State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
MEETING

Location
Centennial Hall
Egan Room
Juneau, Alaska

MINUTES OF
February 12 - 13, 2015

Thursday, February 12, 2015

CALL TO ORDER

CHAIR GAIL SCHUBERT called the meeting of the Alaska Retirement Management Board (ARMB) to order at 9:00 a.m.

ROLL CALL

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

Board Members Present
Gail Schubert, *Chair*
Sam Trivette, *Vice-Chair*
Gayle Harbo, *Secretary*
Tom Brice (absent February 13)
Kristin Erchinger
Commissioner Sheldon Fisher
Commissioner Randall Hoffbeck (telephonic February 12)
Martin Pihl
Sandi Ryan

Board Members Absent
None

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

Investment Advisory Council Members Absent
None

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
Paul Hackenmueller, State Investment Officer
Joy Wilkerson, State Investment Officer
Steve Verschoor, State Investment Officer
Nicholas Orr, State Investment Officer
Emily Howard, State Investment Officer
Victor Djajalie, State Investment Officer
Casey Colton, State Investment Officer
Sean Howard, State Investment Officer
Pamela Leary, Director, Treasury Division
Jerry Burnett, Deputy Commissioner
Judy Hall, Board Liaison

Department of Administration Staff Present
Jim Puckett, Chief Operating Officer, Division of Retirement & Benefits
Kevin Worley, Chief Financial Officer, Division of Retirement & Benefits
Kathy Lea, Chief Pension Officer, Division of Retirement & Benefits
Mike Barnhill, Policy Analyst, OMB
John Boucher, Senior Economist, OMB

Consultants, Invited Participants, and Others Present
Stuart Goering, Department of Law, Assistant Attorney General
Paul Erlendson, Callan Associates, Inc.
Dana Brown, Callan Associates, Inc.
Andrew Susser, MacKay Shields
Kirk Kashevaroff, MacKay Shields
Doug Bratton, Crestline Investors
Keith Williams, Crestline Investors
Jesus Payan, Crestline Investors
Jim McCandless, UBS Agrivest
Tom Johnson, TIR Timber
Mark Seaman, TIR Timber
Chris Mathis, TIR Timber
Larry Semmens, Chief of Staff to Senator Peter Micciche

PUBLIC MEETING NOTICE

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

APPROVAL OF AGENDA

MR. BRICE moved to approve the agenda. MS. RYAN seconded the motion.

MR. BADER requested that an executive session to discuss higher and better uses of land assets be placed after the afternoon break.

MS. ERCHINGER moved to adopt this amendment to the agenda. MRS. HARBO seconded the motion.

The agenda was approved as amended.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES

None.

APPROVAL OF MINUTES: December 4-5, 2014

MRS. HARBO moved to approve the minutes of the December 4 - 5, 2014 meeting of the ARMB. MS. RYAN seconded the motion.

The minutes were approved.

REPORTS

1. CHAIR REPORT

None.

2. COMMITTEE REPORTS

A. Audit Committee

MR. PIHL reported that the Audit Committee had the largest attendance ever at the meeting in Juneau the day before this board meeting. The Commissioner of Administration was there for part of it, as well as both deputy commissioners, representatives from OMB and Treasury, administrative staff, and several ARM Board trustees. KPMG was also at the meeting.

Reports were received from the Department of Administration, and the Division of Retirement and Benefits reported on the employer audit program and on measures being taken to transition the retirement of Kay Gouyton after 37 years and keep the program going smoothly. MR. PIHL stated that legislation was being prepared to strengthen the authority of the DRB in its employer audit compliance and premium payment efforts, which the ARMB has consistently supported.

KPMG updated the Audit Committee on GASB 67 and 68 and its impacts on financial reporting, and the dates of analysis and position of that will be released soon. The Department of Revenue gave a summation of the compliance teamwork for the year and the goals for 2015; the Audit Committee receives monthly reports on that work. The committee also had discussions on how budget constraints and expected personnel reductions will affect the pension system and its funding, and the impact on the state and constituents of the use of the percent of pay method.

B. Legislative Committee

CHAIR SCHUBERT reported that the Legislative Committee also met the day before the meeting of the full ARM Board. They received a long-term liquidity update from MR. BADER, and reviewed the Buck summary. The Legislative Committee also discussed the possibility of creating an actuarial committee so that the board has some input into the assumptions, and discussed the impacts and effects of level dollar as opposed to level percent of pay.

CHAIR SCHUBERT reported that the Legislative Committee also reviewed the charter. Board members were given a copy of the charter showing the proposed revisions, which the Legislative Committee recommended that the full Board adopt.

MR. PIHL moved to adopt the revised charter. MS. RYAN seconded the motion.

The charter was adopted as revised.

MS. ERCHINGER presented a synopsis of the Buck Consultants summary of the impacts of House Bill 385 and Senate Bill 119 which the Trustees had requested at the December meeting. The Trustees had specifically asked for an explanation of what the impacts would be on municipalities and the state if legislation were proposed to increase the employer contribution rate cap from 22 percent to 23 percent. They also asked what the impact would be of an additional $1 billion contribution into PERS in 2016, and requested a comparison of the impacts of level dollar versus percent of pay.

MS. ERCHINGER summarized Buck’s analysis of the impact on PERS of the legislation which placed $1 billion into PERS and $2 billion onto TRS, focusing on PERS because the state pays the bulk of TRS. The overall costs to employers increased by $5.6 billion, because the legislation also changed the amortization method from the level dollar approach to level percent of pay and extended the amortization period by nine years. Assuming the state’s share of that is 60 percent, the overall impact of that legislation is approximately a $3.1 billion increase to the State of Alaska, and an overall increase to municipalities of about $2.5 billion.

The impact of increasing the 22 percent employer rate cap by 1 percent would increase employer costs by $920 million, 60 percent of which would be to the state as an employer, and state assistance would decrease by $860 million.

In its analysis of the impact of an additional $1 billion to PERS, Buck assumed that that would be a direct savings to the State of Alaska because that would go toward state assistance. Therefore, it doesn’t have an impact on municipalities, but it would decrease state assistance by $1.9 billion, like saving two dollars for every one dollar put in. The shift to level percent of pay and extending the amortization period by nine years results in an added cost to the system of $5.7 billion. Sticking with level percent of pay but shaving off the nine-year extension of the amortization would save employers $4.7 billion overall because the contributions would come into the system earlier, and those would earn interest and eliminate the need for the employers to make those contributions.

CHAIR SCHUBERT thanked MS. ERCHINGER for the report, and added that the committee agreed unanimously that it was a very good move of Governor Parnell to put $3 billion into the pension funds when he did.

3. DIVISION OF RETIREMENT & BENEFITS REPORT

A. Membership Statistics/Buck Invoices/HRA Rates

MR. PUCKETT directed board members to the packet, which included membership statistics for 2014; he commented that the active population is basically the same as last year, but the active DB population is trending down and the DC population has been trending upward. The retiree and beneficiary population is increasing between 1,500 and 1,600 per year, and for the fifth consecutive year, the division has processed more than 2,000 retirements in a year. MR. PUCKETT recognized the good service of the retirement processing team, which has the same number of employees as in 2007. He added that the survivor benefit processing team has seen a 67 percent growth in their work since 2009.

MR. PUCKETT noted that the list of Buck Consultants invoices is longer than usual, because Buck had done a lot of work related to HB 385 and SB 119 and a few other things besides the regular work that they would provide during the first half of a fiscal year. MR. TRIVETTE requested a summary of annual costs for Buck since they were hired in 2005. MR. PUCKETT said that they can provide that information at the next meeting.

MS. ERCHINGER commented that it appeared that some termination studies that are required of cities proposing terminations have been billed to the system; MR. PUCKETT said that he would have to check on that, and would get an answer to the board.

B. Legislative Update

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

- HB 3 takes care of some shortcomings on work-related injuries that lead to death, providing survivor benefits to the surviving spouse, including major medical coverage.

- HB 8 cleans up some language for powers of attorney, and is of no concern at all in its current form.

- HB 47 is a reintroduction of a bill from last session to provide some relief from the salary floor amount for those municipalities whose population dropped more than 25 percent between the 2000 and 2010 census. DRB is monitoring that one closely.

- HB 66 also fills a shortcoming for survivor benefits, providing major medical coverage for TRS and PERS in occupational deaths only.

- HB 90 reopens the PERS defined benefit plan to members defined as "protective occupation employees," police and firefighters. It would include some of them using the current PERS definition, and it would expand the pension plan provision to administrative professionals or clerical employees of a municipal police or fire department, the university fire department, or the Department of Public Safety, regardless of date of hire. MR. PUCKETT said that HB 90 would create a nine-member board made up of union members which would make recommendations to the ARM Board for policies and strategies and procedures, set contribution percentages, actuarial equivalent value, and enter into a contract for actuarial services. DRB will be keeping a close eye on this bill.

MR. TRIVETTE asked whether a medical plan has been put forth in writing yet for the defined contribution people. MR. PUCKETT replied that nothing definitive has been put forth yet, but it is a topic of conversation with the new administration.

4. TREASURY DIVISION REPORT

DIRECTOR PAM LEARY gave an update on the FY 2016 budget requests. Three items affect the ARM Board component of the budget. One is custody and management fees, for which the budget includes an additional 8.1 request, and a supplemental request of 10.1 because they are nearing and expect to surpass the budget authorization for FY 15.

The Treasury Division has also requested an increase for salaries to move them closer to market, and two new investment officers as part of the move toward more internal management. MS. LEARY noted that one position would also be eliminated in the FY 16 budget for Treasury. MS. HARBO asked if the division expected to save money on fees by paying in-house managers, so they would pay for themselves, and MS. LEARY said yes.

5. CHIEF INVESTMENT OFFICER REPORT

Chief Investment Officer GARY BADER referred to his report, in which Item No. 1 is an example of rebalancing the portfolios. He noted that all of these are on file in his office if board members are curious, and the portfolios are rebalanced frequently to stay within the Board's target asset allocations.

MR. BADER pointed out several related transactions pertaining to the Blue Glacier Fund, transfers which were made because of changes the Board made in the absolute return strategy.

MR. BADER noted that Item No. 4 reports transfers to Baillie Gifford and Allianz, which are the international manager hires that were approved by the Board at the April 2014 meeting.

MR. BADER briefly reviewed each item in his report, then discussed the final three in more detail. Item No. 18 pertains to Everest Capital, which had a fund that was heavily invested in Swiss francs, and the market went against them and took all the earnings and the assets of that fund. The ARM Board is invested with Everest Capital, but with a different fund. Staff has questioned Everest and reviewed the portfolio, and are confident that the fund that the ARMB is invested in is in good shape. However, MR. BADER asked the Board to approve putting Everest Capital on the watch list.

MRS. HARBO moved to place Everest Capital, the frontier market strategy, on the watch list. MS. RYAN seconded the motion.

There was no objection and the motion passed unanimously.

Regarding Item No. 19, MR. BADER informed the Board that staff has decided to take a pass on Apollo Aviation for the time being. The Board had approved investing in this fund subject to staff and Callan's approval, but they could not come to agreement about certain accounting issues and how they value assets, and the fund is closing soon. They may consider it again when another opportunity comes around.

The last item relates to a strategy approved by the Board a long time ago, a multi-asset strategy with Goldman Sachs. Staff felt that some of the things in the Goldman contract were incompatible with the defined contribution plans, so they have informed Goldman Sachs that they no longer intend to engage them for this program. MR. BADER stated that they intend to present at the next Defined Contribution Committee meeting some strategies that might take the place of what the Goldman offering would have done for the portfolio.

MRS. HARBO asked how many companies are on the watch list, and MR. BADER replied that he would have to report back later on that.

6. FUND FINANCIAL REPORT

State Comptroller SCOTT JONES reviewed the financial statements for the six months ending December 31, 2014. The ending invested assets were $27.6 billion, with a change in invested assets of a little over 6 percent. This total comprises the PERS system with $15.8 billion, the TRS system with $7.4 billion, the JRS with $168 million, the National Guard with $37 million, SBS with 3.4 billion, and Deferred Compensation with $799 million. MR. JONES stated that non-participant directed plans year-to-date are at a $33 million loss and participant directed plans are at a gain of $61 million. Everything is within the target range for asset allocation in the various funds. MR. JONES stated that in January the systems lost a little bit of money, but the non-participant directed plans had shown improvement with some earnings in February.

MR. WORLEY reviewed the DRB supplement report, noting the contributions and monthly payouts of the different plans. MR. TRIVETTE requested that MR. WORLEY prepare a more detailed report, since there is so much material to cover in a short time, including comments on what he thinks is causing the things that are happening. MR. WORLEY said that he would do that.

MR. WORLEY discussed the HRA, Health Reimbursement Arrangement, which is an annual calculation required by statute, with the contributions by employers determined by 3 percent of the average annual compensation of all employees of all employers in the TRS and PERS. This is different than the other contributions that employers make in that the other contributions are a rate, but the HRA is an actual amount. MR. WORLEY pointed out the supplemental schedule which lists the HRA from FY 08 through the current FY 16. It has risen from about $1,500 in 2008 to $2,000 in 2016, which is about a 33 percent annual increase.

MRS. HARBO had several questions:

- Do the employees get an annual statement, and do they know how much is in their account and how they can access it? She noted that under the DC plan, there aren't any retirees, but there are now nine survivors, and she asked what kind of HRA or health benefits they can get.

- What happens to the HRA account when members leave, since only the employer, not the employee, has contributed?

- Since the DC program started in 2006, the ARMB has received statistics on members who are active and those who have terminated, but they don't know how many DC people have actually left and taken all their money out. What happened to all the money that went into accounts for those people that actually left the system and got refunds, which for the first six months of this year amounts to $21 million?

MR. WORLEY responded that he would answer those questions in a report and prepare to discuss it at the April meeting.

MR. BRICE asked whether there is a way to track where funds go from separation of services, whether they are rolled into another plan or taken as cash distributions. MR. WORLEY replied that they can track when people roll their money directly into another fund, but if they take a distribution to themselves and then later roll it into a fund, the division wouldn't know that.

MRS. HARBO repeated her question about what happens to the HRA fund when people are terminated. MR. WORLEY replied that the money stays within the HRA, and is not refunded to the employer. If the employee came back, the account would be reinstated, but the employee would not have access to it at any time once they have terminated. In any case, they have to meet the criteria for being able to use the HRA, and they won't have access to it until they retire.

MR. TRIVETTE requested that the report also explain who pays for the maintenance of these individual accounts, noting that they have previously discussed this and have not gotten a clear answer. He also asked whether any of the nine beneficiaries have accessed these accounts yet. MR. WORLEY said that he would include that information in his report as well.

CHAIR SCHUBERT recessed the meeting from 9:57 a.m. to 10:13 a.m.

7. MANAGER REVIEW/GEMS ANALYSIS

MR. BADER reported that the manager review questionnaire had been sent to all the managers that the ARMB has, and they all responded. In November, Judy Hall, the IAC members, and Paul Erlendson and Dana Brown from Callan all met in San Francisco to discuss the managers. Also, some other Callan representatives, Jay Kloepfer and Karen Harris, discussed the GEMS methodology. MR. BADER requested that DR. JENNINGS summarize the GEMS strategy for the Board.

DR. JENNINGS noted that the GEMS system is highly mathematical, reflecting its actuarial roots, and overall, the IAC's assessment is that it's probably a useful complement to the Callan process, but it shouldn't supplant or replace that. It is a way to calibrate the main capital management assumption process.

MR. BADER discussed the managers and issues that the IAC wants to continue to watch:

- Allianz: Will they be looking for more fees from other sources because of the exit of assets from PIMCO due to the departure of Bill Gross? MR. BADER said that they will continue to monitor that situation, but they don't think there are any imminent changes coming.
- DePrince, Race, Zollo: Their performance has lagged, but they have a long history of satisfactory returns, so as long-term investors, ARMB will stay with them.
- McKinley Capital: A higher and higher proportion of their assets under management are from the ARMB and the Alaska Permanent Fund. There is also some concern about their succession plan, so the next time they report to the ARMB, they will be asked to explain how the firm will be managed in the future.
- Luther King: Concerns are similar to those about McKinley Capital.
- The Capital Group: The returns are doing okay, but are difficult to analyze because Capital's methodology is really dispersed, with different research analysts contributing to the portfolio.
- Master Limited Partnerships: This asset class did extremely well and was a major contributor to last year's strong performance, as the Board got into it at just the right time. Now the value of their shares has declined with the lower energy prices, to the point that MR. BADER has asked staff to report on the possibility of putting more money into it.
- Relational Investors: This was a governance-type investor which has notified ARMB of their intent to close down their fund, with no indication that they intend to have a successor fund.
- Victory Capital has had a number of ownership changes, so it's being watched, although the returns tend to be satisfactory.

- Brandes has done well in the past year. ARMB stuck with them through a rough patch when international value stocks were out of favor, but they seem to be coming back now.

MR. BADER reported that they also talked about hedging, which staff has seen as a zero-sum game; you win some, you lose some, but in the long run are probably better off without the investment management fees. However, MR. BADER suggests reviewing that assumption.

MR. BADER commented that several years ago the Board made an exit from securities lending, which turned out to be timely, and their consensus is to stay away from it now.

Regarding asset allocation, MR. BADER noted that the more asset classes an investor has, the more difficult it is to rely on an optimizer to allocate resources among them, because it becomes very sensitive to the assumptions that are used. MR. ERLENDSON will discuss this in more detail in Callan's presentation on capital market assumptions.

Finally, they discussed the role of the IAC. MR. BADER said that the Board's collective view is that the Investment Advisory Council is a resource and counselor to the ARM Board, and it is the Board's decision whether to expand or reduce the IAC's role.

MR. BRICE asked about the statement that Capital Group, which manages international large cap assets, was "in general, not responsive to questionnaire." He asked if the IAC had any feedback on why they weren't responsive; DR. MITCHELL replied that managers put in varying amounts of effort on the survey, and the responses were probably prepared by assistants, not the sort of people who actually manage the money and report to the Board.

MR. PIHL asked if some analysis could be done on the return that would be available through more passive investments at home in the S & P 500, noting that it seems some managers have not paid their way in recent years. MR. BADER pointed out that this is a continuing discussion, and he has presented analyses of active versus passive management five times in 12 years. MR. BADER explained some of the actions the Board has done and proposed relating to this issue, such as the equity yield fund, and said that they hope to do more once they demonstrate to the Board their ability to do it successfully. MRS. HARBO commented that she is glad to hear that the Board is going to invest more in equity yield and internally manage it, because it has been a good money-earner, and if they hire more people to help with investments, they'll pay for themselves by internally managing these funds.

MR. TRIVETTE commented that he appreciates the work that staff has done, and it is clear now that they are saying that GEMS is a good supplement but not a primary system. He remarked that GRS didn't get a chance to review the Buck report, and it bears watching to make sure that they are not allowed to use GEMS as the primary system. MR. BADER said that he thinks Buck is using it to say that they would not be comfortable with an earnings assumption that was outside of the GEMS assumption, but a more conservative approach is not troubling at all.

CHAIR SCHUBERT thanked MR. BADER for his report, and welcomed COMMISSIONER

FISHER to the meeting.

8. MACKAY SHIELDS

ANDREW SUSSER, senior portfolio manager, and KIRK KASHEVAROFF of client service marketing at MacKay Shields presented an overview of what has been going on in the high yield market. The drop in energy prices led to a lot of selling of high yield bonds late in 2014, but energy bonds have started to recover. MR. SUSSER explained that they have a very disciplined investment process and will not buy a high yield bond unless the company has at least one and a half times asset coverage, which is the value of the company divided by the amount of debt the company has. A lot of the bonds earlier in 2014 needed $100-a-barrel oil to survive, so they didn't buy those. MR. SUSSER said that they have been underweight in energy in the first three quarters, but in the fourth quarter when they became cheap, they bought more of companies that fit their process.

Overall in the high yield market, the quality is good, MR. SUSSER said, and the bonds in the ARMB portfolio are excellent. It's a conservative portfolio with a yield a little lower than the index, but with low volatility compared to market and an average credit quality higher than the market. MR. SUSSER compared statistics of the ARMB portfolio to market in duration, coupon rates, dollar price lower than par, and performance.

MR. ERLENDSON noted that MR. SUSSER had taken over leadership last year, and asked him how much time he was spending leading the team versus interacting with clients. MR. ERLENDSON also asked where they are in the process of finding another sector analyst to do the research that leads to the results that they produce. MR. SUSSER replied that he has many more responsibilities now, but his experienced team helps handle client interactions so that he can do more credit work. He said that they have interviewed several candidates for the sector PM position, looking for somebody who has long experience in high yield and is very smart, who can subordinate themselves to MacKay Shields' investment process, and who will get along with everyone, because they all work closely together. As part of the selection process, they will have the candidates come in and do some credit reviews.

MR. TRIVETTE asked whether as a subsidiary of New York Life they have enough freedom from the large corporation or if they are being pressured to some degree. MR. SUSSER replied that they operate autonomously, although they have a CEO who reports to people at New York Life. MR. KASHEVAROFF added that the purchase was made in 1984, so any growing pains a firm may have from being absorbed by a large insurance company are long under the bridge. MacKay Shields pays New York Life a dividend every year, and New York Life mostly leaves them alone. MR. KASHEVAROFF said that MacKay Shields has a separate compensation scheme and health plan, and they have never been treated as asset gatherers.

MR. ERLENDSON commented that on the charts, credit ratings and default rates look rosy, and asked whether it goes on like that in perpetuity, or whether this could be like 2007 again. MR. SUSSER explained that in 2007, new issuance was of a lower quality, and compared other aspects of high yield then versus now. He stated that he does not think there will be a repeat of 2007, but acknowledged that high yield is a high-risk asset class which may be sensitive to rising interest rates, economic recession, and even natural disasters. However, it gives a very big coupon as a cushion, and investors get a lot of money back pretty quickly. MR. SUSSER concluded by saying that he thinks that the portfolio will perform well in the next year and the default rate will be low, and they will look back at today's energy bond prices as a buying opportunity.

9. ARMB EQUITY YIELD STRATEGY

MR. BADER reminded the Board that in April 2012, they authorized staff to begin an internally managed public equity investment program called the ARMB Equity Yield Strategy. At the time, it was understood that stocks would be selected from the dividend-paying stocks in the Dow Jones U.S. Broad Market Index; the stocks in the portfolio would have a weight of plus or minus 50 basis points of its weight in the Dow Jones 100 Dividend Index at the time of purchase; that stocks not in the index would have a weight no greater than 50 basis points at the time of purchase; that all stocks would have a minimum market capitalization of $50 million and an average daily trading volume of at least $2 million per day; and that at least 90 percent of the market value of the portfolio would be invested in constituents of the Dow Jones U.S. 100 Dividend Index.

Performance would be measured by whether the stock selection resulted in exceeding the index or underperforming it. MR. BADER presented a tabulation of the monthly returns of the portfolio versus the index, showing that in 14 of 23 months since inception, the internally managed fund has exceeded the index. Comparing the characteristics of the portfolio to the index, the price of earnings ratio of the internally managed fund is slightly less than the index, while the yield and price-to-book ratios are about the same.

MR. BADER described the work of Joseph Piotroski on the value of financial statement analysis in stock selection. Piotroski developed the F-Score analysis, a simple accounting-based selection strategy for evaluating a stock's financial performance. It involves nine variables, all taken from a company's financial statement. One point is awarded for each test, so a total of nine points are available, and an 8 or 9 is the strongest score. Research suggests that this type of analysis can be an effective value filter. The ARMB Equity Yield Strategy's investment process begins with two internally developed models, with Piotroski's scores being one of the inputs. They also consider dividends, price to book, price to EBIDTA, price to cash flow, and price to the average price over the last three months, as well as Zack's Research Score, which is a service that they subscribe to.

MR. BADER described the process of rebalancing the portfolio quarterly. They earn dividends and reinvest them monthly, following a rubric designed to maintain balance. MR. BADER reviewed some of the portfolio's holdings, and noted that in the two years they have been managing this strategy, they have saved about $600,000 that might have been spent on active manager fees, while outperforming their target benchmark.

MR. BADER proposed some changes to be made to the constraints under which they operate this fund. He summarized the proposed revised investment constraints: The universe would continue to be the Dow Jones U.S. Broad Market Index. A stock not in the Dow Jones U.S. Dividend 100

Index may not have a portfolio weight of greater than 3 percent at the time of purchase. All stocks would have a minimum market capitalization of at least $500 million and an average trading volume of $2 million per day. At least 50 percent of the market value of the portfolio will be invested in constituents of the Dow Jones U.S. Dividend 100 Index.

These changes would allow them to invest in non-dividend-paying stocks, and to broaden the opportunity set by requiring only 50 percent instead of 90 percent of the investments to be in Dow Jones Dividend 100 members. MR. BADER stated that they further propose increasing the assets in this strategy by about $350 million to bring the total assets under management to about $500 million. Using 30 basis points for the average active manager fee, this would save about $1.5 million annually in manager fees. MR. BADER said that if this change is approved by the Board, his intent would be to direct staff to get more industry-oriented, and that's why they are requesting more analysts to do this. He said that they calculated this once for the fixed income portfolio in which they manage $20 billion, and it costs less than a point to use internally managed people.

MR. PIHL asked whether they would be able to track the performance of the dividend group versus the new non-dividend-paying group and see what the new group either adds to or subtracts from the performance. MR. BADER replied that they would be able to do that, although any type of recordkeeping has associated costs. However, he expects non-dividend-paying stocks to be used only rarely.

MS. ERCHINGER asked how many additional analysts they think they need, and whether the new people would be working on other portfolios than just this one. MR. BADER answered that his long-term vision is to have an investment staff comparable to what you would find in New York, that they would have more than one equity strategy, and that eventually they would get to small cap. MR. BADER said that he hopes to recruit two staff, hopefully Alaskans. MS. ERCHINGER commented that her position on internally managed funds has morphed over that last few years as a result of the outstanding job done by ARMB staff, and it's good to see reductions in management fees and Alaskans being put to work to keep that money in the state.

The Board took up Item 13C from the agenda, the action memo pertaining to the modification of the equity yield portfolio, at the conclusion of Mr. Bader's presentation.

<u>MRS. HARBO moved to approve the proposed changes to the investment constraints of the ARMB Internally Managed Equity Yield Portfolio. MS. RYAN seconded the motion.</u>

A roll call vote was taken, and <u>the motion passed unanimously.</u>

CHAIR SCHUBERT recessed the meeting from 11:45 a.m. to 1:29 p.m.

10. CRESTLINE INVESTORS

DOUG BRATTON, President and CEO of Crestline, and KEITH WILLIAMS, the head of the Opportunistic Strategies group, reported on the absolute return mandate called the Blue Glacier Fund.

MR. BRATTON explained that Crestline has about $9.5 billion of assets under management, 95 percent of which are from institutional investors. Their current primary focus is on credit and opportunistic strategies. The Blue Glacier Fund focuses on the area between hedge funds and private equity.

MR. BRATTON explained that there are three primary characteristics of the opportunistic strategies that they use. They have a one-to-three year average shelf life; they have a shallow J-curve, so money gets invested fairly quickly; and they have about 12 to 16 percent net return expectations. MR. BRATTON gave some examples of opportunistic strategies, ranging from “corporate distressed” to “real assets” such as oil and gas industry assets with royalties. He said that the Blue Glacier portfolio is very diversified, with hundreds of individual investments; they have committed about $275 million, and about $108 million has been called. The value of that $108 million is about $142 million, which is about $35 million in profit. The portfolio is just now being invested and will pay out in three to four years, but it is performing well so far.

MR. BRATTON proposed some changes to the mandate to give the portfolio more flexibility. He proposed creating a recurring series of opportunistic funds as a way to have it be “evergreen”, and including direct investing in the mandate, which would allow for quicker, more consistent capital deployment, more tactical investment approaches, and the opportunity to take advantage of co-investments with certain managers.

MR. BRICE asked about the risks of direct investing; MR. WILLIAMS replied that when considering direct investing versus fund investing, it comes down to the manager’s ability to source, to underwrite, to structure, and to manage the asset in general. The biggest risk would be not picking the right team.

MR. BRICE asked in what economic environments the direct investing strategy works best and in what environments is it most volatile. MR. BRATTON said that today’s environment is probably best, because banks that had been active in these strategies have backed away because of regulatory changes. The best opportunity set would be after a dislocation like in 2008, but right now is very good.

MR. BRATTON explained that the team at Crestline all has direct investing backgrounds, and when they built the opportunistic strategy, it had three legs: fund investing, secondary investing, and direct investing. The Blue Glacier mandate doesn’t have the capability to do direct investing, but some of their other clients’ mandates do, and that’s one reason they would like to add to this mandate.

MR. ERLENDSON inquired about capacity constraints, limits on the assets that Crestline can take and still effectively participate in this market without bidding up prices to make that incremental value disappear. MR. WILLIAMS replied that they are usually investing in areas that have some inefficiency, and when the spread starts to shrink, they focus elsewhere.

MR. BADER asked MR. WILLIAMS to tell the Board about his resume and those of other team members. After that, MR. WILLIAMS described the four categories of direct investments that they would invest in:

- The asset-based cash flow deal, which is a pool of assets that have a cash flow stream, which can either be purchased or lent against.
- Direct lending and structured equity, which is providing capital to lower middle market and middle market companies.
- Distressed or special situations, such as rescue lending, distressed asset purchases, or taking advantage of dislocations in the liquid credit market.
- Side pocket restructuring/lift-out of hedge fund secondaries where there was an asset/liability mismatch.

MR. WILLIAMS then discussed specialty lending, an opportunity that they see as being created by the financial crisis, in which they can achieve significant illiquidity premium relative to high yield and leveraged loans with more structural protection by making loans to middle market and lower middle market companies. He described it as a tale of two borrowers, some who need certainty of execution and some who don't. Those who don't can go to an investment banker who can pull together a group of lenders and price it accordingly. However, for those that need certainty of execution, there are only a handful of people that can provide and close on a $200 million loan. Crestline focuses on senior-secured first-lien lending, in which they have a lien on the assets. These are highly structured securities underwritten with downside protection. Crestline likes market leaders with recurring revenue, and they think that it is a very robust, fragmented market. They believe there is a "core opportunity set" of 150,000 companies with revenues between $25 million and $100 million, and they only need to select 30.

MR. WILLIAMS emphasized that Crestline is unique in having over 40 years of direct lending experience in the middle market, and those involved have built a similar team in the past at Goldman Sachs. They have the ability to club up with others to invest in upper middle market deals, and they do their own direct sourcing. Also, the Crestline platform of specialty funds, its network with Bass, and the fact that a majority of the team has special situations background and they have worked together for many years contribute to their strength.

MR. WILLIAMS pointed out benefits to the investor, such as getting paid for the illiquidity and the fact that the assets will generate cash flow. Trustees asked some questions about the specialty lending strategy and the associated fees. COMMISSIONER FISHER asked whether specialty lending would entail another commitment of capital or would be part of the commitment they currently have with Crestline; MR. BADER said that it would entail a $50 million capital commitment.

11. UBS AGRIVEST

MR. BADER introduced UBS Agrivest as one of ARMB's two managers of farmland, which has been one of the most successful asset classes over the years. MR. BADER added that he believes the ARMB owns more farmland than any other public fund, and it has worked out well.

JIM MCCANDLESS explained that the UBS Agrivest group is based in Hartford in the same offices as the UBS realty investment team that manages some of the ARMB's commercial property investments, and they share accounting and legal staff. The Agrivest group has regional offices in Chicago, Illinois; Nampa, Idaho; Lodi, California; and Dallas, Texas. The regional offices are responsible for the origination, underwriting, asset management, and disposition of farm properties in the portfolio.

MR. MCCANDLESS presented an overview of the farm economy, which has had a pretty good run for the last 10-12 years, with outstanding levels of income for farmers, increasing farmland values, and generally a very strong financial condition for all participants in the farm economy. Net farm income has been at record highs the past couple of years, but is projected to decline or remain flat as commodity prices decline due to large supply. Farmland values are also leveling off, and declining in places where they had risen significantly. MR. MCCANDLESS discussed the importance of diversifying among annual crops, which include commodity crops and vegetables, and permanent crops. He also addressed the water issues in California, explaining that the ARMB properties are in areas that have strong water supplies and rights.

MR. MCCANDLESS described the ARMB's Midnight Sun portfolio as of December 31, 2014. It holds 64 farms in 13 states, just over 97,000 acres. Those farms had a cost basis of $324 million and a market value of $504 million. Permanent crops comprise 12.6 percent, below the target of 20 percent. MR. MCCANDLESS showed that the portfolio was within the constraints established in the investment guidelines. He noted that the total amount invested so far is $324 million, and they have $27.7 million left to allocate, with $11 million of that closing this week on a citrus grove in Florida. The fund is producing a 4 percent return over rolling five-year periods with a minimum of 3 percent distributed income for individual properties after fees and capital expenditures.

12. TIR TIMBER

MR. BADER introduced Timberland Investment Resources as one of ARMB's two timberland investment managers, with assets under management of $268 million.

MARK SEAMAN, President of Timberland Investment Resources, introduced himself, TOM JOHNSON with client services, and CHRIS MATHIS, the director of real estate. They are three of the eight partners in the firm.

MR. SEAMAN thanked the ARM Board for the business since 2008. The original mandate was to assemble a $100 million portfolio, and that was increased to $244 million, with the current market value of $268 million noted by MR. BADER. The goals of the mandate were to have diversification across species, product type, age class, and geography. The return objectives were an absolute return objective of 5 percent real, and a relative objective of the NCREIF Timberland Index Benchmark.

MR. JOHNSON described the geographic footprint of the portfolio and presented a summary of their acquisition activities since 2008. Using a very methodical, selective approach, they have looked at hundreds of possible transactions, and made offers on 76 to acquire the 8 that they have. MR. JOHNSON stated that virtually all of them have been privately negotiated deals that were off market, allowing them to create a customized, structured acquisition to meet the prescribed objectives.

MR. JOHNSON described the timber business and products to the Board, and discussed the markets for timber and its products and how they are affected by U.S. housing starts and international demand. MR. JOHNSON said that this portfolio was formed at an opportune time, and compared to the benchmark, they are at about 190 points on a gross basis, which they are pleased with. MR. JOHNSON said they see potential for a significant upside as the housing market recovers. They still have a little more capital to put to work, and they are looking for opportunities.

COMMISSIONER FISHER asked for a description of the benchmark, and whether certain attributes of the ARMB's property result in them being a little under. MR. JOHNSON explained that the benchmark is a property-level benchmark, which only values the property and does not include the impact of management fees or debt. Also, it is a composite of the managers that contribute to the index and their properties all over the country, but the ARMB portfolio does not have any holdings in the Pacific Northwest, where returns have risen because of exports to China. In the short term, MR. JOHNSON said, the lack of exposure in the Pacific Northwest may have hurt, but in the long term he believes the fund will be better positioned.

MR. ERLENDSON inquired about opportunities outside of the U.S., and MR. JOHNSON replied that they do exist, but when the portfolio and investment guidelines were established, there was a strict philosophical view that it should only be in the United States.

DR. JENNINGS asked if selling the higher and best-use properties out of an acquisition is part of the strategy. MR. MATHIS replied absolutely, part of the strategy is to go from wholesale to retail. They sold about $5 million out of the portfolio last year, and probably will sell about $10 million this year. There are a lot of opportunities to extract premiums for retail tracts.

CHAIR SCHUBERT recessed the meeting from 3:26 p.m. to 3:35 p.m.

After the recess, CHAIR SCHUBERT requested a motion to go into executive session for the purpose of discussing a matter related to the highest and best use of an investment.

<u>MR. BRICE moved to go into executive session.</u> <u>MS. RYAN seconded the motion.</u>

The ARM Board was in executive session from 3:36 p.m. until 4:33 p.m.

When the Board went back on record, <u>MS. RYAN moved that the ARM Board authorizes staff to approve up to $5 million for TIR to explore potential higher and better use opportunities within the timberland portfolio.</u> <u>MRS. HARBO seconded the motion.</u>

With no objection, <u>the motion passed unanimously.</u>

13. INVESTMENT ACTIONS/PROCUREMENT

A. Absolute Return Guideline Revision

CIO GARY BADER explained that the proposed policy revision relates to the presentation by Crestline Investors. The resolution change would do two things: It allows the ARMB to either use an investment advisor or to engage a consultant and, with staff, assist in the investment process for direct fund and hedge fund investing.

MS. HARBO moved to adopt Resolution 2015-01, revising the Absolute Return Policies and Procedures. MR. PIHL seconded the motion.

With no objections, Resolution 2015-01 was adopted by unanimous consent.

B. Crestline Contract Modification

MR. BADER recommended that the ARM Board direct staff to negotiate an amendment to Crestline's contract to allow for direct investments and future opportunistic investments and to negotiate a commitment of up to $50 million to Crestline Specialty Lending limited partnership.

MR. PIHL moved to modify the Crestline contract. MRS. HARBO seconded the motion.

The motion passed by unanimous consent.

RECESS FOR THE DAY

CHAIR SCHUBERT recessed the meeting at 4:38 p.m.

Friday, February 13, 2015

CALL BACK TO ORDER

CHAIR SCHUBERT reconvened the meeting at 9:00 a.m.

Trustees Trivette, Harbo, Erchinger, Pihl, Ryan, and Fisher were also present.

REPORTS (Continued)

14. CAPITAL MARKETS ASSUMPTIONS

MR. ERLENDSON began by saying that capital market projections are used to decide how to allocate capital for specific purposes. The ARMB uses 10-year projections. MR. ERLENDSON reminded the Board that MICHAEL O'LEARY had presented this information last year, and with a few modest exceptions, the projections are the same for the next ten years as they were a year ago. Therefore, if the risk tolerances and time horizon and objectives are the same, it appears there would be modest reason to make a change in asset allocation.

MR. ERLENDSON explained that these projections are the cornerstone of strategic planning, and it's helpful to remember a simple mathematical formula: The benefits paid plus the expenses accrued to pay those benefits have to equal contributions plus investment returns. Thus, with only four components in the equation, the investment returns and how the assets are positioned to generate them are critical to being able to meet benefit obligations. Callan's job is to develop assumptions that can be used to make the case for the strategy that the ARMB board has in place.

MR. ERLENDSON pointed out that he will be talking about assumptions from an investment policy perspective, but as MR. BADER discussed with his report on the GEMS model, the actuaries also have to come up with assumptions about the return on assets when they make their calculations. MR. ERLENDSON said that it used to be that the actuaries would just automatically use the same assumptions as the consultant, but the European financial crisis led to requirements that actuaries justify the assumptions that they are using, which in turn gave rise to the popularity of the GEMS model. Callan looks at a five- to ten-year horizon, but the actuaries are looking at a much longer period of 20 to 30 years. MR. ERLENDSON stated that one of Callan's guiding principles as a firm is to come up with a prudently determined plan and then stick with it, because typically when people make changes out of fear, they end up magnifying the problem rather than solving it.

MR. ERLENDSON explained that their model has three components: a median expected rate of return for each asset class; a standard deviation saying how wide around that median they think are the possible outcomes; and the correlation. The perfect solution changes over time, so investors need to pick a range of assets that will offset the risks of one another to reduce overall volatility, which is why diversification is important. Also, investors have to anticipate inflation and select assets that will appreciate more than the inflation rate. MR. ERLENDSON emphasized that investors need to differentiate asset allocation, like "How big are our exposures to broad asset classes?" versus manager structure, which is "How do we use active and passive management within that asset class?"

MR. ERLENDSON noted that as other managers have said, when considering various investment options around the world, the U.S. has been and continues to be one of the best choices. As low as our bond yields are, they are higher than in many other countries, and the investment of foreign capital is keeping downward pressure on interest rates. Non-U.S. equity markets continue to lag, but many managers are making increasing allocations to emerging markets, wanting to purchase while things are cheap.

Looking ahead to where the ARMB will be positioned one year, three years, and five years from now, MR. ERLENDSON said that it looks like a rough road, and what happens will depend partly on interest rates, but the volatility of those outcomes is probably going to be greater than they have been recently. He showed the returns over the last six calendar years, and the rolling average returns over 5-, 10-, and 15-year periods ending December 31, 2014, and pointed out that the returns from the 15-year period are markedly lower, because that 15-year period includes the global financial crisis of 2008-2009 and the telecom bubble burst in 2000-2001. MR. ERLENDSON said that he thinks the 10-year return is a better example of "normal".

MR. ERLENDSON presented a history of calendar-year returns in the U.S. stock market, and pointed out that returns have now been positive for six years in a row. Looking at the history, there has never been a period when they were positive for seven years in a row, and not many periods of six or five or four consecutive years of positive returns. He commented that it would appear that the ice is getting thinner and thinner as time goes on.

MR. ERLENDSON said that Callan concurs with the IAC's view that the GEMS model is a powerful supplemental tool, but it is not a replacement for longer-term capital market expectations. He noted that its asset optimization module allows them to do what-if scenario analysis that can be very useful.

MR. ERLENDSON discussed current economic conditions in the U.S. and the world, and then led into Callan's 2015 to 2024 capital market assumptions. The only changes they've made from last year are those that are interest-rate-sensitive: fixed income and commodities. However, he said that the net effect will be so incrementally small that it's not worth changing the target.

MR. BADER noted that the fixed income portfolio has a sizable commitment to intermediate-term treasuries, but comparing the returns of short duration with cash, he asked MR. ERLENDSON to address the proposition that maybe they are better off in cash than in Treasury bonds. MR. ERLENDSON explained that although the short-duration bonds' average return has been over 7 percent since the 1950s, the yield curves show that those returns are very low. Any modest increase in yields is going to directly translate to a loss in capital, and managers have to make informed decisions about what they expect over the long term and short term.

COMMISSIONER FISHER asked him to talk about the mix decisions. MR. ERLENDSON discussed the difference between arithmetic and geometric returns, and how the math works in a hypothetical mix. Making informed decisions about managers and finding ways to reduce costs can boost returns. MR. ERLENDSON remarked that the ARM Board historically has done very well in terms of allocating capital, and the steps that were authorized yesterday about changing some guidelines are designed to lower costs by using internal managers and to adjust the exposure to try to get above-average returns with less volatility.

MR. TRIVETTE commented that over time, he thought the ARMB's returns had averaged about 9½ percent. MR. BADER replied that that is true, but it isn't apples to apples, because interest rates and inflation rates were far higher over that long period, and investments were simpler 20 years ago. Now they have a lot more different kinds of investments, which are an attempt to modulate the volatility in the portfolio. MR. BADER added that it would be unwise to assume that the rate of return will be the same over the next 20 years.

MR. ERLENDSON concluded by saying that the inflation assumption that the actuary uses is connected to the nature of the system's liabilities, and there can be big differences, which is why it's important to focus on what the purpose of the plan is, what are the economic factors that drive it, and what is the right way to deploy capital to help offset the cost of contributions without taking undue risk. He commended the ARM Board for being very good at addressing that challenge over time.

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 2015 meeting schedule is included in the meeting packet. MS. HALL noted that she and MR. BADER have begun planning for the Education Conference, which has been in October in the past, but this year they are looking at early September, before the scheduled board meeting in Fairbanks.

CHAIR SCHUBERT welcomed COMMISSIONER HOFFBECK to the meeting.

3. **Legal Report**

MR. GOERING had nothing specific to report, but he commented that he is getting more comfortable with the staff and is finding the level of professionalism and quality of work extremely high. He expressed to the Board that he thinks they are in good hands with the staff that they have.

NEW BUSINESS

CHAIR SCHUBERT noted that the Board had discussed forming an Actuarial Committee to provide input into the assumptions and work more closely with the actuary. CHAIR SCHUBERT pointed out that the Real Asset Committee deals with a lot of the same kinds of matters, so she proposed appointing those committee members to serve on the Actuarial Committee. COMMISSIONER FISHER and MR. TRIVETTE volunteered to serve along with Real Asset Committee members MS. ERCHINGER, MRS. HARBO, and MR. PIHL.

OTHER MATTERS TO PROPERLY COME BEFORE THE BOARD

None.

PUBLIC/MEMBER COMMENTS

LARRY SEMMENS, public member, retiree, and former ARMB Trustee, thanked the Board for the work that they do to fund the retirements of so many Alaskans.

INVESTMENT ADVISORY COUNCIL COMMENTS

MR. SHAW commented that a common theme runs through all of the presentations at this meeting of selecting strategies which reduce risk and protect on the downside. MR. SHAW noted that a lot of board members are somewhat nervous and are looking for differentiated strategies, and he thinks that uncorrelated strategies like timber, agriculture, and Crestline's specialty lending contribute to a portfolio that is well positioned to move forward.

TRUSTEE COMMENTS

MRS. HARBO thanked Trustee Erchinger for her work on the presentation before the Legislative Committee and the work she did on the House and Senate bills that passed last year.

MS. ERCHINGER reported on the discussion with the Legislative Committee. First she thanked the Legislature, who voted unanimously for the $3 billion cash infusion recommended by Governor Parnell. MS. ERCHINGER stated that as a committee, after that legislation was passed, they had to consider the effects of the legislation as it was written, because they hadn't anticipated the changes in the amortization period and methodology. The Legislative Committee asked the actuaries to inform them of those impacts, as MS. ERCHINGER reported to the Board yesterday. She noted that the Board is extremely grateful, and the cash infusion couldn't have come at a better time; if it hadn't been done, the state would have had to cut the budget further this year. CHAIR SCHUBERT reiterated the ARM Board's thanks to the Legislature.

MR. TRIVETTE thanked MR. SEMMENS for his continued involvement, stating that he appreciates his helping educate his boss, Senator Micciche, and other legislators about what has been going on.

MR. TRIVETTE commended MR. BADER for developing a strong staff with extremely low turnover, noting that the past nine months have been hectic with the additional $3 billion to invest. He added that managers from all over the country tell him how much they appreciate the superb job that MR. BADER and staff do at the Education Conference. MR. TRIVETTE said that he is happy that the ARMB will be getting two new investment officers and doing more internally, since they have the skills and have been doing an excellent job.

FUTURE AGENDA ITEMS

None.

ADJOURNMENT

There being no objection and no further business to come before the board, the meeting was adjourned at 10:35 a.m. on February 13, 2015, on a motion made by MRS. HARBO and seconded by MR. TRIVETTE.

Chair of the Board of Trustees
Alaska Retirement Management Board

ATTEST:

Gayle Harbo
Corporate Secretary