State of Alaska
Department of Revenue
State Investment Review Meeting
May 10, 2023

MEETING SUMMARY

Meeting Details:
Start Time: 10:30 AM End Time: 11:46 AM

Department of Revenue Staff present:
Adam Crum, Commissioner of Revenue
Zachary Hanna, Chief Investment Officer
Pamela Leary, Director of Treasury
Casey Colton, State Investment Officer
James Cheng, State Investment Officer
Victor Djajalie, 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
Nicholas Orr, State Investment Officer
Stephanie Pham, State Investment Officer
Steve Sikes, State Investment Officer
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 announced that Commissioner Crum had been recently confirmed. He welcomed the IAC members and noted that it was Dr. Mitchell's last SIR meeting as he would be retiring effective June 30, 2023.

Commissioner Crum thanked Mr. Hanna for his preparation for this meeting. He also expressed his appreciation for Dr. Mitchell's perspective and long service to the State.

II. State Investments

Mr. Hanna began with a brief market update, commenting that there had not really been any notable, market moving changes during the quarter. He touched on inflation, stating that CPI had come down from a peak of 9.1% annualized last June to 5% in March, and 4.9% in April. He added that inflation will likely remain a source of volatility and a headwind to growth.

Mr. Hanna stated that the Fed had increased the front end of the yield curve to 525 basis points (bps) to control inflation. He commented that it was not unprecedented in size, but certainly unprecedented coming off of a zero floor. The market does not anticipate any further rate increases and the impact on growth will likely determine the pace of rate decreases.

Mr. Hanna moved to fixed income, stating that fixed income investments remain exposed to further rate increases but were cushioned by much higher starting yields.

Mr. Hanna then turned to equity markets, which went through a significant correction in 2022. Both equities rebounded this year, but international remains cheap compared to domestic equities.

Mr. Hanna directed the group to the periodic table of returns on page 8. He said most of the damage occurred in the first half of the year. During the second half of the year, most equities actually had positive performance and outperformed bonds. He added that the first calendar quarter and fiscal year-to-date returns through March have been fairly strong, led by most equities.

A. March 31, 2023 Performance – Commissioner's Report

Mr. Hanna transitioned to the Commissioner's Report. He touched on page 5 of the report, which included deviations from the actual asset allocations at quarter-end, largely prior to rebalancing. He explained that most of the asset classes have 5 percent rebalancing bands. He noted that the biggest deviations were less than 1 percent and were largely due to market movement.

Mr. Hanna discussed investment returns by underlying asset class building block. Focusing on quarterly pool performance, he stated that the last quarter had positive performance across asset classes, led by domestic and international equities with performance close to 7 percent. Core bonds and tactical bonds had performance in excess of 3% and the shorter-term pools had performance over 1 percent.

Mr. Hanna touched on the performance stoplight chart at the bottom of page 6. He said the bulk of outperformance came from the fixed income pools, which are actively managed. Equity pools are passively managed, and they work to trade thoughtfully and pick up bps where they can, but it was a mixed bag for this quarter with variations plus or minus roughly 3 bps.

Mr. Hanna reviewed actual performance of each mandate and then transitioned back to the main slide deck.

B. Non-Routine Investments

Mr. Hanna explained 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.

C. FY24 Asset Allocation Discussion

Mr. Hanna gave a brief overview of the state investment policy and asset allocation process. He reminded the group that the Commissioner is fiduciary of $9 billion in assets, spanning 100+ accounts pooled into

24 funds with similar assets or mandates. At least annually, staff review each investment policy and make recommendations considering investment objectives, risk tolerances, time horizon, liquidity needs, and capacity for loss. They use a transparent process that is documented in their investment policy manual. He noted that meeting with the investment advisory committee regularly was a key part of the process.

Mr. Hanna explained staff's evaluation process and the various attributes that they examine, including efficiency and liquidity. For FY2024, staff recommends continuation of the current asset classes: US Equities, International Equities, Short-term fixed income, Broad Market fixed income, REITS, and Cash equivalents. He added that they also recommend investment in Fidelity's tactical bond portfolio for many of the higher risk portfolios. They may also consider adding some exposure to this portfolio to the moderate risk funds.

Mr. Hanna then walked through the asset allocation for each fund by risk group. He invited IAC members to offer input that staff should factor into the final recommendations that would be brought forward to the Commissioner next month.

Mr. Hanna began with the low-risk tolerance funds. He pointed out that the expected return for short-term funds, which are largely bond repayment funds that can take no real exposure to principal loss, basically doubled from FY 23 to FY 24.

Mr. Hanna explained the Constitutional Budget Reserve Fund (CBRF) is the State's rainy-day fund and needs to be liquid and largely principal protected in an extreme financial downturn. Staff is waiting for a budget to be passed to better evaluate the fund's expected size. He added that he is less concerned this year since the yield curve is downward sloping and the risk/return tradeoff is fairly well balanced among cash and bond choices.

Mr. Hanna then moved on to the moderate funds which are dominated by GeFONSI I and II. He explained pooling all these participants together allows them collectively to take some additional risk and potentially earn a higher return than cash only. He directed the group's attention to the right of the screen and reviewed alternate portfolios, noting there was only a 5 bps spread between the portfolios. Staff are likely to recommend leaving this portfolio as-is since the 15 percent exposure provides some insulation against Fed Rate decreases without too much duration and will be monitoring how the markets move over the next 6 weeks.

Mr. Hanna touched on the International Airport revenue fund which historically has followed GeFONSI I. He explained GeFONSI II is a fairly unique construct that was set up in 2018 to allow the general fund to take some incremental risk. From a cash and bond perspective it is similar to the long term GeFONSI I with a little bit of equities. Mr. Hanna explained that there was a divergence between how they set forward expectations for short and moderate funds versus how they do it for the long-term funds. For long term funds, staff uses Callan's capital market assumptions exclusively. The shorter funds are generally thought to have a one-year time horizon, and they usually set one-year forward expectations. Mr. Hanna directed the group to the far column on the State of Alaska Asset Allocation table on page 26 and thanked IAC member Ruth Traylor for requesting the information at the last SIR meeting. He said it helped to quantify the risk and reward to the general fund that accrues through its investment in both GeFONSI I and GeFONSI II. He added that this was a useful way to think about it and would be particularly useful when there is a more normal set of circumstances with an upward sloping yield curve.

Ms. Traylor commented on the additional information stating that it was perfect, and really describes the impact to the general fund.

Mr. Hanna moved to the high-risk tolerance funds. The first fund was the $733 million Retiree Long-Term-Care (RLTC) insurance fund. The fund has an actuarially set 5.25 percent earnings requirement, that is a lot lower than what is typical for a long-life endowment, so staff met with Division of Retirement and Benefits and the actuaries to discuss the fund. The RLTC has a very long-time horizon and relatively well-defined benefits that have low volatility. He reported that the actuaries are completing their every-other-year valuation and will send the forwarded projected cashflows for the fund to help staff evaluate the time horizon. He added that moving forward he thought moderating abrupt changes due to capital market assumptions is a better approach for these funds rather than having a strict return targeting approach.

Dr. Mitchell commented that he needed to leave the meeting soon and wanted to say a formal goodbye to the group. He assured the Commissioner that the funds are managed with great care, within an analytical framework, and that, in his opinion, the state funds are in very good hands.

Mr. Hanna thanked Dr. Mitchell for his comments and turned to the highest risk profile funds, which include the public schools' fund. He said that since the fund has harder inflation-proofing goals, the Department also makes recommendations annually on spending levels that should allow for long term inflation proofing. Staff also does some additional forward modeling to arrive at these recommendations each year. He then shared a few approaches for discussion.

Dr. Jennings commented that the endowments he is involved with have all moved off of five percent. He said the classic conversation is how much lower would we go? He added that they also have a fundraising function, so there is a tension there. He stated that in this case, it was more a question of what can you afford to spend, which can be a nice place to be. Lower risk return funds are dropping the real, after inflation returns down very close to 4 percent. His sense is that close to 4 percent may be hard for folks who are used to the idea of 5 percent, whereas something in the mid-4 percent range may be more palatable.

Dr. Jennings also commented that one would think that something that was supposed to be inflation proofed in the very long term would naturally gravitate towards more real assets. He said various assumptions are not finding the real assets particularly attractive, so having REITs stay at 5 percent seems reasonable and in line with what is being done elsewhere.

Mr. Hanna thanked Dr. Jennings for his comments.

Mr. Hanna then reviewed the Power Cost Equalization rule, which is used to stabilize electricity costs in more rural parts of the state most impacted by high power prices. He explained the statute was changed last year and now calls for the Commissioner to apply the prudent investor rule and invest the assets of the fund considering preservation of the purchasing power over time while maximizing expected total return. He noted that this fund has been actively discussed by the legislature this year, with the main discussion topics being the 2022 losses and a comparison between the asset allocation and the 2022 returns of this fund. He explained that State funds can not be invested in alternatives since each fund has to be able to bear its own liquidity and be subject to annual legislative changes. He added that there was pending legislation to move this fund to the permanent fund. He said that they don't like to lose assets, but ultimately it is the legislature's decision, and he did not think that they could manage the fund any differently.

Mr. Hanna then covered the Alaska Higher Education Endowment, Illinois Creek Mine Reclamation, and Education Endowment. He noted that they continue to recommend that all of these funds be invested with a 70/30 risk profile.

Mr. Hanna closed his presentation with a summary of the asset allocations with all the funds using Callan's 10-year CMAs to make them comparable. Overall, there is $9.1 in total assets and collective asset allocation based on underlying allocations is 22% equities and 78% bonds and cash. Through these optics, the overall expected annual earnings over the 10-year horizon is close to $400 million. Through the lens of short-term expectations, the expected earnings for next year is at about half a billion dollars.

IV. IAC Comments

Ms. Traylor commented that Mr. Hanna's idea of a five-year average risk for the Retiree Long-Term Care insurance fund was a great idea. She also echoed Dr. Mitchell's comment about their asset allocation process being a complete and thoughtful process. She said the Commissioner should be pretty comfortable with all the work staff put into this.

Dr. Jennings endorsed the process as well. He added that some states that reference the prudent investor rule also include a limit such as anything above 7 percent was imprudent and suggested they be mindful of that. He also mentioned that the CPI that the over 62 crowd is experiencing is still higher than five percent. He added that it was interesting that medical is not a big part of that, it is the housing. Dr. Jennings said it was worth noting that the retiree inflation that they are experience is high and the converse of that is that medical is low. He commented that this seemed to be a prudent, thoughtful approach to the State's money.

V. Future Agenda Items & Calendar Review

Mr. Hanna reviewed topics for the upcoming meeting.

The next meeting is tentatively scheduled for August 23, 2023.

VI. Other Matters for Discussion

Mr. Hanna reported that the recruitment for a new Investment Advisory Council member was proceeding on schedule and expected the Alaska Retirement Management Board would be in a position to select a candidate at the June meeting.

VII. Adjournment

There being no further items for discussion, the meeting adjourned at 11:46 a.m.