MEMORANDUM

STATE OF ALASKA
DEPARTMENT OF REVENUE
Treasury Division

To: Patrick Galvin
Commissioner

Date: June 15, 2009

From: Gary M. Bader Gary
Chief Investment Officer

Telephone: 907-465-4399

Subject: Asset Allocation Recommendations for FY 2010

Attached are my recommended asset allocations for investment funds under the stewardship and control of the Commissioner of Revenue for fiscal year 2010. Asset allocations represent the investment strategy designed to achieve the objectives of a fund while taking into account the desired expected investment return, volatility, cash flows, liquidity, and investment income of the fund. Given the objective of the fund or account, and given a set of capital market assumptions about the likely risk, return, yield, correlation, and liquidity attributes of asset classes, an appropriate asset allocation is selected. Following is a general explanation of the process used to develop our recommendations and the rationale behind them.

As you are aware, each year, the asset allocation process begins with Callan Associates, the state's investment consultant, providing staff with financial assumptions for numerous asset classes. The assumptions include: investment returns, standard deviations, and correlations for the various assets.

Usually, the Callan assumptions do not change much from year to year. However, because of the extraordinary losses and volatility in financial markets in 2008, Callan's 2009 equity return projections are generally higher than 2008. They also have lower standard deviations (risk) than 2008. For example, the 2008 Equity – Broad Market expected return was 9.00% with a 16.90% standard deviation. For 2009, the return projection changed to higher 9.48% with a lower standard deviation of 16.40%.

While the changes in expected returns for equity are mostly higher in Callan's 2009 assumptions, return projections for some fixed income strategies have barely changed. For example, the 2008 return assumption for Bonds – Aggregate was 5.25%, in 2009 it is 5.24%.

After we receive the Callan assumptions, they are then entered into an optimizer program. The resulting output is an "efficient frontier" of different asset mixes that are expected to have the highest expected rate of return for a given level of risk. Before an asset allocation is determined, the objectives of a fund must be considered. For example, in the case of funds where the objective is to invest the proceeds of bond sales pending drawdown, the strategy is to minimize the probability of investment loss. Usually, the year to year changes in the efficient frontier are small because the changes in input assumptions are small. This year is different.

Because recent Callan equity assumptions suggest that higher equity returns can be earned with lower risk, the resulting efficient frontier drives the allocation away from equities when attempting to target last year's return target. Selling equities after a large market decline places us in a position of selling equities low after we bought them high. Generally, for funds that have domestic equity allocations in 2009, except for the Children's Trust, I have focused on efficient frontiers with the same risk as last year while holding the domestic equity allocation approximately the same. The Children's Trust is set at the same target return as last year in order to reduce risk.

Historically the goals for funds such as the GeFonsi, and Constitutional Budget Reserve main account have focused on minimizing the probability of loss in one year. My recommendation continues that practice. For accounts that own equities, we used the Conservative Aggregate Fixed Income Asset Class instead of the Aggregate Bonds Asset Class. The Conservative Aggregate is a combination of 90% Barclay's Aggregate and 10% Treasuries.

Many of the funds the Department manages have such high liquidity requirements that it is necessary to invest entirely in short term fixed income. For your convenience, we have not written a separate explanation for each one of these funds, but we have attached an approval sheet which shows the current policy and the proposed policy. The short term fixed income class is expected to yield 3.03%. Following is a list of those funds.

AY03 – Retiree Health Insurance Fund (to be paid down)
AY05 – International Airport Repair and Replacement Fund
AY07 – Alaska Children's Trust Fund – Income Account
AY09 – Public School Trust Fund – Income Account
AY14 – 1999A AIA AMT Construction Fund
AY18 – 1999C AMT Construction Fund
AY20 – 1999B Non-AMT Construction Fund
AY25 – SBS Cash Transition Fund
AY28 – Investment Loss Trust Fund
AY2A – 2002 B Non-AMT Construction Fund
AY2B – 2002A AMT Construction Fund
AY2E – 2002 Series Reserve Account
AY2G – Permanent Fund Dividend Holding Account
AY2M – Accelerated Alaska Transportation
AY2N – Education and Museum Facility
AY2O – Transportation Project

AY2P – 2003A AMT Construction Fund
AY2Q – 2008 Transportation Project GO Bonds
AY2R – 2003B Non-AMT Construction Fund
AY2U – 2003 Series Reserve Account
AY2W – Alaska Sport Fish Hatchery Fund
AY2Z – Alaska Energy Authority Renewable Energy Grand Fund
AY9V – Alaska Sport Fish
AY9W – 2006A AMT Construction Fund
AY9X – 2006B Non-AMT Construction Fund
AY9Y – 2006 Series Variable Rate

For the rest of the department of Revenue funds, we have also attached a short narrative explaining the reasoning for the asset allocation recommendation. Your approval of each asset allocation is requested.

cc: Jerry Burnett, Deputy Commissioner

Attachments

AY01: FY 2010 Proposed GeFONSI Investment Guidelines

Investment Topic	**Current Policy**	**Proposed Policy**
Risk Tolerance	Moderate – Fixed Income	No change
Investment Objective	Minimal exposure to principal loss. Maximize current income within moderate risk tolerance. Minimal inflation protection needed. High liquidity requirement.	No change
Time Horizon	Short to Intermediate	No change
Other Constraints	Ongoing review of the nature and objectives of pool participants can change nature of pool or result in withdrawal of some pool participants. Significant intramonth cash flows require normalization of the pool's investment balances when evaluating compliance with investment policy bands.	No change
Asset Allocation	37% ± 8% Short-term Fixed Income Pool 63% ± 8% Intermediate-term Fixed Income Pool	43% ± 8% Short-term Fixed Income Pool 57% ± 8% Intermediate-term Fixed Income Pool 0% +6% Alaska Student Loan Note
Benchmark	37% Three-month U.S. Treasury Bill 63% 1-5 Year Merrill Lynch Govt. Bond Index	43% Three-month U.S. Treasury Bill 57% 1-5 Year Merrill Lynch Govt. Bond Index

The approved policy for the General Fund is effective July 1, 2009.

Approved

7/17/09
Date

GeFONSI

Rationale

The General Fund constitutes the largest element of the GeFONSI. Much of the money in the fund has been appropriated and a material loss could affect the state's ability to fulfill its obligations. Treasury expects much of the money in the pool to be spent in less than one year. Accordingly, the allocation should allow minimal exposure to principal loss. Equities are not recommended for the GeFONSI.

Over the past year the U.S. economy has been anemic. Recently, fiscal and monetary policy has been directed at stimulating the economy. With 10 year treasuries currently yielding less than 3.8%, the potential gains from further decline in interest rates appears limited. It is therefore recommended that the asset allocation of the GeFONSI be weighted toward fixed income securities with a maturity of five years or less. Accordingly, as done last year, the asset allocation was constrained to restrict investments in the Broad Market Fixed Income Pool.

Effective July 1, 2009 Treasury's recommended asset allocation for the GeFONSI is 43% Short-term Fixed Income and 57% Intermediate-term Fixed Income investments. The allocation is estimated to provide an expected return of 3.60% with a probability of a loss over a one-year period of 2.52%.

AY19: FY 2010 Proposed CBRF Investment Guidelines
Main Account

Investment Topic	Current Policy	Proposed Policy
Risk Tolerance	Moderate – Fixed Income	No change
Investment Objective	Moderate exposure of principal loss in return for higher expected longer-term returns. Limited current income requirement. Moderate inflation protection needed. Increasing liquidity requirement.	No change
Time Horizon	Intermediate	No change
Asset Allocation	20% ± 8% Broad Market Fixed Income Pool 75% ± 8% Intermediate-term Fixed Income Pool 5% ± 5% Short-term Fixed Income Pool	20% ± 8% Broad Market Fixed Income Pool 71% ± 8% Intermediate-term Fixed Income Pool 9% ± 5% Short-term Fixed Income Pool
Benchmark	20% Barclays US Aggregate 75% Merrill Lynch 1-5 year Govt. Bond Index 5% Three-month U.S. Treasury Bill	20% Barclays US Aggregate 71% Merrill Lynch 1-5 year Govt. Bond Index 9% Three-month U.S. Treasury Bill

The approved policy for the Constitutional Budget Reserve Fund main account is effective July 1, 2009.

Approved

6/30/09
Date

Constitutional Budget Reserve Fund

Rationale

The investment policies for the Constitutional Budget Reserve Fund (CBRF) have changed over the years as the balance and the expected uses of the CBRF have changed. Though the price of oil is currently hovering around the $70 per barrel level, declining production and the inconsistency of future prices is still a concern. The CBRF is the state's "savings account" and as such is responsible for covering fluctuations in the general fund.

Intermediate term financial planning by the administration and the legislature is highly dependent upon a reasonably predictable CBRF balance.

With the 10 year treasury currently yielding 3.79%, and the 3 month Tbill yielding 0.17%, it is recommended that the asset allocation of the CBRF favor fixed income securities with a maturity of five years or less. Accordingly, the asset allocation was constrained to restrict Broad Market Fixed Income Investment Pool to no more than 20% of the fund. In addition to controlling the risk associated with investment in longer term fixed assets, the transaction costs associated with moving investments from one pool to another will be minimized.

The recommended asset allocation has a 1 year expected total return of 4.18% with a probability of 8% that the account will experience a negative return for the year.

AY10: FY 2010 Proposed CBRF Subaccount Investment Guidelines

Investment Topic	Current Policy	Proposed Policy
Risk Tolerance	High (Required by statute)	No change
Investment Objective	High exposure of principal to loss in return for higher expected longer-term returns. Limited current income requirement. Limited inflation protection needed. Moderate liquidity requirement.	No change
Time Horizon	Moderately Long	No change
Asset Allocation	36% ± 7% Conservative Aggregate Pool 44% ± 7% Domestic Equity Pool 19% ± 5% International Equity Pool 1% - 1%/+3% LEI+ Mandate 0% + 2% Short Term Fixed Income Pool	35% ± 7% Conservative Aggregate Pool 44% ± 7% Domestic Equity Pool 20% ± 5% International Equity Pool 1% - 1%/+3% LEI+ Mandate 0% + 2% Short Term Fixed Income Pool
Benchmark	36% Barclays US Aggregate / Barclays Treasury (90%/10%) 44% Russell 3000 Stock Index 19% Morgan Stanley Capital International (EAFE) 1% 1 Month Libor + 500 Basis Points	35% Barclays US Aggregate / Barclays Treasury (90%/10%) 44% Russell 3000 Stock Index 20% Morgan Stanley Capital International (EAFE) 1% 1 Month Libor + 500 Basis Points

The approved policy for the Constitutional Budget Reserve Fund subaccount is effective July 1, 2009.

Approved

6/30/09
Date

Constitutional Budget Reserve Fund (Sub-Account)

Rationale

The legislature directed that "in establishing or modifying the investment policy for the sub-account in the constitutional budget reserve fund, the commissioner of revenue shall assume that those funds will not be needed for at least five years." To comply with the legislative directive, the asset allocation of the sub-account is targeted at the same 10.78% projected risk as last year. The one year probability of a negative return is 23.26%

The asset allocation was constrained to asset classes where a public equity market existed to provide liquidity. Asset classes such as real estate and private equity were avoided due to the possibility investments in those assets frequently require an investment horizon greater than five years.

The recommended asset allocation for the Constitutional Budget Reserve Sub-Account is 35% conservative agg fixed income, 44% domestic equity, 20% international equity, and 1% LEI+ Mandate. This asset mix has a one year expected rate of return of 7.87%. There is a 5.12% chance that over a five year period the fund will have a negative return.