State of Alaska
Department of Revenue
State Investment Review Meeting
February 17, 2023

MEETING SUMMARY

Meeting Details:
Start Time: 10:00 AM End Time: 11:43 AM

Department of Revenue Staff present:
Adam Crum, Commissioner of Revenue
Fadil Limani, Deputy Commissioner of Revenue
Zachary Hanna, Chief Investment Officer
Pamela Leary, Director of Treasury
Shane Carson, State Investment Officer
Casey Colton, State Investment Officer
James Cheng, State Investment Officer
Benjamin Garrett, State Investment Officer
Emily Howard, State Investment Officer
Robyn Mesdag, State Investment Officer
Scott Jones, Head of Investment Operations, Performance & Analytics
Ryan Kauzlarich, Accountant IV
Robyn Mesdag, State Investment Officer
Mark Moon, State Investment Officer
Stephanie Pham, State Investment Office
Hunter Romberg, Senior Compliance Officer
Alysia Jones, ARMB Liaison Officer

Investment Advisory Council (IAC) Members present:
Dr. William Jennings
Dr. Jerrold Mitchell
Ruth Traylor

I. Introduction

Mr. Hanna introduced DOR Commissioner Crum and Deputy Commissioner Limani as this was their first State Investment Review (SIR) meeting.

Mr. Hanna also reintroduced the Investment Advisory Council members, Dr. Mitchell, Dr. Jennings, and Ms. Traylor and explained their designated areas of expertise.

Commissioner Crum acknowledged the importance of the SIR meetings, noting that the Legislature was a proponent of the meetings that were started by former Department of Revenue Commissioner Mahoney.

Mr. Hanna briefly introduced Fidelity and handed it over to Senior Vice President of Business Development, Kristin Shofner to introduce the team.

II. Fidelity Tactical Bond
Ms. Shofner introduced Jeffrey Moore and Beau Coash and explained that they would provide a tactical bond overview as well as discuss the State's portfolio.

Mr. Coash asked Mr. Moore to begin with how they feel about bonds today. Mr. Moore responded that this is about as good as you get in the bond market.

Mr. Moore explained the origin of tactical bond investment process which includes five steps: Macro Assessment, Sector Analysis, Asset Allocation, Security Selection, and Portfolio Construction.

Mr. Coash reviewed slide 11, which showed the performance of the State's portfolio as of December 31, 2022. He noted the consistency of the performance over time. Since inception in 2014, annualizing three times more than the BBg US Agg Bond Benchmark. He added that all relative returns were tight across the board.

Mr. Moore shared slide 17 and explained their simulation model, which looks at historical relationships between level of yield, level of spread, and forward level of volatility in the market. The simulation was another way to look at risk and what should be expected.

Mr. Moore then moved to slide 19. He shared various "ski slope runs" that illustrated different scenarios of how core inflation would moderate in 2023. He stated that what they are watching now is OER and wages.

Mr. Moore walked through the valuations chart beginning on slide 21 and discussed the yield rank and spread rank for the various asset classes. Mr. Hanna reminded the group that this was used in State portfolios that have equity exposure, and that it is roughly twenty percent of the total fixed income allocation for those portfolios that have equity exposure.

Dr. Jennings referenced slide 18, and asked Mr. Moore and Mr. Coash to elaborate on the need for house price increase information to be incorporated. He said that the scale is so much that what needs to be in CPI according to some commentators still has a way to go to be added in. Mr. Moore responded that Dr. Jennings was correct about OER, it is lagged in CPI. He explained that the CPI was designed to be smoothed. He said if there was any weakness in OER, he believed everyone would rally because everyone in the business is aware and watching for this. He commented that Dr. Jennings was right to focus on CPI and wages.

III. State Investments
Mr. Hanna provided an overview of the state investment review process. He noted that this meeting marked the third year of the SIR meetings. He explained that the State assets are highly varied in terms of their goals, risk appetite, and there are quite a few considerations and decisions that ultimately get made with respect to them. He added that the State assets also have different constituents.

He commented on the current state legislative session and the high volume of questions. Topics have included returns, smoothing periods, volatility reduction, spending policy, benchmark selection, risk appetite, and inflation protection. He stated that as investment staff, the team works very hard to be thoughtful on all these areas and the SIR meetings adds another level of discipline, transparency, and additional accountability to the process.

A. Capital Market Update
Mr. Hanna provided a brief capital market performance update, focusing on the last year and last quarter. He said 2022 was a challenging year, particularly with the tug-of-war between inflation and growth.

Looking at the chart on slide 8 of his presentation, Mr. Hanna noted that cash equivalents was the only positive return for 2022 due to the combined impact of rising inflation and setting of interest rates to try to control that motion. He stated that the most unique aspect of 2022 was bonds.

Mr. Hanna directed the group to the inset table on the left side of slide 8 that showed any combination of stock and bond portfolios performed poorly in 2022. He noted that losses were concentrated in the first half of the year and that the markets rebounded modestly in the second half, with most equities outperforming bonds.

B. December 31, 2022, Performance – Commissioner's Report
Mr. Hanna walked through the Commissioner's Report. He paused on page 5 of the report which illustrates how far away they were from target asset allocation at the end of 2022. He noted that prior to rebalancing, the largest deviations were in the 1-2 percent range and are largely due to market movement.

Mr. Hanna then discussed investment performance by underlying building block and reviewed how each block was managed.

Mr. Hanna moved to page 9 of the report and reviewed relative performance, which showed performance compared to benchmarks. He commented there was outperformance across the board for the year, with only one exception.

C. Non-Routine Investments
Non-routine investments are potential investment opportunities that fall outside the scope of the Department's existing investment opportunity set. The 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 robust non-routine investment process is included in each SIR meeting packet and non-routine investments remains a standing item on the quarterly meeting agendas.

D. 2023 Capital Market Assumptions
Mr. Hanna reminded the group that the Commissioner of Revenue is the fiduciary for over $8 billion in state assets across 100+ accounts, pooled into 24 funds with similar assets or mandates. Traditionally, staff reviews each investment policy annually and makes recommendations, taking into investment objectives, risk tolerances, liquidity needs, time horizon, and capacity for loss for each fund. He stated that it is a transparent process, documented in their investment policy manual. He noted that this group played a key role in this process as well.

Mr. Hanna reviewed the risk tolerance assessment, explaining that it largely revolves around a funds time horizon and capacity for loss.

Mr. Hanna stated that the release of Callan's Capital Market Assumptions (CMAs) is the catalyst for the asset allocation process. He explained that they use Callan's CMAs as a basis for consistency since Callan is the consultant for both the Alaska Retirement Management Board and Alaska Permanent Fund Corporation. Treasury staff also evaluates current market conditions to develop an asset allocation approach for each state fund.

E. FY2024 Initial Asset Allocations

Mr. Hanna mentioned that as they move forward with the discussion, the group can expect to see at least 100 basis point increase in expected return at a similar level of risk for each of the portfolios we manage. He said they look across the asset class universe and select a set that is the best fit in terms of risk return, diversification, complexity, cost, and liquidity.

Mr. Hanna referred to the table on page 16 of his presentation and explained the dark and light gray shading illustrated asset class exposure. He commented that there were not a lot of asset classes remaining, and that most of what remains are illiquid asset classes. Mr. Hanna explained that State funds were not allowed to purchase unregistered investments, including alternative investments, prior to 2021 due to the SEC's definition of accrediting investor. He said that even with the change illiquid investments remain problematic for State funds and are not consistent with their policy risk.

Mr. Hanna said the formal recommendation to the Commissioner and this group would be presented in May or June. He commented that currently there are not any additional asset classes that they are contemplating to add to the mix, nor is there anything that they are planning to delete.

Mr. Hanna then walked through each of the funds and discussed what they look like through the lens of the recently released CMAs.

Regarding the Power Cost Equalization (PCE) Endowment Fund, Mr. Hanna stated the statute had been amended last year to direct the commissioner to apply the prudent investor rule and invest the assets of the fund considering both preservation of the purchasing power of the fund over time and maximizing the expected total return. He mentioned that they have had a lot of discussion about the PCE fund this year, including risk and return tradeoffs, and three vs. five-year smoothing. He noted that the public schools fund was the poster child in terms of best practice for set up and that five-year smoothing provides some incremental volatility reduction that is useful.

Mr. Hanna wrapped up the discussion of the high risk/endowment profile funds by stating that they were inclined to continue to leave these at 70.30 risk profile. He then moved to the Retiree LTC Insurance funds and mentioned there would likely be further discussion on this fund at the May meeting.

Mr. Hanna then reviewed the moderate risk funds, which includes GeFONSI I and II.

He then reviewed the low-risk funds, which includes a set of bond repayment funds that can take no exposure to principal loss overtime. He mentioned that the Constitutional Budget Reserve Fund (CBRF) gets a lot of discussion both internally within the Department of Revenue as well as legislatively, in terms of appropriate sizing.

IV. IAC Comments

Dr. Mitchell commented that the staff's approach to managing these funds is very careful, logical, professional and fact based. We never know what the results are going to be, but it is really gratifying to see a very professional approach to management. He reiterated that he thinks Callan's inflation assumption is too low and to the degree that that influences the expected returns of other asset classes I would call them into question. He said that if he was asked what his inflation expectation was for 10 years, he would say four percent. He said Peter Lynch who was a great investor at Fidelity said one of the aids to investing is to just look around and if you look around, regardless of what the published inflation numbers are, you will find inflation is really higher than the published numbers. He also commented on the supply chain interruptions, stating that while they may have been rectified to some degree, they are still out there, and you could be hit with further supply chain interruptions in the future. The globalization movement that we have had for many years that has resulted in lower prices is reversing itself together with tariffs, so I just see higher inflation.

Ms. Traylor said she agreed with just about everything Dr. Mitchell said. She does not think that inflation will be quite as high as he does but agreed that Callan's was somewhat low. She asked a procedural question regarding GeFONSI II. She stated that Mr. Hanna had said GeFONSI II is invested with higher risk but that the income or loss goes to the General Fund. Mr. Hanna responded affirmatively. She then asked if they calculate the real impact on the General Fund as far as returns and what this whole scenario is doing? Mr. Hanna stated that they do, but they have not produced that, but certainly could. He explained that the General Fund is currently 1.7 billion in size out of a 2.4 billion GeFONSI I and coincidentally GeFONSI II is 1.7 billion in size as well, so it is effectively doubling the risk and return of the General Fund. It is not inconsequential.

Ms. Traylor also asked about Mr. Hanna's comment regarding no private equity. She said she thought he had previously talked about allocating a piece of the private equity portfolio that the Alaska Retirement Management Board (ARMB)'s invested. Mr. Hanna responded that these funds have never had any illiquid exposure. He said that there may have been discussions about whether that was possible. He reiterated that it was not technically possible until just a couple of years ago and there have been on and off discussions and based upon what we have seen in operation has given us a lot of pause in terms of thinking about those allocations.

Dr. Jennings said tactical bond continues to grow on him. He reiterated his inflation concern centered around housing. He said we have all heard of core inflation, there has been some recent press around the idea that inflation without including housing costs, people are actually experiencing full inflation, whatever their personal basket is. He commented that he might react skeptically to what they heard regarding the residency cost.

Dr. Jennings added that he has had three conversations with folks regarding replacing the irreplaceable Dr. Mitchell on the IAC and believes there is going to be interest.

Mr. Hanna provided a few comments regarding inflation. He said that he does find some of the dialogue between how entrenched is the Fed in that number – 2.0 percent and who is to say that is a magic number? He commented that there may be some other number that is tolerable that aligns with the "no-landing" scenario where you have inflation higher than everyone would like in some sense, while still supportive of growth at some level.

Commissioner Crum thanked everyone for the comments and expressed his appreciation to Mr. Hanna, noting that he was thankful Mr. Hanna was at the helm as CIO.

V. Future Agenda Items & Calendar Review

Mr. Hanna reviewed topics for the upcoming meeting. He encouraged the group to notify him of any things that they should consider with respect to these portfolios so they can fold them into the thought process.

The next meeting is scheduled for May 10, 2023.

VI. Other Matters for Discussion

Ms. Jones reported that they are in the process of recruiting for an Investment Advisory Council member following Dr. Mitchell's retirement. She mentioned that all positions on the IAC have designated areas of expertise and the recruitment is for someone with experience as a portfolio manager. She stated that the Request for Services is posted on both the Treasury and ARMB websites, the Alaska Online Public Notice System and also advertised in *Pensions and Investments.* The deadline for applications is March 30, 2022.

VII. Adjournment

There being no further items for discussion, the meeting adjourned at 11:43 a.m.