ALASKA RETIREMENT MANAGEMENT BOARD
BOARD OF TRUSTEES MEETING
HYBRID/TEAMS

October 12, 2023
10:00 a.m.

Originating at:
Atwood Conference Center
550 West 7th Avenue, 1st Floor
Anchorage, Alaska 99501

Trustees Present:
Bob Williams, Chair
Sandra Ryan
Mike Williams
Spencer Moore
Commissioner Paula Vrana
Donald Krohn
Dennis Moen
Lorne Bretz
Commissioner Adam Crum

Department of Revenue Staff Present:
Zach Hanna, Chief Investment Officer
Pamela Leary, Director, Treasury Division
Scott Jones, Investment Operations, Performance & Analytics
Mark Moon, State Investment Officer
Benjamin Garrett, State Investment Officer
Grant Ficek, Business Analyst
Alysia Jones, Board Liaison

Department of Law Staff Present:
Ben Hofmeister, Assistant Attorney General
Andrew Bocanumenth, Assistant Attorney General

Investment Advisory Council Present:
Josh Rabuck
Dr. William Jennings
Ruth Traylor

Department of Administration – Division of Retirement & Benefits Staff Present:
Ajay Desai, Director
Roberto Aceveda, Education & Counseling Manager

Department of Administration Staff Present:
Dave Donley, Deputy Commissioner

Callan:
Steve Center, Senior Vice President
Ivan "Butch" Cliff, Executive Vice President, Director of Research
Ben Taylor, Senior Vice President, Head of Tax-Exempt DC Research

Empower:
Dan Morrison, Senior Vice President, Government Markets
Marybeth Daubenspeck, Vice President, Government Markets
Kenneth Verzella, Vice President, Participant Advisory Services

Empower Advisory Group (EAG):
Ashleigh Kester, Senior Segment Manager, Advisory Services
Robyn Loftin, AVP Advisory Services
Benjamin Sia, Senior Manager, Plan Sponsor Analytics

Morningstar:
Thomas Idzorek, Chief Investment Officer-Retirement
Trisha Graham, Vice President, Head of Relationship Management
Rajneesh Motay, Senior Vice President, Head of Automated Advisory Products
Tao Guo, Director of Retirement Research

Public Present:
Matt Moeser, NEA Alaska
Kevin Balaod
Greta Myerchin-Tape
Dan Maclean, NEA Alaska
Jeff Stepp
Amory Lelake

PROCEEDINGS

CALL TO ORDER

CHAIR BOB WILLIAMS called the Special Alaska Retirement Management Board meeting to order and asked for the roll call.

MS. JONES called the roll.

PUBLIC MEETING NOTICE

CHAIR BOB WILLIAMS asked if the public notice requirements were met for this meeting.

MS. JONES replied, yes.

APPROVAL OF AGENDA

CHAIR BOB WILLIAMS moved to the agenda and asked for any corrections or additions. Seeing and hearing none, the agenda was approved.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS, AND APPEARANCES

CHAIR BOB WILLIAMS moved to the public member participation and asked if there was anyone online or in the room that would like to speak. Seeing none, he closed the public member participation, communications, and appearances portion of the meeting.

APPROVAL OF MINUTES

CHAIR BOB WILLIAMS moved to the minutes from the September 25, 2023, and the September 27, 2023, Managed Account Working Group meetings. He stated that the largest part of those meetings were in executive session. He asked for a motion to approve the minutes from September 25 and September 27.

> **MOTION:** <u>A motion to approve the minutes of the September 25 and September 27, 2023, meetings was made by TRUSTEE KROHN; seconded by TRUSTEE RYAN.</u>
>
> *There being no objection, the MOTION was APPROVED.*

CHAIR BOB WILLIAMS noted that Trustee Spencer Moore was on the board and attended all the committee meetings last time. He formally appointed Trustee Spencer Moore to the Actuarial and the Defined Contribution Committees.

INTRODUCTION TO MANAGED ACCOUNTS ANALYSIS

CHAIR BOB WILLIAMS stated that the meeting is about managed accounts and provided context for the meeting. He explained the that the Alaska Department of Administration has a contract with Empower, for recordkeeping services and the recordkeeping was for defined contribution, deferred compensation, supplemental annuity (SBS) plans, and included an option for a Managed Account Service. It used to be called Reality Investing and is now known as My Total Retirement. He stated that the ARM Board had several different types of funds that participants could invest in, and the Board reviews the performance of those accounts on a regular basis. The managed account piece, My Total Retirement, is where Empower takes discretionary control of the participants' account and implements investment advice for a fee, based on assets, and makes adjustments as time goes on. He stated that a survey of plans and boards showed $5 billion in defined contribution assets, with approximately two thirds of them having a managed accounts service, so it was common to have a managed account service. He stated that there are over 10,000 participants in our plans that are enrolled in Managed Account Services. $1.6 billion in assets, 7,347, or 71 percent, had 100 percent of their Alaska plan assets enrolled in the Managed Account Service. He explained that the Department of Administration manages the contract; but the ARM Board also has some responsibilities. By Alaska Statute 37.10.210(a), the Board serves as trustee of the assets of the State's retirement systems. Per Alaska Statute 37.10.220, the ARMB establishes and determines the investment objectives and policy for each of the funds to which they are entrusted. He continued that Alaska Statute 37.10.071(c) and Alaska Statute 37.10.210(a) require trustees to apply the prudent investor rule and exercise fiduciary duty in the sole financial best interest of the funds that are entrusted to them, and to treat beneficiaries with impartiality. There is also the responsibility to provide a range of investment options and establish the rules by which participants can direct their investments among those options with respect to accounts established under the defined contribution plans, the supplemental annuity plan, and the deferred compensation plan. He discussed the Callan Periodic Table of Investment Returns, which showed differences in performance of several different asset classes over time. He then shared the target asset allocation for the defined benefit funds. He explained that the Board sets the allocation every year, and that it is one of the most important things that they do. He commented on the mixture of assets, stating that the proportions are critical.

CHAIR WILLIAMS shifted to asset allocation for defined contribution funds. Looking at slide 9 (page 17 of PDF packet), he explained the two glidepaths and how it adjusts how much of your portfolio is in stocks and how much is in bonds, depending upon various factors, such as age. He said one of the Board's questions was what is the asset allocation for our members that are in Managed Accounts?

He explained every quarter the Board has Callan look at all of the Board's accounts and review performance for: last quarter, the year, three years, five years, seven years, and ten years, as well as the risk. He added that they receive performance data for all their other funds, but don't really see it for those in managed accounts and the Board is interested in the performance of our participants that are in managed accounts.

CHAIR WILLIAMS then provided a summary of what the Board did last year beginning with asking Empower for some additional information last fall regarding managed account performance. He noted that they received some incorrect information in late November 2022, and that similar concerns were raised at the March 2023 meeting, so the Board directed staff to contract with Callan for feedback and analysis of the managed accounts known as My Total Retirement. He welcomed Ben Taylor and Butch Cliff from Callan in person, and Patrick Wisdom online.

MR. TAYLOR stated that the intention is to make sure that they codify exactly what the key takeaways are from each of the different exhibits within the presentation. This was done to make sure that verbal commentary within the context of the written takeaway is present should anyone want to come back to see exactly what they are trying to communicate. He thanked Empower and Morningstar for the data received and added that the analysis was only possible through the cooperation of the Department of Administration, the ARM Board, his colleagues at Callan, Empower, and Morningstar. This is a frontier for the field, and we did a lot of work in getting the information exported to be able to conduct the analysis to be done the way we did, which allowed for some very compelling and novel findings. We believe that the findings are quite powerful and deserve significant consideration with respect to their weight and import. He explained that while some aspects are specific to Alaska's plans, this analysis by and large applies to this particular type of methodology. He stated that the information received covered 10,337 unique participants, over 14,000 total accounts, with some participants with multiple accounts. He noted that throughout they took methodological steps to be able to ensure that the differences between multiple accounts or individual were accounted for and is confident in the findings being robust to either frame, if it's accounts or if it's participants. Those accounts represent about $1.6 billion in total assets. For clarity, 7,347 or 71 percent of the participants had 100 percent of their Alaska DC plan balances enrolled in the service, which gave a very good treatment group to ascertain the effect of the service which covers everything that they have. Further, 61 percent of the total have enrolled in the service and had not provided information on outside accounts. He explained that the Morningstar methodology took into account outside assets and other aspects of financial life. This was both a benefit and also one of the critical areas that we will highlight as an area with room for improvement.

MR. CLIFF asked that the meaning of "completion portfolio" be defined.

MR. TAYLOR responded with an example of someone enrolling in the Alaska DC Plan that has outside accounts and how adjustments to risks and exposures are used to align the individual's portfolio. He added that they conducted a test between participants with outside accounts and those without and found that this effect would not materially change the analysis whether or not those outside assets were considered. He stated that the most profound discovery within this is that there was an aspect of the Morningstar methodology that applied a calculation to the total assets that can be observed and what it assumed future earnings would be. The Morningstar model took into account the human capital, the future earnings, as well as the actual financial capital, and blended them together. It then created a funding ratio calculation; it determined how close to achieving the retirement income that the model deemed necessary for target. He explained this more fully, adding that 28% of participants had equity constrained as a result of Morningstar's methodology. He then moved to the key findings: (1) the Morningstar methodology effectively generated a forecast as to what other financial capital a participant would ordinarily have from other employment prior to joining the Plans; (2) if those assets were not provided to the model, it would characterize that participant as underfunded for retirement. This is why they also examined how much of that information was provided by participants or visible to the model; which could (3) result in constraining the equity position lower; and causing (4) significant performance shortfalls relative to either a target date fund or an allocation that would have been chosen if the missing information had been supplied. He continued through the remainder of the presentation and illustrated what was found with respect to both methodology and how they were able to prove what they had seen so far.

CHAIR BOB WILLIAMS stated that it was seen from the periodic table that equities or stocks were going to outperform bonds over the long term for a long period of time. He was shocked to see a 27-year-old with only 85 percent equities, but the glidepaths were at 90. Then, like the 35 to 40, almost over 30 percent bonds by that time in the managed accounts. He asked if the main reason for that is primarily due to this funding ratio and being constrained.

MR. TAYLOR replied yes and addressed the question as to whether or not the outside assets were something that materially explained why that may be the case. He moved to slide 13 of the presentation (page 32 of PDF packet). He stated that Callan ran several, multiple, linear regressions, which are statistical techniques, given these variables, what most effectively would predict or explain the outcomes that were observed. He talked about the puzzle that led to discovering how the methodology worked because it was not understood why adding dollars into the model led to taking on more risk rather than having sufficient dollars and taking less risk. He attributed it to this aspect where failing to achieve the funding ratio threshold constrained it lower.

MR. CLIFF explained that the funding ratio rules explained the counterintuitive nature. The regression showed if someone added in Social Security or a pension, the model actually gave more equity because they are less likely to fall below the threshold. He added that if someone comes in at 50+ and adds their Social Security, they would jump above the threshold, and the model may add equity, but that individual is now twenty years behind.

MR. TAYLOR stated that it was no longer a theoretical discussion as to when this was happening or how it could work. The blue dots were the actual reductions for each participant who had their equity reduced in the plan. This is a full description of every person for whom this effect had taken place, which was over 2,800 participants out of the 10,337. He continued that the green line was averaging percentages, a simple average of the equity target reduction.

MR. CLIFF added that it agreed with the regression results.

MR TAYLOR stated that it was effectively the same number that was found in the regression results. Somewhere between 15 and 20 percent equity reduction was typical for someone with the funding ratio trigger applied to them, and it was very common to apply to people who are roughly of the age of joining the plan and beyond. Consequently, once the plan was joined, there was a very high probability, 28 percent observed so far, of having it constrain equity lower, causing lower accumulation over time.

CHAIR BOB WILLIAMS asked if this was known definitively and not a hunch. He asked if this is known for a fact.

MR. CLIFF replied that Morningstar provided that data and created the slides.

MR. TAYLOR added that these are the actual results for the plan. He stated that Callan vehemently disagreed with the methodology. He continued that being 30 years from retirement, the equity should not be constrained. There was not enough ability to forecast where someone would be in their life to be put in a place that was a slower path. He then turned to slide 18 (page 37 of PDF packet) to address the fees. He stated that the fundamental point is that in blue the expense ratio component is from the underlying funds. The model makes use of the actual funds within the plan. Depending on the way they were mixed, there would be a different level of average fees. He added that the ratio of roughly 5 to 1 is materially more expensive to achieve the outcome that has been critiqued thus far. He moved to a stylized illustration on slide 19 using some real observations from the plan. He reiterated that this was a stylized illustration to illustrate the impact of the preceding slides and turned it over to Mr. Cliff to discuss.

MR. CLIFF stated that later they would share the 10-year actual median dollar-weighted returns for the participants in the managed accounts program and participants in the target date funds. He explained that for this simulation they chose the 65 and older cohort and looked at the last ten years of simulated results for someone in their last ten years leading up to retirement who is in a target date fund or managed account. The simulation showed Managed Account/Advice participants were four percent worse off due to fees, and ten percent worse off due to performance and fees.

MR. TAYLOR added that those are actual returns, actual contribution patterns, actual average balance, and actual asset allocation associated performance that had been observed being illustrated. He continued that it is a fairly typical example over the prior ten years.

MR. CLIFF stated that another upgrade to the chart was taking the actual tiered fee schedule and, for this strawman participant, plugged in the actual fee they would have been paying as their balance grew. The fees went down on the managed account program as the balance grew through time. He thought that was fair with respect to fees.

MR. TAYLOR went through a stylized illustration that used a lot of real numbers. He stated that this looked different because it accounted for actual cash flows and were money-weighted rates of returns. It was not what a fund's performance was going to do. He continued and looked at two subsets of ARM Board overseen participants: No. 1 were managed accounts/advice; and No. 2 were in target date funds. He moved to all plan-level return and balance data which was provided by Empower. He thanked Empower for their help. He stated that Morningstar had been fairly adamant in saying that this would ideally be risk-adjusted. We could not do that with the numbers provided. The necessary data did not exist to do a risk-adjusted return for these calculations.

MR. CLIFF added that, over the long term, a person could not retire on risk-adjusted return. Bonds had a higher risk-adjusted return than equity, but 100 percent bonds in the savings program were not wanted.

MR. TAYLOR stated, for the record, that if this was reviewed at some later point by any other party or for you, trying to provide a risk-adjusted return when there was 22 percent of assets on average in stable value, was not ordinarily the correct way to do that, because stable value funds have a smoothing mechanism that understates risk. He added that it was consistently the crediting rate methodology rather than the volatility of underlying bonds, which would substantially understate the actual observed volatility in that bond portfolio.

MR. TAYLOR and MR. CLIFF discussed annualized returns of the two subsets for different age cohorts. MR. TAYLOR stated that across nearly every observed timeframe in the analysis, at median there is a material and significant performance trail for the Managed Account Service on a money-weighted basis relative to an age-equivalent targeted fund for the participants.

MR. TAYLOR then spoke to the fundamental component. He stated that they did not think this aspect of the methodology for the plans was as impactful as all of what was said before from asset allocation. He spoke briefly as to how funds were selected for use, as well. He continued that there were a lot of flaws in the methodology with respect to the forward-looking Alpha forecasts and fund selection. He thanked Morningstar for commentary in prior versions of this with respect to his phrasing in the summary. He then spoke briefly about the summary prior slides that said that the forward-looking Alpha tracking error process lacked theoretical underpinning. Alpha and tracking error is modern portfolio theory which is quite well-supported, but noted issues with the process and application, which created spurious forecasts. He clarified that it was a critique of the model but was unlikely to be something that contributes to the more important conclusions discussed earlier in the presentation. He then continued with a summary commentary and concluded the presentation.

CHAIR BOB WILLIAMS asked for any questions or comments.

TRUSTEE RYAN thanked them for their work and excellent job of explaining something very complex.

CHAIR BOB WILLIAMS asked for any other questions or comments. There being none, he called a ten-minute break and suggested the possibility of wrapping up the meeting before lunch.

(Break.)

DISCUSSION AND ACTION ITEM

CHAIR BOB WILLIAMS called the meeting back to order and stated that they were at the point of the agenda for discussion and the action item. He continued that, since it is a public meeting and this is the first time this information was shared with the public, he drew attention to Resolution 2023-18, the Alaska Retirement Management Board, Relating to the Empower Managed Account Service, My Total Retirement, for Defined Contribution Plans, Deferred Compensation Plan and the Supplemental Annuity Plan.

He read Resolution 2023-18:

"WHEREAS, the Alaska Retirement Management Board (ARMB) was established under AS 37.10.210(a) to serve as trustee of the assets of the State's retirement systems; and

"WHEREAS, under AS 37.10.220, the ARMB is to establish and determine the investment objectives and policy for each of the funds entrusted to it: and

"WHEREAS, AS 37.10.071(c) and AS 37.10.210(a) require the ARMB to apply the prudent investor rule and exercise its fiduciary duty in the sole financial best interest of the funds entrusted to it and treat beneficiaries thereof with impartiality: and

"WHEREAS, under AS 37.10.220 (a)(5) the ARMB is to provide a range of investment options and establish the rules by which participants can direct their investments among those options with respect to accounts established under the Defined Contribution plans, the Supplemental Annuity Plan (SBS-AP) and the public Deferred Compensation Plan; and

"WHEREAS, the Alaska Department of Administration has contracted with Empower to be the recordkeeper for the Defined Contribution, Deferred Compensation, and Supplemental Annuity Plans and has included a Managed Account Service (My Total Retirement, formerly Reality Investing) that takes discretionary control of a participant account and implements investment advice for a fee that is based on a percentage of assets under management; and

"WHEREAS, in a 2023 analysis of defined contribution providers, the ARMB investment consultant, Callan, found that fee-based managed account services were common and present in 67% of defined contribution plans with assets greater than $5 billion (Exhibit 1, Page 4); and

"WHEREAS, at the September 14, 2022, ARMB Defined Contribution Plan Committee meeting, Empower provided an overview of its Managed Account Service. During that meeting the Committee asked Empower for more information related to the performance of the service; and

"WHEREAS, during the November 2022 and March 2023 Defined Contribution Plan Committee meetings, Empower presented additional information regarding the performance of its Managed Account Service that was incorrect; and

"WHEREAS, on March 16, 2023, the ARMB directed staff to engage with Callan to conduct a thorough analysis of the Empower Managed Account Service, including the performance of the service; and

"WHEREAS, THE Callan ARMB Managed Account Analysis (Exhibit 2) provides an analysis of the Empower Managed Account Service and focuses on the level of participant engagement, asset allocation, account performance, and fund selection. The report uses information and data provided by Empower and their Independent Financial Expert, Morningstar; and

"WHEREAS, the Callan ARMB Managed Account Analysis focused on unique participants enrolled in the Managed Account Service. As of March 31, 2023, there were 10,337 unique ARMB participants enrolled in the Managed Account Service and these accounts had nearly $1.6 billion in assets. Of these, 7,347 (71%) had 100% of their Alaska plans enrolled in the Empower Managed Account Service (Page 3); and

"WHEREAS, the Callan ARMB Managed Account Analysis showed that the majority of Managed Accounts had low levels of participant engagement (Pages 6-7), a significant underweight to equity investments compared to 70 target date fund peers (Pages 8-9 and 13-14), and average fees that were over five times higher than the Alaska Target Date Funds (Page 18), the current default option for participants; and

"WHEREAS, the Callan ARMB Managed Account Analysis found that across the unique participants enrolled in the Managed Account Service, 2,851 (28%) had the level of portfolio equity exposure reduced due to the Managed Account Service Funding Ratio methodology (Pages 15-17), even though most participants did not provide meaningful additional account information or personalization. This resulted in the median Managed Account participant having materially lower equity exposure in their portfolio when compared to the Alaska Target Date Glidepath (Pages 10-14), or to the Morningstar Moderate Glide Path, which is similar; and

"WHEREAS, in the Callan ARMB Managed Account Analysis, the dollar-weighted returns for Managed Accounts were calculated and compared to Alaska's corresponding Target Date Funds. The median Managed Account Service account underperformed the median Target Date Fund across almost all age groups and time periods (Pages 22-34). The underperformance of the median participant in the Managed Account Service was the result of a combination of factors, including a higher level of fees and lower level of average equity exposure.

"NOW, THEREFORE, BE IT RESOLVED BY THE ALASKA RETIREMENT MANAGEMENT BOARD, that

"1. The ARMB expects the current Managed Account structure to continue to have lower investment performance due to the combined effect of its asset allocation, higher fees, and low participant engagement.

"2. The ARMB recommends that the Department of Administration close Managed Accounts to all new participants in any Alaska retirement plan.

"3. The ARMB directs staff to work with the Department of Administration and others to provide the Board with additional recommendations with respect to Managed Accounts."

That included the exhibits they had, Callan's Best Practices for Evaluating Managed Accounts, and also the Callan ARM Board Managed Account Analysis. He asked for a motion.

MOTION: A motion to accept Resolution 2023-18 was made by TRUSTEE BRETZ; seconded by TRUSTEE RYAN.

CHAIR BOB WILLIAMS commented that with us within the room were senior vice president of Empower, Dan Morrison, who oversees all of the government pension plans, and he personally thanked him for being present and for being engaged in some of the discussions. He was quite aware of the presentation and the resolution. He thanked him for the conversations and willingness to collaboratively work with the ARMB in moving forward with this. He also thanked staff within the Department of Law, Department of Revenue, Department of Administration. He continued that there was a lot of work by Callan, and this study was much bigger than originally imagined, with a lot of work that happened on weekends and late evenings. He thanked everyone for the time invested. He asked for a roll-call vote.

After the roll-call vote, the MOTION was APPROVED. (Trustee Mike Williams, yes; Trustee Krohn, yes; Trustee Moen, yes; Commissioner Vrana, yes; Trustee More, yes; Commissioner Crum, no response; Trustee Bretz, yes; Trustee Ryan, yes; Chair Bob Williams, yes.)

CHAIR BOB WILLIAMS asked for any new business. He then asked for any other matters to properly come before the Board. He continued that this was the time at the end of the meeting for anyone in the room, public-member participation, communications, and appearances, or online to make a comment. He asked for comments from the Investment Advisory Council.

IAC MEMBER RYERSON commented that this resolution is a great first step in the Board's attempt to get the best possible outcome for the members. It will be interesting to see what DOA produces as far as next steps for existing participants. It was a great analysis overall, and a lot of work on everyone's part.

IAC MEMBER RABUCK also expressed appreciation for the methodical, evidence-based approach with which the Board approached the matter. He also thanked Callan for the large body of work. He stated appreciation for the work performed with letting the data speak for itself and working collaboratively with the providers. He stated that the value proposition managed accounts have in a defined contribution plan should be that participant outcomes on average were helped by the offering. He continued with support of the recommendation that took the steps to quarantine the managed accounts as other details and ramifications are contemplated.

CHAIR BOB WILLIAMS thanked the IAC members and asked for trustee comments.

TRUSTEE MOEN stated appreciation for all the hard work and careful consideration.

CHAIR BOB WILLIAMS asked for any future agenda items. There being none, he asked for a motion for adjournment.

MOTION: A motion to adjourn the meeting was made by TRUSTEE RYAN; seconded by TRUSTEE KROHN.

MS. JONES noted that Commissioner Crum was on during the vote to accept Resolution 2023-18, but his vote did not come through. She stated that, for the record, he voted yes.

CHAIR BOB WILLIAMS thanked Ms. Jones and stated that there was a unanimous vote on the resolution.

There being no objection, the MOTION was APPROVED.

(Alaska Retirement Management Board of Trustees meeting adjourned at 11:57 a.m.)

Bob Williams
Chair

ATTEST:

Michael Williams
Secretary