PUBLIC PENSION OVERSIGHT BOARD

Minutes

June 25, 2018

Call to Order and Roll Call

The June meeting of the Public Pension Oversight Board was held on Monday, June 25, 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; Senators Christian McDaniel, Gerald A. Neal, Dennis Parrett, and Wil Schroder; Representatives Ken Fleming, DJ Johnson, James Kay, Arnold Simpson, and Russell Webber; J. Michael Brown, Timothy Fyffe, Mike Harmon, and James M. "Mac" Jefferson.

Guests: Jennifer Black Hans and Bo Cracraft, Legislative Research Commission; David Eager, Executive Director, Kentucky Retirement Systems; and David Harris, Chairman, Kentucky Retirement Systems Board of Trustees, and Beau Barnes, Deputy Executive Director, Teachers' Retirement System

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

Approval of Minutes

Senator Bowen moved that the minutes of the June 4, 2018, meeting be approved. Representative Fleming seconded the motion, and the minutes were approved without objection.

Representative Miller welcomed Representative D.J. Johnson to the Public Pension Oversight Board (PPOB).

Senate Bill 2 Compliance Review

Jennifer Black Hans discussed the PPOB's review of 2017 SB 2. The PPOB recommended passage of SB 2, enacted during the 2017 Regular Session, to provide transparency and accountability measures for the state-administered retirement systems. On December 18, 2017, the PPOB adopted a new recommendation directing staff to conduct a review of the effectiveness of the 2017 pension transparency reforms instituted under SB 2 and to report findings to the board.

Ms. Hans summarized SB 2, which includes provisions relating to Governance, Fiduciary Duty and Conflict of Interest, State Codes, including Kentucky's Model

Procurement Code and State Personnel System governed by KRS Chapter 18A, and Transparency. Under Governance, each retirement system must have Senate confirmation of the gubernatorial appointees to its board of trustees; investment experience is required for the appointees. SB 2 changed the board composition for the Kentucky Retirement Systems (KRS) and the Teachers' Retirement System (TRS). The Fiduciary Duty and Conflict of Interest provisions for all systems reconfirmed the fiduciary duties imposed under HB 300 in 2012, refined the current ban on placement agents, and required adherence to the CFA Institute's Code of Conduct for staff, trustees, and contracted investment advisors. All systems are subject to the Model Procurement Code, and KRS is subject to the State Personnel Merit System under KRS Ch. 18A. New transparency requirements include quarterly reporting of investment performance, fees, and commissions for all systems.

In response to a question from Representative Miller, Mr. Cracraft stated that carried interest is an incentive arrangement utilized by many nontraditional asset class managers. After the agreed upon preferred return rate is exceeded, the general partner and limited partner may share any additional return.

Ms. Hans said that the new law requires disclosure of contracts and offering documents relating to services, goods, or property purchased or utilized by the systems. The confidentiality provision relating to the public disclosure of investment contracts was retained, allowing redaction of portions of the contracts, except that investment contracts must be fully disclosed to the board, Auditor, and the Government Contract Review Commission upon request. For investment contracting, a procurement policy is required, including adoption by the board and approval by the Secretary of Finance. SB 2 had an emergency clause, thus some of its provisions went into effect March 10, 2017.

Ms. Hans stated that, as a first step in the PPOB's evaluation of SB 2, staff gathered information from each of the systems to review compliance in the areas of Governance, Fiduciary Duty and Code of Conduct, State Codes, and Transparency. The Judicial Form Retirement System (JFRS) is in compliance with all topics except Governance, which is pending due to the gubernatorial board members' expiring terms on June 30, 2020. Subsequent appointees will require investment experience and Senate confirmation. KRS is in compliance with Governance and State Codes and in partial compliance with Fiduciary Duty and Code of Conduct for investments under which KRS is a limited partner in a commingled fund (including private equity, real estate, and majority of absolute return). The general partners for these funds have not been contacted regarding SB 2 requirements.

In response to a question from Mr. Fyffe, Mr. Cracraft stated that several of the one-to-one investment management contracts are on the KRS website, and a few of those are not redacted.

KRS is in partial compliance with the transparency requirements. The majority of Limited Partnership Agreements (LPA) (92) are not currently available on the KRS website. These LPAs, which include private equity, real estate, and majority of absolute return, contain language that prohibits KRS from making the documents public or would likely subject KRS to litigation from general partners if made public. TRS is in compliance with Governance and in partial compliance with Fiduciary Duty and Code of Conduct provisions as it relates to the external investment managers. For investment contracts executed prior to SB 2, managers are subject to fiduciary duties and an investment policy that met or exceeded the "Asset Manager Code of Conduct." TRS did not notify all current external investment managers of the "Asset Manager Code of Conduct."

In response to a question from Senator Bowen, Ms. Hans stated that with SB 2, Kentucky was one of the first few states to adopt the specific CFA Institute Standard (CFA). It varies on whether investment managers take the additional step of adopting the CFA. It is an industry standard, but in some cases compliance is presumed as opposed to verified. CFA has no requirement that these investment managers indicate whether they are participating.

TRS is in partial compliance with State Codes in following the MPC for nearly all contracts executed on or after July 1, 2017. Contracts used during FY 2018 were adopted prior to this effective date. A pre-SB 2 contract for janitorial services was extended six months to facilitate converting the contract term to the fiscal year. TRS is also under partial compliance with Transparency due to recent quarterly aggregate investment holdings, fees, and commissions that are pending finalization for publication on their website. The dollar value of profit sharing, carried interest, and other performance related fees is not available, and only one investment manager contract appeared to be available.

In response to a question from Representative Miller, Ms. Hans stated that KRS and TRS use similar companies, but she could not say why the contracts between the two systems are different and why TRS had investment advisors who objected to the release of proprietary information.

In response to a question from Senator Parrett, Ms. Hans stated that as of March 31, 2018, the dollar value of profit sharing, carried interest, and other performance related fees should have been reported by TRS.

Auditor Mike Harmon said that his office is conducting a financial statement audit of KRS. He appreciates the efforts of the PPOB, and the efforts of the General Assembly with SB 2.

Ms. Hans stated that TRS notified PPOB that its prior financial audit included all unredacted contracts.

Senator Bowen said that SB 2 passed both chambers unanimously, which says a lot about the goal to be accomplished with and the intent of this legislation. The General Assembly intended for SB 2 to be complied with fully, not partially.

Asset Allocation Update - KRS

David Eager noted the importance of asset allocation and summarized the process KRS utilizes. First, he stated that there is a need for plans to determine which asset classes KRS wanted to invest, which currently includes a broad range of options, including a variety of alternative products. Secondly, plans must determine the securities from each asset class. This generally comes later in the process, but there are rules of liquidity, turnover, and capitalization. KRS evaluates the characteristics of each asset class by volatility, income, liquidity, growth potential, drivers, and correlation to other asset classes. Mr. Eager referenced the expected returns and correlation of several asset classes and said that KRS is trying to figure out the best combination that produces the highest return and lowest risk. Third, Mr. Eager noted that KRS assesses the need of each underlying plan by considering their risk tolerance, growth, volatility, cash flow, and income. Lastly, any constraints or limits on particular asset classes are incorporated into an optimization model that considers several simulations to project expected returns and risk.

David Harris reviewed the recent background (since 2016) of KRS as it speaks directly to asset allocation. He discussed the reduction in hedge funds, which at one point accounted for $1.8 billion or about 10 percent of KRS monies. Hedge funds are useful, and KRS will still invest about $300 million going forward, but KRS is redeeming assets from many hedge funds that were overlapping existing cheaper strategies. Mr. Harris noted the board’s focus on cash flow and specifically the assumptions that were being used to estimate contribution rates. He noted payroll growth assumptions, inflation expectations, and the discount rates being used by actuaries and consultants that were not necessarily consistent with the plans actual experience. As a result, the board made many changes, both to assumptions and the system’s consultants, which has led to a reduction in expenses and better performance. Performance went from 75/80th percentile to 19th percentile out of all public pension funds in the last two years. The board’s job is to make sure there is enough money to make the benefit payments and providing the legislature with accurate projections of what the plan actually needs. This has resulted in the board recommending new economic assumptions in 2017, such as lowering the assumed rate of return and payroll growth assumption, while raising liquidity of the plans.

Mr. Harris said that KRS had hired Wilshire Consulting to perform an asset/liability study and recently recommended new asset allocations that were adopted by the board in June, 2018. He discussed how KRS has diversified assets into three primary strategies; Growth, Liquidity, and Diversifying Strategies. The plans with more cash-flow constraints (Kentucky Employees Retirement System NH and State Police Retirement System) have more liquidity and fewer growth assets, which results in a portfolio that has a much higher probability of meeting its assumed rate of return. The remaining plans have more liquidity, so the plans have more traditional growth assets, such as public equity.

In response to a question from Representative Simpson, Mr. Harris stated the board considers a larger, longer time period of 10 to 15 years to forecast the assumed rate of return. The board reviews assumptions on an annual basis.

In response to a follow up question from Representative Simpson regarding hardship to local government when KRS has an unduly low assumed rate of return, Mr. Eager emphasized KRS' role and fiduciary responsibility to members of the plan. The staff and board of KRS recognize that the changes made to assumptions have had significant impact and have put employers in a tough spot. Mr. Harris referenced the legislature's decision to phase-in the County Employees Retirement System (CERS) rates, which he commended, but he said the board's responsibility was to provide the most accurate estimate of what the plan needs to become healthy.

In response to a question from Senator Bowen, Mr. Harris stated that he was comfortable with the 6.25 percent return for CERS.

In response to a question from Representative Kay, Mr. Harris stated that KRS is watching the penalties and fees before withdrawal from hedge funds.

Review of Actuarial Assumptions -TRS

Beau Barnes discussed periodic experience studies, which are generally conducted every five years for TRS by an actuary. The experience study is a review of actual experience over the prior five years relative to the actual assumptions in place. Mr. Barnes noted that TRS considers and projects assumptions over a 30-year time frame given the liability is being paid off over a closed 30-year amortization period. The last study was conducted in September of 2016 and covered the period ending June 30, 2015. As a result of the study, the price inflation assumption was lowered from 3.5 percent to 3 percent, wage inflation was lowered from 4 percent to 3.5 percent, and assumed rates of withdrawal, disability, retirement, and mortality were adjusted to better match actual experience of the system. These changes decreased liabilities by about $297 million.

Mr. Barnes discussed the investment rate of return assumption and reviewed the factors considered by actuaries, such as long-term historical information, recent experience, forward-looking projections based on current capital market assumptions, as well as peer system comparison. He highlighted investment performance for TRS as of March 31, 2018, saying that TRS outperformed the benchmark over the most recent quarter, 10-year, and 20-year periods. The system' had a 30-year compounded gross return of 8.43 percent. Looking at the most recent fiscal year, TRS returned 15.02 percent net of fees, which was among the best returns in the country. Mr. Barnes discussed historical market returns for the years of 1926-2017, and said that the recent NASRA study of discount rates concluded that TRS was in the middle of assumptions being used.

In response to questions from Senator Bowen, Mr. Barnes stated that other public pension plans are trending downward into the 7 to 8 percent NASRA range. Each of the state systems are different from one another and have their own challenges. TRS' actuaries are trying to provide the best assumptions to pay off the unfunded liability.

In response to a question from Representative Miller, Mr. Barnes stated that the RFP for actuarial services is complete, responses have been scored, and vendors have been chosen. TRS is in the contract negotiation stage and expects to have the contracts available for review by the end of the week.

Mr. Barnes discussed payroll growth for teachers, saying that payroll averages for the last 10-year period was 1.84 percent, the 20-year period was 3.15 percent, and the 30-year was 4.04 percent. The 10-year average included the Great Recession. The payroll growth assumptions are based on payroll growth projections over 30 years, and TRS' assumption is lower than the 30-year average. Moving to a level-dollar method of amortization method to address the unfunded liability will make the payroll growth assumption irrelevant.

In response to a question from Senator Bowen, Mr. Barnes stated that the last 10 years have been lackluster and largely impacted by the Great Recession. TRS considers this a 30-year assumption and is trying to pay off the unfunded liability over a 30-year period. Looking longer term, TRS believes the next 30 years will look more like the last 30 years rather than the last 10 years. TRS sees 3.5 percent as a realistic 30-year projection.

In response to a question from Sen. Bowen regarding the amount of unfunded liability created by the plan not experiencing the assumed payroll growth, Mr. Barnes stated that if TRS remains at 1.84 percent, then there would be an increase in the unfunded liability without additional funding. He noted that the sensitivity analysis in the systems' annual financial reports provides estimated financial impacts for changes in each assumption. Payroll growth was lowered as a result of the experience study conducted in 2016. If TRS moved to a level-dollar method of amortizing the unfunded liability, then payroll growth becomes irrelevant. Senator Bowen said that assumptions cannot be set at what can be afforded; rather, realistic assumptions must be used.

Mac Jefferson said that a simplistic way of going back and reviewing the reasonableness of investment return assumptions would be to consider the spread between the 30-year Treasury rate and what TRS' investment managers can earn. Thirty years ago, when TRS' assumed rate of return was 8 percent and TRS out earned it, the 30-year Treasury rate 30 years ago was over 7.5 percent. During the 30-year period, TRS earned less than one percent above the 30-year Treasury. Looking at the past 20 years, TRS' assumed rate of return was lowered to 7.5 percent, but the system was not able to out earn the 7.5 assumption. Twenty years ago, the 20-year Treasury rate was 6.4 percent, thus over the last 20-years TRS has under-earned the risk-free Treasury rate. Referencing current markets, Mr. Jefferson noted the 30-year Treasury rate was at about 3 percent compared to TRS' assumed rate of return is 7.5 percent. Given this spread, TRS is assuming it will dramatically out earn the 30-year Treasury, although this is something that TRS has never done in past history. The 30-year Treasury rate acts as a form of gravity for investment returns and how difficult it is for managers to consistently out earn this rate over long periods of time, which is why so many plans are reducing assumptions across the country. Mr. Jefferson urged TRS to not wait for the next experience study to take a serious look at TRS' assumed rates of return and encouraged TRS to apply common sense to its request to the legislature to address underfunding.

Representative Miller stated that he would like to have Mr. Barnes back at another time with TRS' Board Chairman to discuss the assumptions.

Mr. Barnes said the historical inflation from 1926 to 2017 reflected an average rate of inflation of 3.8 percent for all 30-year periods. Many indications are that TRS is heading into a higher interest rate period.

Senator Bowen said that he did not understand how TRS was only in partial compliance with SB 2, especially with the dollar value of profit sharing, carried interest, and other performance related fees, and recommended that TRS return to address this issue.

Representative Miller discussed the establishment of the subcommittee to study the separation of CERS from KRS. The co-chairs will be Senator Schroder and Representative Webber, with members being Senator Higdon, Senator Parrett, Representative Johnson, Representative Simpson, John Chilton, and Mac Jefferson. The subcommittee will return with a recommendation by or before December of 2019.

With no further business, the meeting was adjourned. The next regularly scheduled meeting is Monday, August 27, 2018.