State of Alaska
Department of Revenue
State Investment Review Meeting
August 18, 2021

MEETING SUMMARY

Meeting Details:
Start Time: 8:00 a.m.
End Time: 8:49 a.m.

Department of Revenue Staff present:
Lucinda Mahoney, Commissioner
Brian Fechter, Deputy Commissioner
Zachary Hanna, Chief Investment Officer
Pamela Leary, Director of Treasury
Victor Djajalie, State Investment Officer
Scott Jones, Head of Operations and Analytics
Michelle Prebula, State Investment Officer
Hunter Romberg, State Investment Officer
Kayla Wisner, State Comptroller
Alysia Jones, ARMB Liaison Officer

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

I. Introduction

Commissioner Lucinda Mahoney thanked everyone for joining and turned the meeting over to Mr. Hanna.

II. State Investments

Mr. Hanna reviewed the annual table of investment returns by asset class and noted the last quarter of FY21 was a continuation of very strong equity performance led by REITs in the last quarter, as the US economy continued to re-open and rebound. Overall, US equities were up 44% and fixed income was down 30 basis points (bps) due to the rising rates, particularly in the first quarter.

Mr. Hanna directed the group's attention to the last 6 quarters (December 2019 – June 2021), which reflected the full Covid-19 period. He commented that U.S. equities were close to 40% positive return since the start of the pandemic and that could be expected to come out of future growth and returns in some fashion.

Mr. Hanna shared 3 yield curves showing interest rates as of December 2019, July 2020, and June 30, 2021. He said longer rates have increased materially and were closer to pre-pandemic levels towards the 20- and 30-year marks. He added that rates had subsequently drifted down about 20 basis points from what was reflected at the end of FY21.

A. June 30, 2021, Performance – Commissioner's Report

As of June 30, 2021, state affiliated managed assets totaled $8.4 billion and the Commissioner is the fiduciary of approximately $8.1 billion of those assets. Mr. Hanna reported that they also added $77 million in July from the Alaska Student Loan Corporation (ASLC) and staff will be working with ASLC on how to balance risk and return and set longer term asset allocations and migrate over time.

Mr. Hanna showed the relative asset allocation weights as of June 30th. He reminded the group that it was a point in time and that sometimes rebalancing may not be captured in this snapshot for a variety of reasons. He said large cash flows were fairly typical close to month's end or at the start of a month, so often rebalancing was timed to coincide with those.

Mr. Hanna explained the bands are generally plus or minus 10%, noting most funds were managed more tightly and were well within 100 bps. The two exceptions were the EVOS Research fund, which had an outflow at month-end that resulted in a 236 bps underweight to fixed income that was subsequently rebalanced, and the GeFONSI 1 and international airport funds were also underweight fixed income. He explained that they elected to have it remain in cash as part of their transition to the FY22 asset allocation.

Mr. Hanna discussed investment performance by asset class building blocks, focusing on the fiscal year and 3-month quarterly performance. He reported that fixed income was up 9 bps for the quarter and 11 bps for the fiscal year. Domestic equities was flat for the quarter, and down 11 bps for the fiscal year largely due to cashflow drag, which had been discussed in prior meetings. Mr. Hanna said it was one of the practical realities of managing fairly large cash flows in a volatile environment. International equity was up 4 bps for the quarter and 15 for the fiscal year. Mr. Hanna stated that much of the differences were related to how cash was invested in these funds.

Commissioner Mahoney asked is the performance net of fee was relative to the benchmark. Mr. Hanna explained that the section at the top of page 6 was relative to the benchmark, the middle section titled *Pool Performance (Net of Fee)* was the actual performance, and bottom section was the benchmark. Mr. Hanna said overall there was a modest outperformance, which was what they target from these strongly index-aware building blocks.

Commissioner Mahoney asked what strategies were used with the short-term fixed income pool to achieve 10 bps better than benchmark. Mr. Hanna noted that what was potentially more interesting was the fact that the actual pool performance was 19 and the benchmark was 9, so the 10 bps effectively doubled the return of the pool. Mr. Djajalie explained the outperformance was due to asset backed securities and short, high-quality, corporates. Mr. Hanna added that they are taking some additional risk to get those returns.

Looking at the net plan performance, Mr. Hanna explained equity-heavy portfolios, such as the Public School Trust Fund had very strong performance, while bond heavy portfolios, such as GeFONSI 1 had a tougher year. He said GeFONSI 1 ultimately had low, but positive performance for the fiscal year, which was a result of a lot of cash investments with close to zero return and enough fixed income investments in a rising rate environment to potentially put them into close to negative territory.

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. Asset Allocation Process & 2021 Capital Market Assumptions

Mr. Hanna reported that they had set asset allocations for $8.1 billion in state assets across 25 funds that run from low risk tolerance cash funds to high risk tolerance endowment funds.

Commissioner Mahoney asked what the number was at the end of June 30, 2020. Mr. Hanna responded that he did not have the number on hand, but that he would follow up.

For FY22, they added REITS, Fidelity tactical bonds for up to 20% of fixed income portfolios, and the potential for up to a 5% allocation to TIPS. Mr. Hanna noted they were still working through if, how, and when they might invest in TIPS. He also explained that they added some additional context to the structured way they look at risk and time horizon this year, due to rates being so low.

Mr. Hanna presented a summary of the asset allocations by risk category that were adopted for FY22. For the lowest risk funds like the Constitutional Budget Reserve (CBR), the allocation was still 100% cash equivalents. For funds in the moderate category, including GeFONSI 1, fixed income decreased from 23% to 15%, with the balance going into cash equivalents. He said the risk of a negative return for these funds was relatively low, but that they felt a modest reduction of risk of any size was worthwhile. There were no changes from what was previously discussed for GeFONSI 2. For the Power Cost Equalization fund, he said they targeted a 5% return, which was equal to the statutory spending limit for that fund. Mr. Hanna said there were no changes from what was discussed at the June SIR meeting for the higher and highest risk categories, and that these funds were still effectively focused on a 70/30 asset allocation.

III. IAC Comments

Commissioner Mahoney asked the IAC members if they were seeing any changes in trends within the investment landscape, over the past three to four months.

Dr. Mitchell said there was an expectation that the Asian market would continue to do well, in particular the growth sectors of those economies, but that investors had started to question whether they wanted to be in the fast-growing Asian economies. Meanwhile, the European markets took off. He said year-to-date there was a decline in the Asian markets and as much as 20% gains in many European markets. He said discussion of growth versus value were common in the U.S., but now those discussions were taking place in the international market where the value proposition seemed to have more adherence.

Dr. Mitchell also commented on the extraordinary performance of the U.S. market and said it begged the question what would stop it, and mentioned interest rates, earnings shortfalls, and exogenous events. He said there had been two such events in the last two months: (1) increase in Covid-19 cases due to the Delta Variant, and (2) Afghanistan. Dr. Mitchell noted that the market's reaction had been "so what?" He stated that all the "safe havens" were down a bit, and that the market appeared to be shrugging off any problems. He said that was worrisome as those sorts of events eventually do have an effect on the economy and earnings.

Commissioner Mahoney commented that oil had been going down the past few days and was reacting to the recent events.

Dr. Jennings said there were two main conversations that he was hearing. The first was increasing conversations around inflation. He said that Callan forecasted 2%, the Horizon Survey recently ticked up their 10-year forecast to 2.14%, and the Philadelphia Fed jumped to 2.44%. He commented that people were getting more aggressive regarding their thoughts on inflation and suggested there was cause for these types of conversations. He gave staff a thumbs up for including the option to use TIPS in the portfolio and stated that it can handle tail risk and was an attractive thing to include.

Dr. Jennings said the second type of conversations focused on being unable to find attractive opportunities for private equity, private debt, and hedge funds. He added that the public markets approach could end up being the approved solution.

In regard to Afghanistan, Dr. Jennings reported that there were a lot of people that he works with that are despondent and they are working on addressing that. He also suggested that the situation may lead to some geo-political questions.

Commissioner Mahoney asked about China equities within the portfolio. Mr. Hanna said they had index exposure only. Dr. Jennings said that the last emerging markets benchmark he saw was 38% China, and with further Asian inclusion, it was likely closer to 50%. He said the emerging markets benchmark was essentially a Chinese investment. Mr. Hanna said his recollection of the MSCI ACWI Ex-US was that China was roughly 5%. Dr. Jennings said that percent would likely grow to 7 or 8% once A-shares were added and suggested they keep that in mind when discussing emerging markets.

Commissioner Mahoney commented on changes in mindset and workforce as people return to the office to offices and asked the IAC members about their experiences with that.

Dr. Mitchell said anecdotally, in Charleston retail businesses, restaurants, and hotels were unable to find workers because they have migrated to other jobs or are collecting unemployment and may not be interested in returning to those jobs. He said other industries, including investors found that they don't need to be in the same room and don't need to be in the office, noting State Street's decision to close its New York operations.

Ms. Ryerson agreed with Dr. Mitchell, stating that there were many sectors where they are finding people don't need to be face-to-face all the time and the amount of office space isn't necessary.

Dr. Jennings said that one of their distinctive competencies is small class sizes, taught in-person. He said his department initially had a policy of working from home one day in five that is now one day in ten, with 100% masking. With respect to office spaces and hotels, Dr. Jennings believed that those considered second tier buildings may start to see issues and suggested the same may be true for malls.

Dr. Jennings said in terms of benchmarks, staff could choose which risks to take and potentially get out of the way of some of these longer-term trends that may take a while to work their way through in the real estate markets.

Ms. Ryerson asked about teleworking and returning to the office in Alaska. Commissioner Mahoney said the Governor wants to see people back in the office, and that the Department of Revenue's target is three days a week in the office which is mostly focused on recognizing the value of teams and face-to-face communications. She noted that there were some deviations, including the Division of Treasury, which was in the office two days a week, and said it seemed to be working well. She added that the Governor thinks the current experience with the Delta Variant may be the new norm, and staff may need to be prepared for these types of surges going forward. She said that everyone was teleworking really well when they needed to, but that she really values the face-to-face interactions.

Ms. Ryerson asked about staff travel. Mr. Hanna said staff were preparing to start re-engaging with managers in-person, pre-Delta, but that the recent surge had slowed things down a little. He said staff were in the office two to three days a week and that they had level loaded to ensure people have space.

Commissioner Mahoney expressed her appreciate to the IAC members for their comments.

IV. Future Agenda Items & Calendar Review

The next meeting is scheduled for October 27th. Mr. Hanna stated that Ms. Jones would also be reaching out regarding suggested dates for next year's meetings and that a draft calendar would be presented at the October meeting.

V. Other Matters for Discussion

None.

VI. Adjournment

There being no further items for discussion, the meeting adjourned at 8:49 a.m.