PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 8th Meeting
of the 2022 Interim

October 25, 2022

Call to Order and Roll Call

The 8th meeting of the Public Pension Oversight Board was held on Tuesday, October 25, 2022, at 3:00 PM, in Room 154 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 James Tipton, Co-Chair; Senators Christian McDaniel, Robby Mills, Gerald A. Neal, Michael J. Nemes, Dennis Parrett, Damon Thayer, and Mike Wilson; Representatives Jim DuPlessis, Ken Fleming, Derrick Graham, Jerry T. Miller, Phillip Pratt, Russell Webber, and Buddy Wheatley; Mike Harmon, and John Hicks.

Guests: Bo Cracraft, Executive Director, Judicial Form Retirement System; Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System; David Eager, Executive Director, and Steve Willer, Chief Investment Officer, Office of Investments, Kentucky Public Pensions Authority; and Brad Gross, Committee Staff Administrator, Legislative Research Commission.

LRC Staff: Brad Gross, Jennifer Black Hans, Michael Clancy, and Angela Rhodes.

Approval of Minutes

Senator McDaniel moved that the minutes of the September 27, 2022, meeting be approved. Representative Tipton seconded the motion, and the minutes were approved without objection.

Quarterly Investment Update – Judicial Form Retirement System

Bo Cracraft, Executive Director, Judicial Form Retirement System (JFRS), presented a review of the investment performance for the Judicial Retirement Plan (JRP) and the Legislators' Retirement Plan (LRP). He discussed the gross and net performance for the defined-benefit and cash balance plans for the quarter ending September 30, 2022, and for the 1-, 3-, 5-, 10-, 20-year, and inception-to-date trailing time periods. He stated that Baird Trust Company, JFRS' sole source investment manager, expects volatility to continue specifically in the equity markets. However, with the rising inflation rates, the fixed income investments are providing some level of return.

Mr. Cracraft discussed the asset allocation for both plans. He reviewed the equity, fixed income, and cash allocations, stating that JFRS is close to target. There have been three rebalances in the last 15 months, which have reduced equity exposure down to target.

In response to a question from Representative Miller regarding bond maturity, Mr. Cracraft stated that JFRS has historically been within one year of the index and nothing beyond 10 years. More recently, bond return periods have been even shorter because yields have been so low. In response to a follow-up question, Mr. Cracraft stated that the difference in cash allocations for JRP of 1.4 percent and LRP of 3.4 percent are just a timing issue with less assets in LRP.

Lastly, Mr. Cracraft included in the packet for the Public Pension Oversight Board (PPOB) some recent market commentary provided by Baird Trust Company.

Quarterly Investment Update – Teachers' Retirement System

Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System (TRS) provided a review of the investment performance for the pension fund for the September 30, 2022, quarter, which was -4.13 percent net, and discussed the gross and net performance for the 1-, 3-, 5-, 10-, and 20-year trailing time periods, and the 30-year compounded gross return of 7.47 percent. The health insurance trust returns were -2.9 percent net for the quarter as of September 30, 2022, and a 10-year return of 6.47 percent net.

Senator McDaniel asked TRS to provide to the PPOB by November 15, 2022, a 5-year forecast of how much additional funding TRS will need in order to meet the actuarially determined employer contribution (ADEC).

In response to a question from Representative Tipton, Mr. Barnes stated that the cost of investments is just over 30 basis points with the administrative portion being lower. He agreed to provide the PPOB with a breakdown of the cost. The asset values for the retiree annuity trust have declined from $22.9 billion at fiscal year end June 30, 2022, to $21.3 billion as of September 30, 2022. For the health insurance trust, assets have declined from $2.26 billion at fiscal year end June 30, 2022, to $2 billion as of September 30, 2022. In response to another follow-up question, Mr. Barnes stated that it is reasonable to expect requests for additional dollars in the 2024 budget session.

In response to a question from Senator McDaniel, Mr. Barnes confirmed that the valuation results from fiscal year 2022 will impact the first year of the next biennial budget. There is a lag between the yearly valuation and the impact for the budget request.

In response to a question from Representative Miller, Mr. Barnes confirmed that TRS has not changed its investment strategy but has lowered the assumed rate of return from 7.5 to 7.1 percent. Representative Miller commented that recent world events impacting the global economy may require TRS to lower the rate of return even further.

In response to a question, Mr. Barnes stated that he does not believe the recent downturn in the market has seriously impacted the amount of assets that TRS is having to sell right now. Representative DuPlessis requested TRS provide the PPOB with a more detailed response in November.

In response to a question from Senator Higdon, Mr. Barnes stated the funding level as of June 30, 2021, for the pension trust was 57.2 percent and for the health insurance trust was 60 percent. Mr. Barnes will provide more recent funding levels in November.

Quarterly Investment Update – Kentucky Public Pensions Authority

David Eager, Executive Director, Kentucky Public Pensions Authority (KPPA), began his presentation with highlights of the September 30, 2022, quarter. As of June 30, 2021, KPPA's market value was about $2 billion more than the actuarial value. While markets remained challenged, the pension and insurance funds continued to produce strong relative performance. Plans produced better than top quartile performance with consistent top decile risk-adjusted performance within the Wilshire public plans universe.

Mr. Eager reported that all five plans exceeded their benchmarks for most of the periods reported for the quarter ending September 30, 2022, and for the trailing 1-, 3-, 5-, 10-, 20-, and 30-year periods. The KPPA investment staff has continued to work toward revised asset allocation targets, committing and deploying nearly $2 billion across the plans.

Steve Willer, Chief Investment Officer, KPPA, discussed the market asset class returns as of September 30, 2022. He reviewed a chart that showed negative performance across almost all asset classes with quite a bit of variance. Specifically, there were recent negative returns in the fixed income markets, which usually serve as a ballast against riskier investments in equity and bonds. Anticipated stabilization of interest rates in the future may improve fixed income returns, but market volatility will remain across all markets.

Mr. Willer discussed the preliminary pension and insurance investment returns net of fees for periods ending September 30, 2022, for all plans for the quarter, 1-, 3-, 5-, 10-, 20-, and 30-year.

Mr. Willer provided an update on the asset allocations to equity, fixed income, and inflation-protected classes for the pension and insurance plans as of September 30, 2022, providing the actual, target, and range percentages. He noted that KPPA anticipates having all plans within their allocation range by early next year.

Senator McDaniel asked KPPA to provide to the PPOB by November 15, 2022, a 5-year forecast of how much additional contributions the KPPA plans will need in order to meet the ADEC.

In response to a question from Representative Tipton regarding the low assumed rates of return, Mr. Eager stated that sometime in the spring of 2023 the boards of trustees for the Kentucky Retirement Systems and County Employees Retirement Systems (CERS), in conjunction with actuaries and investment staff, will discuss whether to raise their respective assumed rates of return. The funding level for the Kentucky Employees Retirement System (KERS) has improved from 12.9 percent in 2016 to an anticipated 18 to 19 percent in the upcoming valuation for the fiscal year ending June 30, 2022. However, forecasting how the funding level impacts the assumed rate of return would require a more detailed actuarial analysis. In response to a follow-up question, Mr. Eager stated the basis points for management fees are coming down, and the incentive fees vary year-to-year.

Representative Miller commented that it is his first time in six years on the PPOB that the 30-year return for KERS has been higher than TRS' 30-year return.

Mr. Eager discussed plans for the KPPA investment department. He stated that KPPA is slowly developing a 3 to 5 year staffing plan, focusing on areas to reduce investment-related fees and expenses, evaluating opportunities to manage additional assets in-house, and analyzing its consultant, research, and reporting needs.

Senator Thayer reminded the systems and any other stakeholders that any pension related bill needs to be vetted first by the PPOB.

Annual Investment Review – Legislative Research Commission

Brad Gross, Legislative Research Commission, began his presentation reporting the assets under management by all systems for 2022 fiscal year ended returns. The total pension fund assets dropped $4.34 billion to $38.07 billion, and the health insurance fund assets dropped $0.65 billion to $8.83 billion. He noted that the assets included the fiscal year 2022 additional appropriations of $215 million above the actuarially determined contribution to the State Police Retirement System (SPRS) and $479 million to TRS to pay off the Green Box Dollars.

Mr. Gross discussed the investment performance experienced by public pension funds across the nation for fiscal years 2021 and 2022. In fiscal year 2021, public pension funds across the country, experienced record setting positive investment returns which led to actuarial gains and reduced employer costs. In fiscal year 2022, public pension funds experienced significant negative investment returns which will likely lead to actuarial losses and increased costs to employers.

Mr. Gross discussed general investment performance for fiscal year 2022. He reviewed asset class returns and commented that high inflation, growing interest rates, and other factors like geopolitical issues and consumer sentiment, influenced the 2022 investment market results. The market experienced a precipitous drop in the last quarter of fiscal year 2022 with the S&P down 16.1 percent for the quarter and 10.6 percent for the year. Regarding alternatives, commodities were up primarily in the energy and petroleum sectors. He also noted that private assets values, like private real estate and private equity, typically lag by a quarter or more, and it is likely to see write downs in value to reflect what has happened in the public markets.

In response to a question from Representative DuPlessis, Mr. Gross addressed how in the short run higher interest rates create problems for the markets.

Mr. Gross discussed performance for all pension plans as of June 30, 2022, for the 1-, 3-, 5-, 10-, 20-, and 30-year periods. He presented peer group median returns and a scatter plot chart showing a high level of variability among peer funds in fiscal year 2022. The funds with the best returns had a high asset allocation to private equity, private real estate, and commodities. Mr. Gross also provided a chart showing 25 years of fiscal year returns by system.

Mr. Gross discussed asset allocation, which drives 90 percent of returns. He reviewed the traditional assets of public equity, fixed income, and cash and the alternative assets of real estate, private equity/credit, real return, and absolute return.

In response to a question from Senator Wilson, Mr. Gross stated the private equity class does not include private real estate, but will provide the more detailed percentage of private real estate held by the systems later in the presentation.

Mr. Gross continued reviewing the asset allocations by fund. He provided a chart for all systems showing their percentages to public equity, public fixed, private fixed, private equity, real return, real estate, and cash, as well as a peer comparison chart.

Mr. Gross discussed investment management fees and incentive fees. KPPA management fees have continued to decline while incentive fees, which are tied to performance, remain variable. TRS management fees remain low and like KPPA incentive fees tied to performance, remain variable. JFRS has the lowest fee structure and only has investment management fees.

Mr. Gross provided an update on cash flow levels based upon a calculation recommended by the pension actuaries a few years ago. Based upon this calculation, a negative cash flow of 3 to 5 percent is in a satisfactory range but an acceptable range can vary based upon the overall health and goals of the plan. For the KERS nonhazardous plan, higher contributions and HB 8 funding has led to continued positive cash flow and improved stability. Negative cash flow for the CERS nonhazardous plan has fallen within the 3 to 5 percent range since 2009 and is improving. Continued additional funding since 2009 to TRS has helped reduce negative cash flow.

Mr. Gross provided a chart of the distribution of investment return assumptions for public pension plans from fiscal year 2001 to the present, based on data from the National Association of State Retirement Administrators. Since 2000, the median assumed rate of return among public pension plans has dropped from 8 percent to below 7 percent (FY 2023 median of 6.94 percent). Assumptions for Kentucky's state pension plans were currently 5.25 percent for KERS nonhazardous and SPRS, 6.25 percent for CERS, 7.1 percent for TRS, and 6.5 percent for JFRS.

Representative DuPlessis commented that all three state-administered retirement systems need to be reporting percentages of cash flow in a consistent format like the way staff reported the data.

With no further business, the meeting was adjourned.