State of Alaska
Department of Revenue
State Investment Review Meeting
June 9, 2021

MEETING SUMMARY

Meeting Details:
Start Time: 8:00 a.m.
End Time: 10:09 a.m.

Department of Revenue Staff present:
Lucinda Mahoney, Commissioner
Zachary Hanna, Chief Investment Officer
Shane Carson, State Investment Officer
Brian Fechter, Administrative Services Director
Scott Jones, Head of Operations and Analytics
Michelle Prebula, State Investment Officer
Stephen Sikes, State Investment Officer
Alysia Jones, ARMB Liaison Officer
Mike Barnhill, Deputy Commissioner
Pamela Leary, Director of Treasury
Victor Djajalie, State Investment Officer
Sean Howard, State Investment Officer
Mark Moon, State Investment Officer
Hunter Romberg, State Investment Officer
Kayla Wisner, State Comptroller

Investment Advisory Council (IAC) Members present:
William Jennings
Jerrold Mitchell
Ruth Ryerson

Others present:
Kristin Shofner, Fidelity
Jeffrey Moore, Fidelity
Michael Plage, Fidelity

I. Introduction

Commissioner Lucinda Mahoney thanked everyone for their flexibility in rescheduling the May 12th meeting to June 9th. She said she was very interested in the advisors' observations, particularly given that recent performance had been incredible.

II. Fidelity Tactical Bond

CIO Hanna said that staff would be recommending the addition of the Fidelity Tactical Bond portfolio and introduced Kristin Shofner, Senior Vice President of Business Development at Fidelity, and Relationship Manager for Alaska.

Ms. Shofner expressed her appreciation to Department of Revenue and introduced Jeffrey Moore and Michael Plage, Co-Portfolio Managers for the tactical bond portfolio. Mr. Moore explained that Fidelity launched tactical bond in 2006 to address what he referred to as "in-between markets". He said the approach was to look at how to get the most yield and return out of the market without tipping the portfolio one way or another so that when something happened there was an obvious asset allocation. He explained that the DNA of tactical bond is core. He said they wanted to provide a product that was low

volatility, low correlation to stocks, and more yield than the benchmarks, in order to increase ways of getting positive returns for the portfolio.

Mr. Plage discussed their philosophy, team, and process for the portfolio. He said tactical bond was the most flexible bond offering and their goal was to be transparent, keep it simple, and perform well in a variety of market environments. He said they have a variety of professional resources on their team including analysts and traders, as well as portfolio managers in specific asset classes.

Mr. Plage walked through their five-step investment process used for all their benchmark strategies, including the tactical bond portfolio.

Mr. Moore said they worked closely with other colleagues using a cross firm collaboration tool throughout each step of their process to get a full picture of what was happening with specific companies and mitigate risk down the line.

Mr. Moore reviewed the tactical bond performance as of March 31, 2021. He said he expected to see trends similar to the 1990s and late 2000s which ended with 4 to 5 percent returns over the long period. He suggested keeping those percentages in mind over the next 10 years and anticipating a slightly lower return because the starting point this time around was so low. He said the portfolio was designed to find the bits of the market that were cheap, while caring for draw down risk, and ensuring that when the drawn down happens, there is maximum flexibility to do what clients need done.

Dr. Jennings asked Fidelity to comment on the FIAM GIPS Composite Report (slide 20 of their presentation) and AUM growth in terms of scale versus capacity. He also asked if any of that money was retail that may lose faith at the wrong time. Ms. Shofner said the portfolio was 100 percent institutional. Mr. Moore added that year-to-date numbers were phenomenal with 0 total return for the year and the Agg was down 2 ½ percent. He said that they are considering how much growth they could take and said at some point down the road they would close it.

Ms. Shofner, Mr. Moore, and Mr. Plage left the meeting.

Mr. Hanna said they had invested in the tactical bond portfolio in early 2014 on behalf of the Alaska Retirement Management Board (ARMB). He said staff really liked the combination of downside protection and risk management, in terms of how they construct the portfolio, with insulation from rising rates and access to other pieces of the bond market that we do not currently have on the State side.

He reiterated that staff would be recommending adding this portfolio, seeing it as a nice compliment to the aggregate portfolio.

III. State Investments

A. March 31, 2021 Performance – Commissioner's Report

Mr. Hanna reviewed the periodic table of investment returns by asset class, noting there was a modest continuation of the equity rebound in the 1st quarter. He said broadly speaking, fixed income had its worst quarter in approximately 30 years with yields on the 10-year almost doubling over the quarter, which had led to losses in some of the fixed income portfolios. He commented that the negative performance in Q1 was similar to the positive performance seen in the same portfolio in Q1 of last year, illustrating a reversal of the protection this portfolio provided in the start of the pandemic.

Looking at the broad U.S. equity market, Mr. Hanna said that it had been the highest or second highest returning asset class over the past 4 quarters. He said both the fiscal YTD numbers highlighted how strong equity returns had been and how high the equity markets were currently.

CIO Hanna discussed current interest rates. The top curve showed where rates were on 12/31/2019 before the pandemic. It was a fairly flat curve starting with cash rates of 1.55%, which was about where the 10 year was currently. He commented on the dramatic movement within the past year and a half. The bottom curve showed where they were on 6/30/2020 when they did the last asset allocations. He said the front end was near-zero and the back end was roughly 100 basis points lower than where it had been six months prior. The middle curve showing rates as of 4/30, was fairly steep with front rates near zero and very long rates close to where they were pre-pandemic. He said rates were generally down 10 basis points on the longer tenures, but the curve remained largely the same. He explained that most of the rise in longer rates and reduction in shorter rates occurred in the first quarter, which led to losses in their bond portfolios, and reduced cash equivalent yields.

CIO Hanna said in terms of inflation, the big question for them was how transitory potential inflation would be. He said TIPS break-even rates provided some insight into what the market was saying, with current rates of 2.9% for 2 years, falling to 2.3% over 30 years. He said the market was predicting a 2 to 5-year period where inflation may be elevated, but that there was an expectation that it was transitory. He said there were very few productive yield-generative ways to protect against inflation, and often there was a need to give up return generation in a portfolio to protect against this risk, which is very difficult to quantify.

He said asset allocation was never an easy task and noted factors that made it particularly challenging this year, including high asset prices and interest rates below inflation expectations. He also explained that the risk postures of some of the state assets were more cash and bond-oriented and therefore had less exposure to equities that might provide a natural hedge against inflation.

Mr. Hanna walked through the Commissioner's Report. He explained that the asset allocation deviations presented reflect the variations prior to rebalancing. He said all were brought in to less than 21 basis points after the rebalance at month end. He explained that they set asset allocations for all the state funds, and that last year the four underlying investment building blocks for the state were domestic and international equity pools, fixed income, and cash. He said the broad market fixed income pool was managed internally to the Bloomberg Aggregate Benchmark. Both the domestic and international equity pools were passively invested by State Street in Russell 3000 and MSCI ACWI ex-us indices. He said the short-term fixed income pool was managed internally and had a 90-day T-bill benchmark.

Mr. Hanna reviewed the three-month quarterly performance. He said fixed income was down 3.49% for the quarter. He said they lost 11 basis points of their recent outperformance during the quarter but added that the longer-term numbers were still strong, and most of the underperformance had been regained subsequent to quarter end. Equities were up, with domestic up 6.3% and international up 3.5%, while cash returns were close to zero at 4 basis points for the quarter. He added that investing cash had been challenging with the markets due to all the stimulus funds.

Commissioner Mahoney asked where the recent stimulus money that they had received was invested. Mr. Hanna said it was in GEFONSI 1, which was a 77% cash, 23% fixed income allocation. He said they were in close contact with fiscal staff on when the money comes in and how it goes back out. He said based upon evaluation of how the funds will go out, it seemed reasonable to keep the current asset allocation.

Mr. Hanna reviewed actual plan performance, highlighting the impact low yields and rising rates had on the portfolios. He said the equity-heavy portfolios like Alaska Higher Ed, all had performance of 2.5% or so for the quarter, while the bond heavy portfolios, like GeFONSI 1, had performance of -77 basis points for the quarter. He said there was always some downside risk and that they were continuing to be thoughtful in considering the magnitude of downside risk and limitations of some of their investors with respect to asset allocation.

B. Non-Routine Investments

Non-routine investments are investment opportunities that fall outside the scope of the Department's existing investment opportunity set. Mr. Hanna said the Department does not currently have, nor is presently contemplating any non-routine investment opportunities, and reminded the group that it was a standing item on the SIR meeting agendas in the event such an opportunity arises.

C. FY2022 Asset Allocation

Mr. Hanna explained that in late June, the Commissioner would be setting investment policies and asset allocations for $7.1 billion in state assets, which have been pooled into 25 funds with similar mandates. Each year staff review and make recommendations for this process considering specific investment objectives, risk tolerances, and other attributes.

He said they use Callan's publicly available capital market assumptions as a part of their asset allocation process for continuity with the ARMB but added that they also survey other market participants and use current market rates for shorter term investments.

Mr. Hanna stated that they used domestic equities, international equities, core fixed income, and cash equivalents for the FY21 asset allocations. He said they planned to recommend continuing with all four of those core asset classes, along with the following three changes:

- R-establish an allocation to REITs for higher risk portfolios to provide some additional yield and inflation protection,

- Re-establish an unfunded allocation to TIPS with a 0-5% band as an inflation protection tool moving forward, and

- Hiring Fidelity to provide their tactical bond portfolio to be used for up to 20% of State bond portfolio, which would allow the State to access more opportunistically attractive fixed income sub-asset classes like High yield, bank loans, and TIPS.

With respect to the third recommendation, Mr. Hanna said they used this fund in the ARMB portfolio and that it helped provide some cushion against rising rates and believed there was potential for higher returns for the State portfolios.

Mr. Hanna reviewed the risk tolerance framework used to evaluate State investment policies. He said the 1-year probability of loss had historically been one of the main ways they looked at the risk of some of the state funds. He said they were taking a more nuanced approach for FY2022 because the prior framework did not address the magnitude of the potential loss. He explained that they had added a magnitude of potential loss to the framework for each risk category in an attempt to characterize the potential size of losses in various portfolios. He said the specific ranges were still being discussed and suggested keeping them in mind as they look through the asset allocations.

He explained that they blend Callan's longer term capital market assumptions with current rates to bridge the time horizon gap for their shorter-term asset allocations. He said they also truncated the risk of loss of cash portfolios this year, as they expected the Fed to maintain a near-zero bound for cash rates. There were no further modifications to risk.

Mr. Hanna walked through a table depicting risk levels for each asset class and explained the expansion of the framework to better illustrate the downside potential for various portfolios, risk of loss at various return levels, and expected shortfall. He said they believed loss in 1 out of 10 years to be a reasonable downside planning case and that it was common enough that they should be able to plan for how the portfolios would response in that case.

Dr. Jennings encouraged Mr. Hanna and staff to remember that losses are not experienced in years, but in a peak to trough loss. He said the 10% cvar may be reasonable to focus on but suggested not overselling it because peak to trough losses are larger than that. He also suggested clarifying that the magnitudes of loss listed on the risk tolerance assessment are annual magnitudes of loss.

Beginning with the low risk tolerance funds, Mr. Hanna presented the existing investment policy statement adopted last year, a history of return, risk and 10% cvar result for those accounts, and asset allocation for both the prior year and recommendations for FY2022. For the Short Term Funds, staff recommend the collection of funds remain invested in cash equivalents only.

For the Constitutional Budget Reserve, he said that the state is still working through the budget, but that if nothing material changes, the default assumption for the next fiscal year was to leave the fund as an all-cash allocation, as it was last year. He said there was a potential that the CBRF would increase in size and have a longer life. In this case, Treasury would work to understand the expected weighted life of the fund and put together an asset allocation that is aligned with the liability and tolerance for downside risk.

Mr. Hanna then moved on to the highest risk tolerance funds, which included the Public School Trust Fund, Alaska Higher Education Endowment, Education Endowment, and Illinois Creek Mine Reclamation fund. For these endowment, long-term timeframe funds, the highest risk tolerance that they adopted for them would be equivalent to a 70/30 equity/ bond portfolio. He said they take the risk budget of a simple 70/30 portfolio, which was 12.5% this year and optimized the portfolios using the asset classes they had available to come up with the optimal structure. The FY2022 recommendation for these four funds, includes 65% equities, including 5% in REITS, and 30% in cash and bonds with some rounding for an expected return of 5.62%. Mr. Hanna noted that the expected return for the Public School Trust was down 75 basis points from last year, but that the 10% risk of annual loss (16.4%) was tolerable given the longtime horizon of these portfolios.

The Retiree Long-Term-Care Insurance Fund, currently at $720 million, was the State's self-insured LTC insurance. Mr. Hanna said that the fund undergoes an actuarial valuation every few years. The last actuarial valuation assumed a 5.0% return and staff targeted modestly above the return to cover all fees and expenses. He said the next actuarial valuation will occur later this year and staff would adjust the asset allocation if necessary.

Mr. Hanna explained the power cost equalization or PCE endowment, currently at $1.1 billion, was used to stabilize costs in parts of the state most impacted by high power prices. He said historically the fund was considered to have a long-term time horizon and targeted at a higher risk level. He noted that the fund was part of this year's budget discussion and that once more clarity on how the fund is to be structured long term, they may adjust their asset allocation recommendation.

Mr. Hanna then moved on to the moderate risk funds, reiterating that these funds were more challenging given the low-rate environment. He said the funds were dominated by the GeFONSI funds, which stands for general fund and other non-segregated investments. GeFONSI 1 is comprised of the State's operating

accounts entitled to their own income, which meant they get any earnings accured from their investments as well as any losses. The general fund was the largest participant at approximately $1 billion, however there were roughly 100 other participants in these funds. He explained that pooling all those participants together collectively allowed them to take some additional risk and earn a return higher than cash only investments.

Mr. Hanna said GeFONSI 2 started in 2018 as a way to earn additional return for the general fund, and was now $1.1 billion in size, with over 70 accounts that, by statute, were not entitled to their own earnings. He suggested it was a form of leverage with some additional risk being taken, and that any risk taken with the pool accrued to the general fund. He noted that the GeFONSI funds were highly integrated into the state's accounting and cashflow system. He said they were considering pros and cons of setting up additional risk profiles but noted they were being very thoughtful about any changes given the close connection between the funds and state operations. He reviewed the current asset allocation and shared five asset mix alternatives for FY2022. He said they were still determining the best way to invest GeFONSI 1 for the next year.

The International Airport Revenue fund contains operating capital for both the Anchorage and Fairbanks airports. Mr. Hanna said that this fund typically followed the asset allocation for GeFONSI 1, and the intent was to continue to do so for FY2022.

CIO Hanna then reviewed GeFONSI 2. He said the maximum risk they would be willing to take with those funds was a -1.5% loss. He said staff were thinking really hard about GeFONSI 1 and 2 with respect to the general fund and the other participants in GeFONSI 1 and recommendations were still in process.

He summarized his presentation, stating that staff were comfortable with the recommendations to changes in asset classes including working to contract with Fidelity to add tactical bonds, as well as adding REITS and unfunded TIPS. He said that they were also comfortable with the recommendations for both the low-risk and high-risk funds but were still working through recommendations for the moderate-risk funds, including GeFONSI 1 & 2.

Deputy Commissioner Barnhill asked the IAC members what tactics other treasurers use in these kinds of market environments? Ms. Ryerson said that going with Fidelity's tactical bond was in line with how other treasurers were trying to de-risk. She said portfolios with a lot of risky assets were not doing well nowadays. She also said spreading out large losses could be extremely difficult. Mr. Hanna said a lot of state treasuries were conservatively invested and effectively cash equivalent portfolios. He said they probably did not have significant bond holdings in their most short-dated funds.

IV. Rebalancing

Mr. Sikes provided an overview of the rebalancing process for state funds. He explained rebalancing was the internal adjustments to keep portfolios on track and within their target asset allocations over time. He said portfolios drift due to external cash flows (in or out of a fund) and that can impact fund size and differences in asset class performance affect asset weights. He said the goal of rebalancing was to maintain the risk/return profile of a portfolio over time. Mr. Sikes reviewed the rebalancing policy which stipulated funds be invested in accordance with the asset allocation approved by the Commissioner and that the CIO has discretion to rebalance within approved asset allocation bands. He provided several examples to illustrate the dimensions of the rebalancing process, including fund dollar size and investment pools. He said that each fund required its own lens in order to maintain the appropriate return calibration over time, given the different asset allocations of the funds.

Mr. Sikes explained that portfolio staff review all state funds on a daily basis to ensure they are within approved asset allocation bands and review external cash flow forecasts to plan portfolio adjustments

accordingly. He said they rebalance to drifted targets intra-month, meaning they adjust to performance adjusted targets. Staff rebalance to static target allocations at month end. He noted that one of the enhancements made over the years was to recognize the affected targets, from a tracking error perspective, changed depending upon the timing of the rebalancing cycle. He said they currently rebalance monthly and were recommending shifting to rebalancing quarterly.

Mr. Sikes said managing investments through investment pools creates efficiency at both the portfolio construction level as well as for rebalancing. He said most often month-end rebalancing involved both internal pool rebalancing and open market transactions.

He said staff recommends moving the State rebalancing cycle from monthly to quarterly to be consistent with ARMB's rebalancing cycle and further align internal processes; reduce frequency of trading and transaction costs; and tilt more toward momentum concepts. He also stated that the current policy was based on monthly benchmarking conventions and tracking error control. He suggested that it was more of a mechanical by-product and not necessarily the best approach from an investment standpoint.

Mr. Sikes shared research on rebalancing from Callan, Fidelity, and Vanguard. He said staff concluded that it does not matter precisely how you do it, just as long as you do it. He also said less frequent rebalancing was generally better but noted that may vary depending upon the time period. He said keeping it simple and providing better control over tracking error were important factors.

Commissioner Mahoney asked about the potential risks of moving from monthly to quarterly. Mr. Sikes said he did not believe there were a lot of risks moving to quarterly. Commissioner Mahoney asked what would happen if they were in a market that was declining rapidly. Mr. hanna said that he regarded rebalancing as a risk control mechanism. He said the bands around various asset classes were set to help control the risk budget and they would still provide some control despite a change in the cycle. He also noted that there was natural rebalancing due to the external cash flows.

Dr. Mitchell commented that he thought the recommendation to rebalance quarterly was a good one and that he would be happy with semi-annual rebalancing. He asked about their rebalancing schedule, noting that in the early days of rebalancing some traders noticed people were rebalancing on a particular day and could take advantage of the market then. Mr. Sikes said they had discussions on that topic, but that they were fairly tight at month end and quarter end.

Dr. Jennings recalled the scenario of the Covid sell off and asked for clarification on where they would rebalance to if that had not happened at quarter end. Mr. Hanna said they are required to get within the band. He added that there was not a set rule for how far back they needed to rebalance within the band and that they likely would have rebalanced modestly. Dr. Jennings said everything said here seems within bounds of what other people are doing in regard to rebalancing.

In response to Commissioner Mahoney's question regarding risk of moving to quarterly rebalancing, Dr. Jennings said that it was not a big risk. He said there were technical ways to evaluate it and operationally it made sense. He did take exception to Dr. Mitchell's comment about semi-annual rebalancing, stating that he believed monthly and quarterly to be interchangeable and more in line with best practices.

V. IAC Comments

Ms. Ryerson asked if the earnings for GEFONSI 2 were allocated back to the general fund each year and if they expect the possibility of losses in that fund, whether it made sense to accrue some of the earnings on the accounting side to help offset those?

Ms. Leary confirmed that earnings were transferred on an annual basis and that while they had not see a loss yet, the practice would be to do it at the end of the fiscal year.

Dr. Mitchell said it was a good meeting and thanked Fidelity for their presentation and was pleased with the funds moving into it. He also noted that the discussion of risk tolerance was very good and felt that the funds have a handle on that. He said his big concern with the stock market was hubris. He said it was worrisome that the fed, treasury, and many market participants think they can do what they want without any market reaction. He also said that the presence of new participants in the market was also worrisome, as that usually happens at a market top. Dr. Mitchell added that not everything had gone up. He commented that S&P was up 100% from 5 years ago, but that several companies were down for the same period and provided examples that ranged from 2% to 52% down.

Dr. Jennings stated that the 7.38% discount rate seemed high and recommended staff think through the components - real return and inflation. He said the 2.5% inflation may be more palatable than it had been but suggested it may be a high number over the very long term, which was what discount rates were all about. He said the incremental real return also seemed a bit high to him. He said he believed a lower discount rate would be more reasonable and suggested they engage in discussions about incremental adjustments to the discount rate, given the present context.

Commissioner Mahoney thanked the advisors for their comments and said the rebalancing presentation was very informative.

D. Future Agenda Items & Calendar Review

Ms. Jones indicated that they plan to present a draft of the 2022 meeting schedule at the August meeting with the intent to finalize before the end of the year.

E. Other Matters for Discussion

None.

F. Adjournment

There being no further items for discussion, the meeting adjourned at 10:09 a.m.