

SENATE FINANCE COMMITTEE  
February 28, 2019  
9:01 a.m.

9:01:58 AM

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:01 a.m.

MEMBERS PRESENT

Senator Natasha von Imhof, Co-Chair  
Senator Bert Stedman, Co-Chair  
Senator Click Bishop  
Senator Peter Micciche  
Senator Donny Olson  
Senator Mike Shower  
Senator Bill Wielechowski  
Senator David Wilson

MEMBERS ABSENT

Senator Lyman Hoffman

ALSO PRESENT

Senator Cathy Giessel; Senator Mia Costello; Bruce Tangeman, Commissioner, Department of Revenue; Michelle Prebula, State Investment Officer, Department of Revenue; Bob Mitchell, Chief Investment Officer, Department of Revenue.

SUMMARY

PRESENTATION: INVESTMENT FUNDS UPDATE, CASH FLOW DEFICIENCY PLAN

Co-Chair Stedman noted that the committee would continue an earlier discussion on the cash flow and investments of the state. He had wanted presentations pertaining to the overall budget and had heard introductory comments on the state's cash position. After hearing more about the budget, the cash deficiencies of the state were becoming clearer.

Co-Chair Stedman continued his remarks and spoke to the balance in the Constitutional Budget Reserve (CBR) and the Statutory Budget Reserve (SBR). He thought it appeared that the state was getting down to its minimum comfort level with regard to savings. The presentation would give further detail on the state's cash positions and investment funds and would opine the minimums that should be left as shock absorbers for the budget. He mentioned contingency funds for state emergencies and unplanned events.

^PRESENTATION: INVESTMENT FUNDS UPDATE, CASH FLOW DEFICIENCY PLAN

9:05:00 AM

BRUCE TANGEMAN, COMMISSIONER, DEPARTMENT OF REVENUE, introduced himself. He recalled that Director Pam O'Leary, Director, Treasury Division, Department of Revenue had reviewed a presentation earlier in the month. There had been many comments, questions, and requests as a result of the presentation. He introduced his staff.

9:07:39 AM

MICHELLE PREBULA, STATE INVESTMENT OFFICER, DEPARTMENT OF REVENUE, discussed her work experience. She had started with the state in 1993, working with the Legislative Audit Division, where she earned her Certified Public Accountant certificate before working as the internal auditor for the Department of Labor and Workforce Development. She had taken the position of cash manager for the state in 1998, where she worked for 20 years before transitioning to her current position the previous July. She had degrees in economics and accounting, as well as a master's degree in business administration. She relayed that she was an accredited ACH professional, which meant she had experience in electronic fund transfers; and had a certified treasury professional designation.

Ms. Prebula discussed the presentation "State of Alaska Discussion of State Cash Flows," (copy on file).

Ms. Prebula turned to slide 2, "Daily General Fund Sufficiency Balance Calculation," which showed a flow chart. She discussed the definition of "cash" as cash in the bank less payments outstanding, warrants that had not cleared, electronic fund transfers that had left the state,

and less cash receipts in suspense. She stated that the vast majority of revenue came into the treasury through the General Fund (GF). She qualified that at the point the funds came in, it was not known if the funds would remain GF money or not, and the funds were not considered available to be spent until the determination was made.

Ms. Prebula reviewed slide 3, "Cash vs. Accrual Accounting Periods":

FY19 Cash Accounting Period  
July 1, 2018 - June 30, 2019

FY20 Begins  
July 1, 2019

FY19 Accrual Accounting Period  
July 1, 2018 - August 31, 2019

Ms. Prebula thought the slide showed the difference between cash accounting and accrual accounting. She thought it was an important distinction to know when discussing cash flow that two months of every year (July and August) the state expended funds both on behalf of the prior year and the current year.

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Ms. Prebula spoke to slide 4, "Seasonal Cash Flow Fluctuations":

- Summer - Peak season for construction projects and seasonal workers.
- Re-appropriation (July & August):
- Finishing prior FY expenditures + current FY expenditures.
- Allocating funds in or out of GF per new legislation.
- July - Debt service payments.
- June - Annual oil & gas property tax revenue.

Ms. Prebula informed that there had been a request for more information regarding the nature of flows. The state had a very seasonal flow to its cash. There was a lot of fund transfers early in the year for debt servicing, school district funding, and payment retirement funds. The bulk of expenditures was early in the year, but there was a lag in

revenues. The majority of revenues came at the end of each month, or quarterly. The biggest revenue day of the year was June 30, when the state received oil and gas property tax revenues.

Mr. Prebula continued to discuss slide 4. She noted that the state had specific monthly trends, when flows in were allocated and payroll went out. She discussed weekly cash flows and referenced a previous question about Medicaid payments, which caused a large outflow once per week. She qualified that generally in-flows and out-flows varied by department.

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Ms. Prebula referenced slide 5, "Cash Deficiency Memorandum of Understanding":

- o Original MOU signed 1994 by DOR, DOA, OMB & LAW.
- o Updated December 1, 2017.
- o Targets \$400 million dollar minimum threshold in the GF.
- o Outlines procedures for addressing cash deficiencies:
  - Develop monthly cash projections.
  - Monitor daily general fund cash balances.
  - Transfer from SBR, CBR & ERA as appropriated.
  - Perform temporary interfund borrowing.
  - Borrow from general fund sub funds.
  - Seek legislative action through governor.
  - Prioritize disbursements, restrict expenditures.

Ms. Prebula stated that there was an agreement of what was done during times of cash deficiency.

Co-Chair Stedman asked about the bullet referencing transfers. He asked if the order of accounts listed depicted the order of execution if a transfer was made.

Ms. Prebula stated that generally the order of execution was whatever had been appropriated. She recalled generally only one account at a time had been appropriated.

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Co-Chair Stedman asked about statutory authority to access the SBR or CBR. He recalled that the legislature normally gave the treasury access to one of the accounts for budgetary purposes if the state missed on the revenue and expense relationship at the end of the year. He wanted to make clear the point that a simple majority vote was easy compared to a three-quarter vote needed to access the CBR or the Earnings Reserve Account (ERA). He was concerned that if the state started relying on the ERA and diminished or depleted the CBR or SBR.

Commissioner Tangeman addressed Co-Chair Stedman's question, and noted that DOR followed what the appropriation bills allowed for the state to do. The order of use was the order that the executive branch had authority to access.

Co-Chair Stedman asked if the department could access the CBR for a cash deficiency if the legislature did not produce a three-quarters vote in the budgetary process.

Commissioner Tangeman stated that the question might need to be addressed by the Department of Law (LAW), because the memorandum gave authority to borrow against accounts, but he was not sure about not having an authorization through a CBR vote.

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Senator Micciche pondered the impetus for the signing of the Memorandum of Agreement in 1994. He saw that transfers were only appropriate as appropriated. He asked if there had been a cash flow emergency after appropriations from the legislature were too tight.

Ms. Prebula stated she was not much of an alarmist and would not refer to anything as a "cash emergency," but there had been times the state had been low on cash. She referenced FY 99, the first year that legislature put a cap of \$700 million on the borrowing from the CBR. She recalled that there had been a drop in oil prices, the state had spent the money quickly, and there was a subsequent special session in which the legislature voted to increase the cap.

Senator Micciche was interested in the topic being discussed. He recalled that Co-Chair Stedman had remarked that the budgeting process provided some level of

stability. He commented on the volatility of oil prices. He was curious how the department would manage if the state was appropriated tightly and there was a drop in oil price.

Co-Chair Stedman added that there was separate language in the budget for borrowing versus a three-quarter vote to extract funds to balance the budget.

Commissioner Tangeman thought with the percent of market value (POMV) draw of the ERA being in place, it was possible to absorb minor changes in oil price. He pondered the different oil price levels that could be considered an emergency. He questioned a drop of \$20 in the price of oil. He discussed the timing of action taken to react to big changes in oil price.

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Co-Chair von Imhof asked about the monthly cash projections, and asked about the amount of flexibility with the Department of Education and Early Development (DEED) and the Department of Health and Social Services (DHSS). She wondered if the funds were paid out in a lump sum or otherwise. She recalled a letter that referenced 'slow paying' of Medicaid payments and asked how it could be used to manage cash flow.

Commissioner Tangeman thought Co-Chair von Imhof's question was policy related. He relayed that the department was instructed to pay out as required by the departments and thought Co-Chair von Imhof's question about slow-pay was a policy call.

Ms. Prebula stated that the department used to make the full school funding appropriation at the beginning of the year; however, with increased tightening control over cash it had been reduced to four quarterly payments. She addressed Medicaid and Medicare and stated that DOR tried to encourage Department of Administration (DOA) to continually stay on top of reports in order to continually bill the federal government. She added that DOR had not made any recommendations with regard to payment.

Co-Chair von Imhof thought it was important that Ms. Prebula had an ACH credential, and thought electronic transfers were a way to get federal payments faster. She hoped requests for payments were sent electronically. She

asked if Ms. Prebula did nightly sweeps of cash going in and out to earn some type of interest.

Ms. Prebula deferred the question to Commissioner Tangeman.

Commissioner Tangeman thought the question would be best addressed by the state's chief investment officer.

Senator Wielechowski asked how oil severance taxes and royalties were paid.

Commissioner Tangeman stated that the taxes were paid on a monthly basis.

[9:25:39 AM](#)

Ms. Prebula looked at slide 6, "General Fund Sufficiency July 1, 2018 - December 31, 2018," which showed a line graph depicting a monthly cash flow projection. She stated that the projection was the biggest tool for anticipating the cash needs of the state. The department considered the cash flows of the previous year, and adjusted bigger payments, fund transfers, and borrowings. The department wasn't able to forecast for the year until the month of May. The department considered the projection on a daily basis and made adjustments monthly. She cautioned that things diverged within the month, and the projection was an estimate.

Ms. Prebula pointed out the large inflows and outflows shown in the box atop the line graph on slide 6. She explained that six-month increments were the most effective for looking at completed transfers.

Co-Chair von Imhof was curious about what bank the state's cash was in.

Ms. Prebula informed that there was a conglomeration of the available state funds, which were in five different banks.

Co-Chair von Imhof asked for the names of a couple of the banks.

Ms. Prebula specified that the state's primary custody bank with the bulk of investments was State Street Bank in Boston, Massachusetts. Primary depository activity was done within the state. She noticed that ACH payroll payments,

retiree payroll, and vendor payments were done through U.S. Bank. There were also deposits to First National Bank of Alaska. She mentioned Key Bank and Wells Fargo.

Co-Chair Stedman explained that the chart showed transfers from the ERA to the General Fund, including dividend monies to be paid out, and other monies used in the previous year's budget. He wanted to clarify that the funds were not used for general expenditures outside of the 5.25 percent POMV draw.

Commissioner Tangeman answered in the affirmative. He pointed out that the first green line in the box showed a CBR transfer. It had been agreed that leaving the funds in the ERA as long as possible to earn the highest return was in the best interest of the state. The decision had been to draw the CBR down first (which was earning a lower return) and then engage in a cash-call process which was choreographed between the department and the Alaska Permanent Fund Corporation (APFC). In October and December there had been cash-calls to the ERA, in the amounts of \$350 million and \$250 million.

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Ms. Prebula explained slide 7, "General Fund Sufficiency January 1, 2019 - June 30, 2019," which showed a line graph depicting a balance projection for the second part of the fiscal year shown on the previous slide.

Senator Wielechowski asked about a \$982 million transfer to the Permanent Fund Dividend Fund on September 11, 2018 as shown on slide 6. He asked if there was a reason that the funds were transferred three weeks before the dividends were paid out. He estimated that there was a few hundred thousand dollars in interest that had been missed out on.

Ms. Prebula was not involved in the transfer. In prior years, the funds were transferred when the books were done at APFC. She couldn't speak to the timing for 2018.

Commissioner Tangeman stated that he would look into the matter.

Ms. Prebula displayed slide 8, "Takeaways":

- Cash flow forecasting is always wrong.

- Even if the State budget is balanced, borrowing for cash flow deficits will occur.
- Budget deficit borrowing may occur if forecasted assumptions are wrong.
- How much is borrowed depends on the actual amounts and timing of revenues and expenses.

Ms. Prebula emphasized that cash forecasting was an art, and the direction and magnitude of changes was unknown.

[9:33:11 AM](#)

Ms. Prebula discussed slide 9, "General Fund Sufficiency July 1, 2019 - June 30, 2020 With Projected Cash Outflow Reduction of \$1.6B/year," which showed a line graph showing a depiction of cash outflow and what might happen with a proposed reduction in outflows of \$1.6 billion. She explained that the need for cash would depend on what sort of fund transfers were appropriated, and what other things occurred.

Commissioner Tangeman thought the slide put something into perspective. He thought it was important to discuss the appropriate size of the CBR. He thought the graph gave a little bit of a glimpse into where the state should be looking. He pointed out an almost \$800 million drop in the initial part of the graph. He noted that many expenditures for the fiscal year occurred in the first part of July. Throughout the year it was possible to see other drops, and he estimated that about \$1.4 billion was reflected on the graph. He opined that the state was at a level it needed to be at for the CBR. He thought a balance of \$1.7 billion or \$1.8 billion provided a needed cushion.

Senator Bishop asked to revisit slide 6. He asked about the ERA draw, which was \$1.6 billion, out of an authorized \$2.7 billion; and a remaining balance of \$1.1 billion available to draw.

Commissioner Tangeman answered in the affirmative.

Senator Bishop considered that if revenues rebounded and there was \$1 billion in surplus - and wondered if the state would not need to draw the \$1.1 billion from the ERA.

Commissioner Tangeman thought Senator Bishop posed a good question, and that oil prices were slightly higher than

forecast. He thought the forecast \$700 million deficit would be closer to \$250 million. The plan was to still draw the ERA down as anticipated, and the funds would remain in the General Fund.

Co-Chair Stedman summarized that the state was at its minimum comfort level in the CBR. He thought the committee needed to take the matter under consideration as it pondered shock-absorber mechanisms in the budget and other budgetary issues.

Commissioner Tangeman agreed.

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BOB MITCHELL, CHIEF INVESTMENT OFFICER, DEPARTMENT OF REVENUE, discussed his experience. He referenced a February 5, 2019 presentation on investments by Treasury Division Director Pamela Leary; and stated there had been a number of performance questions that had come up in committee. He hoped to provide additional information on the questions. He had worked with the treasury division for twenty years. He had worked in the fixed income team, including as the senior portfolio manager for 13 years. He was named deputy chief investment officer (CIO), and had made recommendations to the CIO relating to asset allocation and risk management. He was hired as CIO in May 2017.

Mr. Mitchell discussed his educational background. He had received a Bachelor's degree in Economics and a Master's degree in Business Administration from the University of Alaska Fairbanks. He had attained the right to use the charter financial analyst designation.

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Mr. Mitchell discussed the presentation "State of Alaska Performance Comparison," (copy on file).

Mr. Mitchell turned to slide 2, "Investment Performance," which showed a table. There had been questions centered around apparent differences in returns among state portfolios. He recalled that the committee had questions in

a previous meeting about the Public School Trust Fund (PSTF). He informed that there had been references to differences in return expectations between the state funds and the retirement funds, which he would address. He noted there was a request to compare performance of the state retirement systems with the performance of the Permanent Fund.

Mr. Mitchell continued to address slide 2. He noted that state funds had investments that were in publicly traded securities; and as a result, the performance information was available fairly quickly. He considered the portfolios in the retirement system and Permanent Fund, which had significant parts invested in non-liquid assets; more time was required to get performance information. When Director Leary had made a presentation, there was different performance information. The slide attempted to break out the performance for specific time periods.

Mr. Mitchell continued to discuss slide 2. There were four tables on the slide. The top two tables covered the December 31 time period. He had made the determination that there was a more appropriate "high-risk" designation for the Alaska Retirement Management (ARM) Board Fund and the Permanent Fund rather than the "moderate" designation reported by Director Leary. Mr. Mitchell clarified that the determinations were his own.

Mr. Mitchell addressed the error on slide 2, which pertained to the FY 19 Equity Target column for the ARM Board for private and public equities.

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Mr. Mitchell continued to address slide 2, noting that there was no performance available for the retirement systems for the December 31, 2018 period. He discussed the 'Equity Target' column, in which one could observe that both the Permanent Fund and the retirement systems had significant equity allocations, as well as significant alternative investments. The numbers did not fully reflect the risk profile of the portfolios. To the right of the equity numbers, he pointed out the 10-year return target and projected standard deviation. The ARM board expected return for an over 10-year horizon was 6.6 percent, with a long-term objective of 7.38 percent. The reason for the difference was due to increased returns expectations over

time. He discussed sources of information. He thought it was important to be cognizant of the time horizon being considered when discussing expected returns.

Mr. Mitchell stated that the existing allocation for the ARM board had 7.4 percent expected return, but over 10 years was 6.6 percent. He hoped it was possible to see that expected returns were somewhat consistent. He noted that the information on the Permanent Fund was sourced from the APFC website.

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Mr. Mitchell addressed state funds on slide 2. He noted that the asset allocation of PSTF had changed fairly significantly over the previous five years. He thought it was useful to consider the five-year average equity allocation in order to understand the risk profile of the portfolio over time. He discussed average return targets for the PSTF; which was 53 percent for the five-year average and was currently in the high 60s. The reason for the difference was two-fold. He detailed changes to the asset allocation that started December 1, 2019 which reflected new spending methodology for the PSTF.

Mr. Mitchell continued discussing the difference in the return targets for the PSTF. There was a change to a more risk-seeking portfolio, which had a substantially higher equity allocation. He discussed the management of asset allocation. He discussed inflation-proofing and noted that a 3 percent cushion had been used. Over the previous five or more years, the expected return had a declining pattern. To achieve the expectation of PSTF's purchasing power, it was necessary to increasingly ramp up the equity allocation in the fund. Conceptually if the return expectation was lower, it required more risk in the portfolio to maintain a minimum threshold of purchasing power.

Mr. Mitchell discussed equity allocations by fiscal year. He noted that the equity allocation was about 42 percent in FY 14, which increased to 50 percent the following year and hovered in the mid-50s for the subsequent three years. He referenced HB 213 [legislation passed in 2018 that created an education endowment fund and dividend raffle fund], after which the asset allocation was changed. He detailed declines in the domestic equity market.

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Mr. Mitchell continued to discuss equity allocations as shown on slide 2. He discussed the low performance of the PSTF and pointed out that substantially lower equity allocation. He compared the PSTF to the Power Cost Equalization (PCE) Fund and expected that the asset allocation and performance of the two funds would be more similar in the future.

Mr. Mitchell discussed the low one-year performance of the PSTF. He noted that during the same period, the Permanent Fund had a substantially better performance during the same period. He commented that risk was rewarded over time, either in the public or private markets. He expected funds like the Permanent Fund and the retirement systems (which had illiquid investments) would show some impact.

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Mr. Mitchell continued to discuss slide 2. He noted that shorter term performance could be harder to interpret and encouraged members to think about long-term performance from five-year numbers or longer. He commented on state funds, which unlike the Permanent Fund and retirement systems, were not permitted to invest in unregistered securities. State funds could not be invested in private investments, which was a primary reason for state funds being invested in stocks and bonds.

Mr. Mitchell noted that he provided the information to show the impact of different quarters, but also because there had been a request to compare returns of the pension systems, state funds, and the Permanent Fund. He noted the similarity in performance of the funds. He did not expect all five-year periods to equal out but reiterated that it was important to focus on "the long game."

Co-Chair von Imhof appreciated slide 2, and thought it was a "dashboard" that would be helpful to continue reviewing. She pointed out the difference between the performance of the funds in different quarters. She commented on the volatility amongst the funds. She pondered another quarter of poor returns and considered the impact on the state's daily cash flow. She suggested that when the CBR was low, and if the ERA was transferred, the state would have less of a collective cushion to address medium returns if there

was a prolonged market recession. She thought it was important and fiscally prudent to maintain a cushion to monitor the state's cash flow. She hoped members would recognize the importance of volatility.

[9:58:40 AM](#)

Senator Micciche thought it seemed that the PCE was disproportionately adversely affected above the Permanent Fund and the Alaska Retirement Management Board allocation. With the expectation of upcoming lower returns, he questioned if the asset allocation was over-exposed.

Mr. Mitchell thought it was necessary to take risk in order to generate returns over time. He considered the requirements of funds within the state system and mentioned taking the least amount of risk to achieve the objective. The objective for the PCE was a 5 percent return, which required a meaningful allocation to the equity market. The fund had a long time-horizon, so the portfolio could handle lower market periods. In the long term, it was expected that the equity market would provide higher returns, but it was necessary to absorb short-term losses. He did not think the state should take more risk than necessary to achieve objectives. He believed the maximum amount of risk the state could take was roughly 70 - 30. The PCE had a higher allocation to equities five years previously, and return expectations were going down.

Mr. Mitchell continued to address Senator Micciche's question. The expected returns shown on slide 2 were a function of the capital market assumptions provided by the state's general consultant, Callan and Associates, and were updated annually. There were revised capital market assumptions that would be used for the upcoming fiscal year. The early indications were that the ten-year return expectations in the capital market assumptions were higher than the previous year. There was a declining trend that was flat and then rose. He discussed how Callan and Associates generated the assumptions. He expected marginally higher returns.

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Co-Chair Stedman asked Mr. Mitchell to discuss capital market assumptions in greater detail.

Mr. Mitchell stated that assumptions were required when formulating expected returns, such as performance of the bond market and stock market. Volatility of returns was considered. Fixed income tended to have less volatility, while there was more volatility on the equity side. He summarized that in the context of retirement systems or other asset classes, it was best to first consider the return and time horizon.

Mr. Mitchell discussed volatility of returns and to what extent did investments move up or down together. He mentioned diversification. Capital market assumptions were used to do math to determine what allocation would achieve the best outcome with a minimum amount of certainty.

Co-Chair Stedman asked about "basis points."

Mr. Mitchell stated that in fixed income, every basis point mattered, and was 1 one-hundredth of a percent.

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Senator Micciche appreciated Mr. Mitchell's answer, but did not hear an explanation of the inconsistency in investment logic between the PCE endowment, the Permanent Fund, and the ARM Board investments.

Mr. Mitchell characterized the funds as having similar risk tolerances. The funds were all long-term, and the proportion of the funds going out were relatively low. The three funds had fairly aggressive return targets, which required aggressive risk in the portfolios. The Permanent Fund and the retirement systems had the ability to invest in illiquid assets, a tool which was not available for state funds. The funds with illiquid assets were not affected as quickly by drawdowns in the market.

Senator Wielechowski wanted to understand the PSTF and PCE equity targets. He wondered how it was possible to have 5-year equity targets of 53 percent for the PSTF and 70 percent for the PCE endowment, yet with the same 10-year projected return and projected standard deviation.

Mr. Mitchell stated that one amount reflected looking back and one reflected looking forward. There had been substantial changes for the asset allocation for the PSTF, primarily as a result to changes to the POMV payout from

the Permanent Fund. The previous five years the PSTF had a lower equity allocation (reflected in the 53 percent versus the 70 percent for the PCE); but looking forward, the funds had substantially the same asset allocation and same return target.

Senator Wielechowski discussed the equity target of the PCE and the Permanent Fund. He thought it seemed that a 50 percent equity target was not a very high risk.

Mr. Mitchell commented that if the other 50 percent was invested in bonds, then the fund had a relatively lower risk allocation than the fund with 70 percent in equities. The Permanent Fund and retirement portfolios both had significant allocations to things such as private real estate and hedge funds. He thought it was harder to discern how equity-like some of the investments were. He discussed aspects and risk profiles of real estate investments. He commented that focusing on the equity portion of a portfolio that had illiquid investments might not fully appreciate the risk being brought to the portfolio.

Mr. Mitchell continued addressing Senator Wielechowski's question. He stated that in the Treasury Division, the thought of high risk included a significant chance of seeing a negative return in a given year. He thought it was appropriate to consider the Permanent Fund and the retirement systems as having a meaningful chance of a negative return. The Permanent Fund did show a negative return for a one-year period.

[10:11:50 AM](#)

Senator Shower asked how to receive the data on slide 2 more frequently.

Mr. Mitchell stated that the department produced return information for state funds on a monthly basis, and the information was located on the Treasury Division's website. There was quarterly information on the retirement system also available on the website.

Co-Chair Stedman recognized the work of DOR and the ARM board as functioning as two different offices. He looked at the projected standard deviation numbers of the Permanent Fund and the ARM Board Non-participant Directed Fund. He did not think the numbers correlated when there was a

significant change in risk and barely a change in projected return. He thought it would be nice to have a representative from the ARM Board as well as DOR in committee to discuss the funds.

Mr. Mitchell stated that with the exception of the Permanent Fund, the underlying capital market assumptions were very similar for the retirement system and the state. He continued that for the retirement system and the Permanent Fund, the department relied less on the generic Callan and Associates capital market assumptions, which were suitable for state funds. He cited differing definitions of asset classes and noted that it was not uncommon to enter into conversation with Callan about what were appropriate assumptions. Ultimately Callan made the determination, but to some extent the capital market assumptions for the Permanent Fund and retirement system were influenced by the discussions. He believed that (with respect to private equity) the standard deviation expectation employed by the ARM Board was significantly higher than it was for the Permanent Fund, which was why there were differences in the assumed standard deviation.

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Co-Chair Stedman noticed that the ARM board always had a higher standard of deviation and higher projected volatility than the Permanent Fund. He considered that the Permanent Fund was in perpetuity, and the Defined Benefit Plan might last another 30 years. He thought the Permanent Fund (being in perpetuity) would have a higher standard deviation expectation versus something that was finite in nature.

Mr. Mitchell thought to some degree the difference was embedded in slight differences in the capital market assumptions that were employed. He thought the source of the difference was the need to provide capital market assumptions that were reflective of the underlying investments in each of the portfolios. He believed private equity had consistently been higher than the risk assumption employed by the Permanent Fund. He was happy to provide a comparison for further information.

Mr. Mitchell thought Co-Chair Stedman was correct to point out that the Defined Benefit Retirement System was finite, and new employees were entering the Defined Contribution

Plan. Legacy defined benefit employees would remain in the Defined Benefit Plan, which would extend the life of the liabilities that would need to be paid. He thought it was a significant consideration that would enter into the ability to take risk in the portfolio, but he did not believe the point had been reached yet. To supplement, DOR frequently engaged in an asset liability study, and was in one currently. He expected at the April 2019 board meeting the ARM board would receive the study from Callan and Associates. One of the key elements of the study was to what extent did the shortened time horizon impact the ability to take risk and to give liquidity in illiquid assets.

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Co-Chair von Imhof thought the projected standard deviation was important to consider. She asked if the projected standard deviation described volatility or the extreme ups and downs. She opined that the Permanent Fund, even with a POMV, was correctly invested. She wanted to point out that it was imperative to keep the ERA somewhat protected so the state could weather high volatilities. She noted that the Permanent Fund had not been inflation-proofed in three years and thought there was associated risk. She thought that there was a balance needed to inflation-proof the corpus and keep the ERA intact. She appreciated the comparison with the ERA and the CBR, which was more of a daily cash flow.

Commissioner Tangeman stated that there was an inflation-proofing appropriation just short of \$1 billion in the current budget submitted by the governor.

Senator Wielechowski asked if SB 26 [legislation passed in 2018 relating to the Permanent Fund and the ERA] and the requirement for billions of dollars in funds from the Permanent Fund be available from the ERA would impact the risk tolerance and return targets from the Permanent Fund.

Commissioner Tangeman thought the bill would help stabilize the investment strategy around the Permanent Fund, considering the fact that the exposure to the entire ERA was laid out up until the previous year. He thought putting in a structured draw around a certain portion would give stability. He recalled the previous year there had been discussions with big swings around accessing the CBR. He

thought the Permanent Fund had to stay liquid since the appropriation structure coming from the legislature was not known. He thought the fact that there was a structure around a good portion of the ERA helped stabilize the ERA itself and helped stabilize the Permanent Fund's assets in the market to earn a higher return on the remaining balances.

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Co-Chair von Imhof appreciated Commissioner Tangeman's remarks about how a disciplined structured draw somehow insulated or protected the ERA. She pointed out that the Senate was hearing two bills proposed by the governor to take additional transfers from the ERA outside the structured draw in order to pay back dividends. She recounted that Office of Management and Budget Director Donna Arduin had also stated for the record that it was the administration's interpretation that transfers from the ERA at any given point were within the realm of the administration, and the funds were available for expenditure. She emphasized that there was a structured draw in place that was a disciplined and sustainable approach.

Co-Chair Stedman commented that the committee was very protective of the Permanent Fund. He recounted that in previous years when the legislature had dealt with the issue of unfunded pension, the state owed roughly \$6 billion. He thought the legislature would struggle over the next years to pay down a current \$6 billion debt for unfunded pension obligations. He commented on rising interest rates. He asked about duration matching the state's liability and assets. He recognized that a decade previously the equity infusion was out of reach due to the state's financial position at the time. He pondered a mechanism to fix part or all of the state's unfunded liability.

[10:26:59 AM](#)

Mr. Mitchell stated he could conceptually speak to Co-Chair Stedman's question. He thought a significant part of the process of the retirement system was estimating what was due and when it was due. He continued that DOA hired an actuary, and DOR hired another actuary to check the actuary and make sure the assumptions were acceptable. He stated

that the result of the analysis was an expectation of how much cash was required to make the benefit payments each month. He considered that there was a fair amount of investment risk to gain a return. He thought one strategy for addressing the mismatch was to purchase high quality bonds. He thought it was possible to build a portfolio of bonds to the extent the bonds were available in the maturity range the state wanted. He thought it was theoretically possible to build a portfolio that would have a cash flow profile that matched expectations of benefit payments when due.

Mr. Mitchell continued to address Co-Chair Stedman's question. He stated there were two issues with the portfolio he described. He qualified that bonds did not yield as much as stocks. In the short term, the volatility was significant and there was uncertainty. He discussed selling assets for assets that matched cash flows. If return assumptions were lowered (for bond portfolios), the state's funded situation would deteriorate. There was an embedded return assumption with the state's assets; when lowered, there would be a magnified impact.

Mr. Mitchell continued to address Co-Chair Stedman's question. To the degree that actuarial assumptions did not reflect reality, the state could end up building a portfolio of bonds that did not have the cash flow profile that it ultimately needed. He thought the bigger issue was that when the expected return of the asset went down, it required the state to pay more into the system.

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Co-Chair Stedman mused that when volatility decreased, one neutralized the volatility, which took an upfront cost. If the state had the cash and tried to do it year by year over the same amortization schedule, it would not be possible. It would take an up-front appropriation to match volatility of liabilities against assets. He thought it was possible with partial pieces of the portfolio.

Co-Chair Stedman had asked Mr. Mitchell's predecessor why the portfolio had not been duration-matched. He thought the issue had been burning in the background over the years the state had been trying to pay the liability off.

Mr. Mitchell thought that duration matching would remove some uncertainty about what the payments would be. He relayed that the department would take up the issue internally, and would work with Callan and Associates to explore the issues as part of the asset liability study it was engaged in.

Co-Chair Stedman thought volatility could be removed from the table with strategies.

[10:34:26 AM](#)

Senator Olson considered slide 2 and asked why there was not a comparison between international investments versus domestic investments. He thought that there had been concern that there were countries that were allegedly involved in activities the state found offensive such as terrorism.

Mr. Mitchell stated that international equities were a significant component of state funds as well as the ARM Board funds and the Permanent Fund. The previous ten years had been remarkable in that domestic equities had significantly outperformed international equities. He stated that DOR was guardedly optimistic about the relative performance of international equities over domestic equities going forward.

Mr. Mitchell addressed diversification and social concerns. To the degree that it was possible to diversify into international equities, he thought it lowered the risk profile. He relayed that the state's interests were for the financial best interest of the funds; and on the retirement side, the fiduciary duty was to the financial best interest of the participants. He explained that to the extent that there were social concerns (which came up from time to time), the department was guided by the rule that it was looking out for the sole economic best interest of the participants. Absent a compelling reason, the agency preferred to diversify rather than to restrict investments. He restated that absent any statutory restrictions for investing, the preference was to diversify the portfolio.

[10:37:09 AM](#)

Mr. Mitchell reviewed slide 3, "Investment Fund Snapshot 12/31/2018," which showed several data tables that were

primarily for informational reasons. He highlighted that the annual presentations to the committee from the Treasury Division had evolved over time. The slide was to provide a comprehensive look at the funds managed in the division. The 5 funds that had been the focus of the presentation by the director's presentation comprised about 80 percent of the total assets managed by the division, while the slide was a complete list.

Senator Wielechowski commented on the longest bull run in history. He asked if Mr. Mitchell had heard that there was a forthcoming recession and if he was changing risk tolerance or event horizons to prepare for a potential market crash.

Mr. Mitchell thought it was possible to see a recession coming, but he tried to resist the temptation to desire to tactically change the portfolio and tried to stay with the long-term asset allocation. He thought chances of achieving the long-term return was higher if discipline was maintained in terms of asset allocation. He could see the impacts of forward-looking views in Callan and Associates capital market assumptions. He mentioned the declining trend of expected returns. The goal of DOR was to set a strategic asset allocation and rebalance towards to the strategic allocation with in-flows and retirement payments.

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Senator Shower thought it was important to protect the ERA and the Permanent Fund. He thought a structured draw added stability was important, and an adequate stream of revenue from the POMV draw. He asked about the equitable split of the earnings between the people and the government. He was curious about Commissioner Tangeman's thoughts and he would agree the items were important.

Commissioner Tangeman agreed that Senator Shower's points were important and thought that it was reflected in the administration's budget. He thought the state was in a position that was much better than most state's even thought it was experiencing a struggle. He thought Alaska had a very healthy Permanent Fund, had good laws in place to inflation-proof the fund, and had accessibility to the ERA. He thought it was fortunate that there were protections. He had found that during discussions of the POMV that it was a wise move of the legislature to

bifurcate the issues of protecting and accessing the funds. He referenced the state's credit rating and thought rating agencies recognized the healthy Permanent Fund. He thought the urgency and importance of getting a structure in place had been more important than the split.

Commissioner Tangeman thought the Permanent Fund could provide adequate revenue. He mentioned optimism from the oil sector and good investments. He discussed a flat production curve and a fairly stable price. He thought the POMV was a structured dependable revenue stream. He thought the state was as stable as it could be.

10:45:36 AM

Co-Chair von Imhof referenced the commissioner's comments about a healthy Permanent Fund and stability; and asked if he would say the state was in a fiscal crisis.

Commissioner Tangeman stated that the state was in a revenue stream crisis. He thought the state had depleted its accessible shock absorbers and opined that the state could not sustain the budgets it had enjoyed for some time. He thought revenues did not match expenditures.

Co-Chair von Imhof asked if the state had a revenue crisis, the commissioner was suggesting the state should look at new taxes.

Commissioner Tangeman relayed that he was on the record as saying that a tax would be in place someday. He personally thought a tax could be pushed off for some time; because he thought the state was in a position to match expenditures with revenue.

Co-Chair Stedman thought the conversation was drifting off topic. He anticipated that the commissioner would be back in committee when it considered the updated Revenue Sources Book and spring forecast presentation in the middle of March. He was optimistic that the legislature would make a forward step but was not sure it would reach a final budget solution. He thought the state would still be struggling with the same issues in one year. He thanked the testifiers and DOR. He discussed the agenda for the following day.

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ADJOURNMENT

10:48:36 AM

The meeting was adjourned at 10:48 a.m.