PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 3rd Meeting
of the 2018 Interim

June 4, 2018

Call to Order and Roll Call

The 3rd meeting of the Public Pension Oversight Board was held on Monday, June 4, 2018, at 1:00 PM, in Room 154 of the Capitol Annex. Senator Joe Bowen, 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; Senators Jimmy Higdon, Christian McDaniel, Gerald A. Neal, and Dennis Parrett; Representatives Ken Fleming, James Kay, Arnold Simpson, and Russell Webber; J. Michael Brown, John Chilton, Timothy Fyffe, Mike Harmon, and Sharon Mattingly.

Guests: Beau Barnes, Deputy Executive Director, Teachers' Retirement System; Donna Early, Executive Director, Judicial Form Retirement System; David Eager, Executive Director, and Rich Robben, CFA, Interim Executive Director, Office of Investments, Fixed Income Assets, Kentucky Retirement Systems.

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

Approval of Minutes

Representative Kay moved that the minutes of the March 26, 2018, meeting be approved. Representative Miller seconded the motion, and the minutes were approved without objection.

Investment and Cash Flow Quarterly Update

Beau Barnes, Teachers' Retirement System (TRS) discussed investment performance as of March 31, 2018 for pension and medical returns. Addressing pension returns, Mr. Barnes highlighted the portfolios net of fee return for the quarter of 0.32 percent, compared to a benchmark return of -0.54 percent, which put TRS in the top 24 percent of peers. Discussing medical trust fund returns, Mr. Barnes noted that the medical fund was not prefunded until 2010, but highlighted the portfolios return of -0.05 percent net of fees, compared to a benchmark return of -0.26 percent.

Mr. Barnes provided a FYTD 2018 cash flow update for the pension fund and compared it to the first three quarters of FY 2017. Mr. Barnes highlighted the additional funding of $356 million received from the General Assembly and Governor's budget toward meeting the Actuarially Determined Employer Contribution (ADEC). Cash inflows were supplemented by investment income (net of investment expense) of $306.3, which was up from $237.6 million in FYTD 2017. Mr. Barnes noted that total cash outflows were slightly up from $1.471 billion in FYTD 2017 to $1.540 billion in FYTD 2018, primarily due to an increase in benefit payouts. Mr. Barnes discussed the negative cash flow and stated that it was very manageable and had improved tremendously from just a couple years ago.

In response to a question from Senator Parrett, Mr. Barnes stated that the fund's exposure to international equity was about 22 percent of funds, while approximately 40 percent was held in domestic equity assets.

In response to a question from Senator Bowen, Mr. Barnes stated that the $258 million in negative cash flow is greatly reduced from $650 million just a couple of fiscal years ago. Mr. Barnes also stated that quarterly installments are being received from the additional appropriations coming in, but there are assets that will have to be sold during the fiscal year due to not having enough cash coming in to pay benefits.

In response to a question from Senator Higdon, Mr. Barnes stated that investment returns are always measured against a target of the assumed rate of return, but the policy benchmark is a good measure of how the fund did relative to markets. TRS uses well recognized benchmarks, such as the S&P 500 and Barclay's family of fixed income indices.

In response to the discussion, Mr. Fyffe recommended that each of the retirement plans begin including s assumed rate of return as secondary benchmarks for future presentations. For legislative committees, such as the Public Pension Oversight Board (PPOB), the actuarial target carries more importance given its impact on contribution rates and budgets, but that policy benchmarks are important to see if underlying managers and asset allocation decisions, which are made by the investment teams of each system, have been successful or not.

In response to questions from Representative Fleming, Mr. Barnes noted that the timing of member contributions can fluctuate from quarter to quarter, given the timing of receipt and underlying employer reporting. When evaluating contributions, the best time frame would be the conclusion of each fiscal year, which reports audited results. TRS anticipates it will see increasing membership of teachers in the coming years due to population increases and teachers needing to be in the classroom.

In response to a question from Senator Higdon, Mr. Barnes stated that the cash balance plan does not close the existing plan and TRS will continue to invest the new monies as well as investing the old monies.

In response to a question from Representative Miller, Mr. Barnes stated the slight change in investment targets with an increase in allocations in real estate by 1 percent and a decrease in the allocation to alternative investments by 1 percent which includes high yield bonds. Domestic equities is 40 percent and international is 22 percent.

In response to a question from Senator Bowen, Mr. Barnes stated that under the direction of SB 2, TRS is in the process of issuing RFP's and that the process will be concluded before July 1.

In response to a question from Representative Miller, Mr. Barnes stated that the RFP for actuarial services has not been closed to any entity. Mr. Barnes stated that Cavanaugh Macdonald has been TRS's consultant since the mid-2000s. Representative Miller stated concerns of having the same consultants year after year and wants TRS to be cautious of continuing such.

Investment and Cash Flow Quarterly Update

Donna Early, Executive Director, Judicial Form Retirement System (JFRS) provided a performance overview for the judicial and legislative retirement plans as of March 31, 2018. She highlighted that the plans are segregated between the defined benefit plans and the hybrid cash balance plans. For the third quarter of the 2017 fiscal year, the judicial retirement defined benefit plan posted a slightly negative return of 1.1 percent, which slightly trailed its benchmark. The hybrid cash balance plan had similar performance, falling 0.96 percent for the quarter. Ms. Early noted the legislative plan's performance was very similar to judicial.

In response to a question from Mr. Fyffe, Ms. Early confirmed that there were no international investments in this portfolio.

In response to a question from Representative Miller, Ms. Early stated there were no changes expected with regard to JFRS's asset allocations in the coming months and she noted that JFRS currently targets 70 percent equity and 30 percent fixed income with a range of 80/20 or 60/40. Also, the return assumptions for actuarial purposes during this fiscal year is 7 percent, but going forward it will be 6.5 percent.

Lastly, Ms. Early discussed the statement of changes in net position for judicial and legislative pensions through the first three quarters of FY 2018. Ms. Early noted that the funds expected to have positive cash flow for the fiscal year, compared to a slightly negative result in FY 2017

Investment and Cash Flow Quarterly Update

David Eager, Executive Director, Kentucky Retirement Systems (KRS) began by providing a general update on KRS activities. He highlighted several areas where KRS is moving in the right direction, such as funding, investment results, member services, communications, employer and member outreach, and working with the Legislative and Executive Branches. He also discussed several challenges that remain, such as funding and patience, education, implementing SB 151 and other legislation, spike in retirements, and filling staffing vacancies.

Mr. Eager emphasized several key take aways from the quarter. First, he noted that KRS asset allocation changes continue to reflect each plan's needs with liquidity, income, and risk. A recent Wilshire proposal proposed targets similar to existing KRS targets. Secondly, investment returns year-to-date are up 7.7 percent for pension and 8.0 percent for insurance. Third, asset levels are up $905 million, with net cash flow at -$197 million and investment gains for the fiscal year are 1.1 billion. Lastly, Mr. Eager stated that the Opt-Out provisions planning are underway.

Mr. Robben stated the new investment consultant, Wilshire Associates (Wilshire), was hired in September 2017. Wilshire recently presented its first asset liability study on each of the plans on May 1, 2018, which included minimal changes to the current asset allocation for County Employees Retirement System (CERS) nonhazardous, CERS Hazardous, and all insurance portfolios. For the severely underfunded plans, Kentucky Employees Retirement System (KERS) and State Police Retirement System plans, Wilshire recommended a slight reduction to riskier assets in favor of more traditional fixed income to lower the expected annual volatility, increase the plans liquidity, and increase current income.

In response to a question from Senator McDaniel, Mr. Robben stated he did not believe a decrease in the assumed rate of return would be required prior to the next ARC recommendation.

Mr. Robben continued with a review of current allocations for each plan and noted that the healthier CERS plans and KERS hazardous plans tended to have more equity exposure with the highest annual volatility.

Mr. Robben discussed pension plan performance for the period ending March 31, 2018. He stated that for the quarter, which saw the S&P 500 decline by 1.5 percent, pension assets were up 41 basis points. Interest rates have been going up and moved fairly materially in the first quarter. Mr. Robben stated that in the full reporting package reviewed by staff, the assumed rate of return is included and he noted that the KERS net return through three quarters of the fiscal year was 6.8 percent compared to the assumed rate of return of 3.9 percent. On the CERS side, the net return through three quarters was 7.9 percent versus the assumed rate of return of 4.65 percent.

Mr. Robben discussed the insurance performance for the period ending March 31, 2018. He noted that results were similar to the pension plans, with funds up 0.48 percent for the quarter and 8.02 percent for the fiscal year-to-date.

In response to a question from Mr. Fyffe, Mr. Robben stated that underlying plans within the Wilshire Trust Universe Comparison Service (TUCS Universe) do not necessarily have similar asset allocations. He noted that the TUCS Universe is crafted based on overall plan size and type, which would be public pools of money that are over a billion dollars, but not necessarily state pension plans.

Mr. Eager discussed the cash flow as of March 31, 2018. He stated that in aggregate KRS was down $197 million last year, but with the additional funding, within the next few years it will become a positive number along with investment returns and income.

Mr. Eager discussed current provisions for employers seeking to opt out of participation and provided an outline for trying to come up with a potential solution in the future. He noted that HB 351 currently outlines how employers can cease participation, but that many employers are financially stressed and unable to meet obligations required to exit. Mr. Eager reviewed several key components of reviewing the opt-out process in the future, including:

1. KRS has a fiduciary responsibility (systems and members).
2. KRS recommended solution due December 2018.
3. Principals and objectives of Agency opt-out plan completed.
4. Discussions with many constituents.
5. Assistance from GRS (actuary).
6. Consulting with other retirement systems regarding employer cessation and unfunded liability reduction efforts.
7. May need more than one option for agencies and/or implementation stages.
8. Need to get buy-in; requires effective communication and education.

Senator Bowen commented that this is one of the most important tasks that KRS and the PPOB has been given. He emphasized how huge the issue is for many districts and communities and encouraged all to engage with the process and communicate with Mr. Eager.

Representative Kay commented on the many challenges facing KRS and stated he sees a lot of the burden and responsibility coming from the General Assembly to KRS. He referenced comments made by the PFM Group in September 2017, which indicated a spike in retirements should not be expected as a result of the changes and potential reform. Representative Kay stated a belief that retirements had spiked, and while it may not be due to the effect of changes in the system, it could be due to employees losing trust in the General Assembly and to some degree in KRS. Representative Kay noted that KRS is working hard to rebuild that trust and that the General Assembly needs to as well.

Senator Higdon commented that until the PPOB was created by Senator Bowen’s bill, legislators did not understand the pension system and legislation was passed with no idea of the effects on future employees and General Assemblies.

In Senator Bowen’s closing remarks, he emphasized the importance of the PPOB and due to the participation of the committee, knowledge has grown. He stated that the General Assembly needs to be able to look to the PPOB for answers on pension issues. Senator Bowen stated that under the provision of Section 86 of SB 151 the PPOB is directed to establish a subcommittee to study the benefits and drawbacks of separating CERS from KRS or restructuring the administration of the systems administered by KRS. A report is due by December 1, 2019. The PPOB already has statutory authority under KRS 7A.260 to establish subcommittees for specific purposes. Additional information will be provided in the future.

With no further business, the meeting was adjourned. The next regularly scheduled meeting is Monday, June 25, 2018.