

PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 1st Meeting of the 2019 Interim

February 25, 2019

Call to Order and Roll Call

The 1st meeting of the Public Pension Oversight Board was held on Monday, February 25, 2019, at 1:00 PM, in Room 154 of the Capitol Annex. Representative Jim DuPlessis, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Jimmy Higdon, Co-Chair; Representative Jim DuPlessis, Co-Chair; Senators Christian McDaniel, Gerald A. Neal, Dennis Parrett, Wil Schroder, and Mike Wilson; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, Russell Webber, and Buddy Wheatley; J. Michael Brown, John Chilton, Timothy Fyffe, Mike Harmon, and James M. "Mac" Jefferson.

Guests: David Eager, Executive Director, and Erin Surratt, Executive Director, Office of Benefits, Kentucky Retirement Systems; Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System; and Donna Early, Executive Director, Kentucky Judicial Form Retirement System.

LRC Staff: Brad Gross, Jennifer Black Hans, Bo Cracraft, and Angela Rhodes.

Approval of Minutes

Senator Parrett moved that the minutes of the December 17, 2018 meeting be approved. Senator Higdon seconded the motion, and the minutes were approved without objection.

Investment and Cash Flow Quarterly Update – Kentucky Retirement Systems

David Eager, Kentucky Retirement Systems (KRS), began by expressing gratitude for a special appropriation of \$16 million in funding that had recently been received.

Mr. Eager commented on cash flow for the first six months of the fiscal year for both the pension and insurance funds. Mr. Eager focused on the Kentucky Employees Retirement System's (KERS) nonhazardous plan and reviewed cash inflows, outflows, and asset losses as compared to the prior fiscal year. He pointed out the KERS nonhazardous plan was experiencing positive cash flow for the first time in many years, primarily driven by the increase in employer contributions. Across the remaining pension and insurance plans, negative investment returns outpaced positive cash flow, and each of the plans saw

net assets decline for the first six months of FY 2019. Mr. Eager noted that, while markets were down and drove the decline in assets, the KRS portfolio had performed better than the market.

In response to questions from Senator Higdon regarding administrative expenses, Mr. Eager stated that the most recent measurement of expenses was a benchmarking study performed in 2016, which reported that the KRS cost per member was \$7 below the peer group. Senator Higdon commented that administrative costs are very important and moving forward he hopes that the costs can be lowered.

In response to questions from Representative Miller regarding County Employees Retirement System (CERS) employer contributions, Mr. Eager stated that, if a phase-in did not exist, KRS would have received a contribution of 28 percent versus the 21 percent actually received. He noted that, if the full actuarially determined contribution rate were received, the plans asset value would have still declined, but not nearly as much.

In response to a question from Mr. Chilton regarding why KERS, the least funded plan, was the only plan to have positive change in assets, Mr. Eager stated the primary reason was due to the base of assets in KERS being so low. At just over two billion dollars, he commented that any gain or loss on existing assets would have less leverage than the significant increase in contributions.

Mr. Eager discussed asset allocation and reviewed current targets for pension and insurance assets. He pointed out that assets would fall into one of three broad categories, which included growth investments, liquidity investment, or diversifying assets. Mr. Eager noted that staff were focusing in on the portion of the portfolio that could provide alpha, such as aggressive equity, emerging markets, private equity, or specialty credit. For the CERS portfolios, this accounts for roughly 50 percent the portfolio, while within the KERS and State Police Retirement System funds it results in about 33 percent. The remaining portion of the portfolios would be invested passively or in strategies that provide returns less correlated to traditional stocks and bonds.

In response to a question from Mr. Fyffe regarding the portfolios fixed income allocation, Mr. Eager stated that the bulk of the fixed income is actively managed.

In response to a question from Representative DuPlessis, Mr. Eager stated there has been a gradual shift towards more internal management, which accounts for about 18 percent of assets currently.

Mr. Eager discussed recent investment performance for pension assets as of December 30, 2018, for all plans. Mr. Eager stated that fiscal year to date returns were down roughly 3 percent for the first six months of the fiscal year through December, but January saw markets rebound, and KRS was up about 4 percent for that month alone. Mr.

Eager also noted recent discussion regarding KRS' return assumption and pointed out that, depending on the time frame (i.e. 5-, 10-, 20- of 30-year), the results differed quite a bit. He indicated the KRS board and investment committee felt like the past should not drive the future, and while KRS might be more conservative with its assumption currently, they have erred on the side of too aggressive in the past.

Representative DuPlessis commented that maybe KRS should have some type of rolling average and a way to adjust the loss of compounding interest.

In response to questions from Representative DuPlessis regarding upcoming studies of assumptions, Mr. Eager stated that KRS was currently in the process of having an experience study conducted, which should be reviewed at the April board meeting.

Mr. Eager briefly discussed performance from the insurance plans as of December 30, 2018. He indicated the plans were largely invested similarly, and returns were roughly down 2 percent for the first half of FY 2019.

In response to a follow up question from Representative DuPlessis regarding the experience study, Mr. Eager stated that it is conceivable that mortality assumptions will change and any revised assumptions would be incorporated in the 2019 valuation process.

In response to a question from Representative Miller regarding how long current mortality assumptions have been used, Mr. Eager was not completely sure, but indicated the assumptions pre-dated Gabriel Roeder Smith, KRS' current actuary.

In response to a question from Representative Graviss regarding KRS' portfolio benchmark, Mr. Eager stated the benchmark is a blend of each index used for each asset class, such as U.S. equity, international equity, emerging markets, core fixed income, etc. In response to a follow up question regarding how many benchmarks are used, Mr. Eager stated each plan has a single composite, but that composite is based on a group of approximately 10 indexes for each asset class, which are weighted by allocation.

In response to a question from Representative DuPlessis with regards to system checks related to retired reemployed or "double dippers," Ms. Surratt stated that KRS' employer reporting system has edits built in, which require a check to see if a retired member has been reemployed within the allotted time period. Also, the members are required to submit a form prior to returning to employment with a participating agency on which both the member and employer must certify there was no prearranged agreement. There is also an anonymous tip line on KRS' website. Ms. Surratt stated that all accounts, whether reported internal and/or external, are investigated by the legal, benefit, and employer reporting staff. If the member is found to have violated the retired/reemployed laws, the retirement is voided. Ms. Surratt stated there have been several reports of

violations from Representative DuPlessis' district and that none of those reports violated the retired/reemployed provisions.

Investment and Cash Flow Quarterly Update – Teachers' Retirement System

Beau Barnes, Teachers' Retirement System (TRS), began by discussing recent investment performance as of December 31, 2018. He referenced how difficult the end of the year was as markets reacted to the Federal Reserve tightening monetary policy and increasing interest rates. He reviewed net of fee returns for the pension fund across the most recent quarter, along with fiscal year to date, 1-, 3-, 5- and 20-year trailing periods. Lastly, he noted the 30-year compounded gross returns were 8.04 percent.

Mr. Barnes indicated the start of 2019 had also brought an upturn since January 1, 2019, and he provided a snapshot from *The Wall Street Journal* showing the market hitting a low on December 24, 2018, before rebounding and pushing stocks near new highs. Mr. Barnes stated that, while December saw negative returns, it also gave staff an opportunity to put money back into the market. He indicated that TRS had sold over half a billion in stocks from July 2018 to September 2018 as staff rebalanced assets into short term bonds, which increased in value. In December, Mr. Barnes stated TRS had put \$350 million back in the market from the sale of those bonds.

Lastly, Mr. Barnes discussed the cash flow update as of December 31, 2018, and stated that the total cash inflows totaled \$1.4 billion, while outflows were \$1.071 billion. Net cash flow before asset gains or losses were \$333 million, with realized investment losses totaling \$489 million. This resulted in total net plan assets of \$18.2 billion (end of period), compared with \$19.9 billion at the start of the fiscal year.

In response to a question from Representative DuPlessis, Mr. Barnes stated that the investment income includes interest and dividend income, but it also reflects where TRS sold assets.

Investment and Cash Flow Quarterly Update – Judicial Form Retirement System

Donna Early, Judicial Form Retirement System (JFRS), opened with a brief historical review of the retirement funds managed by and the board of trustees governing JFRS. She expressed a belief that the board had been good stewards of the plans and referenced current funding levels as evidence.

In response to questions from Senator Higdon regarding the size of JFRS, Ms. Early stated that JFRS has 2 employees, herself and one other. She also noted that, while administrative costs are managed carefully, JFRS' costs can appear to be higher than the other retirement systems due to the limited number members.

Ms. Early discussed the membership profile of the legislators' plan, noting that 41 out of 138 are members of the hybrid plan, while 58 participate in the defined benefit plan and 38 are members of KERS. She pointed out that when the hybrid plan was created, the board of trustees choose to keep the funds segregated for cost and appropriation purposes.

Ms. Early reviewed recent investment performance for the Judicial Defined Benefit Plan and the Judicial Hybrid Cash Balance Plan. Like her TRS and KRS counterparts, she noted performance was not favorable in December, but noted the funds' market value had increased from \$385 million on December 31 to \$415 million as of February 22, 2019. The hybrid cash balance plan has a market value of \$1 million.

Ms. Early reviewed the Legislators' Defined Benefit Retirement Plan and the Legislators' Hybrid Cash Balance Retirement Plan. In the defined benefit plan, the market value was \$112 million ending December 2018 and has increased to \$121 million. The hybrid cash balance plan has a market value of \$247,636.

Lastly, Ms. Early reviewed the statement of changes in net position for the Judicial and Legislators' Retirement Plans. She stated that the judicial net plan assets as of December 31 fell by \$10 million, which was driven primarily by asset losses of 12 million. On the legislators' plan side, net plan assets had declined by \$3 million as of December 31.

In response to a question from Representative Wheatley, Ms. Early stated that legislators cannot opt out of the pension system.

Dolly Guenthner, retiree, testified that she was a whistleblower regarding the city of Elizabethtown for fraud against the KRS. She stated she wants support for whistleblowers.

There being no further questions, the meeting was adjourned.