

SENATE FINANCE COMMITTEE
February 11, 2009
9:05 a.m.

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CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:05 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Charlie Huggins, Vice-Chair
Senator Johnny Ellis
Senator Kim Elton
Senator Donny Olson
Senator Joe Thomas

MEMBERS ABSENT

None

ALSO PRESENT

Michael O'Leary, Executive Vice President, Callan Associates; Mike Burns, Executive Director, Permanent Fund Corporation, Department of Revenue. Jerry Burnett, Deputy Commissioner, Division of Treasury, Department of Revenue; Gary Bader, Chief Investment Officer, Treasury Division, Department of Revenue; Pat Galvin, Commissioner, Department of Revenue.

SUMMARY

^Overview:

Retirement Trust Performance Review

Constitutional Budget Reserve Performance Review

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MICHAEL O'LEARY, EXECUTIVE VICE PRESIDENT, CALLAN ASSOCIATES, gave a presentation designed to answer questions that arose during the Senate Finance Committee meeting of 2/10/09. He stated that he was misconstrued in press reports regarding statements made during the 2/10/09 Senate Finance Committee meeting. He stressed that Callan Associates did not anticipate the financial meltdown and that the firm was clearly incorrect in their view of the recovery.

Co-Chair Stedman asked if Mr. O'Leary was referring to the magnitude or the direction of the financial meltdown. Mr. O'Leary replied that he was referring to the magnitude of the situation.

Mr. O'Leary proceeded using a PowerPoint presentation, "Initial Response to Committee Questions" (Copy on File). The first question was in regard to the National Association of College and University Business Officers (NACUBO) study. The graph on Slide 2 illustrates that there are 77 institutions with assets greater than \$1 billion. The dispersion policies in the institutions are provided within the NACUBO study. Slide 3 lists the largest institutions participating in the study. He noted that 20 funds had assets of more than \$4 billion.

Mr. O'Leary turned to the committee's second question regarding the Alaska Retirement Management Board (ARMB) Public Employees' Retirement System (PERS) and Teachers Retirement System (TRS) policies. The question concerned expectations for PERS and TRS policies and subsequent action two years ago. He noted that many people expect higher returns in the near future, but he opined that the returns will not overcome the money lost during the market downturn in 2008.

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Mr. O'Leary explained Slide 4 "ARMB and Alaska Permanent Fund Corporation (APFC) Policies Throughout Recent Years." The chart illustrates that both the ARMB and the AFPC boards annually review investment policies and update them as new projections become available. Changes are minor and infrequent. The slide depicts a comparison of the ARMB policies for PERS and TERS and the APFC funds for FY06/FY07, FY07/FY08, FY08/FY09, and FY09/FY10. Neither board adopted a policy for FY09 and FY10 so the difference is in expected returns from lower values.

Mr. O'Leary explained the difference in expected returns. The permanent fund had a heavier fixed income allocation without other assets. In the case of the ARMB, farmland, energy investment, and timber are grouped together as "other" assets. In FY07 and FY08, the policies were changed for both ARMB and AFPC. In the case of the AFPC, an introduction of the other category established an infrastructure investment as part of the policy.

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Mr. O'Leary addressed "Important Notes" on Slide 4:

1. Composition of "other" category varies by fund

- ARMB - farmland, energy, timber, and Treasury Inflation Protected Securities (TIPS)
APFC - Infrastructure
2. Both funds include sub-sectors within fixed income
 3. APFC actual allocation to Private Equity is much more recent and therefore underfunded relative to ARMB.
 4. Implementation (structure) approaches to public equity allocation vary by fund. Big difference is the use of "global equity managers" by APFC. We have apportioned global to domestic and international to help ease of comparison.
 5. Neither board has yet adopted a policy for the 2009-10 fiscal period. We simply applied new projections to the current policies.

Co-Chair Stedman requested the aggregate of the Constitutional Budget Reserve (CBR). Mr. O'Leary explained that Callan Associates does not work with the CBR.

Mr. O'Leary introduced the graph on Slide 5, "Cumulative Wealth." He suggested that if a digression was made to the beginning of calendar year 2007, and began with \$100 achieving the expected return for ARMB, a growth of 8.05 percent would be seen, represented by the red line. The yellow line represents the APFC expected return of 7.77 percent. The green and blue lines depict actual events in calendar year 2008, which were typical of other funds of this type.

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Mr. O'Leary continued that the initial \$100 declined to \$85 in the case of ARMB and \$81 in the case of the APFC. He noted that the ARMB return for 2008 is not yet complete and results are not typically available until next week. Preliminary 2008 real estate numbers were used to create an estimated return for the committee's deliberation. He guessed that the fund was down between 22 and 24 percent.

Co-Chair Stedman asked if the actual return for January was the starting point. Mr. O'Leary answered that he used the \$80.98 for the APFC as the beginning value and then grew that by the expected return given the new return estimates seen on Slide 4. The APFC was grown at 9 percent for next five years. The ARMB was grown at 9.09 percent given its policy mix for the next five years. With the optimistic assumption, the result at the end of calendar year 2013 is for returns comfortably above the initial \$100 but well below numbers that would have been achieved with the anticipated amounts prior to the financial meltdown.

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Senator Thomas asked about a comparison of numbers for 2013. Mr. O'Leary stated that some fluctuation in the rate of return was anticipated.

Co-Chair Stedman supposed that there was a significant change in the ending dollar value in 2013. Mr. O'Leary agreed. He stated that there is a tendency for the public to believe that a higher return is anticipated, but the severity of the 2008 downturn was so great that it will take a long time to recover.

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MIKE BURNS, EXECUTIVE DIRECTOR, PERMANENT FUND CORPORATION, DEPARTMENT OF REVENUE, addressed the Permanent Fund Corporation Asset Allocation (Copy on File). He felt that in light of market place changes the long term investment is an advantage. The year has been arduous, but the difficulty was not anticipated. Different action would have been taken if the market collapse had been anticipated. The asset allocation is fine for the long-term, but it was not advantageous in the fall.

Senator Thomas requested a projection for calendar year 2009. He asked what would happen in the event of another market decline with the magnitude of 2008. Mr. O'Leary stated that he did not believe it likely to happen because of policy actions taken to push liquidity into the system. He explained that he was focusing on the difference in interest rate levels as opposed to an economic plan. The market fall led to a credit freeze. He did not expect a similar situation to occur again.

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Co-Chair Stedman asked about a potential market decline of lesser magnitude, (10 or 15 percent). He requested a graph representing a market decline of 10 percent.

Senator Elton asked about the asset allocation decisions made in May. He asked about possible advantages in increasing the timetable to remain ahead of the investment curve, given the rapid market change in 2008.

Mr. Burns answered that premature decisions can lead to a gamble with market timing. He explained that different asset classes were not the issue. Some weakness was noticed in the credit markets two years ago leading to a \$500 million allocation to distressed debt, but the credit cycle was the focus as opposed to the collapse of the financial system.

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Mr. O'Leary stated that the commitment to distress was made two years ago with the understanding that the money would be drawn down gradually by the manager as distressed opportunities arose. He anticipated a more traditional credit cycle. In addition, assets are adjusted in portfolios to reflect the best thinking in regard to outlook. The global equity managers have latitude to shift money from abroad to domestic accounts.

Co-Chair Stedman requested assistance regarding the difference between the ARMB is a board allocation and the permanent fund allocation. The Permanent Fund Dividend (PFD) has a longer time horizon than the retirement fund without a demand on liquidity. He asked for help understanding why the PFD doesn't have a higher risk level than the retirement fund.

Mr. O'Leary answered that the movement in the permanent fund has been toward the higher return and higher volatility. The fund is the most permanent of the pools with the least long term liquidity requirements. The permanent fund is more conservative because of legislative restrictions. The limiting factor in the permanent fund is the limitation on the payment of distributions with regard to earning reserves.

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Mr. O'Leary explained that the permanent fund is similar to the pension system with funded private equity exposure. Investment policies in the pension system will eventually be more conservative. The pension system will have a lower chance of achieving the earnings assumption of 8.25 percent, which equates to a real return of 5.5 percent requiring a heavy equity commitment. The expectation is that the pension system will be in a net inflow position for a protracted period. The policy will be more conservative because the liquidity needs of the system will be growing.

Senator Thomas asked for an explanation of an actuarial assumption of 8.25 percent equating to 5.5 percent in reality. Mr. O'Leary answered that he was simply subtracting the estimated 2.75 percent inflation from the 8.25 percent. There is an embedded inflation assumption higher than 2.75 percent.

Co-Chair Stedman concluded the presentation and moved on to the retirement trust performance review.

JERRY BURNETT, DEPUTY COMMISSIONER, DIVISION OF TREASURY, DEPARTMENT OF REVENUE, introduced the PowerPoint presentation, "Investment Operation Orientation: Treasury Division, Portfolio Management Section. February 2009" (Copy on File).

Co-Chair Stedman requested that the discussion point remain on the CBR and its policy procedures rather than the Public Employees' Retirement Trust Fund which required only a brief update on status and performance.

GARY BADER, CHIEF INVESTMENT OFFICER, TREASURY DIVISION, DEPARTMENT OF REVENUE explained Slide 2 and the outline of resources available to the ARMB. The retirement management board uses the staff of the Department of Revenue (DOR) as it's investment arm. An Investment Advisory Committee (IAC) consisting of three individuals is available to the board. The IAC has a general consultant (Mr. O'Leary), a Chief Investment Officer (CIO) (Mr. Bader), and the staff to the CIO. The general consultant exercises control over the external asset management of funds, as well as managing \$16 billion internally, of which \$2 billion is the board's fixed income.

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Mr. Bader discussed Slide 3 and 4 "Fiduciary of the Fund":

- AS 14.25.007
- Consider status of the fund's investments and liabilities
- Determine the appropriate investment objectives
- Establish investment policies to achieve objective
- Act only in regard to the best interest of the system's plan and beneficiaries
- Nine Members
- Establish Investment Policies
- Review Actuarial Earnings Assumption
- Establish Asset Allocation
- Provide Investment Options

Mr. Bader explained the functions of the ARMB consultant Mr. O'Leary (Slide 5):

- Assert Allocation/Strategy
- Performance Measurement
- General Consulting
 - General
 - Specific
 - Assist in Asset Manager Searches

Mr. Bader described that the Investment Advisory Council (Slide 6):

- Permitted by Statute

- Three to Five Members
- Review and Advise on Investment Policy, Strategy and Procedures
 - Dr. Jerrold Mitchell
 - Dr. William W. Jennings
 - George Wilson

Mr. Bader discussed the "Asset Allocation Decision" (Slide 7):

- Investment Objective
- Risk Tolerance
- Expected Return of Each Asset Class
- Expected Volatility of Each Asset Class
- Correlation of Performance Between Asset Classes
- Efficient Frontier

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Mr. Bader discussed a graph on Slide 8 depicting the historical risk/return tradeoff. The graph gives an idea over the long run of how the various asset classes perform. He explained that the Y axis shows the investment returns of these asset classes over a long period of time (1926-2004). The X axis defines risk as standard deviation or the volatility of the returns.

Mr. Bader explained another graph on Slide 9 depicting standard deviation and its impact. If the expected return is said to be 6 percent with a standard deviation of 9, then 9 would be lost from the expected return of 6. A positive standard deviation would be 6 plus 9 or a return of 15. Highly unlikely events seen at the end of the graph somehow occur even with low probability.

Mr. Bader described Slide 10, which illustrates the correlation of asset class returns. The range of correlation can be plus one to minus one. Plus one means the stocks move together and minus one means the stocks move opposite of each other. When asset allocations are reviewed, the expected return of assets, the volatility of returns, and the movement of returns in conjunction with each other are all taken into account. The product of the exercise is what is known as an "efficient frontier."

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Mr. Bader discussed Slide 11 and efficient frontiers. An efficient frontier is a series of expectations where a person determines the highest rate of return for the lowest amount of volatility. The example shows a 100 percent cash portfolio with low return and low volatility. On the other

side, 100 percent stocks show greater return with much more volatility.

Mr. Bader reviewed Slide 12 and the current asset allocation of the ARMB for the PERS and TRS legacy funds. He explained that markets change and volatility is seen, however, the fund is not automatically rebalanced.

Mr. Bader reviewed Slide 13 and the cumulative attribution effects seen in September. He explained that the return was a negative 12.89 percent. A negative 14.51 percent net manager effect would have been seen if the target return had been met, but the investment managers did better than the established index or benchmark so the net manager effect was positive.

Mr. Bader reviewed Slide 14 addressing the calendar year September to September when the ARMB fund was in the top 23 percent of public funds. If the fund would have been all fixed income the state would have been close to number one because of the down market. He explained that years two and three exemplify both up and down markets with good returns for both.

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Mr. Bader presented Slide 15 regarding the impact of the downward market on the expected rate of return and the earning assumption of the PERS fund. He compared the base used in 2007, assuming that the portfolio has a negative 22.24 percent, to the actuary for the retirement systems. The actuary assumes that the fund will earn 8.25 percent. If the beginning is down 22 percent adding the 8.25 percent brings the fund down 30 percent. His estimate was that the fund would have to earn 50 percent, which is a very unlikely outcome.

Co-Chair Stedman understood that the actuarial target was 8.25 percent and the portfolio target was 8.11 percent. Mr. Bader stated that the 8.25 percent is the actuarial assumption over a long period of time, generally 30 years. He admitted difficulty reconciling the ARMB target return. The actuary considers the inflation assumption of 3.5 percent over the next 30 years. Mr. O'Leary's current inflation assumption is 2.75 percent last year and this coming year. There is a disconnect when looking at nominal returns. If the chart were graphed in terms of real returns, he opined that it would be close to the actuarial prediction.

Co-Chair Stedman asked about the 8.25 percent which may be a high estimate and require some response. He stated concerns that market dynamics were moving away from 8.25 percent and as the market moves down, the liability gap increases.

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Mr. Burnett outlined a comparison of major funds under the permanent fund, the ARMB, and the projections of the Commissioner of Revenue. He addressed asset values, purposes, and market values for 12/31/08 versus current market values. He used Slide 16 as a reference beginning with the general fund. The market value for the general fund fluctuates, but the primary difference in market value for the general fund is appropriations out and revenue in. The three year actual returns on the general fund are all in short and intermediate term fixed income with a current balance of \$7 billion.

Co-Chair Stedman asked for clarification regarding dates. Mr. Burnett answered that he was speaking of the 2008 calendar year.

Co-Chair Stedman asked for a definition of short term and intermediate term. Mr. Bader answered that the short term fund is similar to a money market fund, which is essentially a 90-day account. Co-Chair Stedman asked if the holdings are beyond five years. Mr. Bader explained that there are some mortgages that reset. As interest rates fall and homes are refinanced the mortgage portfolio is repaid quickly. If interest rates increase, the portfolio could extend in terms of length. Portfolios with asset backed securities are subject to interest rate volatility and might have investments over five years, depending upon the interest environment.

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Mr. Burnett pointed out that \$4 billion of the \$7 billion is money restricted for the public school fund and other accounts for tax credits. The general fund has \$3 million in unrestricted funds.

Co-Chair Hoffman asked if the SBR exists in the general fund category. Mr. Burnett answered in the affirmative and added that the SBR also sits in the General Fund.

Co-Chair Stedman asked how the SBR is treated internally. Mr. Burnett answered that the SBR is a part of the General Fund and Other Non-Segregated Investments (GeFONSI) for investment purposes. The earnings from the SBR flow to the general fund.

Co-Chair Stedman reviewed that the SBR was funded last year with \$1 billion of excess revenue. A simple vote of the legislature is required to access the funds. The earnings and losses accumulate to the general fund. Mr. Burnett

agreed that the general fund would maintain a balance of \$1 billion regardless of investment performance.

Co-Chair Stedman asked if the SBR was comingled within the general fund? Mr. Burnett answered that the investments are comingled.

Co-Chair Stedman asked if a particular gain or loss could be identified for the SBR. Mr. Burnett stated that the SBR does not have a separate asset allocation or target return.

Mr. Burnett continued to address the CBR (main fund), which is the short term constitutional savings account invested for moderate risk and intermediate investment horizon. The CBR is invested at 100 percent fixed income: short term at 5 percent, intermediate term at 75 percent, and broad market at 20 percent. The CBR has a calendar year return of 5.67 percent for 2008, a three year actual return of 5.71 percent and a forecast return of 4.53 percent.

Co-Chair Stedman requested a definition of moderate risk and intermediate investment horizon.

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Mr. Burnett answered that moderate risk is fixed income with low volatility. The intermediate investment horizon is used for less than five years and would not suffer large losses if appropriated.

Co-Chair Stedman asked the duration of the CBR. Mr. Bader answered that the target asset allocation was 20 percent broad market, 75 percent intermediate term fixed income, and 5 percent short-term fixed income.

Co-Chair Stedman informed that the legislative body had not decided how to respond to the revenue projection decline and which accounts would be used to meet liquidity needs. It appears that \$1.3 billion will be needed for FY09. A high likelihood exists that the CBR will be the source of that need. Fiscal Year 2010 may incur a \$2 billion deficit putting the state at \$3.2 to \$3.3 billion and liquidating the main fund of the CBR. He expressed concerns regarding the policy implementation of the use of the CBR and the structure preventing the liquidation of holdings that the legislature prefers not to liquidate.

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Mr. Burnett answered that the CBR main account would be liquid in a short period of time, at the stated value. The CBR account is invested to reduce the risk of losing value. He stated that when the legislature makes an appropriation

from the CBR in the beginning of FY09, the cash will not be drawn out until some period in the future. Several months to one year exist between the need for cash and the drawing of appropriations to meet the deficit need. The main account of the CBR is managed to reduce volatility.

Mr. Burnett introduced the CBR (sub-fund), which had a value of approximately \$3.4 billion. The sub fund is a high risk, moderately long investment horizon, and has an asset allocation of 37 percent fixed income, 44 percent domestic equity, and 19 percent international equity. The CBR sub fund has a statutorily five year investment horizon. He stated that the commissioner should consider not using this money for a period of five years.

Co-Chair Hoffman asked when the value of the reported sub fund of the CBR was \$3.4 billion. Mr. Burnett answered that the \$3.4 billion was as of December 31, 2008.

Co-Chair Hoffman asked if the fund had been projected to make money as of December, but lost \$200 million since December 31, 2008. Mr. Burnett stated that was correct because the fund is invested with a five year time horizon. The sub fund is high risk and the calendar return was nearly 30 percent negative.

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Co-Chair Hoffman stated he had recently asked the commissioner of the Department of Revenue for a projection of the remainder of the fiscal year. He could not remember the exact amount although it was substantial. He explained that the commissioner did not know if there would be positive returns for the first 30 days, although his inclination was that the state would see positive returns. The committee is now informed that the account lost \$190 million dollars in the first 30 days of the second half of the year.

Mr. Burnett answered that he was not sure about the amount in the sub account of the CBR on the day that the commissioner was testifying to the subcommittee.

Co-Chair Stedman wanted the commissioner present to discuss the policy question and the plans for managing the sub-account of the CBR in the future.

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Co-Chair Stedman recognized that there had not been an FY10 update and the committee was flexible since the price of oil was not determined. The price of oil could be \$71 per barrel or \$40 per barrel. The legislature is in the policy process

of determining which sources of funds to address first. He asked that the sub account be reviewed once more.

Mr. Burnett stated that the sub-fund of the CBR is invested with a five-year time horizon, a high risk, moderately long investment horizon. The sub-account is composed of 37 percent fixed income, 44 percent domestic equities, and 19 percent international equities. The sub-account has had a calendar year return of negative 29.34 percent and three year actual return of negative 5.17 percent, but it has a target return of 7.61 percent. The sub-account began 2007 with a balance of \$5.76 million and contained an additional \$4.1 billion added to it and now has a balance of \$3.382 billion dollars as of January 31, 2009.

Co-Chair Hoffman requested the six month estimated returns for the CBR.

PAT GALVIN, COMMISSIONER, DEPARTMENT OF REVENUE, answered that he did not have the requested information with him. He stated that the department uses target returns as the projection for any period in the future.

Co-Chair Hoffman asked if the projections presented earlier to the committee would remain accurate. Mr. Galvin answered that the expectations are merely a projection and the department is not vouching for the accuracy of the projection. The department will continue to update the committee with fund balances for the varying accounts throughout the budgeting cycle.

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Co-Chair Hoffman stated that the fund had lost one billion dollars for the first seven months. He asked if the department would continue to invest in the same manner or with a different strategy. Mr. Galvin answered that the value of any investment strategy is consistency. The sub account of the CBR will remain with a similar asset allocation. The question, as he understood it, was whether the department was planning to move funds between accounts. His answer was that the sub account will remain with a similar asset allocation in the current term.

Co-Chair Hoffman asked how this strategy fits into the legislative policy of stretching the funds out as long as possible. He asked for the anticipated longevity of the CBR with 50 percent draws on the fund by the end of FY10. Mr. Galvin answered that the department's responsibility is to identify an appropriate mix between the main account and the sub-account of the CBR. The department can anticipate the direction of the budget process based on various decisions made while understanding the savings accounts and where the amounts will be taken from. Until other appropriation issues

have been settled the department will not know the projected fund balances. The legislature's appropriation process determines the use of the various funds.

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Co-Chair Stedman asked how the allocation rating was modified and implemented last year from a policy and physical perspective within the department. He queried how the finance committee should interact with the commissioner's office.

Mr. Galvin answered that the CBR sub-account was created ten years ago with the statutory direction of a five year plus target for the investment horizon. The intent was to have it invested to provide higher return. The main account is intended to cover the first five years before the need to access the sub-account. Revenue has increased through the last couple of years. A draw on reserves was not anticipated and the reserve balances were growing. An interest existed in seeing the returns on the reserve accounts maximized in the appropriate way given the expected need of the funds. He had requested that the issue be taken to the finance co-chairs. The dilemma was whether to have the allocation moved, remain in the main account, or be reallocated since the main account was growing. He asked for feedback from the co-chairs of the finance committees 12 months ago.

Co-Chair Stedman asked which finance co-chairs the commissioner was referring to.

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Mr. Galvin responded he had spoken with Representative Chenault and Representative Meyer of the House Finance Committee, and with the current Co-Chairs of the Senate Finance Committee .

Co-Chair Stedman asked if the commissioner recalled having the discussion with him regarding changing the allocation. Mr. Galvin answered that he did not have the conversation himself, but requested that Deputy Commissioner Andrews approach the finance co-chairs about this issue. He stated that he was seeking feedback and asking for correspondence stating the request of the finance co-chairs because the House co-chairs were particularly interested in seeing a more aggressive strategy with regard to the CBR.

Co-Chair Stedman asked what the response was from the Senate co-chairs. Mr. Galvin stated that he was not engaged in direct communication with the co-chairs, however, it was relayed to him that the language would not come in the form of a letter, but instead in budget language. The final budget included language stating that the CBR deposits

should be invested to maximize returns, which meant placing then in the more aggressive sub-account.

Co-Chair Stedman stated that his recollection of the conversation with Mr. Andrews was that the senate finance committee had not agreed to moving the funds into the sub-account of the CBR. He remembered that the prospect was not well received.

Senator Elton reported understanding moderate risk accounts and the roll of outside advisors. He asked if there were outside advisors consulted about the sub-account. He asked whether the moving of money between accounts is an internal process only or if other consultants advising about the high risk component of the sub-account.

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Mr. Galvin answered that there are no consultations for asset allocations. The asset allocation is developed with the investment professional in terms of providing the asset allocation to meet the statutory objective of the fund, which is to have returns targeting a five-year horizon. The goal is to have the investment remain fairly liquid because the state may need immediate access to the funds.

Senator Elton understood the differences between the sub account and the main account. He did not have an adequate understanding of how investment decisions were made in regard to the CBR and SBR.

#

ADJOURNMENT

The meeting was adjourned at 10:40 AM.