

PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 3rd Meeting of the 2022 Interim

April 25, 2022

Call to Order and Roll Call

The 3rd meeting of the Public Pension Oversight Board was held on Monday, April 25, 2022, 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 Robby Mills, Gerald A. Neal, Dennis Parrett, and Mike Wilson; Representatives Derrick Graham, Jerry T. Miller, James Tipton, Russell Webber, and Buddy Wheatley; and Mike Harmon.

Guests: David Eager, Executive Director and Steven Herbert, Executive Director, Office of Investments, Kentucky Public Pensions Authority; John Chilton, Chief Executive Officer, Kentucky Retirement Systems; Ed Owens III, Chief Executive Officer, County Employees Retirement System; Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System; and Bo Cracraft, Executive Director, Judicial Form Retirement System.

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

Approval of Minutes

Representative Tipton moved that the minutes of the March 7, 2022, meeting be approved. Senator Higdon seconded the motion, and the minutes were approved without objection.

KPPA Investment Update, ESG Investing/Proxy Voting Update, Response to Prior Meeting Data Requests

Steven Herbert, Kentucky Public Pensions Authority (KPPA), made opening remarks regarding the investment performance and asset allocation for the Kentucky Employees Retirement System (KERS), State Police Retirement System (SPRS), and County Employees Retirement System (CERS). For the returns, both the equities and bond portfolios are experiencing negative returns calendar year-to-date. The asset allocation is in a mini-transition period due to deliberate and involuntary change. The deliberate piece involves the CERS, which had a liquidity event upon moving away from an investment manager with a 60 percent equity and 40 percent bond style portfolio. Out of caution,

investment management is moving slowly toward an allocation for CERS that is a few percentage points higher in the public equity space. The involuntary changes to asset allocations were a couple of agencies opting to cease participation, which increased the cash allocation in the KERS nonhazardous plan, and the COVID-19 pandemic, which has made it very difficult to invest in real assets.

Mr. Herbert continued with slides that showed the preliminary data for all the pension and retiree health plans as of March 31, 2022. He discussed the net of fees' rates of return for the 3-month, fiscal-year-to-date, 1-, 3-, 5-, 10-, and 20-year periods for all plans along with their plan index. Mr. Herbert provided additional slides demonstrating the relative weights for each plan's asset allocation. He explained that heavier allocations to cash and fixed income were temporary with expected investment of those assets in real return and real estate, which are currently underweight.

In response to a question from Senator Higdon regarding what were the outcomes compared to the goals of the set target allocations, Mr. Herbert stated that the outcome was neutral; year-to-date, the cash did better, but the KERS plan would have done better with more real assets. Mr. Eager added that KERS nonhazardous would have been favorable and CERS nonhazardous would not have been favorable.

In response to a question from Representative Tipton regarding what impact high inflation and rising interest rates would have on asset allocation, Mr. Herbert stated that they are putting the assets to work in real return, real estate, inflation-protection specific portfolios, such as Treasury Inflation-Protected Securities (TIPS), along with the private infrastructure consumer price index (CPI) adjustments that go along with leasing. Mr. Eager added that the duration of the fixed income portfolio tends to be shorter than the market, which means there will be less impact by rising rates.

Mr. Eager announced that KERS nonhazardous received two recent infusions of cash, one totaling about \$230-240 million in payoffs from Northern Kentucky University and the Kentucky Housing Corporation, and a second infusion from the termination of a manager with about \$800 and \$900 million in assets.

In response to a question from Representative DuPlessis, Mr. Herbert confirmed that this resulted in a 14.5 percent allocation to cash for KERS nonhazardous, exceeding the upper maximum of 10 percent set by the investment policy statement. In response to follow up questions, Mr. Herbert stated that the KPPA plans to invest the cash in real estate and real return, including ongoing searches for commodities and infrastructure for inflation protection and investments being made in real estate, which were slow to occur in 2021 due to COVID. KPPA is currently investing assets as quickly as possible to bring the allocation within the ranges.

Mr. Herbert continued with slides showing the asset allocations before and after the systems' recent allocation study. In response to a question from Representative Miller, he explained that the decision was made to combine U.S. Equity and Non U.S. Equity into a Public Global Equity asset class, which is how it will be managed going forward.

In response to a question from Representative Tipton, Mr. Herbert stated that the systems renamed the "high yield/specialty credit" asset class to "specialty credit," which still includes publicly- and privately-traded high yield portfolios, but now includes private credit and loan portfolios. An example of a private loan would be a private asset-backed loan where the asset could be anything from airplanes to cargo. High yield would be on a company that had a debt rating publicly traded bond below triple B. In response to a follow-up, Mr. Herbert stated the growth assets (equity) are higher risk and liquidity investments (fixed income, cash) are lower risk with the diversifying or inflation-protected assets (real estate, real return) having some risk, particularly when there is no inflation.

In response to a question from Representative DuPlessis, Mr. Eager stated that in the short term, as interest rates rise, it will hurt the pension funds due to the assumptions not being adjusted that quickly. In the long run, the assumptions will most likely go up to match inflation along with the liability and benefits also being more costly.

John Chilton, Chief Executive Officer, Kentucky Retirement Systems (KRS), discussed the environmental, social, and governance reporting (ESG). He stated there is a worldwide trend toward significantly increasing disclosures of ESG-related information to investors. The initial focus is on environmental issues, with social and governance issues coming later. Publicly-traded companies, including businesses doing business with those companies, and investment advisors/managers will be rated on metrics associated with ESG rules. Mr. Chilton gave examples of what might be included in ESG reporting.

Mr. Chilton stated that on March 21, 2022, the Security and Exchange Commission (SEC) proposed rules to enhance and standardize climate-related disclosures for investors, which do not include social or governance issues. The initial reporting is expected to begin in 2023. He concluded with the KRS perspective on ESG issues, such as, how it can affect businesses, the profitability, and the sustainability in those businesses.

Ed Owens, Chief Executive Officer, CERS, discussed ESG reporting. He began by stating that within the time the CERS board has been governing, great strides have been made under the leadership of its chair and vice chair. He discussed the standards the trustees abide by, which include the board's duty of loyalty to act in the interest of the trust, Kentucky's statutes, and federal court opinions on fiduciary duty.

On November 10, 2021, the CERS board adopted an ESG policy under which the overriding consideration for the trustees will continue to be investing to maximize the long-term returns for plan beneficiaries.

Representative Miller commented that ESG reporting is an evolving issue, and the focus needs to remain that it is the beneficiaries and the state that are due the obligation of prudent investing.

In response to questions from Auditor Harmon, Mr. Owens stated, on behalf of the group, that they are aware of the legal challenge to the proposed SEC ESG rule and the attempt to change the duty of loyalty on the federal level but, due to the pending nature of those matters in the courts or otherwise at the political level, they would not wish to comment. The boards will watch those pending matters and see how they unfold.

In response to a question from Senator Mills asking for the KPPA's perspective on Senate Bill 205 from the 2022 Regular Session regarding state divestiture from companies that engage in fossil-fuel boycotts, Mr. Eager stated this is not the first bill that has addressed divestiture of investments based on a company's position on an issue, such as companies doing business in the Sudan. However, the trend toward responding to investments based on ESG issues is now experiencing organized push back.

Representative DuPlessis commented that people need to be concerned that forces that are not elected are making policy decisions that affect how a company does business.

Mr. Herbert discussed proxy voting. In general, proxy voting is a form of voting whereby a member of a decision-making body, such as an institutional shareholder of a publicly-traded company, may delegate their voting power to a representative to enable a vote in the absence of the member. Each retirement system board recognizes that voting its shares of public companies by proxies is an important responsibility in assuring the overall performance goals of each plan. KPPA currently uses Institutional Shareholder Services (ISS) as its proxy to cast votes. ISS is guided by the respective proxy voting policies of each board.

In response to questions from Auditor Harmon, Mr. Herbert stated that the votes are monitored on a periodic basis to assure that votes are in compliance with the boards' proxy statements. He also explained that the only ESG matter addressed by proxy policy would be its social and policies issue statement regarding the conduct of the company and whether such conduct could damage profitability, directly or indirectly, and any vote of that nature would need the board of directors' approval, and KPPA would take the position of management on such a vote. In response to a follow-up, Mr. Herbert stated if ISS were to breach its contract or not live up to expectations, KPPA would bid for a new vendor.

In response to a question from Representative DuPlessis, Mr. Herbert stated that ISS reports their votes to KPPA and that is monitored under KPPA's investment compliance process. Mr. Herbert will provide additional details to the Board on how the process works to verify the recorded votes.

Mr. Eager discussed the impact of the 8 percent salary increase for state employees in the recently adopted budget for FY 2023 on the retirement system. He stated that there is not an immediate impact on the 0 percent payroll growth assumption. GRS' opinion is the current 0 percent assumptions are appropriate until the systems experience several years where active membership has at least ceased declining. Upward assumption changes will be more likely if pay raises help employers hire more people so both the number of members and the average compensation are rising. Mr. Eager reported the dollar amounts for the additional pension cost attributable to the 8 percent raise to each of the systems.

In response to a question from Senator Higdon regarding the Governor's veto of House Bill 297 and the concern expressed about KPPA being able to hire non-residents, Mr. Eager stated that he is not aware of any statute that requires employees to live within the state boundaries. KPPA is worried that staffing the investment area is faced with limited qualified candidates and may have to look outside the state and consider remote working options.

Senator Higdon discussed the expansion of the PPOB under House Bill 297. He commented that pension issues should be well vetted before statutory changes are made. He advised committee members and interest groups wanting bills passed next year to bring their bill proposals forward for discussion before the PPOB prior to the legislative session or the bill's consideration in other committees.

Representative DuPlessis, Senator Mills, and Representative Graham seconded Senator Higdon's recommendation that bills should be discussed before the PPOB before session.

In response to a question from Representative Wheatley, Mr. Eager stated that for the additional four exempt investment positions permitted under House Bill 297, the KPPA board will have to authorize the positions, not the director, and will set salary ranges/limits for the positions.

TRS Investment Update, ESG Investing/Proxy Voting Update, Response to Prior Meeting Data Requests

Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System (TRS), began his presentation with investment performance for the pension fund for the quarter as of March 31, 2022, which was -4.9 percent net, and discussed the gross and net performance for the fiscal-year-to-date, 1-, 3-, 5-, 10, and 20-year trailing time periods, and the 30-year compounded gross return of 8.25 percent. The health insurance trust returns were -3.88 percent net for the quarter as of March 31, 2022, and a 10-year return of 8.17 percent net for the newer fund.

Mr. Barnes discussed proxy voting and ESG reporting. He stated that the primary focus of TRS' policy statement on proxy voting is to protect the system's long term financial interest. Like KPPA, TRS also uses Institutional Shareholder Services (ISS) as proxy. ISS makes recommendations to TRS about proxy votes, which are reviewed by TRS' internal investment management staff before those votes are cast.

Regarding ESG issues, TRS is not an ESG investor, but rather a fiduciary with the fundamental goal of having the highest return with an acceptable risk level that brings value to the portfolio. Responses to social issues, such as prior proposals to divest in companies doing business in the Sudan, are better left to foreign policy via the federal government from TRS' perspective.

In response to questions from Representative DuPlessis, Mr. Barnes stated there are general guidelines within the proxy statement that make sure the proxy votes are aligned with TRS' goals, which do include good corporate governance. Along with ISS, TRS reviews all proxies, and then TRS casts the votes in-house.

In response to a question from Auditor Harmon, Mr. Barnes stated that the total invested amount is probably a little under \$26 billion in the retirement annuity trust and a little under \$2.3 billion in the health insurance trust as of June 30, 2021. In response to a follow-up, Mr. Barnes stated TRS is not receiving any pressure to vote along ESG issues or in disagreement with its fiduciary responsibilities, but they are aware that those issues exist in other places in the country and among a few large institutional investors.

Mr. Barnes concluded with his 2022-2024 biennial budget. He stated that there has been eight straight years of full or nearly full retirement annuity funding. In the current budget, the General Assembly appropriated more than \$1.36 billion to meet actuarially required contribution for annuities with about \$900 million more to TRS in salary contributions from Kentucky Department of Education (KDE) budget; \$149 million for state statutory contribution for under-65 health insurance under shared responsibility; \$479.2 million to pay off liabilities for certain previously awarded benefits that had been amortized over several years; and \$78 million up front for sick leave-related annuity liabilities projected to occur from retirements in the next two years.

In response to a question from Senator Higdon, Mr. Barnes stated that the \$900 million is the state's fixed statutory contribution of 13.105 percent to teachers' salaries that goes through the SEEK formula in the KDE budget request.

In response to questions from Representative Tipton, Mr. Barnes stated that the health insurance fund is close to being 100 percent funded in a few years. In response to a follow-up, Mr. Barnes stated the Commonwealth pays the cost of health insurance for active teachers. Representative Tipton commented on the state's cost of health insurance.

In response to questions from the Board, Mr. Barnes explained the different appropriations to retire liabilities relating to sick leave that are contained in the biennial budget. All “green box dollars” for liabilities resulting from previously awarded benefits, including retired teacher sick leave, that had been amortized over prior years were paid with the appropriation of \$479.2 million to completely retire that debt. For newly retired teachers with accrued sick-leave related liabilities, \$78 million was appropriated to cover these amounts in the current biennium without amortizing the cost. Finally, the ADEC appropriated to TRS includes approximately \$50 million per year for active teacher sick-leave liability, which totals approximately \$534 million.

In a follow-up question from last month’s PPOB meeting regarding annual leave being converted into sick leave, Mr. Barnes reported there are two districts that allow unused annual leave that is in excess of a certain amount to roll over into sick leave. He indicated that he would have to report back to identify the two specific districts. Additionally, governmental agencies within KDE allow annual leave to be converted into sick leave for service credit. However, for individuals who became members on or after July 1, 2008, annual leave may no longer be used for retirement calculation purposes, and sick leave is capped at 300 days and not permitted for defined benefit retirement calculation purposes at all for the new tier members beginning on or after January 1, 2022.

In response to questions from the Board, Mr. Barnes explained that only school districts may apply sick leave to increase the member’s final salary, and TRS is restrictive about what is allowed for the multiplier, which must be worked days. The option to convert sick leave into service credit is still available to school districts, provided they pay the full actuarial cost.

JFRS Investment Update, ESG Investing/Proxy Voting Update

Bo Cracraft, Executive Director, Judicial Form Retirement System (JFRS), started his presentation thanking the PPOB members for helping with the passage of the JFRS housekeeping bill. Mr. Cracraft discussed investment performance as of March 31, 2022. He reviewed the trailing performance for the fiscal-year-to-date, 1-, 3-, 5-, 10-, 20-year, and inception-to-date for the defined benefit and cash balance plans for each of the Judicial Retirement and Legislators’ Retirement Plans as compared to benchmarks.

Mr. Cracraft discussed ESG investing. He stated that demand for ESG has increased recently. While not perfect, the board of trustees does believe the new emphasis is an overall positive development for both business and society as it has increased accountability and forced companies to think more holistically. A corporate focus on creating value for shareholders has to be balanced with investing in employees, dealing fairly and ethically with suppliers, and supporting the communities in which they operate. JFRS does not currently have an ESG policy, is not an ESG investor, and potential investments are not screened based on criteria with an ESG focus. However, the investment strategy aims to find high-quality companies with competitive advantage and strong

management teams that can be held in the portfolio for a very long-term period. The result is a portfolio of companies that are generally good corporate citizens, respect their employees and customers, and take all stakeholders into consideration.

Mr. Cracraft discussed proxy voting. He stated that JFRS does not currently vote any proxies in-house. JFRS has contracted with Baird Trust Company, who manages all JFRS assets across fixed income and equity assets. Baird Trust does have an approved proxy voting policy and also receives additional proxy research and recommendations from Glass Lewis, who is an industry leader in proxy voting research and execution.

With no further business, the meeting was adjourned.