

MINUTES
SENATE FINANCE COMMITTEE
January 28, 2005
9:06 a.m.

CALL TO ORDER

Co-Chair Green convened the meeting at approximately [9:06:11 AM](#).

PRESENT

Senator Lyda Green, Co-Chair
Senator Gary Wilken, Co-Chair
Senator Con Bunde, Vice-Chair
Senator Bert Stedman
Senator Donny Olson
Senator Fred Dyson

Also Attending: GARY BADER, Chief Investment Officer, Treasury Division, Department of Revenue; MELANIE MILLHORN, Director, Department of Administration; TOM BOUTIN, Deputy Commissioner, Department of Revenue; BILL CORBUS, Commissioner, Department of Revenue

Attending via Teleconference: From Offnet Sites: SENATOR LYMAN HOFFMAN; CHRIS BURNS, Actuarial, Mercer Human Resource Consulting

SUMMARY INFORMATION

Department of Revenue: Roles of ASPIB & Treasury Division
Department of Administration: Tier Redesign Project Report

The Departments and the State's actuarial consultant answered Committee questions regarding the Alaska State Pension Investment Board, the Public Employees Retirement System, the Teachers Retirement System, and the Tier Redesign Project.

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Department of Revenue:
Roles of ASPIB & Treasury Division

Department of Administration:
Tier Redesign Project Report

This was the second hearing regarding these presentations in the Senate Finance Committee.

Co-Chair Green announced that the purpose of today's meeting is to provide Members the opportunity to ask questions regarding the previous day's presentations. She noted that Chris Burns, an Actuarial Consultant with Mercer Human Resource Consulting, would be participating via teleconference in lieu of Mercer actuarial Bob Reynolds, who was unavailable due to unforeseen circumstances.

Senator Stedman asked for further information pertaining to the Alaska State Pension Investment Board (ASPIB) investment policy utilized by the Department of Revenue; specifically how that investment strategy interfaces with Mercer Human Resource Consulting's actuarial determinations.

GARY BADER, Chief Financial Officer, Treasury Division, Department of Revenue, recounted previous day's testimony in that ASPIB utilizes "strategic allocation" investment strategy. This strategy reviews "the asset classes and their probable rates of return and variation over the long run." This approach differs from the "tactical asset allocation" investment strategy, "a far more active strategy" in which people in the market attempt to assess "the relative value of stocks, bonds, and usually, cash." While the Tactical Asset Allocation strategy, which has a "large component of market timing", has existed for years, the number of investment managers utilizing it has declined over time because this approach "has not worked." The Strategic Allocation approach utilized by ASPIB and most pension funds "does not try and time the market" and make estimations of the relative values of the different asset classes. When ASPIB annually establishes its asset allocations, "it usually does not vary much from one year to the next." Once the allocations are set, the Division's Chief Investment Officer is instructed, "to stay with the asset allocation unless its gets too far away from the target return." In addition, ASPIB might dictate the amount of the investment portfolio that could be invested in different asset allocation classes. For example, large cap stocks might account "for 30 percent of the portfolio plus or minus three percent." In summary, the asset allocation action is conducted strategically, is not timed to the market, and does not "guesstimate" which direction the market might move.

Mr. Bader stated that the actuarial earnings assumption put forth by the actuary, Mercer Human Resource Consulting, is presented to the PERS and TRS Boards for consideration each year. The actuary assumption is based on historical rates of returns. In addition, the actuary would apply "a reasonable test" to the assumptions that

might be adopted by the Boards.

Senator Stedman commented that, while the presenters and the Members are familiar with the acronyms being used, for clarity, terms should be defined by name.

Senator Stedman understood that the Division and Mercer's procedures align in that both utilize historical look-backs regarding asset allocations and returns. Furthermore, the fact that the State has such a large liability is a reason for not utilizing market timing. He noted that, in addition to setting a target rate, Mercer must develop some "sort of market allocation." He asked whether a target rating is developed in that regard.

Mr. Bader understood that Mercer is anticipating a real rate of return of 4.75 percent plus an inflation assumption of 3.5 percent. ASPIB has specified a five-percent real rate of return. "They are very close to each other." Were ASPIB to continually seek a return of 7.6 percent "and Mercer always anticipating that we would get 8.25 percent, there would be a mismatch of liabilities and assets that would go even farther if this persisted over a long period of time." Approximately ten years ago, Callan Associates had projected a 3.75 percent inflation return. Callan Associates rates are sometimes below and sometimes above those of Mercer. He reminded that there are two different investment horizons at play: Callan Associates utilizes a five-year investment horizon and Mercer utilizes a 25 to 30-year horizon. Callan Associates has been requested to prepare an efficient frontier analysis with an 8.25 percent asset allocation with the recommendation that the Division's Investment Advisory Council members and the consultant review that analysis when completed. Were they to determine that the standard deviation or the variation of returns was an acceptable level, then ASPIB should review "and perhaps adopt an 8.25 percent return."

Senator Stedman asked that Members be provided a copy of the report when that exercise is concluded, as "it is important for the Legislature to understand the magnitude of the risk level in dollar terms." Dollar terms as opposed to statistical terms "are easier for most people to understand" when referring to such things as standard deviations.

Co-Chair Green agreed that there is an intimidation factor relating to financial investment jargon. In that regard, she asked whether something akin to "an Investment 101 glossary" might be available regarding such things as strategic asset and tactical asset allocation investment strategies.

Mr. Bader disclosed that an introductory program has been developed by the Department of Revenue for new Board members. In addition, new Board members are invited to spend a day with the Department's Treasury Division to further learn about the process. Some of this material could be made available.

Co-Chair Green acknowledged.

Mr. Bader noted that, as requested by Senator Stedman, a report in dollar terms has been developed. Handouts titled the "Range of Returns (in dollars) and the "Historical Returns for PERS and TRS (Fiscal Years)" [copies on file] were distributed.

Senator Stedman asked whether there are any negatives to the State's policy to fully fund the ASPIB system.

Mr. Bader recalled that a [unspecified] chart discussed the previous day in the Department's presentation, depicted that the funding ratio would lower in approximately 25 years.

CHRIS BURNS, Actuarial Consultant, Mercer Human Resource Consulting, testified via teleconference from an offnet site and commented that, in 2002, there was a "reset" of the Past Service Rate, which is one of the components of the contribution rate paid each year by employers. This reset resulted in the total unfunded amount being amortized over 25 years. The unfunded amount drop reflected in the year 2002, as depicted on the [unspecified] graph, is representative of the initial unfunded amount "being completely paid off."

Senator Stedman asked for further explanation.

Mr. Burns expressed that in the year 2002, it was established that the entire unfunded liability of the systems' amount would be paid off over a 25-year period.

Senator Stedman asked whether policy discussions have included a funding scenario that would fund the systems' unfunded liability to a zero balance by having "a balloon payment at the end." This would have the affect "of lowering the contribution rate for several years into the future and allow more time for the State and municipalities to adjust to the financial impact."

Mr. Burns voiced being unaware of any such discussion.

Senator Bunde asked the reason the PERS system's five-percent "smoothing mechanism" that limits the maximum employer contribution increase to five percent is not uniform to the TRS system. In

addition, he asked whether Mercer might recommend that this limitation be expanded to the TRS system or be eliminated from the PERS system. He understood that the Retirement Boards, which consist entirely of beneficiaries of the retirement system, "basically employ experts to advise them regarding investments." The experts provide recommendations to the Board, to which "the laymen" on the Board "could choose which of the recommendations, if any, to implement."

Mr. Bader responded that while the Board could vary from the recommendations, "they typically do not..."

Senator Bunde stressed however, that they could. The question is, "whose advice should they follow, laymen who are beneficiaries of the program or investment experts." He suggested that this is an area that should be reviewed.

Mr. Bader responded that the ASPIB Board members include the current and former Commissioners of the Department of Revenue and a finance officer from a municipality. The Board "is not devoid of financial expertise."

Senator Bunde summarized that the Board includes two political appointees and one financial person.

Co-Chair Green asked, for clarification, whether this Board member discussion was relevant to the PERS/TRS Boards or the ASPIB board.

Mr. Bader replied that his comments pertained to the ASPIB Board.

Senator Bunde had understood the discussion to regard the PERS/TRS Boards.

Co-Chair Green asked that information regarding the differences in the membership of the various boards be provided to the Committee.

Senator Bunde additionally asked each Board's process regarding the actuarial advice; specifically whether the laymen on the Board might or might not follow that advice.

MELANIE MILLHORN, Director, Division of Retirement and Benefits, Department of Administration, informed the Members that the five-member PERS Board consists of two members "elected by the membership" and three members appointed by the Governor." All five members of the TRS Board "serve at the pleasure of the Governor."

Ms. Millhorn stated, in response to the question regarding how the Boards' utilize the actuarial consultants' advice, that the Boards

review "the assumptions that underlie the actuarial valuations." Approximately every four or five years "a very in-depth study" occurs in which each actuarial assumption and the actual experience of the system is reviewed, and the components are "recalibrated". For example, when the most recent review of the investment return was conducted in the year 2000, it was determined that that the investment target of 8.25 percent "was still an accurate investment option."

Ms. Millhorn asserted that "there is Board interaction and they do take the advice of their consultants." Defined Benefit Plan systems "commonly" have an actuarial consultant advise them on their assumptions, recalibrate the assumptions, and conduct an audit process. The actual experience of the program is a factor and adjustments are made, "as needed, because they are looking at a historical look-back. They don't have the modeling to say that this is what we are expecting in the future. There is more reliance on their past historical experience when looking at that information."

Ms. Millhorn pointed out that, as reflected on page 21 of the "State of Alaska PERS & TRS Tier Proposals Senate Finance" handout [copy on file], the TRS Board had not followed the advice of the Mercer actuarial assumptions for a period of nine years, and, during those years, up to a seven-percent deviation occurred between the actuarial calculated rate and the adopted rate. Each one percent deviation between the actuarial calculated rate and the adopted rate represents 5.5 million dollars. The investment return during this time period was much higher during this time period. However, because the system had not adopted the recommended rate, the reduced investment return during those years "had the consequence of putting them in a further under-funded status. And then in the last years, while they adopted a rate that may have been a little bit higher than what the actuary recommended, those were years when there was a downturn in the market, and so they were really losing ground in that process."

Ms. Millhorn noted that the Boards do ask the actuary during experience studies and at other times when assumptions are changed, what might occur, for example, were the system, by policy, to adopt a funding status lower than 100 percent when the targeted ratio was 102 percent. The actuarial consultant would model that scenario and show "that if you do this, this is what's going to happen." She mentioned that the Board adopted the recommendation to change the mortality table in the year 2000.

Senator Bunde declared a conflict of interest in that he is a retired teacher.

Co-Chair Green clarified that while Senator Bunde might be a retired teacher, he is not a member of the TRS Board.

Senator Bunde concurred. Continuing, he summarized that the TRS Board, which could consist of a group of laymen who are beneficiaries of the System, might seek the advice of experts and then might choose to accept "some of the advice, none of the advice, all of the advice, or some version of the advice and that's the final decision."

Ms. Millhorn concurred.

Co-Chair Green asked whether there are organizational charts available that would reflect the PERS/TRS Boards' interaction with the Department of Administration and the ASPIB Board's interaction with the Department of Revenue, as well as the relationships between the two Departments and the three Boards. She questioned whether improved communication between the groups might be beneficial.

Ms. Millhorn responded that an organizational chart would be provided.

Co-Chair Wilken informed the Committee that the PERS Board's vote regarding the establishment of a new tier was two-to-two with one member absent and the TRS Board vote was two-to-three against it. It should be noted that, in both instances, the Board members who served on the Tier Redesign Project, voted in support of it. He asked that background information on the ten Board members be provided.

Co-Chair Wilken, referencing the Department of Revenue's ASPIB handout "Combined Schedule of Invested Assets" [copy on file], asked whether some efficiencies might be realized were the Permanent Fund Corporation to manage PERS, TRS, and ASPIB investments.

TOM BOUTIN, Deputy Commissioner, Department of Revenue, responded that, "the statutory authority for the ASPIB is different than statutory authority for the Permanent Fund."

Co-Chair Green asked whether there is "a prohibition" to allowing the Permanent Fund Board to take this action, were the Statute changed.

Mr. Boutin responded that, "it could be done statutorily."

Mr. Boutin recalled hearing numerous discussions regarding

"different potential efficiencies in the investment of State money". These discussions extended beyond the money invested by the Treasury Division and the Permanent Fund to include the assets invested by different State agencies, independent corporations, and instrumentalities of the State government. Furthermore, the opinion has been expressed "very often that there is some safety in having a diversification of the investment responsibility." This should be tested against possible efficiencies including the potential "for lower management fees, which is the primary efficiency cited. In the analyses that he has studied, "the efficiencies didn't seem to be there because money management contracts throughout the industry are based upon the amounts invested and the performance." The determination "as to whether there is safety in diversification or not is a more subjective kind of thing."

Co-Chair Wilken countered that increasing the amount of money managed by the Permanent Fund Board from the current \$29 billion to \$49 billion "would not make much difference." It could however, enhance the State's buying power in the market.

Mr. Boutin pointed out that "the Permanent Fund has one mandate and that is to maximize the returns of the one fund, and they have one cash outflow a year" in that funds are provided to the Department of Revenue to be distributed as Permanent Fund Dividends. The money in the 27 different funds invested by Treasury and the money in the PERS/TRS systems "have regular cash flows, as does the general fund. So these are pretty different mandates." The degrees of complexity at the Treasury Division are not experienced at the Permanent Fund.

Co-Chair Wilken noted that, in response to his question regarding which employers had responded to the Tier Redesign Survey, Ms. Millhorn had provided his office a 25-page Department of Administration report [copy not provided]. He understood from the report that while the Fairbanks North Slope Borough had responded, the Fairbanks North Slope Borough School District had not.

Ms. Millhorn clarified the meanings of the colored highlights on the report in that a yellow line indicated that the employer had responded either fully or partially; a green line denoted that the employer had communicated that they had chosen not to participate; and a white line indicated that no response, in any form, had been received. She agreed that the chart legend was unclear.

Co-Chair Wilken acknowledged the clarification and corrected that the Fairbanks North Star Borough had not responded and that the Fairbanks School District had responded either fully or partially.

Co-Chair Wilken voiced concern that, "due to things that have happened in the system," the PERS employer contribution rates, which have averaged between six and ten percent, would increase to 30 percent, and, in the TRS system, the employer contribution rates would increase from an average of ten to twelve percent up to 50 percent. Elevated rate levels are projected for at least the next 20 years in order to allow the systems "to play catch-up for something that happened" in the past. The question is, "What happened?" Noting that 75-percent of the funds in the PERS/TRS systems result from investments, he observed that that side of the equation has tracked close to projections. It exceeded expectations for seven years; dipped below expectations in 2000; and is now on target again. Everything in this regard, "has been tracking very well." Therefore, if the problem is not due to the investment side of the equation, he asked, "what did happen" in the systems.

Co-Chair Wilken noted that the remainder of the funds' balance, 25-percent, is attributed to Employer Contributions. Referencing the chart on page 15 of the "State of Alaska PERS & TRS Presentation to the Alaska Legislature" [copy on file], he observed that, since the current under-funded situation is not the result of the system's investments from 1987 to today, the problem causing the increase in the employer contribution levels must be elsewhere. The PERS Board had closely followed the recommendations of the actuary and, in only three out of 17 years had they adopted rates below those recommended by the actuarial; two of those being the two most recent years. The PERS Board "toed the line, made tough decisions and stayed with it." In contrast, the TRS Board adopted a lower employer contribution rate than was recommended by the actuarial 12 out of 17 times; "they punted and they did not make the tough decisions and they under-funded ... sometimes by as much as eight points." "That explains why TRS is being asked to go from ten to 50 while PERS is being asked to only go from six to 30."

Co-Chair Wilken stressed, however, that this does not provide the answer to the question, "how did we get to where we are today?" Were neither the investments nor the Employer Contribution Rate levels "with the exception of TRS", the reason for the unfunded liability, he asked what factor has negatively affected the system to the degree that would require Employer Contribution rates to increase dramatically for the next twenty years. He noted that the Legislature was initially briefed on this situation in March 2004. While the reason for the current situation is unclear, it must be addressed in order to prevent this scenario from being "a burden on the next generation of Legislators and payers ... in Alaska to fund this sort of contribution." He concluded that, "he cannot make the dots connect on how we got to where we are today." With the exception of the Employer Contribution Rates adopted by the TRS

Board, "the rules seemed to have been followed for the past 17 years."

Mr. Bader explained that in approximately 1992, an automatic Post Retirement Pension Adjustment (PRPA) that was included in legislation enacting Tier 2 changed the TRS Pension Formula. While Tier 2, over a long period of time, would result in savings over what Tier 1 employees receive, "its initial impact to the system was that there would be an annual post retirement pension adjustment given to retirees." The Administration and the Legislature understood that there would be a big spike in the Contribution Rate. However, while the TRS Board was fully aware of the situation, they adopted a 12-percent rate for a series of years, due to their "not wanting to cause massive layoffs in the school districts around the State." The actuary agreed, "that this was a sound way to do it ... to set it at 12-percent and maintain it for several years until the indebtedness was paid off." The rate was reduced to 11-percent in 1999 when that debt was paid off. It was at this same time "that the stock market tanked and all the actuarial assumptions were revised." The actions of the TRS Board would not appear as bad were one to remember what happened in approximately 1992.

Mr. Bader apologized that he could not provide an answer to the question as to the reason for the four-fold increase in the Employer Contribution Rate.

Senator Stedman referenced the Department of Revenue handout titled "Cumulative Performance Relative to Target" chart [copy on file] and commented that the chart is not an actual depiction of where the systems are, as, from viewing the chart, it would be expected that the systems "would be 100-percent fully funded." Therefore, he questioned whether it might be the weighting or the timing of the cash flows that distort the information.

Mr. Bader clarified that the intent of that chart was to depict how the returns of the system perform relative to the Actuarial requirement. He believed that the funds would have been close to being fully funded "if the Employer Contribution Rate had been held to its level" and no "substantial changes in Actuarial Assumptions" had occurred in the year 2000." The combination of changes in assumptions and low contribution rates conjoined "to create this environment."

Senator Olson inquired as to whether any safeguards are in place through which to protect the systems from future significant market fluctuations.

Mr. Bader responded that the investments could be protected were such things as "a very conservative asset allocation" implemented by placing all of the funds into United States Treasury securities. However, this low-risk approach would require higher contributions to the system.

Senator Olson asked whether other safeguards such as directing the consultants to alert the Boards when significant problems were foreseen or a significant decrease in funding were occurring. The stock market has such safeguards.

Mr. Bader was unaware of any safeguards.

Senator Bunde understood that the PERS/TRS Boards review the entirety of information provided to them prior to making their determinations. Therefore, it could be stated that what the Boards are doing is market timing.

Ms. Millhorn opined that the Boards "do follow" the actuarial consultants' counsel. After studying the process, her understanding is that actuarial reports are "their very best guess at what they believe will happen based on the different assumptions." The information provided by the actuarials "is their very best professional statistic analyses," based on other national situations, and the multitude of statistical information that is utilized in the modeling. They provide this information and their "very best recommendations" to the Boards. At times, the assumptions utilized are inaccurate and are updated. The adoption of a new mortality table in the year 2000, which added approximately 2.9 years to the 28,000-member population, added 8.5 percent to the Employer Contribution Rate burden. This is significant in that there has been a ten-percent rise in health care costs over the past decade. The cost consequences of the increase in mortality rate are added to the system's liabilities. A variety of factors contribute to the systems' under-funded status, as detailed on page seven of the Department of Administration handout titled, "State of Alaska PERS & TRS Presentation to the Alaska Legislature" handout [copy on file], a variety of factors including health care costs and demographic experience, contribute to the systems' under-funded status, and there is impact when a variety of the factors change simultaneously in a three year period.

Senator Bunde opined that similar information is also available to individual investors who are market timers. "Sometimes you guess right and sometimes you guess wrong."

Co-Chair Wilken, recognizing that the benefit of having 20/20

hindsight could not be ignored, stated that the continuing position that the decline in the stock market is the reason for the unfunded liability for the systems is unfounded, as "the record does not show that." He stated that the investment component that contributes 75 percent of the systems' funding should be removed from the equation as the information on page 15 and page 16 of the aforementioned handout indicates that "while the stock market had something to do with it", it did not cause the employer contribution rate to quadruple for the PERS system or to increase six-fold in the case of the TRS system for the next 20 years.

Co-Chair Wilken stated that the information on page 15 depicts that from 1987 through the year 2004, the actual return was less than the return assumption only four out of 17 years. Two of those years, 1991 and 1994, were miniscule amounts. The significant lower years were in 2001 and 2002 when the expected return was 8.25 percent and the actual return for 2001 was minus 5.25 percent. "That is a fourteen-point swing and that is significant." However, the question is whether the investment side of the equation was significant enough to affect the system to the degree reflected for twenty years out. He argued that the investment side should be set aside as it is not the cause of the current situation.

Mr. Bader agreed. He clarified that his comment regarding the stock market's decline in the year 2000 was coincidental to the time the problem with the systems was discovered. He stated that both he and the actuaries would agree that the stock market "was not the reason for this problem."

Co-Chair Green asked therefore whether medical expenses should be the focus of the problem.

Mr. Burns commented that while the investments played a role, the higher than expected trend in health care expenses had a substantial impact on the systems. The health care assumptions were reset in 2002 to more accurately reflect what was thought to be future experience. "The best indicator of future experience is past experience."

Co-Chair Green understood that there is a difference between the PERS and TRS health systems in that the TRS system is self-insured and as such has "conducted a more aggressive front line review of medical needs, etc." There is an investment by the participant to keep that program whole.

Senator Stedman furthered Senator Olson's remarks regarding whether "some floor or exit" or protection strategies could be considered to protect the portfolios. However, he understood that the

Strategic Asset Allocation policy adopted for the management of the fund does not allow this; "it ignores short term market fluctuations in the market and utilizes longer term averages and correlations..." Unfortunately, there have been periods of time in which the market had experienced some "unfavorable" returns.

Mr. Bader concurred with Senator Stedman's definition of the investment strategy.

Senator Stedman asked for confirmation "that there is no market timing going on."

Mr. Bader provided that assurance.

Senator Stedman summarized therefore that the State's adopted asset allocation strategy policy "doesn't allow for market timing."

Senator Olson asked whether changing the investment policy to a Tactical Asset Allocation strategy might be considered.

Mr. Bader responded that this could be done. There are Tactical Asset Allocation managers' however "their record is not good." He noted that, "there is a way to set a floor on losses. You can probably enter into an agreement with Wall Street firms to swap your returns and they'll guarantee a certain rate of return, kind of like portfolio insurance. But it turns out to be very expensive. They only do things if they are going to make a profit. There is a way to do it but it would be very expensive."

Senator Olson asked whether steps or policies are being considered, other than the establishment of another tier, to prevent this unfunded liability burden from re-occurring in the future.

Ms. Millhorn responded that the "three levers that are available as a policy matter" include: putting additional funds in to the system to pay off some or all of the unfunded liabilities; to reduce benefits going forward through such means as the development of a new tier; and, "to have higher than expected targeted investment income returns over some period of time." While the third lever is possible, few investment analysts would view this as being "probable."

Senator Bunde clarified that the establishment of a new tier would not result in reducing the benefits provided to current employers. The State Court system has ruled that retirement contracts could not be changed once a person becomes vested.

Ms. Millhorn affirmed that Article 12, Section 7 of the State's

Constitution "protects those members' benefits from being diminished or impaired."

Senator Bunde asked whether the legal opinion also established that medical benefits, "which are a large portion of this problem ...could not be changed for current members of the system."

Ms. Millhorn affirmed that existing members' medical benefits are protected. An Alaska Supreme Court decision issued in the year 2001 addressed this issue. She noted that while this decision was remanded to the State Superior Court, the reason was "just for remedy. They have determined that those medical benefits are protected."

Co-Chair Green understood that it would be permissible for the benefits to be changed "as long as they were not diminished."

Ms. Millhorn clarified that the Court ruled that changes to the plan or increases in the benefits could be made provided that the proposed increases and decreases "must be offset" with the end result of the redesign being neutral.

Senator Bunde expressed that comparing this system to the plight of the federal social security program might be inappropriate, as this system would not "go broke." In addressing the three levers suggested to address the problem, he opined that the stock market is highly speculative, and since the benefits for current employees could not be changed, the only way to address benefits would be to establish a new tier. "And the central issue then will be, still, increased contributions."

Co-Chair Wilken turned attention to the aforementioned information on page 15 and asked whether the PERS system would have been fully funded were the difference in the actual computed rate and board adopted rate for the depicted 17 years, zero.

Ms. Millhorn informed that the Department has requested Mercer to prepare this information, and once completed, the information would be provided to the Committee.

Co-Chair Wilken asked whether his perspective of the situation is "somewhat right."

Mr. Burns responded that there are "two components to being fully funded: one is the liabilities and one is the assets." The alignment of the actuarial computed rate and board-adopted rate would only pertain to the asset side of the equation. "The liabilities, on the other hand, have increased more than expected"

since 1987 due to such things as changes in assumptions and increased medical expenses. Therefore, the response to Co-Chair Wilken's question "is no, but not necessarily because of the asset component but because of the liability component."

Co-Chair Wilken asked whether it is the actuarial's responsibility to review the liability component and make recommendations to the State in regards to what contribution levels should be charged.

Mr. Burns responded yes; however, he reiterated that actuarial assumptions are reviewed approximately every two or three years, and were it determined that the "data has changed," the actuarial assumption would be changed at that time. While future experiences are forecast based on past experience, "the future experience does not always occur."

Co-Chair Wilken stated that he looked forward to receiving the requested report.

Senator Stedman asked for further information regarding the methodology utilized in arriving at the 8.25 percent investment target rate with a 3.5 percent inflation assumption imbedded in the total.

Mr. Burns responded that, in general, both past experience and return expectations are considered in the asset return assumption. Several reviews conducted by Mercer and other independent auditors have supported the continuance of the 8.25 percent rate.

Senator Stedman understood that there are different asset groups to which different weights and asset strategies are applied.

Mr. Burns affirmed that the asset strategy and allocation is taken into consideration.

Senator Stedman stated that further information in this regard would be appreciated, as he would "like to compare it to the strategy that is implemented." Continuing, he asked for an explanation of the Department of Revenue handout titled "Range of Returns (in dollars)" [copy on file], as he is attempting to determine "how much risk is associated with this endeavor. Clearly, as expressed by Co-Chair Wilken, there is substantially more risk assumed than a lot of people anticipated."

Mr. Bader stated that the "Range of Returns (in dollars)" handout was developed to further define the "1-Year Range of Return Comparison" graph on page 22 of the "Alaska State Pension Investment Board Presentation to the Senate Finance Committee The

Role of ASPIB and the Treasury Division" handout [copy on file]. The graph, which was developed by Callan Associates, depicts "percentile probabilities of having different returns "relative to the medium rate of return. The medium rate of return in the exemplar was 7.84 percent, and the graph depicted that achieving a rate of 23.94 percent "would only happen about ten percent of the time." The handout depicts these percentile probabilities in terms of dollars as they relate to the PERS system. Were the rate of return to be in the 10th Percentile one year, the system would profit by approximately two billion dollars. Conversely, half a billion dollars could be lost were the rate of return to be in the 90th Percentile.

		Range of Returns (in dollars)	
		PERS	TRS
		\$8,185,108,000	\$3,913,423,000
	Proposed	Gain/(Loss)	Gain/(Loss)
10th Percentile	23.94%	1,959,514,855	936,873,466
25th Percentile	16.03%	1,312,072,812	627,321,707
Medium	7.84%	641,712,467	306,812,363
75th Percentile	0.22%	18,007,238	8,609,531
90th Percentile	-6.17%	(505,021,164)	(241,458,199)

Senator Bunde understood therefore that there would be a ten percent chance of achieving a 23 percent rate of return and a ten percent chance, rather than a ninety percent chance, of achieving a minus-six percent rate of return.

Mr. Bader affirmed.

Senator Stedman asked whether the asset allocation information presented during the previous day's meeting was developed by Callan Associates or by Mercer Human Resources Consulting. He understood that Callan Associates developed the standard deviation information.

Mr. Burns responded that Callan Associates developed the asset allocations presented.

Senator Stedman stated therefore that Callan Associates developed "the 8.25 percent target, but not the portfolio."

Mr. Bader expressed that the "Range of Returns (in dollars)" exemplar depicts that Callan Associates' efficient frontier would earn 7.84 percent.

Senator Stedman asked whether Callan Associates' allocation mirrors

the portfolio allocation of the asset classes.

Mr. Bader replied, "Yes, it is, within the bands approved by the Board. It would never be right on target."

Senator Stedman asked the effect of being "on the left side of standard deviation for four years, in regards to the fund's assets and the contribution rate. In other words, he is attempting to determine how much risk is inherent in the portfolio and the upward pressure it might exert on the contribution rate depending on whether a tight dispersion or a wide dispersion exists.

Mr. Bader responded that the aforementioned presentation included three exemplars depicting the range of returns for one-year, five-years, and ten-years, on page 22, 23, and 24, respectfully. He stated that the ten-year Range of Return Comparison "would not have that dispersion." The longer the term, the closer one would get in obtaining the target.

Senator Stedman acknowledged. He suggested that were the three exemplars depicted in dollars rather than in statistical terms, it would be easier to determine how much downside risk there is.

Mr. Bader replied that he would work with Senator Stedman in this regard.

Senator Dyson voiced appreciation for the discussion, particularly in regards to Co-Chair Wilken's questions. Were the problem to include other factors besides the collapse of the equities market, he asked whether it would be fair to say that the funds' managers "failed to anticipate the increases in the liability both on the health side and the number of participants and failed to alert or make the changes in the contribution rates, several times over in the past."

Ms. Millhorn responded that, "the way that the system works is that that actuarial valuation will go each year and measure the assets for the system and the liabilities for the system. That is the process that we have in place. They are using the actual experience and then they are calibrating that against their assumptions in making those changes. There are liabilities that were taken into the system beginning in 2000 through 2003 through some assumption changes. That happens on an annual basis and there's not a process where Mercer will say or anticipate in advance that there would be a downturn in the market or that mortality tables will be changed prospectively. It happens at a set point in time and that's when that assumption is adopted. That's when those liabilities are taken into" the various systems. Rather than being prospective in making

the changes to the system and anticipating what the market would do, the process is more of a forecasting or "best guess" based on historical experiences. "The forecasters do not have a crystal ball to know what the health trend is going to be exactly." This is how defined benefit packages are managed nationally.

Senator Dyson stated that while the comments are that there is no look forward, the chart appears to reflect that the adjustments were made to fit the reality. The point is that the assumptions for the future are made and adjusted based on historical data. However, he pointed out that "there are few people in North America that didn't understand that health costs have been going up more than linear, and it would seem to me that the mathematical model of the number of people who are retiring can't have much of an error margin in it." In conclusion, he asked, "What went wrong" and how could we avoid this scenario in the future.

Ms. Millhorn acknowledged the comments and replied that the convergence of numerous factors created this situation. It is recognized "that the health cost trends are volatile" and would be reviewed annually, going forward, instead of every three or four years.

Senator Dyson expressed that, 20/20 hindsight aside, competent experts in this field should have foreseen the situation. He suspected that what occurred "was that people were robbing the future to avoid the pain of very difficult decisions in the past." While he understood that, "it really is an irresponsible position that we have been in." We must "create an environment in which distress flags" that force us to make decisions, could be raised without fear. He asked whether he was wrong.

Mr. Bader and Ms. Millhorn agreed that he was not wrong.

Ms. Millhorn reminded however, that all pension systems and all defined benefits systems, nationally, are in the very same situation. While the contributing factors might differ in each plan, all defined benefit plans have some very significant exposure to their employers and all of the risk is borne by the employer, and, because of that, "any changes that happen, because those members, those pensioners are guaranteed and promised those pensions for the rest of their lives, any changes, any adjustments that happen is borne by the employer."

Co-Chair Green asked how private employers have addressed these trends in defined benefit plans.

Ms. Millhorn stated that, defined contribution plans have "changed

pretty dramatically over the last 15-year period." Currently defined benefit plans represent approximately 17-percent of plan options, as private employers have moved toward defined contribution plans for a number of reasons: "to afford portability to their members because it is recognized that employees go from one job to another job and it allows that portability. It is also recognized that having the employer bear all of the risks in the defined benefit plan is not an exposure that they are willing to take on." About 90-percent of the government sector continue to have defined benefit plans, "but every year, and especially in the last three years, there is an increase in the number looking at pension reform as the question is whether the employer should continue to bear all of the exposure and all of the risk."

Senator Bunde declared that Legislators and many others should share in the responsibility for the situation, as, as long as ten or twelve years ago, a Legislator from Fairbanks raised the warning flag about the sustainability of defined benefit plans but no action was taken.

Co-Chair Wilken recounted that, in the 1990s, another Legislator raised the issue of a defined contribution plan.

Senator Stedman asked for confirmation that the 7.70 percent number depicted on the "Efficient Frontier Segment" chart depicted on page 19 of the Department of Revenue handout was the target amount.

Mr. Bader stated that at the time the chart was developed, it was. Currently the target amount is 7.84 percent.

Senator Stedman reviewed some calculations he had developed based upon that information and compared it to the Range of Returns handout. He reiterated that the impact was easier to visualize when the percentages were translated to dollars.

Co-Chair Green pointed out that the Department of Administration has distributed information [copy on file] pertaining to the PERS, TRS, and ASPIB Board memberships and responsibilities.

There being no further questions, Co-Chair Green thanked the Departments for the presentations.

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ADJOURNMENT

Co-Chair Green adjourned the meeting at 10:38 AM.