State of Alaska
Department of Revenue
State Investment Review Meeting
October 25, 2022

MEETING SUMMARY

Meeting Details:
Start Time: 10:00 AM End Time: 10:58 AM

Department of Revenue Staff present:
Deven Mitchell, Commissioner of Revenue
Brian Fechter, Deputy Commissioner of Revenue
Zachary Hanna, Chief Investment Officer
Victor Djajalie, State Investment Officer
Scott Jones, Head of Investment Operations, Performance & Analytics
Stephanie Pham, State Investment Officer
Alysia Jones, ARMB Liaison Officer

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

I. Introduction

Mr. Hanna began the meeting by welcoming Deven Mitchell, the new Commissioner of Revenue. He explained that former Commissioner Mahoney had established the State Investment Review to add transparency and counsel from the Investment Advisory Committee to the State investment process.

The Commissioner thanked Mr. Hanna for the introduction and said he looked forward to his presentation.

Mr. Hanna reviewed the agenda, which included market and performance updates for Q3. He noted that the asset allocation information covered at the August 23, 2022 meeting was included in the appendix in case anyone had further questions.

III. State Investments

Mr. Hanna reported that not much had changed since Q2 and that inflation remained all-consuming for the markets. He said CPI reached 9.1% annualized in June driven by energy, other commodity prices, and shelter costs. It backed down to 8.3% in October but remains sticky. He also noted there was significant wage pressure since employment remains tight with 4.5 million more job openings than unemployed workers.

Mr. Hanna said the Fed raised rates 325 basis points (bps) through July and are expected to raise them roughly 5 more times this year, including an expected 75 bps rate hike next week. The Fed also intend to start reducing their balance sheet, which doubled in size through the pandemic as they supported bond markets. He commented that controlling inflation without crushing growth was a very delicate balance and the market is tuned in to any signs that the Fed may begin to back off in raising rates.

Mr. Djajalie commented on the extreme volatility of the fixed income portfolios. He said in his opinion, the Fed was nowhere near done with raising rates, so the team continues to maintain a defensive posture in rates, keeping the portfolio's ratio modestly shorter than the index. He said they also reduced their corporate bond exposure in July and August but continue to maintain an overweight posture in that area and are very selective in choosing bonds that come through the market.

With the U.S. equities down 25% YTD, including 5% in Q3, Mr. Hanna stated that the equity markets had gone through a significant correction, which has brought valuations back down to more normal levels. He mentioned that this week's earnings reports would be important for the market to digest and could provide important clues about how inflation is impacting sales and margins.

Mr. Hanna mentioned that he had added a couple new charts to the presentation. He then shared a JP Morgan slide comparing historical annual returns to intra-year declines for stocks and bonds.

Mr. Hanna stated that global uncertainty remains very high and there will likely be a lot of volatility moving forward for both equity and fixed income and challenging investment performance. He discussed the team's approach.

Dr. Mitchell commented he was very much in favor of CIO Hanna's policy not to be overly tactical and keep the focus on the long term, making small adjustments as needed, and riding it through. He said he didn't think it would be easy to bring inflation down. He said he believed corporate price increases in both the service sector and other sectors are not going to stop just because a rate cut goes from ¾ to ½ a percent, where inflation goes from 8 to 5. He said he thinks people will still say 'we are in an inflationary environment, let's hike up the prices while we can and get a wage increase while we can'. He added that a few years ago, he had said four percent seemed a better number for long term inflation than what Callan was using at the time, and he planned to stick with his statement.

Mr. Hanna thanked Dr. Mitchell for his comments and turned to Callan's periodic table of returns. He stated that cash was the only area that had positive return for Q3 at 50 bps, everything else had poor performance. He also noted how poorly TIPS had done. He said they are authorized to use TIPS in State portfolios but have elected not to use it because even though TIPS benefit from rising inflation, they are also nominal bonds with significant interest rate exposure which has hurt.

A. September 30, 2022 Performance – Commissioner's Report

Mr. Hanna moved to the Commissioner's Report, saying they would be covering $8.6 billion in assets, $8.3 billion of which was under the fiduciary control of the Commissioner, and roughly $300 million that has other fiduciaries, including the Alaska Student Loan Corporation, the Alaska Mental Health Trust, and the Exxon Valdez Oil Spill Trust.

Dr. Jennings joined the meeting.

Mr. Hanna shared the asset allocations for the current fiscal year and noted one important addition which was adding the intermediate fixed income asset class to GeFONSI I, II, and a few other accounts. He commented that it was a fair amount of effort on the part of the fixed income team to bring it back to life, but that it is a much better fit for the risk profile of the funds.

Deputy Commissioner Brian Fechter asked if that was the "secret sauce" in terms of the additional performance they were seeing for the EVOS funds. Mr. Hanna responded, saying that the timing was perfect on that one. He then explained that he has assigned senior staff to work with some of the funds, and Shane Carson had been working with EVOS. They had been advising EVOS to reduce their risk profile to effectively match what the liabilities were telling them from a time horizon perspective for some time. Action was taken in mid-August, and they went from a 40/60 asset allocation, with 40% exposed to equities to an asset allocation that is effectively all cash and intermediate fixed income. He added that the change was largely a risk-based rationale.

He also reviewed the deviations from the target asset allocations at the end of Q3, noting that all deviations were well within bands.

Mr. Hanna then reviewed performance by asset class building block. Fixed income was down 4.60% for the quarter with the rise in rates, however the team did a good job delivering 15 bps of outperformance. Equities were also down, with domestic down 4.5% and international down 9.9%. REITs were down 10.8%. He said cash equivalents had positive performance of 54 bps, beating the index by 8 bps, and congratulated the fixed income team for navigating a challenging rising rate environment. He also mentioned the tactical bond fund was down, but that it outperformed investment grade credit by 206 bps.

Mr. Hanna moved to net plan performance, showing actual returns for the various plans. He commented that it was a very difficult market for all the portfolios with rising interest rates continuing to impact both stocks and bonds materially. He said they tend not to be very tactical with these funds but did reduce risk in the GeFONSIs by increasing their cash allocation last year and switching to a shorter duration bond exposure this year.

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 stated that Department does not currently have, nor is presently contemplating any non-routine investment opportunities.

In the event such an opportunity arises, a summary of the diligence process for reviewing a non-routine investment is included in each SIR meeting packet and non-routine investments remain a standing item on the quarterly meeting agendas.

IV. IAC Comments

Commissioner Mitchell thanked Mr. Hanna for his presentation, saying it was beneficial and a good process to continue going forward. He said it was extremely helpful to get staff's perspective on how the markets are evolving.

Dr. Mitchell commented on a few "bright spots" noting that Exxon was at an all-time high. He said he wondered when things do turn whether they'll have the same leadership as they've had for the past ten years, which have been technology stocks, or if they will go back to older favorites such as energy. He recommended it be something staff think about.

Mr. Hanna thanked Dr. Mitchell for his comments. He said it was very front of mind for him and noted that with respect to the Alaska Retirement Management Board (ARMB), there is significant factor exposure, which is a counterweight to much of what has driven market cap indexes over the past couple of years. He said they continue to think about how they should position those exposures over the longer term.

Dr. Jennings said meetings were a forcing function – it forces staff to be ready to present and those with fiduciary responsibility to listen, and that is a good practice. He commented that there is a prudent asset allocation here that is professionally implemented. He suggested that commissioners and executive directors be ready to address two questions pertaining to political risks. The first question relates to the indexers and the underlying index. The second question relates to their benchmark is ACWI Ex-US. On the international front, definitionally that includes emerging markets, nearly half of which is China. Dr. Jennings then circled back to Mr. Hanna's comments on factors and tilts. He said the risk was reversing at exactly the wrong time. He encouraged folks to remain steadfast and to proceed in a risk management and thoughtful way.

Mr. Hanna said ESG was something they give a fair amount of thought to and China has been topical from a political standpoint for a while. He noted that the State's tight fiduciary standard is helpful in terms of being a prudent investor as well as in the sole financial best interest but added that sole financial best interest is open to interpretation and anticipates dealing with both issues in the coming years.

Ruth Ryerson commented that their ability to stay disciplined and stick with their asset allocation and being conservative has really paid off this year. She said with the difficult markets, it is easy to not to want to rebalance at exactly the right time. She thought the little bit of outperformance they were seeing would pay off in the long run.

V. Future Agenda Items & Calendar Review

Mr. Hanna explained they were deferring the draft 2023 meeting calendar until a new commissioner was appointed, given that Commissioner Mitchell was transitioning to a new position in a couple weeks.

VI. Other Matters for Discussion

Mr. Hanna mentioned that IAC member Dr. Jerry Mitchell would be retiring at the end of the fiscal year (June 30, 2023). He explained that Dr. Jennings' term is set to expire coincident to Dr. Mitchell's retirement and that staff intend to recommend to the ARMB that they extend Dr. Jennings' term by one year, to maintain staggered terms for the IAC members. He added that Dr. Jennings was onboard with the shorter term and thanked Ms. Ryerson for agreeing to a two- and half-year term to help with re-staggering as well. He said staff plan to begin soliciting for a new IAC member early next year, with an anticipated start date of July 1, 2023.

VII. Adjournment

There being no further items for discussion, the meeting adjourned at 10:58 a.m.