Gifford.

MR. GILLAM commented that they are still the same global growth specialist as always, and they have spent a lot of time trying to make sure that they made up some ground when the cycle was in their favor over the past couple of years. MR. GILLAM thanked the board for their patience in that regard. He added that they do a lot of factor-related research like behavioral study of markets and trading patterns, and have also spent time trying to fine-tune the definition of a growth company.

MR. GILLAM went through the report and described the returns of the past year. He said that the firm is cautiously optimistic that 2014 will be a good year, and gave a quick overview of the portfolio positioning.

VICE-CHAIR TRIVETTE asked how they sort out winners and losers when looking at other countries, and MR. GILLAM described a process of sorting through every weekend to find the best growth and momentum companies around the world. A scoring system nominates a set of attractive securities, and then when McKinley sells something, they choose from that list what would best fill the hole that was vacated in the portfolio, using risk management models to narrow down the choices. Then the portfolio managers do a qualitative review, with help from the New York-based team of advisors who review information from over 13,000 analysts all over the world to try to find out what is accurate.

After a few questions from board members, VICE-CHAIR TRIVETTE thanked MR. SLIVKA and MR. GILLAM for their time.

12. CAPITAL GUARDIAN

MICHAEL BOWMAN is the relationship manager of Capital Guardian, and CHRIS RYDER, an investment specialist from Chicago, joined him.

MR. BOWMAN referred to page 2 for an overview of the $800 million account that Capital manages for the ARM Board. He described Capital as an employee-owned firm out of Los Angeles which focuses solely on investment management services, and he noted that its name is now Capital Group, as Capital Guardian and American Funds have consolidated.

MR. BOWMAN noted that in 1958 the company began the Capital System, and in 1965 they helped create the MSCI index. Page 6 of Capital's report gives a brief overview of the Capital System, which is built on their research portfolio. The analysts are listed in the report, and they are actually managing money, which is different than how most fund managers are organized, MR. BOWMAN pointed out. VICE-CHAIR TRIVETTE noted that he appreciates that Capital focuses on the long term instead of the short term. The compensation system is constructed to encourage a long view, as the managers earn bonuses based on 4-year and 8-year performance.

MR. RYDER talked about the portfolio itself, and commented that he thinks the U.S. is likely to continue to do quite well in 2014. Page 21 of the report shows what went right and what went wrong last year, and MR. RYDER commented that what hurt most was holding cash during a time when markets were so strong. Other pages showed the portfolio's breakdown by sector and by geography.

VICE-CHAIR TRIVETTE commented that he is happy with the way things have turned around in the portfolio to show positive results now, and he thanked them for continuing to work on it.

RECESS FOR THE DAY

VICE-CHAIR TRIVETTE recessed the meeting at 4:16 p.m.

Friday, February 7, 2014

CALL BACK TO ORDER

VICE-CHAIR TRIVETTE reconvened the meeting at 9:00 a.m. and thanked a number of distinguished guests for attending.

Trustees Harbo, Erchinger, Pihl, Brice, Ryan, Rodell, and Thayer were also present. CHAIR SCHUBERT was absent.

REPORTS (Continued)

13. ACTUARIAL ANALYSIS: BUCK CONSULTANTS

VICE-CHAIR TRIVETTE stated that the ARM Board had passed a resolution at the December meeting supporting the governor's proposal to transfer $3 billion into the PERS and TRS funds, and the board asked the state's actuary, Buck, to analyze how this infusion would affect those funds.

DAVID SLISHINSKY of Buck Consultants began by reviewing the circumstances that led to the increasing unfunded liability. MR. SLISHINSKY then discussed what a funding policy is, the specifics of the ARM Board's funding policy, and the changes that would be made under the governor's proposal.

MR. SLISHINSKY explained that a funding policy determines the pace and pattern of funding. The ARM Board's policy was amortizing on the basis of a level percentage of payroll for years, then recently changed that policy to a level dollar amount. MR. SLISHINSKY explained how the unfunded liability is calculated, how it can change from one year to the next, and how they smooth the losses over a five-year period. He said that different states use different approaches, and described some examples.

MS. ERCHINGER asked what the industry today considers a target for a funded ratio, and MR. SLISHINSKY replied that opinions are changing and going up, and he's heard some say 110-115%, but he prefers 120% to 125% to have a margin for adverse deviation. MR. SLISHINSKY noted that one state saw their funded ratio drop from 124% to 76% during the financial crisis.

MS. ERCHINGER then asked him to explain the difference between the actuarial determined contribution rate and the actuarial required contribution rate, and how it affects what the industry will expect in terms of how much the system is funded. MR. SLISHINSKY replied that the GASB is changing their standards, and there is a de-linking of the accounting requirement for funding and the actuarial requirement for funding. It is now required that systems disclose their policy for funding the system, and an actuary has to do an analysis of a projection to show whether or not the funding policy is sustainable; if it is not sustainable, the projection should show cross-over dates when the fund goes from having assets to having no assets.

MR. SLISHINSKY explained how net pension liability is calculated, and said that the GASB now requires unfunded liability to be shown on the balance sheets of all employers responsible for paying into the system. MR. SLISHINSKY said that bond-rating agencies have been examining how they should consider pension obligations in the ratings for public employers that issue debt instruments, and some have devised their own methods of judging risk.

MR. SLISHINKY reviewed the ARM Board's funding policy and the rate caps which result in the state having to make additional contributions to meet actuarial requirements. The ARM Board adopts an actuarial funding policy by selecting one of six actuarial cost methods defined under GASB 25 and 27; the ARM Board uses the entry age cost method, which is used by most public employers. MR. SLISHINSKY noted that in the change for GASB under 67 and 68, the entry age method is now required, so it's nice that that's what ARMB uses.

MR. SLISHINSKY explained that the actuarial value of assets is smoothed over five years, which is consistent with most plans. The level of unfunded liability is determined by calculating the difference between the accrued liability and the actuarial value of assets. If there is an unfunded liability, then an additional amortization payment has to be made. MR. SLISHINSKY added that the change from level percent of pay to level dollar amount changes the pattern of amortization, and in the future payments will be lower than they would be under the level percentage of pay method.

MR. SLISHINSKY said that it is important to have a dedicated funding policy that addresses how unfunded liability will be paid off, and if unfunded liability is maintained, it will require continued interest payments, raising the overall cost. Studies have shown that for well-funded plans, most of the benefit payments that go out are not financed by the contributions; they are financed by the investment returns on those contributions. The sooner the money is in the pension fund earning investment returns, the lower the long-term costs to the pension system.

MR. SLISHINSKY discussed the governor's proposal to transfer $3 billion from the Constitutional Budget Reserve to PERS and TRS. Allocating those funds to pay a percentage of the unfunded liability for each fund would mean $1.9 billion to PERS and $1.1 billion to TRS, which would be paid in July of 2014 for FY 15. This money would include any amortization payment or additional state payment that would otherwise have been made, plus some extra. Then in each future year, the state would appropriate $500 million annually to PERS and TRS beginning in FY 16 until the systems are fully funded. MR. SLISHINSKY explained that this would immediately increase the funded ratios and increase the value that is in the funds, and the contribution amount of additional state assistance would continue until 2036, when the system would be fully funded.

MR. SLISHINSKY reviewed the projections and how they were calculated, noting that Buck does an experience analysis every four years that results in recommended changes to assumptions based on the most recent experience. Also, every year when they do the actuarial evaluation, they test the gains and losses and look at trends and patterns that affect their assumptions, and if something significant appears, they bring it to the board, as they did with healthcare assumptions last year. MR. SLISHINSKY also noted that a limited-scope auditing actuary reviews their results every year before the results are presented to the ARM Board, and every four years, a third actuary does a full-scope audit; these audits give the ARMB confidence in Buck's results.

The Trustees discussed the projections and asked questions, then MS. ERCHINGER noted for the audience that the board spent a lot of time on liquidity because as the projections show, at no time from the present until the end of the system do contribution payments exceed the benefits being paid out. There is negative cash flow every month except the months in which the state makes its state assistance payments into the plan. MS. ERCHINGER emphasized that the state assistance payments have been crucial in preventing the need to liquidate investments, and that is why she supports the governor's proposal to inject cash into the system. The projected earnings column shows a significant impact on the ability of the plan to pay benefit payments from the interest earnings on that $3 billion; without a cash infusion, it is unlikely that the ARM Board would be able to meet its 8% earnings assumption.

VICE-CHAIR TRIVETTE recessed the meeting from 10:42 a.m. to 10:55 a.m.

SENATOR ANNA FAIRCLOUGH addressed the Board on behalf of the co-chairs of the Senate Finance Committee, Senator Pete Kelly and Senator Kevin Meyer, as well as the majority caucus and Senate President Charlie Huggins. SENATOR FAIRCLOUGH stated for the record that they are watching, they have met with ARM Board representatives, and they are taking the Board's considerations under advisement as well as the governor's proposal.

SENATOR FAIRCLOUGH stated that the Senate Finance Committee has sent a letter requesting a review of the ARM Board's finances with an actuary, and they are preparing a proposal outlining a specific scope of work. SENATOR FAIRCLOUGH stated, "The bottom line is, the State of Alaska understands our obligations to the people that are inside of our pension system, and we want to move responsibly, given the criteria and the cash flow, in our future as well as in the ARM Board's future. So we will make every attempt to engage in a communication that is constructive and that benefits the people of Alaska."

MR. BRICE noted for the record that David Teal, the head of Legislative Finance, was present, and numerous staff people from both co-chairs of finance and from Representative Hawker's and Senator Micciche's staff as well. VICE-CHAIR TRIVETTE noted that Senator Egan and his staff had also been present earlier. VICE-CHAIR TRIVETTE informed those present or listening that the ARM Board is very open to questions and comments to board members, staff, and the actuaries.

COMMISSIONER RODELL commented that the governor's proposal is important not only because of the $3 billion in funds, but also because it attempts to create near-term certainty of reducing the state assistance payments to $500 million per year. She asked what the effect of that is on the actuarial reports. MR. SLISHINSKY replied that the effect is that, with gains and losses, the amortization period will either be extended or shortened. The ultimate downside risk would be that the amount wouldn't be enough to meet all of the future obligations, and eventually it would reach a crossover date and have to switch to pay-as-you-go or make another large cash infusion.

MR. PIHL commented that he supports the governor's proposal, noting that an analysis a few years ago showed that if they had been on level dollar instead of level percent of pay, the liability would have been several billion less, so this would get it going in the right direction and put that money to work instead of sitting in the CBR.

UNFINISHED BUSINESS

1. Disclosure Reports

MS. HALL stated that the disclosure reports were included in the meeting packet, and there was nothing unusual to disclose.

2. Meeting Schedule

MS. HALL stated that the 2014 meeting schedule is included in the meeting packet, and there are no changes to report.

3. Legal Report

MR. JOHNSON had nothing specific to report.

NEW BUSINESS

None.

OTHER MATTERS TO PROPERLY COME BEFORE THE BOARD

None.

PUBLIC/MEMBER COMMENTS

None.

INVESTMENT ADVISORY COUNCIL COMMENTS

DR. JENNINGS stated that he has some views on lump-sum versus phased investments that he hopes will be germane at the next meeting.

TRUSTEE COMMENTS

VICE-CHAIR TRIVETTE stated that he was planning to spend about five minutes talking about one specific part of the Callan conference, but he will do it at the April meeting.

FUTURE AGENDA ITEMS

MS. ERCHINGER commented that in the discussion today about actuarial projections, it might be interesting to ask for a sensitivity analysis around interest rates, mortality, and healthcare costs, assuming those are the biggest drivers, to get a sense of the magnitude of the impact of, for instance, a lower earnings assumption or people living 10 years longer than expected.

including the work session, to get people engaged in this process. MS. HARBO expressed her appreciation to the Governor for what she would call a fair and reasonable solution to a problem we have worked on for several years. MS. HARBO stated she will miss COMMISSIONER HULTBERG and has really enjoyed working with her. She is grateful for her work on the Board and wishes the best.

CHAIR SCHUBERT expressed her appreciation to MR. PIHL for bringing the underfunded status liability, his reference of a snowball effect, to the Board many, many, many times for many, many, many years. She believes the Governor's proposal recognizes the Board focused on the issue and took it seriously, came up with recommendations and under his leadership, the Governor took a very bold step. CHAIR SCHUBERT applauds the Governor for that.

CHAIR SCHUBERT stated when she spoke with the Governor yesterday, she committed the Board to doing everything we can to support his action, including Trustees at different times and in different configurations going down to Juneau to either testify or talk to legislators. CHAIR SCHUBERT thanked MS. ERCHINGER for her hard work and believes her message was heard. CHAIR SCHUBERT commented MS. ERCHINGER did an excellent job of presenting succinctly and clearly.

CHAIR SCHUBERT wishes the best for COMMISSIONER HULTBERG in her future venture and hopes she stops by the meetings just to say hello. CHAIR SCHUBERT echoes MS. HARBO'S comments regarding the excellent working relationship the Board has with both Departments. It has been supportive and has helped the Board in its deliberative process. CHAIR SCHUBERT expressed her gratitude to both Departments.

FUTURE AGENDA ITEMS

None

ADJOURNMENT

There being no objection and no further business to come before the Board, the meeting was adjourned at 11:28 a.m. on December 6, 2013, on a motion made by MS. HARBO and seconded by MR. BRICE.

Chair of the Board of Trustees

ATTEST:

Gayle W. Harbo
Corporate Secretary