PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 4th Meeting
of the 2020 Interim

August 24, 2020

Call to Order and Roll Call

The 4th meeting of the Public Pension Oversight Board was held on Monday, August 24, 2020, at 1:00 PM, in Room 171 of the Capitol Annex. Senator Jimmy Higdon, 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 Dennis Parrett, Wil Schroder, and Mike Wilson; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, Steven Rudy, Russell Webber, and Buddy Wheatley; John Chilton, Mike Harmon, James M. "Mac" Jefferson, and Sharon Mattingly.

Guests: Chris Biddle, Executive Director, Kentucky Public Employees' Deferred Compensation Authority; David Eager, Executive Director, Rich Robben, Executive Director, Office of Investments, and Dave Harris, Chair, Board of Trustees, Kentucky Retirement Systems; Rebecca Stephens, Interim Executive Director, and Stephen LeLaurin, Chair, Judicial Form Retirement System; and Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System.

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

Approval of Minutes

Representative DuPlessis moved that the minutes of the July 28, 2020 meeting be approved. Senator Parrett seconded the motion, and the minutes were approved without objection.

Kentucky Deferred Compensation Authority Update

Chris Biddle, Kentucky Public Employees' Deferred Compensation Authority (KDC), began his presentation by giving a brief description of KDC. He stated that KDC is the official supplemental retirement plan for all state employees, public education employees, and local programs that include local government employees.

Mr. Biddle discussed how KDC has adapted during the pandemic by stating that, although KDC is a state agency that acts as an authority by state law, it is also required to report directly to the Internal Revenue Service. He stated that the biggest adaption was implementing the CARES Act, which allowed access to accounts for COVID-19 related expenses. To date, KDC has assisted 357 participants with COVID-19 related withdrawals totaling almost $5 million.

Mr. Biddle stated that there have been zero interruptions or delays in services due to COVID-19 with requests being processed electronically online or via telephone. Mr. Biddle presented charts demonstrating that, even with an uptick in demand, KDC has maintained the same level of client service. Also, KDC has conducted statewide webinars virtually.

Mr. Biddle provided a chart of KDC's assets under management on all plans from January 2020 to August 20, 2020. He stated that in January KDC assets totaled $3.1 billion. KDC experienced a drop in assets in March to $2.7 billion due to COVID-19, but has since reached $3.4 billion.

Lastly, Mr. Biddle discussed auto enrollment. He explained that under the auto enroll program, all new state employees have $30 per month deducted from their pay to be placed in a money market fund. Employees have a 90-day period to decide whether they want to be in or out of the deferred compensation program. He stated that auto enrollment has been a huge success with a total of 3,869 participants since the July 2019 inception. He stated that there is a 94 percent retention rate.

Senator Higdon commented that the auto enrollment is a great success story, crediting the legislation that now requires employees to opt out of KDC instead of opting in the program. He also thanked Mr. Biddle for providing the data regarding the withdrawals permitted under the CARES Act.

Representative Graviss commented that KDC's response rate is impressive and asked how much of the portfolio is in private equity. Mr. Biddle responded that KDC has no private equity.

In response to questions from Representative Wheatley, Mr. Biddle stated that enrollment has increased by two thirds since the inception of auto enrollment and that KDC has not had to increase its staff.

In response to a question from Mr. Chilton, Mr. Biddle stated that, as set by statute, $30 is the minimum payroll deduction per month under the auto enroll program.

In response to a question from Mr. Jefferson, Mr. Biddle stated KDC's bonds and fund lineup is under certain and continuous review on a quarterly basis. KDC has a highly experienced investment subcommittee and an outside investment consultant.

In response to a question from Senator Higdon, Mr. Biddle stated that KDC has not had any issues with hacking of any of its online systems.

Quarterly Investment/Cash Flow Update & Fund Stress Testing – Kentucky Retirement Systems

David Eager, Kentucky Retirement Systems (KRS), began his presentation with opening remarks thanking the House members for HB 171 and stating that it is vital to get it passed.

Mr. Eager discussed a GRS Consulting (GRS) chart comparing the funded ratio. He stated that the Kentucky Employees Retirement System (KERS) had 12 consecutive years of underfunding and 17 years of negative cash flow and was almost off the chart. However, he declared his belief that the system is in a good position of becoming fully funded. He stated that as members retire out of Tier 3, KERS will see reductions in contributions as a result of the cash hybrid plan.

Next. Mr. Eager provided an overview of the realistic adjustments that KRS had made to KERS' assumptions in 2017, which had resulted in $7 billion in liabilities to the system. He emphasized that this was an increase in liability as opposed to a loss, as recent news articles had reported. He summarized other factors keeping KERS on track toward full funding, including a conservative portfolio. Finally, he outlined the stress testing data that KRS would offer later in the presentation.

Mr. Robben discussed a coronavirus timeline and provided a Wilshire Consulting chart that showed a rundown of the last quarter. He stated that KRS was down 38 percent at the peak of the pandemic, and it took about four months for KRS to get back to their pre-pandemic status.

Mr. Robben discussed KRS asset class returns for FY 2020. He stated that KRS has about 39 percent of their assets invested in equities that returned 1.44 percent during the fiscal year with the next highest being fixed income at 29 percent allocation with a 5.33 percent return. He stated that KRS' best performer in the portfolio was real estate with a 5 percent allocation and 9.77 percent return. He noted that there is still a 1.41 percent allocation in absolute return, also referred to as hedge funds, but that with a net effect of a negative six one-hundredths of one percent to the portfolio, its impact has nothing to do with KRS' performance.

In response to a question from Representative Miller, Mr. Robben stated that private equity was probably a bit higher four years ago, but, as to hedge funds, KRS had liquidated almost $1.7 billion of absolute return in the last four years. In response to a follow up, Mr. Robben confirmed that the KRS board had reduced the allocation in absolute return from approximately 10 percent to just over 1 percent. Mr. Harris added that KRS has done a lot of fee negotiations and stated there is no need for absolute return.

In response to a question from Representative Graviss, Mr. Robben agreed that private equity and high yield credit are included in the plan sponsor peer group analysis for the period ended June 30, 2020. In response to a follow up question regarding why KRS does not classify private equity and high yield credit in the alternative category, Mr. Harris explained that KRS is managing its monies in the categories of growth, fixed income, and diversified strategies. High yield, which is below investment grade debt, and private equity are categorized as growth investments given they are very economically sensitive and often act like public equity. Representative Graviss expressed his concern that KRS has invested 38 percent of its assets into investments that can be categorized as alternative investments, which are riskier than public equity and other more traditional investments.

Mr. Robben discussed the plan sponsor peer group analysis. He stated that KRS returned almost 9 percent in the quarter ending June 30, 2020, which was an outstanding quarter for a very risk averse plan.

Mr. Robben continued with the plan sponsor peer group analysis, stating that KRS continues to be one of the most risk averse plans, even with 38 percent in alternatives. Mr. Harris added that timing is important when looking at a performance snapshot. He noted that looking one quarter back to March, the KRS portfolio peer rankings were very attractive, but 90 days later they are below peers. He explained that there is quite a bit of volatility in the market right now, and with only 40 percent of investment in public equities, KRS will not fully experience higher returns when the market peaks.

Mr. Harris provided a chart from the Board of Governors of the Federal Reserve System on interest rates. He stated it is very difficult to project and assume liability numbers.

Next, Mr. Harris provided a chart of the Wilshire 5000, Warren Buffett's favorite indicator, which is the stock market value divided by the gross national product. He stated that the indicator is at the highest level ever recorded in history. He said, if investing for long term, KRS would be hard pressed to get risky at this point for the next three to five years.

Next, Mr. Harris provided a Shiller PE Ratio chart that takes the last 10 years' earnings of corporate America and smooths them out. He stated there has only been one other period where KRS had a higher valuation than today.

Mr. Robben discussed individual plans and stated that the KERS nonhazardous plan was the best performer at 2.36 percent being 129 bases points over its index, which equates to about $26 million extra in that plan. The County Employees Retirement System (CERS) was at 0.84 percent being 33 bases points over its index. He stated the real difference is the KERS and the State Police Retirement System plans went into the pandemic very conservatively and by policy they have a bit more latitude. At the end of March, KRS took all plans up to their maximum risk. He stated that the insurance plans have the same risk profile as the CERS plans with returns ranging from just shy of 1 percent for KERS nonhazardous to about 0.25 percent for CERS hazardous.

Representative Graviss commented that GRS looks 30 plus years out when looking at investment returns. Mr. Robben stated he is not certain of the time horizon that GRS uses for its projections. Representative Graviss stated, if the actuaries are looking at that long of a timeline for assumed returns with a 7.82 percent 30-year return, but the KRS board is still assuming a 5.25 percent return, then it would help the state financially and still comply with actuaries if the KRS board were to revisit its return assumptions. Mr. Harris commented that the actuaries do not set the assumed rate of return, but rather accept them with no calculation or projection. Rather, they use the return assumptions set by the board.

In response to a question from Representative DuPlessis, Mr. Harris stated that GRS has about a 27-year schedule of amortization of liabilities, and that GRS does not have any involvement in selecting the assumed rate of return. KRS uses a 10- to 15-year capital market assumption and revises it every year. He added that GRS looks at long term liability.

Senator Higdon commented that, in the 1990s, stock prices were extremely high due to the Dot.com bubble and that, as those years start to fall off, the 30-year average and the yields will start to go down. Mr. Harris agreed.

Mr. Harris added his concerns with KRS continuing under the Kentucky Revised Statutes (KRS) Chapter 18A, relating to the classified personnel system. He stated that it is difficult recruiting people under KRS Chapter 18A, particularly hiring and retaining a chief financial officer. Senator Higdon commented that there are issues without the controls of KRS Chapter 18A in place, and he does not favor removing KRS out from under the classified personnel system.

Mr. Eager discussed FY 2020 cash flow. He stated that at this time the CERS plans are the only two plans that are cash flow stressed caused essentially by the contribution phase-in. He stated that the KERS nonhazardous pension employer contributions declined from $1,035.5 million to $948.6 million, which was due to $75 million in special appropriations in FY 2019 that KRS did not receive in FY 2020.

Mr. Eager discussed risk management and stated that KRS routinely looks at and adjusts as necessary asset allocation, modeling, targets, and ranges. There is manager risk that entails selection, due diligence and ongoing monitoring, and KRS does terminate managers if warranted. KRS conducts asset/liability studies periodically with an actuary and the help of Wilshire. Finally, KRS conducts stress testing with GRS that entails deterministic and stochastic scenarios.

Mr. Eager said that KRS analyzed the three scenarios requested by the Public Pension Oversight Board, which included positive markets, flat markets, and negative markets. Mr. Eager then discussed the stress testing results for KERS nonhazardous and CERS nonhazardous for FY 2020, 2022, and 2040. He discussed the impact to contributions and funded status for each plan under each scenario.

Mr. Eager then discussed the 2019 sensitivity analysis for the KERS nonhazardous that included the investment return assumption and the payroll growth assumption for the pension plans. He also mentioned the scenario analysis that included pension and health combined for the positive, flat, and negative market scenarios. For the KERS nonhazardous, both the sensitivity analysis and the stress test modeling indicate contributions and funded status are not severely impacted (either positively or negatively) by investment results and payroll growth in the near term. Longer-term effects are more pronounced.

In response to a question from Senator Higdon regarding what the payroll growth would be if it is based on the actual percentage instead of the 0 percent that is being used currently, Danny White, GRS, stated that the board is assuming payroll is flat from year to year, but what actually happened is that last year's payroll declined by 3.9 percent. So, if the board used a negative 3.9 percent payroll growth for just one year, there is a smaller impact than if it extrapolate the same negative payroll growth over each future year going forward. Mr. White said that the impact of one year's experience can be smoothed. However, a trend of declining payroll growth at that rate raises an urgent policy question of whether the system should move away from the level percentage of pay method of amortization.

In response to a question from Representative Graviss, Mr. White stated that with a 0 percent payroll growth, historically, the state has been losing personnel at a rate of about 2 percent per year. However, the data presented shows a prospective number with the assumption that there will be some payroll growth in the future.

In response to a question from Representative Wheatley, Mr. Harris confirmed that the percent of payroll growth represents the number of employees and the potential raises the employees would get over a period of time. In response to a follow up question, Mr. Harris confirmed his statement that a 2 percent decline in personnel over 20 years would result in practically 0 employees.

Mr. Eager discussed the sensitivity analysis and the scenario analysis for CERS.

In response to a question from Representative Wheatley regarding the CERS separation, Mr. Eager stated the separate governance boards will have the power to make changes to these assumptions on April 1, 2021.

In response to a question from Representative DuPlessis, Mr. White stated that the comparison of funded ratio graph previously referenced does include the Teachers' Retirement System (TRS). Therefore, TRS like CERS is ranked below the 25th percentile in funded ratios among other statewide retirement plans in the nation.

In response to a question from Representative Graviss, Mr. Eager stated that, due to litigation, fiduciary insurance for KRS board members is so expensive it is not cost-effective to carry it.

In response to a question from Auditor Harmon regarding redaction issues and how many contracts will renew after the original SB 2 date, Mr. Eager stated he would have to send the information at a later date. Mr. Harmon stated based on the redacted examples provided, KRS has done a fine job.

Quarterly Investment/Cash Flow Update – Judicial Form Retirement System

Rebecca Stephens, Judicial Form Retirement System, began her presentation discussing the plans' performance overview that included the market value, 1-, 3-, 5-, 10-, 20- and 27-years for the judicial and legislators' defined benefit and hybrid cash balance plans period ending June 2020. She also noted that FY 2020 was the first year that the hybrid cash balance plan members received an interest credit greater than the statutory minimum 4 percent with the judicial plan members receiving a credit of 7.5 percent and the legislators' plan members receiving a credit of 7.54 percent.

Ms. Stephens discussed the cash flow for the judicial and legislators' retirement plans, which included the cash inflows, cash outflows, net cash flow before asset gain/(losses), realized/unrealized investment gains/(losses), and net plan assets for the period ending June 30, 2020.

Representative DuPlessis commented that no money was added to the legislators' plans for the ARC, yet, due to the investment performance, the plans went cash positive.

In response to a question from Representative Tipton regarding a comparison of the cash inflow for the judicial and legislators' plans, Ms. Stephens reviewed the data on cash flow for Judicial Retirement Plan and Legislator Retirement Plan.

In response to a question from Senator Higdon, Ms. Stephens stated that an ARC payment was made in the judicial plan, but no appropriation for the legislators' plan during FY 2021 except for administrative expenses.

Quarterly Investment/Cash Flow Update & Fund Stress Testing – Teachers' Retirement System

Beau Barnes, TRS, began his presentation with investment performance as of June 30, 2020, and discussed the gross and net performance for the quarter, fiscal-year-to-date, 1-, 3-, 5-, 10-, 20-year trailing time periods, and the 30-year compounded gross return of 7.98 percent.

In response to a question from Senator Higdon, Mr. Barnes stated that the 1-year top 5 percent ranking is TRS's performance in investment returns as compared to other large public pension plans in the nation.

Mr. Barnes continued with a discussion of TRS's investment performance. He stated that from 2008 to June 2020, TRS's investment returns totaled a net $14.5 billion, compared to the average pension plan returns which would have resulted in a $10.9 billion net value, resulting in an outperformance of $3.6 billion for the benefit of Kentucky teachers.

Mr. Barnes reviewed cash flow for the pension fund through June 30, 2020, compared to June 30, 2019. He pointed out the cash inflows, outflows, investment gains or losses, and the total net plan assets across both time periods. He noted that the current year's member and employer contributions are down slightly because TRS has not yet booked the accounts receivable. Also, he reported that the benefit payments to retired members had increased to $2.195 billion in 2020 up from $2.126 billion in the previous year. As a result, TRS's negative cash flow is higher this year, but still very manageable, and with investment gains for the year, TRS' net plan assets grew by $330 million.

In response to a question from Senator Higdon, Mr. Barnes confirmed that TRS's asset levels went up $330 million in 2020. In response to a follow up, he stated that, during the 2020 budget session of the General Assembly, TRS had provided a version of its budget request to executive budget staff that showed what adding $110 million extra in each fiscal year above the actuarially determined employer contribution (ADEC) would accomplish. However, this additional funding in excess of the ADEC was not included in any version of the budget presented last year.

Representative DuPlessis commented that he believes TRS is investing wisely, but until the system is 80 percent plus funded, the negative $391 million should not be taken lightly. Representative DuPlessis wanted to know how to fix the structural cause of having a cash flow loss for the long term. Mr. Barnes stated that TRS was 58.1 percent funded as of June 30, 2019, and he believes with additional funding it will continue to grow. In response to a follow up, he stated that structural changes, including a new benefit tier for teachers, would not have an immediate impact.

In response to questions from Senator Higdon, Mr. Barnes stated that the timeline for possible assumption changes with the experience study will be 2021. He stated, if there are assumption changes, those changes would become effective around 2024.

Mr. Barnes continued with a review of cash flow for the health insurance fund through June 30, 2020, compared to June 30, 2019. He pointed out cash inflows, outflows, investment gains or losses, and the total net plan assets across both time periods.

Senator Higdon commented that TRS would need to continue its presentation at the next meeting due to time constraints.

Representative Miller commented that he would like TRS to provide a chart of returns by market segment.

With no further business, the meeting was adjourned.