PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 6th Meeting
of the 2020 Interim

November 17, 2020

Call to Order and Roll Call

The 6th meeting of the Public Pension Oversight Board was held on Tuesday, November 17, 2020, at 1:00 PM, in Room 171 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, Steven Rudy, Russell Webber, and Buddy Wheatley; John Chilton, Joseph Fawns, Mike Harmon, John Hicks, James M. "Mac" Jefferson, and Sharon Mattingly.

Guests: Bo Cracraft, Legislative Research Commission; David Eager, Executive Director, and Kathy Rupinen, Interim Executive Director of Legal Services, Kentucky Retirement Systems.

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

Approval of Minutes

Representative Miller moved that the minutes of the September 22, 2020 meeting be approved. Representative Pratt seconded the motion, and the minutes were approved without objection.

Representative DuPlessis announced that Bo Cracraft, Legislative Research Commission (LRC) Staff, has accepted the position of Executive Director with Judicial Form Retirement System.

Semi Annual Investment Review – Legislative Research Commission

Bo Cracraft, LRC, provided a semi-annual investment review. He began by providing a summary of total assets managed across the Kentucky Retirement Systems (KRS), Teachers' Retirement System (TRS), and Judicial Form Retirement System (JFRS). Collectively, total pension and insurance assets totaled $40.8 billion as of June 30, 2020, which was an increase of over $600 million from the prior year. Mr. Cracraft provided pie charts showing the total by each retirement system.

Mr. Cracraft discussed the performance across various investment markets and provided index returns for several major asset classes. Mr. Cracraft noted that there were only two asset classes that provided returns above 7 percent. He noted that even within asset classes, the range of winners was narrow. For instance, US Large Cap was at 7.5 percent, and US Small Cap was at -6.6 percent. Mr. Cracraft added that even with positive returns, it was a difficult year for managers and asset allocation given the limited areas of growth.

In response to a question from Representative Miller, Mr. Cracraft stated that public real estate was publically-traded real estate investment trusts, or what are called REITS within the industry.

Next, Mr. Cracraft discussed plan specific performance for KRS, TRS, and JFRS. First, he began with a slide that displayed annual fiscal year returns for the past 23 years. He noted that, while not reflected in the slide, staff had data for KRS and TRS dating back to 1987 and that neither of the plans had experienced a negative fiscal year return until 2001. Next, he reviewed a slide that provided trailing 1-, 3-, 5-, 10-, and 20-year performance for each plan relative to its assumed rate of return and policy benchmark, as well as three peer groups. He referenced the narrow market performances and noted that plans, like JFRS and TRS, which had a larger cap within US Equity, also reported the strongest returns.

In response to a question from Representative DuPlessis regarding whether any plans might need to change their expected rate of return in the near future, Mr. Cracraft stated that plans do find themselves in a lower expected return environment, and this has forced many to lower return assumptions. He referenced KRS and JFRS, which had made changes in the past couple of years, and stated that TRS was conducting an experience study and would be making a decision about its assumption soon.

Mr. Cracraft began a discussion on asset allocation by noting that, historically, a plan's asset allocation decisions will drive 90 percent of its returns. He then provided some research that had been conducted by Callan Associates, which compared asset allocation decisions over the past 30 years and how plans had been forced to increase complexity and add risk in order to meet the same return target. Lastly, Mr. Cracraft referenced the BNY Mellon U.S. Master Trust Universe Median Quarterly Peer Group data as of June 30, 2020, which reported trailing period returns across the full peer group, as well as underlying plan types. He noted the wide range of returns over the year, as well as the fact that public plans had uncharacteristically outperformed endowments and foundations over the past 5- and 10-year periods.

In response to a question from Mr. Chilton regarding how risk was measured in the Callan research, Mr. Cracraft stated the research utilized standard deviation of returns as the measurement of risk.

In response to a question from Representative DuPlessis with regard to how plans mitigate risk, Mr. Cracraft stated that he believes that pension systems should try and have a long term perspective and be able to manage assets with that perspective of 10 to 15 years. However, a plan's cash flow and funding situation can limit that ability, and so, plans try to mitigate risk by using alternatives or managing volatility. Representative DuPlessis commented that some investors are risk adverse and would rather take a little less pay, but have comfort knowing it is going to be there at retirement.

In response to a question from Representative Miller regarding risk and return assumptions, Mr. Cracraft clarified that none of the state plans were invested as heavily in growth assets as reflected in the Callan Research. However, the research did show that tougher decisions were required in the lower rate environment in which investors were finding themselves. Given inflation and current yields, investors have had to either reduce return expectations or add more growth assets to reach existing targets. He referenced recent surveys and noted how many plans had reduced assumptions given the trend in market expectations.

Next, Mr. Cracraft provided a review of investment fees for the three retirement systems as of June 30, 2020. He noted that the management fees for KRS has dropped from 48.5 to 39.9 bases points and have recently approved new allocations and have eliminated hedge funds. He noted that the KRS incentive fees did drop significantly, but it was largely due to a timing issue and the first quarter of 2020, which was down and resulted in negative incentive fees due to clawback accruals. He stated that, while KRS closed their fiscal year on June 30, most general partners use a calendar year close, so the March quarter would be the first quarter of their new fiscal year. He stated that TRS management fees have been stable at 30 bases points, and JFRS remains stable since its renegotiation in 2017.

Mr. Cracraft discussed cash flow and provided a summary of some comments from the prior year's study. He noted that more plans are having to manage negative net cash flow as they mature, see the number of retirees grow, and see benefit payments increase. He discussed how negative cash flow was not necessarily implying trouble, but that measuring cash flow as a percent of plan assets could serve as a warning sign.

In response to a question from Representative DuPlessis regarding TRS negative cash flow and its funding policy, Mr. Cracraft stated that a poorly funded plan could not handle negative cash flow, while a fully funded plan would be expected to have negative cash flow due to declining contributions. He identified TRS, which is just under 60 percent funded, as a plan that would fall in between those examples and stated that he believed TRS had manageable negative cash flow, but that he would like to see its trend improve.

Mr. Cracraft continued with the cash flow summary that showed comparisons from the 2019 cash flow to June 30, 2020, with a mix of negative and positive cash flows, but with most plans similar to the prior year.

In response to questions from Senator Higdon regarding TRS reporting carried interest, Mr. Cracraft stated that there has been a lot of discussion regarding TRS reporting carried interest, but that TRS had not provided any information. In response to a follow up question, Mr. Cracraft stated that TRS does not have any absolute return assets, and therefore, there were no fees to report for them in that asset class.

In response to questions from Representative DuPlessis, Mr. Cracraft stated that TRS paid $60 million in management fees in addition to any carried interest or other incentive fees.

In response to a question from Representative Graviss regarding TRS not reporting carried interest, Mr. Cracraft stated TRS views carried interest as profit sharing and not a fee and believes that it is exempt from reporting. Representative Graviss commented that the actuarial timeline is 30 to 40 years, yet these plans' timelines are at 20 years, and he believes they should match up with the actuaries. Representative Graviss also commented that he believes more attention should be made looking at the portfolio allocation with risky assets and the amount of fees required.

Representative Miller commented that once the actuarial reviews take place, the TRS board will likely vote to change their assumptions, and the cost to the state could increase by a half a billion dollars, which would get TRS closer to cash flowing.

Legislative Proposal Discussion

Representative Miller invited David Eager and Kathy Rupinen with KRS to discuss BR 14 (Prefilled bill), which is a housekeeping bill and a descendant of HB 207 from the 2020 session. Ms. Rupinen discussed three provisions of BR 14: 1) an amendment to KRS 61.640 and KRS 16.578 to restore language that was deleted on accident by 2009 amendments regarding payment options for death prior to retirement; 2) an amendment to KRS 61.540(1) to change "shall" to "may" to make the section consistent with other administrative provisions; and 3) an amendment to the implementation date to reflect December 2019 for an amendment that was made in 2017 on how a service purchase costs are calculated. Mr. Eager discussed an amendment establishing a floor for pension spiking.

In response to a question from Ms. Mattingly regarding the benefit of retroactivity of the implementation date of certain BR 14 provisions, Ms. Rupinen stated that it would prevent KRS from making changes that could adversely impact members.

Representative Miller discussed BR 17 (Prefiled bill). He stated that BR 17 is like the original HB 194 from 2020. It would ensure actuaries are evaluating the financial impact of bills to 30 years rather than 20 years and establish a standard reporting feature for actuarial analyses from the systems. He stated that the LRC would like to implement these changes as a policy matter, if the Public Pension Oversight Board (PPOB) will recommend it.

Mr. Cracraft discussed the standard actuarial analysis template form for BR 17. He stated that it would be a short two page analysis that would accompany the full analysis to aggregate key data.

Representative Graviss commented that the liability timeline needs to match the investment timeline. He stated that employers are suffering with higher rates due to the unmatched timelines.

Representative DuPlessis discussed BR 424 (draft). He stated it is a continuation of HB 171 from 2020, relating to the allocation of the employer cost of the unfunded actuarial liability (UAL) for Kentucky Employees Retirement System (KERS) nonhazardous. He gave the highlights of the bill: 1) it eliminates the incentive to reduce payroll to avoid paying contributions; 2) it sets up a fixed allocation system for payment of UAL, which helps solidify budgets going forward; 3) for all new hires, the employer's cost will go to normal cost of roughly 10 percent of pay, which could incentivize bringing people back into the system; and 4) by reallocating costs, some employers will see an increase and some will see a decrease. Representative DuPlessis stated that GRS Consulting comments were: "We believe this legislation will significantly reduce the System's risk of receiving insufficient contributions because employers will no longer be able to reduce their pension cost by reducing their covered payroll. In summary, we believe this legislation will result in an improved and sustainable funding policy for the KERS Non-Hazardous system."

Representative Graviss commented that he believes BR 424 is a good bill and hopes that it will pass.

Senator Parrett discussed BR 460 (draft). He stated this bill relates to omitted service in KRS and the impact it has on benefits for a member who has retired from the TRS. Omitted service credit occurs when a KRS employer fails to report a full time employee's service as required by law and the employee does not receive the benefits that are due. Current law provides for a mechanism to restore benefits in most situations even when the omitted service is detected after retirement by paying the contributions that would have been due. However, if a member has retired from TRS and the KRS omitted service is paid for after TRS retirement, then the benefits are not the same since reciprocity provisions do not apply. The measure works to address this issue so that the omitted service would have the same value of service that was reported on time, but only for those TRS retirees who had returned to work after retirement to build upon their current TRS account. The bill will be retroactive in application to December 31, 2009.

Representative Wheatley discussed BR 411 (draft). He stated this bill passed the House of Representatives last year as HB 104, and it deals with retirement beneficiaries. The bill would allow a change of beneficiary after retirement when a person marries or remarries, which affects a lot of people. Also, the naming of the new spouse as beneficiary and selection of an optional survivorship benefit, will cause the system to reannuitize their pension calculation, but it cannot have any negative financial impact on the pension system. The next change will allow retirees who are currently receiving the basic or a period certain optional benefit that was chosen upon retirement to also make a change to their beneficiary. However, this change will not affect the benefit amount the retiree receives, will not require reannuitization, and will not affect the system in any way.

Representative DuPlessis stated that he and Senator Higdon are recommending that the LRC require the state-administered retirement systems: (1) to extend their evaluation period from 20 to 30 years on all actuarial analyses completed by their actuaries for the 2021 regular session and thereafter, and (2) to utilize a uniform standard format/summary approved by the PPOB on all actuarial analyses completed by their actuaries for the 2021 regular session and thereafter. Representative DuPlessis moved that the Actuarial Analysis Template be approved. Representative Miller seconded the motion, and the recommendation was approved by voice vote (roll call vote: 14 yeas, 0 nays).

With no further business, the meeting was adjourned. Next scheduled meeting will be December 14, 2020.