PUBLIC PENSION OVERSIGHT BOARD

Minutes

March 26, 2018

Call to Order and Roll Call

The 3rd meeting of the Public Pension Oversight Board was held on Monday, March 26, 2018, at 1:00 PM, in Room 154 of the Capitol Annex. Representative Jerry T. Miller, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Joe Bowen, Co-Chair; Representative Jerry T. Miller, Co-Chair; Senator Wil Schroder; Representatives Ken Fleming, and James Kay; J. Michael Brown, John Chilton, Mike Harmon, James M. "Mac" Jefferson, and Sharon Mattingly.

Guests: Bo Cracraft, Legislative Research Commission; David Eager, Interim Executive Director, and Richard Robben, CFA, Interim Executive Director, Kentucky Retirement Systems; and Beau Barnes, Deputy Executive Director, Teachers' Retirement System.

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

Approval of Minutes

Representative Fleming moved that the minutes of the January 22, 2018, meeting be approved. James M. "Mac" Jefferson seconded the motion, and the minutes were approved without objection.

Calendar Year Ended Investment Review

Bo Cracraft, Legislative Research Commission (LRC), provided a semi-annual investment review covering the recently completed calendar year of 2017. Mr. Cracraft began with a review of the year from a market perspective, highlighting the fact that all major asset classes were positive for the year, with public equity markets globally leading the way. Fixed income closed the year with attractive results, and alternatives continued to add value.

Mr. Cracraft provided a summary of investment performance for each of the pension plans for the several trailing time periods ending December 31, 2017. Looking at the shorter, 1-year period, performance was evaluated relative to the plans' assumptions, performance benchmarks, and peer groups. With trailing one-year returns ranging from 14 to 18 percent, each of the plans exceeded their assumed rates of return, which is the primary objective. When compared to respective benchmarks, most of the plans provided returns close or above their benchmark. Lastly, Mr. Cracraft provided three peer groups, two public (Wilshire TUCS and Bank of New York Mellon) and one internally calculated (LRC Calculated), noting that 1-year returns for most of the better funded plans (County Employees Retirement System (CERS), Kentucky Employees Retirement System (KERS) Hazardous, and Teachers' Retirement System (TRS)) had performed favorably to a median return of around 15.5 to 16 percent for each of the peer groups.

In response to a question from Representative Fleming, Mr. Cracraft stated the last half of 2017 was very much an extension of the prior fiscal year, which ended in June. At the same point in 2016, returns likely were not quite as strong as currently, but the second half of 2016 and all of 2017 had been pretty strong.

Mr. Cracraft continued with a review of longer term performance and stated that, given the strong performance over the 18 months, each of the plans trailing 5-year returns now exceeded their assumptions used in actuarial valuations. Over the longer term 10- and 20-year periods, performance relative to assumptions was mixed. Most of the plans were struggling to meet assumptions over a 10-year time frame still weighed down by the 2008/2009 downturn. Only the Judicial Form Retirement System (JFRS) plan had exceeded, while TRS and Kentucky Retirement Systems (KRS) were slightly below.

In response to a question from Senator Bowen, Mr. Cracraft stated that trailing period returns are largely dependent on timing and the particular years included. He highlighted the current 10-year results, which still show the impact of 2008/2009 correction, but noted the future 10-year performance would likely improve over the next couple of years as those negative returns are hopefully replaced by results better than the downturn.

Mr. Cracraft continued with a review of longer term performance relative to benchmarks and median peer returns. First, with regards to assumptions, the median peer return over the last 10 years was 6.0 percent, which highlights a difficult period and one where most of the states plans struggled to keep pace with assumptions. He noted that KRS, which had reduced its assumptions, and TRS were just short of their assumptions. The JFRS plans had exceeded assumptions. Relative to benchmarks, TRS and JFRS have exceeded, while the KRS plans have shown improvement, but are still slightly below assumptions.

Mr. Cracraft provided current asset allocations for each plan as of December 31, 2017 and highlighted the specific allocations for each of the underlying KRS plans. He referenced the January Public Pension Oversight Board (PPOB) meeting, where KRS staff identified the better funded plans (CERS and KERS Hazardous) as the model portfolio, while adapting the asset allocation for the more cash-flow sensitive plans. When reviewing performance over the recent 1-year period, one could see the KERS and State Police

Retirement System (SPRS) plans had slightly trailed the other plans due to these asset allocation differences.

Representative Miller commented that TRS and the JFRS plans outperformed the other plans, and clearly, absolute return and real return are not much of a factor on those plans.

Mr. Cracraft provided a summary of recent changes to asset allocations for the plans since June 30, 2017, and noted that all three plans had reduced their equity exposure in the last half of 2017. While more noticeable for the KRS and JFRS plans, TRS had also reduced its equity exposure, but the continued growth in those markets had muted the reduction. Mr. Cracraft stated the reduction is likely an indication that the plans have some concern over valuations and recent growth within the U.S. market.

In response to a question from Senator Bowen, Mr. Cracraft stated that while KERS and CERS are being managed differently and have specific asset allocations that are being transitioned to new targets, the asset classes being used have not really changed. The plans are still utilizing the same asset classes they were six months to one year ago, but now are seeing movement within the asset classes. Mr. Cracraft referenced the recent changes in asset allocation (slide 5), where the plans transition out of equity and absolute return assets could be visibly seen. He noted the investment committee of KRS had approved a new target asset allocation that called for reinvesting much of those assets in to fixed income over the course of the next several quarters.

In response to a question from Senator Bowen, Mr. Cracraft stated hedge funds are reflected in the absolute return asset class for the KRS plans. KRS has decided to reduce its exposure to hedge funds and is drawing down assets, but this takes time due to how the funds make distributions. As cash is being received from absolute return, staff is reallocating into fixed income.

Lastly, Mr. Cracraft closed his presentation with a discussion on the start of 2018, which had been characterized by volatile equity markets. Markets were largely flat for the first quarter, but significant swings had occurred since January. Mr. Cracraft also noted that each of the plans, as of December 2017, had returned 6 to 9 percent for the fiscal year.

In response to questions from Senator Schroder, Mr. Cracraft stated that management fees have been included in staff's fiscal year end reviews provided to the PPOB. Senate Bill 2 expanded the level of reporting and went into effect July 1, 2017. Mr. Cracraft stated there are different ways to consider or manage investment fees, such as utilizing index providers or choosing to manage assets internally, which are generally more cost effective from a basis point of view.

In response to questions from Representative Fleming, Mr. Cracraft stated that KRS is in the process of transitioning to a new asset allocation and is moving about 10 percent of its assets from equity into fixed income and reducing absolute return. TRS is more related to market movements, where non-US equity assets have outperformed fixed income. TRS' long term strategic goal is to continue to add to private assets.

In response to questions from Representative Kay, Mr. Cracraft stated that, more recently, hedge funds have bounced back and, while clearly they have not kept up with the equity markets, they had performed in line with fixed income. Mr. Cracraft referred to slide 2 of the presentation and stated that the absolute return fund of fund index was up 6.64 percent for the calendar year and referenced the 5-year benchmark of KRS, which was up roughly 4 percent.

Representative Kay commented on hedge funds and his belief that they are bad deals for Kentucky. Not only have the hedge funds underperformed, but those that manage the funds are receiving a bunch of money in terms of fees. Hedge funds are bad deals for Kentucky, but good deals for those that manage, while providing less returns than the market overall.

In response to a question from Representative Miller, Mr. Cracraft stated that hedge funds are classified and included within the asset allocation titled as absolute return.

Representative Miller called on David Eager and Richard Robben, KRS, for comment and questions. Mr. Eager opened by highlighting the systems work to reduce fees and stated that in FY 2016, when KRS was running between $10 and $11 billion in assets, total fees were $88 million. In FY 2017, KRS ran a billion more in assets, but total fees were down $2 million. He also noted that KRS does manage about 18 percent of the funds internally in three different equity index funds, and those fees are less than one basis point. Mr. Eager stated that KRS is also looking into managing or indexing fixed income internally.

Mr. Eager stated that with regards to performance, all five of the KRS plans have tended to underperform TRS and JFRS, and this is because all of the KRS plans are managed more conservatively. The KRS plans have lower funded status, have more cash flow constraints, need more liquidity, and are just not able to take the risks. The additional funding received over the past several years has helped reduce cash flow concerns.

In response to questions from Senator Bowen, Mr. Robben stated that he believed that 5.25 percent will still be a realistic assumption for KRS even with more fixed income targeted. He referenced a recent rise in the base interest rates and the fact that short term rates are up approximately 100 basis points over the last year.

In response to a question from Representative Miller, Mr. Robben indicated that the decision to reduce absolute return and equity assets was more of a long-term strategic decision made by the investment committee. Specifically as to the absolute return portfolio, Mr. Robben noted the investment committee had focused on reducing managers that were not cost effective or were redundant.

In response to a question from Senator Bowen, Mr. Robben stated that the investment procurement process developed by Senate Bill 2 was going as planned. Mr. Robben also noted that fee reports, as required by Senate Bill 2, were also provided quarterly on the systems' website.

Senator Schroder commended KRS on its increased transparency and reiterated a comment made earlier that the underlying KRS funds required more conservative portfolios due to current funding levels and cash flow situations. He expressed his hope that the General Assembly could continue to help with that problem.

Representative Miller called on Beau Barnes, TRS, for comment and questions. Mr. Barnes opened with an overview of TRS' targeted asset allocation. The plan has a target of 62 percent to public equities, 15 percent to fixed income, 8 percent to additional categories (high yield, fixed income, and alternative credit), 6 percent to real estate, and 7 percent to private equity. Mr. Barnes stated that one third of TRS' portfolio is managed internally.

In response to questions from Senator Schroder, Mr. Barnes confirmed that the General Assembly's authorization to move roughly $500 million from the pension fund into the health insurance fund between 2005 and 2010 was repaid in full with interest in August 2010 via a bond issued by the state. Mr. Barnes confirmed the timing of the bond was very advantageous for TRS and was invested just before one of the better performing periods for TRS. Mr. Barnes indicated he had been employed by the retirement system since 1999 and, since that time, he had no knowledge of other times the General Assembly borrowed from the pension fund to put towards the insurance fund.

In response to a follow-up question from Senator Schroder regarding a presentation provided to the PPOB by Mr. Barnes in May of 2016, Mr. Barnes confirmed the following benefit features were not subject to the inviolable contract:

- Retirement allowances calculated on the average of member's three highest salaries, if member is at least 55 and has at least 27 years of service;
- Postretirement re-employment provisions;
- Retirement benefits for members providing part-time or substitute teaching services;
- A 3 percent retirement factor for qualifying years or service exceeding 30;
- Retiree health insurance. Retirees are only guaranteed access to group coverage; and
- Sick-leave payments for retirement calculation purposes.

Senator Schroder highlighted that a lot of misinformation and confusion regarding the borrowing of funds and inviolable contract provisions still exists.

In response to a question from Representative Miller, Mr. Barnes stated there is a fixed statutory contribution rate of 13.105 percent, and the Commonwealth has always funded that statutory requirement. Mr. Barnes indicated that the issue has been with funding the full actuarially required contribution (ARC). In response to a follow-up question from Representative Miller, Mr. Barnes stated there is a provision in KRS 161.550(6), which some have argued describes the ARC or captures an over/under methodology for capturing any shortfall. Mr. Barnes highlighted there is some disagreement regarding the interpretation of that provision of KRS 161.550(6).

In response to a question from Senator Bowen regarding the prefunding of cost of living adjustments (COLAs), Mr. Barnes stated that the normal cost of providing the 1.5 percent annual COLA was 1.74 percent of payroll paid over the life of a teacher's active employment by both the employee and employer. Provided the plan's other assumptions are met, then this normal cost contribution would be sufficient to cover the annual increments provided post retirement to teachers.

Senator Bowen provided an example scenario and highlighted how important the various assumptions, such as payroll growth, investment returns and inflation, were in the actuarial process of determining a normal cost and in cases where assumptions are not met, additional contributions would be required to fund those COLAs.

In response to questions from Representative Miller, Mr. Barnes confirmed that TRS was roughly $17 billion underfunded across the pension and insurance funds and from 2009 to 2015, the Governor's/Legislative versions of the Executive Branch Budget gave roughly $2.0 billion more than requested. Mr. Barnes also noted that negative cash flow, which when combined with the underfunding, would result in an amount closer to $3.8 billion.

In response to a question from Senator Schroder, Mr. Barnes indicated that TRS does incorporate payroll growth within the actuarial process. The valuations assume that payroll is going to grow 3.5 percent per year.

In response to a question from Auditor Harmon, Mr. Barnes stated the unfunded liability for the pension is not broken down by the actuaries according to specific benefit components.

In response to a question from Representative Kay, Mr. Barnes stated that the COLA is a 1.74 percent contribution in total divided between the teacher and state. Mr. Barnes stated that the teachers' percentage comes out of their pay automatically. Mr. Barnes also stated that teachers are not in Social Security, but TRS is considered a Social Security replacement plan. Part of that plan is to provide the COLA because Social Security provides one.

Representative Kay commented that over the past twenty years, the average COLA for Social Security is about a 2 percent return, so teachers under TRS get less than Social Security. He said that a COLA is not a raise, although it has been referenced as one recently. Teachers do not get a raise in retirement, and those who have Social Security do not get a raise in retirement.

In response to questions from Senator Bowen regarding teachers not wanting to participate in Social Security, Mr. Barnes stated the Windfall Elimination Provision (WEP), which reduces Social Security benefits for teachers, is the primarily reason. Secondly, the cost of TRS is actually less than Social Security participation, given the ability to invest, so it benefits the state as an employer if teachers do not participate.

In response to a question from Representative Miller, Mr. Barnes stated that there are roughly 55,000 retired teachers and about 75,000 active teachers, including about 60,000 full time members. Mr. Barnes indicated that TRS has not asked for the 13.105 percent language to be changed, however, there have been various bills in recent years to reference that an ARC be paid by the Commonwealth. Senate Bill 1, as introduced during the current session, had language that would address the ARC rather than the existing statutory language.

In response to a question from Senator Schroder with regards to factoring in a longer life expectancy of members, Mr. Barnes stated that TRS is continually monitoring assumptions, including life expectancy, and preformed experience studies at least every five years, to see where assumptions are and if adjustments need to be made along the way.

Representative Kay followed up on the conversation regarding teachers joining Social Security and referenced the recently conducted PFM report, which indicated making that change would be extremely expensive for the state and local school districts. In addition, in the scenario, the current defined benefit plan would be walled off and require even more money, which the state does not currently have. Regardless of what teachers or the General Assembly believe should be done, there is a lack of funds needed to make a transition into Social Security or a defined contribution plan at this point.

In response to questions from Representative Miller, Mr. Barnes referenced that breaking down the causes of the unfunded liability will depend on the time frame a study reviews. Some have taken a shorter, 6-year time frame, while others look back 15 years. Mr. Barnes noted that the 2008 great recession put pressure on budgets and, in the case of TRS, there was the issue of health insurance that had to be addressed in 2010. Mr. Barnes stated that the budget has not been able to provide the full funding to fund the pension.

Representative Miller responded and noted that underfunding only accounted for roughly $2.2 billion of the $17 billion dollars, so while he was not blaming teachers, given the size of the remaining unfunded liability, there appears to be some fundamental, structural problems that need to be addressed. In response to Representative Miller, Mr. Barnes stated his belief that the TRS board had done a good job running the system. He highlighted the system's administrative expenses, which were among the lowest in the nation according to a 2012 LRC staff report, and the system's investment fees, which have been amongst the lowest in the country. Mr. Barnes also referenced investment performance, where TRS' returns placed them in the top 3rd percentile for both the trailing 1- and 10-year periods. Mr. Barnes did state the PFM report noted the issue of actuarial back loading, or utilizing a level percent of payroll method, but the issue was the budget could not even support the lower amount requested by TRS under the level percent methodology. Mr. Barnes reiterated that the system is being run well at the board level, but believes the real issue dates back to 1998. At that time, TRS appeared to be 96 percent funded and in a very healthy position, but much of this was an illusion that the tech/ telecom market bubble highlighted. After the market correction, TRS' funding levels slid to the low seventies, and the system experienced a flat 13-year period in the market from 2000 to about May of 2013.

Dolly Guenthner, Retiree, testified that she was a whistleblower regarding the city of Elizabethtown for double dipper fraud of at least $500,000 per year. She stated she was terminated four months short of her retirement. She stated she wants support for whistleblowers.

With no further business, the meeting was adjourned. The next regularly scheduled meeting is Monday, April 23, 2018.