

SENATE FINANCE COMMITTEE
March 10, 2023
9:02 a.m.

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CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:02 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Donny Olson, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Click Bishop
Senator Jesse Kiehl
Senator David Wilson

MEMBERS ABSENT

Senator Kelly Merrick

ALSO PRESENT

Zachary Hannah, Chief Investment Officer, Treasury Division, Department of Revenue.

SUMMARY

PRESENTATION: POWER COST EQUALIZATION ENDOWMENT FUND PERFORMANCE - DEPARTMENT OF REVENUE

Co-Chair Stedman discussed the agenda. He relayed that the committee would hear a presentation dealing with the Power Cost Equalization Fund, which affected many people around the state. Topics would include the endowment, the investment policy, cash flow, asset allocation, and market performance.

^PRESENTATION: POWER COST EQUALIZATION ENDOWMENT FUND PERFORMANCE - DEPARTMENT OF REVENUE

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ZACHARY HANNAH, CHIEF INVESTMENT OFFICER, TREASURY DIVISION, DEPARTMENT OF REVENUE, discussed his background. It was his twentieth year as an investment officer for the Treasury Division, and his third year as the Chief Investment Officer (CIO). He discussed a PowerPoint presentation entitled "Power Cost Equalization Fund: Investment Policy, Performance, Downside Risk, and Spending Volatility," (copy on file).

Mr. Hannah referenced slide 3, "Power Cost Equalization Program Background," and noted that the program helped to reduce high energy costs for close to 80,000 Alaskans in approximately 200 communities. The Alaska Energy Authority (AEA) administered the program, and the Department of Revenue (DOR) managed the investments.

Mr. Hannah spoke to slide 4, "PCE: Cashflow," which showed the PCE cash flows over the previous 10-plus years including earnings, withdrawals, balances, and other information on the table. He noted that the totals over the long term, including 2022, showed earnings of roughly 6.8 percent and well in excess of the 4.3 percent spending rate. He cited that 2022 was notable for a downside perspective, but prior 9 years were strongly positive with an average of over 9 percent. He discussed 2022 and cited that the decrease in fund balance was \$191 million, through a combination of investment losses and fund withdrawals. Overall, \$55 million had come from withdrawals, and \$137 million from investment losses.

Mr. Hannah showed slide 5:

DOR/PCE Endowment Fund
Investment Policy and
Asset Allocation Process

Mr. Hannah turned to slide 6, "State Investment Policy and Asset Allocation Process," and noted that the next several pages covered an overview of the state investment policy and asset allocation process that was used for the roughly \$8 billion in funds under the fiduciary control of DOR. He explained that the division worked to design an investment program for each fund that balanced investment objectives, risk tolerance, and other attributes. Starting in December 2020, the state transitioned to a more transparent and independent process for doing so.

He continued that currently state investments were covered each quarter with the commissioner and an independent investment advisory committee. He highlighted that everything was subject to scrutiny and discussion, including investment policy and asset allocation. The meeting materials and summary were publicly available. The process was in its third year and in some respects mirrored that of the state's retirement systems.

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Co-Chair Stedman asked to stop on slide 6 and discuss the two charts.

Mr. Hannah explained that the top right-hand chart was a scatter-gram of compound ten-year returns using Callans current market assumptions for 2023. The range of returns included cash through 100 percent bond portfolios and stock portfolios in increments of 10 percent. He noted that the top chart would be addressed in more detail in a later slide. The bottom chart on the slide showed a range of risk tolerances that were employed for various state funds.

Co-Chair Stedman observed that the PCE Endowment was listed on the table on the bottom, followed by the Public School Trust Fund and the Higher Education Fund. He asked Mr. Hannah to address why the funds were classified at a higher risk level than the PCE Fund and the difference.

Mr. Hannah described that all the funds on the table were at the same high-risk profile as the PCE Fund. He noted that he would address that the funds were at the highest acceptable risk profile recommended for state funds, and for a variety of reasons the funds had a time horizon that allowed for taking on a certain amount of risk and an ability to accept some amount of volatility.

Co-Chair Stedman asked if the funds were comingled.

Mr. Hannah answered that the funds were comingled at the underlying investment level. When the funds were invested in domestics stocks or fixed income, the funds were comingled but were not comingled at the overall asset class level and could have different asset allocations.

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Co-Chair Stedman asked if everything listed below and including the PCE Endowment was comingled, or was the group mixed in with the Constitutional Budget Reserve (CBR).

Mr. Hannah affirmed that all of the funds on the table shared an underlying common group of investment building blocks by asset class. He continued that all of the funds above PCE Endowment (with the exception of General Fund and Other Non-Segregated Investments (GeFONSI) and the International Airport Fund) had different asset allocations. Starting with the PCE Fund through the Higher Education Fund, the funds had the same highest risk profile asset allocation.

Co-Chair Stedman asked if the group had different allocations amongst the group.

Mr. Hannah answered affirmatively and stated that the funds used the same underlying building blocks, and most had different asset allocations.

Co-Chair Hoffman recounted that the administration had deemed the PCE Fund to be sweepable, and eventually it was not determined so by the courts. He asked what other funds on the table had been deemed sweepable.

Mr. Hannah relayed that the only other fund on the list of the highest risk funds that was sweepable was the Higher Education Fund.

Co-Chair Hoffman asked what action Mr. Hannah's office had taken regarding investments when the funds had been deemed as sweepable.

Mr. Hannah relayed that he had a slide that covered the topic specifically.

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Mr. Hannah considered slide 7, "Asset Allocation," and explained that Callan was the investment consultant for both the Alaska Retirement Management (ARM) Board and the Alaska Permanent Fund Corporation (APFC). The department also used Callan's capital market assumptions. He noted that the charts on the right-hand half of the slide illustrated a couple of aspects that had influenced investing over the previous 30 years. He described that in

1993 it was possible to have a fairly simple portfolio composed of largely fixed income. Over time as interest rates fell, fixed income was providing less return to portfolios and required supplementing with increasing levels of risk in the form of equities and other asset classes.

Mr. Hannah made note of increasingly risky portfolios on the graph from 2008 to 2022, as measured by the risk number going up to an almost 17 percent in 2022. He observed a curiosity in 2022, after a huge increase in interest rates that had made a huge negative impact on returns with a positive impact on forward expectations. To achieve the nominal 7 percent return, it was necessary to hold less equity risk assets.

Mr. Hannah noted that the chart on the bottom corner of the slide had the forward risk and return including a 2022 line and 2023 line. He noted that 2023 was a significant step up because the expectation for fixed income returns was so much higher, with a forward expectation for equities that was modestly higher.

Co-Chair Stedman summarized that as interest rates went up, bonds went down. He observed that bonds came under significant downward pressure at the same time as the stock market.

Mr. Hannah agreed.

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Mr. Hannah highlighted slide 8, "2023 Capital Market Assumptions," and noted that each year DOR went through the process of selectin asset classes for inclusion in state portfolios. The asset classes currently being used were shown in bold and italics and included a diverse set of liquid public market investments. He noted that he used the term "liquid" to refer to securities that were traded daily. He noted that a characteristic of state portfolios was the composition of strictly liquid securities.

Mr. Hannah noted that the bottom of the table showed items not publicly traded that the state did not invest in, including private equity and private real estate. The state could not invest in most of the asset classes until late in 2020, when the United States Securities and Exchange

Commission (SEC) changed the definition of accredited investor to include direct state funds. For a long time, retirement funds had been considered an accredited investor, and the APFC had a letter ruling from the SEC that allowed it to invest in alternative assets.

Mr. Hannah explained that holdings that were direct holdings of state governments could not invest in unregistered securities like private market investments. While it was possible starting in 2021, it was possible for the state to directly invest in alternative investments, the DOR did not recommend the practice. He qualified that there was ultimately a liquidity mismatch between the illiquidity of the investments compared with the annual budgetary and policy changes that could take place with the legislature and administration. He relayed that there was some interest from the committee to compare the PCE Fund asset allocation with that of the ARM Board and the APFC, and noted that there was a comparison in the appendix of the presentation. He summarized that the biggest difference was the alternative investments, which altered the liquidity profile and the character of the returns.

Co-Chair Stedman asked about the ARM Board.

Mr. Hannah explained that the ARM Board were the pension assets managed by DOR on behalf of the state.

Co-Chair Stedman asked if Mr. Hannah was comparing the allocation relative to the allocation of the retirement funds.

Mr. Hannah informed that the appendix had a comparison of the PCE Fund to the ARM Board's and APFC's asset allocation, which both included significant exposure to alternative investments.

Co-Chair Stedman asked Mr. Hannah to refrain from using acronyms when possible.

Mr. Hannah looked at slide 9, "PCE Investment Policy is Based on Statute." The slide showed the investment policy as adopted for the current fiscal year, which was an annual process. The portfolio was designed to target the statutory goals of prudently maximizing total return and considering future purchasing power. He noted that the degree of asset smoothing did impact spending goals. He mentioned a natural

tension between current spending and the preservation of purchasing power.

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Mr. Hannah showed slide 10:

Performance Through December 31, 2022

Mr. Hannah advanced to slide 11, "Capital Market Performance Update," which focused on 2022, which was a challenging year. He noted that the chart on the right was sometimes referred to as a periodic table of returns. The chart rank ordered asset class returns from highest to lowest for each time period. He considered 2022 and observed that only cash had a positive return of 1.5 percent due to the impact of rising inflation and interest rates. Broad market U.S. equities were down 19.2 percent. He pointed out that the most unique aspect of the prior year was that bonds were down materially at 13 percent. He noted that the inset table on the left showed that any simple combination of stocks and bonds performed horribly in 2022.

He commented that on the far right, 2022 was broken into two halves on the chart. He observed that the first half of the year was almost universally bad, but the second half of the year showed most equities had positive performance and outperformed bonds.

Co-Chair Stedman asked if the asset mix shown on the left had fairly common results or if it happened once in a time period.

Mr. Hannah thought the results were a once-in-a-lifetime event. He thought it had been since the 1800's since stocks and bonds had co-performed so poorly. He identified the unique set of circumstances from the Covid-19 period, massive stimulus pushing bond yields down, followed by starting with a low base and having to react to an inflationary environment. He identified that one of the advantages of bonds over equities was that as returns were low during an interest rate reset, the ultimate expectation would likely still be met in time whereas equities were more volatile. While there was a sharp negative trend for bonds the previous year, the upside was higher forward expectations.

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Senator Bishop asked about the highest yielding bonds.

Mr. Hannah referenced the yield curve and discussed riskier bonds that were a spread off of government owned bonds. He noted that for risky bonds, there could be yields in the high single digits or even double digits.

Co-Chair Stedman referenced Mr. Hannah's discussion of bond maturity. He asked if the bond portfolio was made of individual bonds.

Mr. Hannah relayed that the bond portfolio was actively managed with individual bonds.

Co-Chair Stedman asked if an actively managed bond portfolio was different than a laddered approach to bond portfolio management that one would hold to maturity.

Mr. Hannah affirmed that there was a difference, and the portfolio was holding bonds at various levels of maturity. He added that there was still a contractual commitment for repayment of bonds, unlike for equities, that did allow for bringing forward higher yields.

Co-Chair Stedman asked about the turnover rate of the bond portfolio.

Mr. Hannah did not have the information at hand.

Co-Chair Stedman asked Mr. Hannah to provide the information to the committee and give an estimate including the previous two to three years.

Mr. Hannah looked at slide 12, "PCE Performance Through December 31, 2022," which showed a table. He pointed out that the performance for the one-year period and for most periods had been modestly ahead of the fund's benchmark. He noted that 2022 clearly was a poor year from a total return perspective overall. Most of the outperformance came from fixed income asset classes, which were the most actively managed as opposed to the equity asset classes that were largely invested in stock market indices.

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Mr. Hannah showed slide 13, "PCE Performance Compared with Prior Asset Allocations," which he thought was responsive to Co-Chair Hoffman's earlier question. He wanted to address the committee's request to compare the fund's portfolio with prior asset allocations. He noted that there had been a number of changes over the years including legislative changes. He made note of three asset allocation moves over the last few years. He had compared the actual returns of the PCE Fund with the returns of three portfolios as if there had been no additional asset allocations. The change the previous year to prudent investor resulted in better returns since it increased equity risk. The original portfolio that targeted a 7 percent return had the worst performance in 2022 and had the best performance over the full four-year period.

Mr. Hannah thought the correct standard made good sense, and forward asset allocations were subject to a very transparent and independent review.

Mr. Hannah referenced Co-Chair Hoffman's question and noted that the largest change that could be seen on the table was the five percent target return shown on July 2020. There was a de-risking that had occurred at the time. He recounted a legislative change in 2017, that went from a target of a 7 percent nominal return to a target down to a minimum return of 4 percent. He relayed that DOR had continued to invest towards a 6 to 7 percent return for a number of years after the legislative change was made.

Mr. Hannah discussed the uncertain environment in July 2020, which is where he thought much concern with regard to sweeping funds had come into consideration. He thought the time horizon was the biggest determinate of how much risk a fund could bear. There had been a view that there was a risk that the time horizon for PCE was shortening, and the decision had been made to take the risk down a bit and focus on a 5 percent return.

Co-Chair Stedman asked if de-risking referenced building the cash position or building short-term bond position.

Mr. Hannah explained that in the stock-bond column, the de-risking was largely a shift from equities into bonds. There was a small cash allocation that did not change.

Co-Chair Stedman asked about the time frame for bonds.

Mr. Hannah explained that the bonds were broad-market bonds with a duration and maturity of 5 to 6 years.

Co-Chair Stedman asked about duration.

Mr. Hannah explained that duration was the amount of interest rate sensitivity in a bond portfolio. He cited that a bond portfolio with a duration of 6, with a 1 percent change in interest rate one could expect an increase or decrease of 6 percent.

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Co-Chair Hoffman asked what DOR did when the administration viewed the PCE Fund as sweepable. He asked where the funds were moved and for how long. He thought most of the funds that were swept were very small in comparison with \$1 billion. He asked about the actions of DOR.

Mr. Hannah thought the table on slide 13 accurately showed the trail of the PCE Fund. He thought there had been a concern that the fund would be swept and would go into the CBR. He understood that the fund was not swept. He thought that the fund was de-risked because of concern that the fund could be swept, which had the impact of potentially shortening the investment horizon. The fund had not been swept into the CBR.

Co-Chair Hoffman had been informed that the funds were taken out of the asset allocations in getting ready to be swept. He asked if it was Mr. Hannah's understanding or knowledge that he was referring to.

Mr. Hannah relayed that it was his knowledge.

Co-Chair Hoffman asked if the funds were never taken out of the asset allocations.

Mr. Hannah answered in the affirmative.

Co-Chair Stedman surmised that the funds were just reallocated into a shorter time horizon. He asked about the impetus for DOR to draw the conclusion that it should look at the asset allocation for the PCE Fund and prepare for liquidation.

Mr. Hannah relayed that he was not involved in some of the discussions involving the change, and could not speak to the specific impetus. He understood that the view that the risk of the funds being swept was material enough to decrease the risk of the funds.

Co-Chair Stedman asked where the information had come from, and whether it was from the legislature or from a chain of command in DOR.

Mr. Hannah reiterated that he had not been the CIO at the time of the change and understood that all of the decisions were made in discussions had happened at the department with information provided by the collective group that led to the decision.

Co-Chair Stedman asked about the collective group.

Mr. Hannah referenced the collective group of DOR. He referenced the annual asset allocation process that the department went through in 2020. The time horizon of every fund was considered as part of the process. He understood from going through documentation that for the PCE Fund, there was a view that there was a risk that the fund might have a shortened time horizon. The fund still had a fair amount of investment risk and had a targeted 5 percent return rather than a target of 6 to 7 percent previously.

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Co-Chair Stedman asked Mr. Hannah to provide information regarding the dates of de-risking and the dates of alteration of asset allocation.

Mr. Hannah relayed that typically when DOR made annual asset allocation changes, the shift in risk happened fairly quickly within the first several weeks of the fiscal year, which was what he thought took place in this instance.

Co-Chair Stedman asked Mr. Hannah to get back to the committee with the weeks the allocation de-risking took place, as well as the weeks that it was unwound.

Mr. Hannah agreed to provide the information.

Senator Wilson wondered who had been involved in the decisions such as changing the target return.

Co-Chair Stedman asked Mr. Hannah to provide more information pertaining to Senator Wilson's question. He asked the broader question of how the department dealt with asset allocation decisions. He thought the commissioner had extensive powers and authority. He thought the commissioner may or may not have counsel from others.

Mr. Hannah agreed to look into the matter and commented that since he had been CIO there was a very independent quarterly process that was transparent and was subject to review. He specified that every change in asset allocation was subject to a lot of scrutiny by independent experts.

Co-Chair Stedman relayed that the legislature had encouraged every commissioner to have a process to fall back on and reflect decision making. He mentioned past incidents that had cost the state over \$1 billion.

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Senator Bishop referenced Co-Chair Stedman's comments regarding the timeline of when the funds would theoretically be swept and changes in asset allocations. He asked Mr. Hannah to provide information regarding any resultant losses or gains that may have occurred.

Mr. Hanna relayed that the table on slide 13 attempted to answer the question. He pointed out the actual PCE Fund portfolio over one-, two-, and three-year periods. He observed that the original 7 percent target fund had worse performance over the one-year period, but better performance over the three-year period. He commented on the higher risk during the Covid-19 pandemic. If there was higher risk during the period in the longer term, funds tended to outperform. He thought that generally speaking, a new asset allocation was put into effect fairly quickly. He noted that it was probably a matter of days or as much as a week or two and explained that a date of July would signify the first week or two of the new fiscal year.

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Senator Bishop relayed that he would work with Co-Chair Stedman about clarifying his question.

Co-Chair Stedman thought it might help to have more precise information pertaining to the date of the change in asset allocation.

Co-Chair Olson acknowledged that there were tumultuous times when the PCE Fund was being discussed as sweepable. He referenced Senator Bishop's question and about the net outcome of the changes and liquidation of the fund.

Mr. Hannah agreed to get back to the committee with numbers. He noted that the fund's returns were on the slide. He clarified that there was no liquidation that had occurred, and that there was a decrease in risk that had occurred. He characterized the change as not a full de-risking but rather a move from a 6.5 percent expected return down to a 5 percent expected return. He continued that if the funds had moved down to the CBR, it would decrease to a 1 percent expected return. He agreed to provide additional information. He emphasized that the fund was not liquidated but was modestly de-risked due to the view that there was increased risk that the time horizon might decrease.

Co-Chair Olson considered the fund in 2022 and the loss of \$200 million. He clarified that he had been asked how much the PCE Fund had lost in the de-risking of the fund.

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Mr. Hannah displayed slide 14:

Asset Allocation,
Downside Risk, and
Spending Volatility

Mr. Hannah turned to slide 15, "The Risk and Return Tradeoff," which addressed how the division thought about risk. The table on the slide showed the prospective asset allocation for the PCE Fund for FY 24. He highlighted that the PCE Fund asset allocation in the middle of the chart. The first set of bold numbers showed return statistics for a 10-year forward period. The nominal or total expected return was 6.8 percent, which was expected to remain steady if the fund was in the same asset allocation. The real return was 4.3 percent after being reduced by 2.5 percent inflation. He cited that if the goal was to completely

inflation-proof the fund, the real return number would be the forward expectation of how much the fund could expend and be fully inflation-proofed.

Mr. Hannah continued to address the table on slide 15. He pointed out that the last number in the section showed the amount of inflation-proofing that it could be if the PCE Fund spent at 5 percent. If spending was at 5 percent, the earnings that remained in the portfolio would cover roughly three quarters of expected inflation.

Mr. Hannah compared the portfolio to some alternatives, which had been requested by committee members. He addressed the right-most table, which showed six example portfolios which ranged from no risk, 100 percent cash up through 100 percent in equities. Starting with the cash-only portfolio, the expectation was a low nominal return of 2.7 percent and real return of .2 percent. The cash-only portfolio gave no ability to retain purchasing power in its risk-less investment. He looked towards the right and observed that at about the 60 percent equity area, the returns and inflation projection started to look modestly acceptable. Further towards the 80 to 100 percent equity portfolios, there was less diversification, and the division viewed the portfolios as testing the bounds of prudence. He highlighted that DOR positioned the portfolio at the roughly 70 percent equity level, which should provide for adequate earnings. The level preserved reasonable purchasing power and had manageable volatility, and had a prudent risk posture from an institutional perspective.

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Mr. Hannah continued to speak to slide 15 and addressed downside risk. He noted that all of the investments came at potential cost. He summarized that low levels of risk were unlikely to produce acceptable earnings, and high levels of risk added potential uncertainty and downside losses. The last section at the bottom of the table showed risk statistics. He explained that the standard way of discussing risk was as a standard deviation of returns, which he found "a bit opaque." He had included some downside statistical risk measures that addressed estimates of potential loss. He cited the 10 percent probable return over one year of negative 15.4 percent, which was an expected loss once in ten years. Since it was a 10-year forecast, it was the return that one might expect in one of

the next ten years. He pointed out that somewhat coincidentally, the estimate was close to the actual loss from the previous year.

Mr. Hannah addressed the 5 percent downside return over three-year periods of negative 8.2 percent, which he thought was a downside case worth considering for planning, since the PCE Fund did have a 3-year smoothing period. If the PCE Fund had a 5-year smoothing period, the number would further be reduced to negative 4.8 percent. He discussed smoothing over time and the lessening of loss over longer smoothing periods.

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Co-Chair Stedman asked Mr. Hannah to discuss inflation expectations over the next decade, and to address other information he had seen in the investment world regarding inflation expectations.

Mr. Hannah informed that the department used Callan's capital market assumptions, which were independent and had a robust process. He cited that Callan's expectations for 10-year forward inflation was 2.5 percent, and market inputs were providing roughly the same figure. He mentioned break-evens for inflation protected bonds, which were also in the 2.5 percent bonds. He mentioned the "tug-of-war" between inflation and growth.

Co-Chair Stedman understood that the department used information from Callan, where the committee also received oil price information that it benchmarked against other indices around the world. He asked about the payout rate of the portfolio under the expectations and wondered about the level of the draw.

Mr. Hannah offered that his perspective on the spending rate was colored by the expected real return. He cited that a 4.3 percent rate for a portfolio like the PCE Fund was where the Treasury Division was comfortable. With spending at the real return level, there would be a forward expectation of complete inflation proofing. He highlighted that the statute did not say "complete inflation proofing," but referred to future purchasing power. If there was spending beyond 4.3 percent, there should be an expectation of cutting into forward purchasing power. Spending 5 percent still allowed for inflation proofing at a three-

quarters level. If the goal was to completely inflation-proof, then the recommendation was to expect to spend at about 4.3 percent, which was what PCE Fund had expended historically. The real return from the capital market assumptions being the same amount as the spending was a coincidence.

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Mr. Hannah considered slide 16, "Hypothetical Historical Drawdowns of a 70% Stock / 30% Bond Portfolio," which showed another way to triangulate downside risk. He explained that the chart compared three- and five-year smoothing for a 70-30 bond portfolio similar to the PCE Fund over the past forty-plus years. The chart used actual stock market data. The dotted line showed rolling annual returns. He pointed out extreme volatility. The blue line showed three-year smoothing of annual returns, which reduced volatility considerably. With five-year smoothing (shown by the red line) there was incremental additional volatility reduction.

Mr. Hannah pointed out that the inset table showed that the three-year periods were very similar, but the historical market had been more volatile over one-year periods and less volatile over five-year periods. He thought the statistical forward measures penciled out fairly well with what the market had looked like historically from a downside perspective. He pointed out that the shaded region represented the prior two market drawdowns and recoveries. As expected, three-year smoothing was more reactive. He summarized that as one went through market turmoil, three-year smoothing would go down more quickly and go up more quickly, while five-year smoothing averaged the amount out further.

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Mr. Hannah displayed slide 17, "Spending Volatility Reduction with Smoothing - History," which showed two graphs that looked at three- and five-year smoothing over the recent history of asset levels for the PCE Fund. He observed that that over the period both had been close, but the three-year smoothing would always be higher from a combination of generally rising markets and the PCE Fund's spending profile. He noted that the lines had basically

converged at the end of the year with 2022's losses, and there was expectation that the lines would cross over.

Mr. Hannah commented that PCE spending was based on average balances, that were affected both by investment returns and spending almost in equal measure. He continued that over a three-year period, it was expected that spending evenly at 5 percent per year lowered the average value of the fund by 7.5 percent. In a downside case that resulted in a 3-year 5 percent probable loss of 8.2 percent, the total reduction in the three-year average would be roughly 16 percent when combined with spending. He offered the context that if the downside scenario was put upon the FY 24 budget, the fund would be reduced to \$46 million by FY 27.

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Mr. Hannah highlighted slide 18, "Prospective Spending with Smoothing - Median Forward Case," which illustrated a forward baseline case for the PCE Fund. The two charts showed what asset levels and spending could look like over the following decade, with three- and five-year smoothing, if the PCE Fund hit baseline case with a median return of 6.8 percent. He observed that the lower chart showed that the three-year smoothing would bottom out with a roughly 13 percent reduction from the peak at \$48 million.

Mr. Hannah noted that five-year smoothing was the most oft-used method for a fund like the PCE Fund, as it would better cushion the blow of possible decline in assets. He cited that often there was some form of volatility reduction through smoothing or other measures, and often some form of spending control if it appeared necessary.

Co-Chair Stedman considered historic highs for the fund and thought that the view looked forward a decade.

Mr. Hannah agreed.

Co-Chair Stedman asked if shortening the time horizon would require an equity infusion or a riskier portfolio.

Mr. Hannah added, "or a market correction beyond these baseline estimates." He explained that the slide showed a baseline smooth projection forward. He commented on the possibility for a quicker rebound, and discussed the math for an asset base to support preferred spending.

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Mr. Hannah looked at slide 19, "Conclusion and Summary Observations." He reminded that there was a comparison of the PCE Fund to the ARM Board and APFC if the committee wanted to discuss it.

Mr. Hannah advanced to slide 22, "PCE Statutory Investment Powers and Duties," which had been in response to some questions from the committee and Co-Chair Stedman. He referenced the Prudent Person Rule versus the Prudent Investor Rule, and relayed that the current standard was the Prudent Investor Rule. He explained that the care in which the fiduciary of the funds needed to treat them was the care that a Prudent Investor would treat like funds in like circumstances as if they were their own. The concept built on a body of work including the prior Prudent Person Standard. He discussed the history of the standards, which had started in the 1800's.

10:09:59 AM

Co-Chair Hoffman asked how the Prudent Investor Rule translated to the highest risk funds as shown on slide 6.

Mr. Hannah relayed that a prudent investor, looking at a set of circumstances that the department looked at with respect to the funds, would reach largely the same conclusions given the same facts for the funds. If one combined goals of maximizing returns, some inflation proofing, and the need to support a reasonably high level of expenditure, a prudent investor would come to the same conclusion that the department did in developing the same relative risk profile.

Mr. Hannah relayed that the second paragraph of slide 22 outlined the investment powers and duties of the DOR commissioner had with respect to the funds that were under fiduciary control. Some of the items were the same as a definition of the Prudent Investor. He thought there was an important clarification in statute to "exercise duty in the sole financial best interest of the beneficiaries." He thought the clarification came into play, particularly with respect to DOR's investment of the pension systems.

Co-Chair Stedman asked who the beneficiaries of the PCE Fund were.

Mr. Hannah answered, "Many residents of the state."

[10:12:45 AM](#)

Mr. Hannah spoke to slide 23, "Asset Allocation Comparison - PCE, ARMB, and APFC," which was a summary comparison. He noted that the PCE Fund did not have any alternative investments like private equity and private real estate. He noted that the PCE Fund column only had public equity and fixed income assets. The ARM Board had 36 percent in alternative investments, and the APFC had 42 percent in alternative investments. He noted that new asset allocations had not been made for all the groups, and the market assumptions were from the previous year.

Mr. Hannah noted that the second table illustrated a hypothetical scenario in which the PCE Fund was adjusted to the risk level of the ARM Board. He compared a 6 percent expected return for the PCE Fund adjusted to a 13.9 risk, versus a 6.3 percent return for the ARM Board.

Mr. Hannah considered administrative or legislative changes that occurred annually with portfolios, and thought it was difficult to invest in alternative investments with liquidity profiles that could stretch beyond five years. He discussed the perception of public portfolio investments, and the options provided by liquidity. He noted that the ARM Board and APFC had long time horizons and had a lot of control of governance risk. He thought the groups had made sensible decisions in terms of investments.

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Mr. Hannah commented that particularly at points of market inflection, it made it difficult to compare public market portfolios with portfolios that had significant exposure to alternative investments. He continued that anytime there had been a crisis or significant drawdown and rebound, one would see that alternative investments lagged public market investments considerably, even though they were tightly

linked. He explained that over time, the valuations would work themselves out. He thought the most difficult time to compare returns and draw conclusions was during times of market inflection. He thought for a portfolio like the PCE with 100 percent public market investments would likely strongly outperform portfolios that had a lot of alternative investments.

[10:19:53 AM](#)

Senator Wilson wondered if DOR also used Callan and other standardized aspects that the APFC and ARM Board used. He pondered DOR in competition with staff at APFC. He asked about investment decisions that had lacked transparency. He estimated that DOR had about 27 investment officers and managed about \$8 billion, while APFC had about 32 staff and managed about \$77 billion. He pondered shifting some long-term investments to APFC and employing fewer investment officers to manage accounts such as the SBR, CBR, and the General Fund and Other Non-Segregated Investments (GeFONSI) accounts. He mentioned issues at DOR such as staff and administration changes every four to eight years. He thought it could be more cost-effective for the state to make a shift.

Co-Chair Stedman asked if Senator Wilson was making a comment or asking a question.

Senator Wilson relayed that he had seen some questionable accounting practices with DOR. He thought it seemed more efficient and effective to downsize DOR's investment officers.

Co-Chair Stedman did not think there was a question of accounting, but rather the decisions coming from the top. He mentioned a question earlier regarding reallocation that had not come from investment officers but rather somewhere upward in the chain of command.

Mr. Hannah relayed that DOR had 15 investment officers, and estimated that it was roughly half the size of APFC. He thought the department's cost structure was quite a bit lower and thought DOR's performance was excellent. He clarified that the \$8 billion (mentioned by Senator Wilson) was only the assets under the fiduciary control of the commissioner of DOR. The department managed roughly \$50 billion in total, which was largely retirement assets and

was how he spent most of his time. He commented on the complexity of the systems. He cited that there were 14 retirement funds. He did not expect consolidation would result in cost savings, and he thought there was far less duplication of resources than people might expect.

[10:24:11 AM](#)

Co-Chair Hoffman asked to go back to slide 4, and consider June 2021, which appeared like it was an outstanding year with earnings of \$150 million. He thought the Permanent Fund had over 6 percent higher earnings for the same period. He asked how much potential earnings the state could the PCE Fund have because the department was anticipating the sweep.

Mr. Hannah discussed the returns of the PCE Fund and the Permanent Fund during the period in question. He clarified that the state could not own alternative investments prior to 2021. He noted that alternative investment portfolios took much time to build.

Co-Chair Hoffman clarified that his question was about the anticipation of the sweep of the PCE Fund, and asked if there were decisions made by DOR that precluded the fund from earning investments.

Mr. Hannah reiterated that there was a slide in the deck that showed the returns expressed in percentage. He relayed that he would provide the comparisons in numbers.

Co-Chair Stedman asked Mr. Hannah to be expeditious. He cited concern, directed at politics rather than portfolio managers, that politics had been pushed into management of the portfolio. He wanted to gather information on the timing and when meetings and discussions had taken place. He did not want the situation replicated.

Mr. Hannah was happy to provide the additional information. He reiterated that since he had been CIO there was a new process that was very transparent and well vetted.

Co-Chair Stedman recognized that the department did not look forward to discussing political winds in the department. He expressed the desire to keep politics out of the management of the three funds. He thanked Mr. Hannah for his testimony.

Co-Chair Stedman discussed the agenda for the next meeting the following week.

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ADJOURNMENT

10:29:15 AM

The meeting was adjourned at 10:29 a.m.