PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 5th Meeting of the 2018 Interim

August 27, 2018

Call to Order and Roll Call

The 5th meeting of the Public Pension Oversight Board was held on Monday, August 27, 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 Gerald A. Neal, Dennis Parrett, and Wil Schroder; Representatives Ken Fleming, DJ Johnson, James Kay, Arnold Simpson, and Russell Webber; J. Michael Brown, John Chilton, Timothy Fyffe, Mike Harmon, James M. "Mac" Jefferson, and Sharon Mattingly.

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

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

Approval of Minutes

Representative Kay moved that the minutes of the June 25, 2018 meeting be approved. Representative Johnson seconded the motion, and the minutes were approved without objection.

Investment and Cash Flow Quarterly Update/SB 2 Compliance Review/Agency Opt-Out Review Update - KRS

David Eager discussed investment performance, cash flow, SB 2 compliance, and agency opt-out HB 362 replacement. Investment markets continue to perform well and the investment group added approximately $120 million above benchmarks during the year. Regardless of performance, Kentucky Retirement Systems (KRS) will not earn its way out of this situation and will need funding from external sources. For the fiscal year, KRS was up 8.6 percent in the pension fund and 9.1 percent in the insurance fund, which ranked within the 26th percentile of the Wilshire Trust Universe Comparison Service (TUCS). Cash flow still presented a problem to the funds. Cash flow has improved significantly over the past few years, and with the additional funding expected, KRS is anticipating a positive cash flow for fiscal year 2019. Regarding SB 2 compliance, the 18A and 45A transition and implementation have been somewhat problematic and investment manager contract compliance has been met with some resistance from a few managers at this point. KRS is on target for a December completion of agency opt-out.

Mr. Robben discussed the investment performance as of June 30, 2018. KRS is pleased with the fiscal year results for all plans with pensions ranging high at 8.8 percent for the County Employees Retirement System (CERS) to 7.5 percent for Kentucky Employees Retirement System (KERS). The cash flow profile of the KERS plan does not allow the same level of risk as the other plans under KRS, thus the moderately lower return. The insurance results are very similar with a high of 9.3 percent for CERS and 8 percent for KERS. Mr. Robben highlighted the performance relative to peers, with KRS ranking close to the first quartile, and noted how performance had continue to improve since the current investment committee had joined KRS.

Mr. Eager reviewed a risk/return analysis for the KRS pension plan, which measures both the amount of risk taken and total return of a portfolio. Staff expects the pension portfolio to have less risk than most peers, however staff's goal is to meet or exceed the median return over time.

In response to a question from Mr. Fyffe, Mr. Eager stated that the risk/return analysis includes about 130 public funds, which utilize a variety of asset allocations. Mr. Robben stated that TUCS' Total Return Master Trust is a public universe that compares performance and risk of all public pension funds regardless of pension size. The universe includes only public pension funds and does not include endowments, foundations, corporate pension plans, or the like.

Mr. Eager discussed cash flow for KERS nonhazardous for FY 2018. Member contributions were $110.8 million, employer contributions/appropriations were $689.1 million, a Northern Trust settlement was $0.3 million, and investment income (dividends and interest) were $34.6 million. Total cash inflows were $834.8 million and total cash outflows were $991.7 million. For the CERS nonhazardous for FY 2018, member contributions were $171.2 million, employer contributions were $358 million, Northern Trust settlements were $0.4 million, and investment income was $101.2 million. Total cash inflows were $630 million and total cash outflows were $760.8 million.

Mr. Eager discussed SB 2 compliance with KRS Chapters 18A (State Personnel System) and 45A (Model Procurement Code). Compared to the past, operating under 18A and 45A requires more time to complete tasks, requires more management and administrative time, and expense, and provides less flexibility and responsiveness.

Mr. Robben discussed SB 2 and investment manager contracts. KRS' efforts have been split between prospective compliance and retrospective compliance. For new investments considered, KRS is using a gating process that is sent to every prospective manager and outlines a list of requirements for doing business, which includes the SB 2 compliance requirements. About 35 to 40 percent of managers approached have decided to opt out.

In response to a question from Mr. Fyffe with regards to reasons managers choose to opt out, Mr. Robben stated are several reasons. In the private equity or real estate markets, KRS tends to invest primarily via general partnerships or commingled vehicles. For example, KRS is not large enough to buy a portfolio of office buildings so it becomes a limited partner in a partnership with other funds to go buy buildings together. The predominant comment among general partners is the different standard of fiduciary care created amongst the limited partners. Secondly, the requirement to post offering documents online is problematic because any fund currently open to investors is required by SEC Investment Manager Code of Ethics (SEC) law to deliver offering documents one on one, in person, to an institutional qualified investor. If KRS were to post those documents on its web site, the SEC might construe that to be a general offering that could put KRS at risk of losing its SEC safe harbor. Lastly, most managers feel like their Limited Partnership Agreement is proprietary.

In response to a question from Representative Johnson regarding why investment fees decreasing, Mr. Robben highlighted several of the investment committee's initiatives. The committee is unwilling to pay the older fee arrangement of 2 percent management fee and 20 percent carry. Those type of strategies are not considered. The committee and staff focus on identifying managers where KRS' capital is important. Staff is not interested in being the last $50 million into a $10 billion fund, but rather finding managers where KRS is important to the fund, which then translates into better fees.

In response to a comment from Senator Bowen regarding funding levels, Mr. Eager stated that actuaries are working on the June 30, 2018 valuation. Staff anticipates very little movement in the level of funding. Looking at longer term projections with a 30 year horizon starts with small increments and gets bigger later in that time period.

In response to a question from Mr. Chilton regarding cash flow, Mr. Eager noted that both the higher funding levels of CERS, added return, and active members all lead to stronger cash flow relative to KERS. For example, if CERS' assets are around $7 billion and the plans return is 1 percent higher than KERS, just that difference adds $70 million. Additionally, the ratio between contributions and benefits is far better in CERS than KERS. In KERS nonhazardous there are 40,000 retirees and 36,000 actives. In CERS the ratio is about 1.4 to 1 roughly.

In response to a question from Senator Bowen, Mr. Robben stated that to his knowledge under SB 2 compliance, he has not had anyone make a reasonable case that the contracts cannot be shared with all appropriate parties. He stated the managers feel by posting to the website, their contract is shared with their competitors. Senator Bowen asked if the information had been shared with anyone, such as the Auditor and/or Legislators. Mr. Eager stated that KRS is in the middle of their APA audit and does not know of any Legislator who has asked for the information. Mr. Robben stated that their APA Auditor has unlimited access to all investment contracts.

Auditor Harmon stated that his office was in the middle of a financial statement audit of KRS and have made the decision to expand testing to include many elements of SB 2.

In response to a question form Representative Miller, Mr. Robben stated that KRS will not be a top tier client to certain managers.

Mr. Eager discussed the requirement to incorporate the CFA Institute Code of Ethics and Standards of Professional Conduct and Asset Manager Code of Conduct (CFA Code) into manager contracts and noted staff often gets a push back from managers. KRS would like to suggest replacing the CFA Code with the SEC. The SEC requirement is an industry standard, carries punitive powers, and includes periodic on-site audits, whereas the CFA Code lacks enforcement authority.

In response to a question from Representative Kay, Mr. Eager stated that the SEC is more stringent than the CFA Code and includes punitive powers.

Representative Kay commented that it was his understanding there are over 100 contracts that are not disclosed on the website, which is out of compliance with SB 2. Also, there are many contracts that are overly redacted and other managers who do not want to do business with KRS because of the stronger, more stringent transparency laws. Instead, they want their lobbyists to deal with legislators and the executive branch to change the law so they do not have to comply. Representative Kay stated that KRS is not in full compliance with 18A, 45A, CFA, and contract disclosures. Mr. Eager responded that KRS is in complete compliance with 18A and 45A. Mr. Robben explained that all fees are reported and published on the website.

In response to a question from Representative Miller, Mr. Eager indicated the investment manager who returned $58 million to KRS did so as a result of the CFA Code requirement. Mr. Robben stated it had less to do with what the code actually said but that the manager believed it was creating a different fiduciary standard within the partnership.

In response to a comment from Senator Bowen, Mr. Eager stated that with regards to transitioning from the CFA to the SEC standards, KRS has begun a discussion with the Teachers' Retirement System (TRS).

Mr. Eager discussed staff's work on creating new opt-out provisions for employers and stated that KRS had formed a four person task force to lead the project. Recommendations will be made by staff by December of 2018. The task force is spending a lot of time with actuaries, legislators, and employers. Initial focus has been placed on roughly 120 quasi-state agencies that account for approximately $3.5 billion in unfunded liabilities.

In response to a question form Senator Bowen, Mr. Eager stated that if HB 362 were enacted as originally introduced, the impact would be noticed on day one. The impact would not be catastrophic but would grow over time. If enacted, the bill effectively would give the agencies opting out a $3.5 billion loan for 40 years with no interest and no ability to earn investment returns.

In response to a question from Representative Simpson, Mr. Eager stated that Kentucky is unique with regards to the level of funding in KERS nonhazardous. He mentioned a recent conference in which he asked to spend time with other state plans to discuss employer opt-out issues; there were effectively no other states dealing with similar issues. Kentucky is in a unique spot with the quasi challenge.

Investment and Cash Flow Quarterly Update/SB 2 Compliance Review/Investment Returns Assumption Detail – TRS

Beau Barnes, LRC staff, and P.J. Kelly, AON Hewitt, presented. Mr. Barnes discussed SB 2 compliance and addressing several issues identified during the committee's prior meeting in June. First, with regards to partial compliance with the CFA Codes of Conduct, Mr. Barnes stated TRS believes it would be a great idea to codify minimal ethical standards in statute. What TRS has found with their managers is that each has created their own code of conduct that meets or exceeds the CFA Code. TRS had requested a copy of the code of conduct from all managers. Secondly, with regards to some partial compliance with the Model Procurement Code, Mr. Barnes noted that TRS was in the procurement process and has now submitted each contract to the Government Contract Review Committee for review, and TRS is compliant with SB 2 requirements regarding the Model Procurement Code. Third, LRC staff identified some partial compliance as to transparency, which Mr. Barnes indicated had been addressed. TRS will have quarterly updates posted online quarterly. TRS had posted most of its traditional contracts online. Some other contracts are only listed by name but cannot be posted due to the confidentiality of proprietary information asserted by the managers.

In response to a question from Senator Bowen, Mr. Barnes stated that he has not had any inquiries regarding the confidentiality of contracts.

Mr. Barnes said that TRS uses an external service provider conflict of interest statement that basically requires all vendors to sign that they recognize their responsibility to TRS, will conduct all business in an ethical manner, will avoid any conflict of interest, and will adhere not only to the Executive Branch Ethics law, but will also adhere to the applicable provisions of KRS 161.430.

In response to a couple of questions from Representative Johnson, Mr. Barnes highlighted the amount of due diligence conducted by TRS and AON Hewitt prior to ever doing business with a manager. TRS with AON Hewitt conducts a lot of due diligence and a thorough review of both the firm and individuals working for it. As for enforcement, the SEC would provide compliance enforcement and assessment of penalties.

In response to questions from Senator Bowen regarding existing managers with whom TRS reinvests prospectively, Mr. Barnes stated that TRS is going to require every manager to comply with SB 2 requirements, but indicated that with each of their private equity relationships the managers were going to assert the confidentiality exemption and this would limit TRS from posting contracts. All TRS contracts are available to the Public Pension Oversight Board (PPOB), the Auditor, or any other elected officials. TRS would still fall within compliance of SB 2 even though the contracts were not disclosed given that an appropriate statutory exemption was being exercised.

In response to a question from Senator Bowen with regards to reporting carried interest, Mr. Barnes indicated that TRS asked each of the managers if carried interest could be reported and were told that TRS cannot report carried interest. Mr. Barnes and Mr. Kelly outlined what carried interest was and how reporting it as a fee can be misleading given it is really a sharing of profits.

Senator Bowen said that, regardless of the reasons, TRS was not reporting carried interest. Reporting of carried interest is important for PPOB, which may explore this issue further.

Mr. Barnes reviewed cash flows for the fiscal year and noted that total cash inflows for FY 2018 were $1.731 billion and total outflows were $2.047 billion. The net cash flow before asset gain/losses was a negative $315 million, with investment gains totaling $1.310 billion. The total pension fund increased from $18.5 billion in FY 2017 to $19.8 billion in FY 2018. TRS has reached a record level of assets with about $21 billion in assets in pension, health, and life insurance trusts.

Mr. Barnes discussed investment performance and noted TRS's fiscal year return of 10.5 percent ranked in the top 2 percent when compared to other pension plans with $1 billion or more in assets. Mr. Barnes reviewed trailing performance and highlighted TRS' performance ranked in top 10 percent of peers across all time periods. The 30-year compounded gross return is at 8.39 percent. Mr. Barnes provided a review of returns relative to a peer group from Callan Associates and reviewed trailing performance for periods ended June 30, 2018. For the 30-year, TRS had a rate of return of 8.4 percent compared to the median return of 8.6 percent. Over the 1-year, TRS returned 10.8 percent compared to median return of 8.2 percent of the peer group.

Mr. Barnes reviewed TRS' approach to investments. He stated that TRS never has used placement agents, does not invest in hedge funds, and discloses annual fees in their annual report and quarterly on their website. Lastly, TRS adheres to its fiduciary duty in the procurement of investments.

Mr. Barnes reviewed private equity and noted managers are regulated by the SEC. All TRS' fees are disclosed on the annual report and quarterly on their website. Alternatives account for less than 7 percent of the TRS portfolio and private equity is less than 5 percent. Mr. Barnes provided returns for the asset class over the past seven years and highlighted that the private equity portfolio has provided some of the best returns.

Mr. Barnes discussed the basic actuarial assumptions and stated that the assumed investment rate of return is 7.5 percent with the projected wage (teacher salaries) increase at 3.5 percent. Assumptions are long-term estimates, so short-term fluctuations are expected. Ongoing analysis of assumptions includes peer system comparison, long-term historical information, modeling using market assumptions, and recent experience. Mr. Barnes noted that TRS had a full actuarial audit in 2015 and experience study in 2016, which both supported a 7.5 percent assumed rate. Changes made from the 2016 experience study included the price inflation assumption, lowered from 3.5 to 3 percent, and wage inflation (teacher's salaries), which was lowered from 4 to 3.5 percent.

In response to a question from Representative Miller, Mr. Barnes indicated that looking back historically, prior to 2008, TRS was experiencing a payroll growth rate above assumptions, while more recently it has been below. Payroll growth is more stable in TRS than other plans like KERS because schools cannot reduce the number of teachers and salaries have to grow. So over 30-year periods, TRS feels pretty comfortable with its current assumption.

Mr. Barnes provided a review of historical market returns, using rolling 30-year periods beginning covering 1926 to 1955 and 1988 to 2017. The S&P 500 Index average return was 11.2 percent, minimum return was 8.5 percent, and the maximum return was 13.7 percent. For the 60 percent S&P/40 percent corporate bonds, the average return was 9.1 percent, the minimum return was 6.6 percent, and the maximum return was 12.1 percent. The historical price inflation for the same 30-year period showed the average rate was 3.8 percent, the minimum rate was 1.4 percent (1926-1955), and the maximum rate was 5.4 percent.

Mr. Barnes reviewed TRS' current projected return using capital market assumptions and from a survey of 36 large investment consultants conducted by Horizon in 2017. Mr. Kelly reviewed TRS' current asset allocation and when the Horizon Survey assumptions were applied, the expected return of the TRS portfolio is 7.7 percent, which is slightly above the 7.5 percent assumption of TRS.

In response to questions from Mr. Jefferson regarding AON's use of actuarial data and scenario testing, Mr. Kelly referenced an Asset Liability Study that AON conducts periodically. The study incorporated all the assumptions and the projected cash flows, both in and out of the portfolio, used by the actuary and models all types of good and bad scenarios for the portfolio based on that information. AON tends to focus on the bad scenarios and tries to build a portfolio that can have reasonable probability of meeting assumptions. For returns not meeting assumptions, the mechanisms that balances those scenarios are the actuarial determined contribution. If returns are better than assumed, the contribution rate will decrease, and vice versa. TRS' current portfolio mix, based on AON's market assumptions, which are more conservative that the Horizon study, has a 40 percent probability of reaching 7.5 percent.

Senator Bowen commented that the assumed rate of return is a critical factor. TRS has made its case for utilizing a 7.5 percent; PPOB's role is to question and counter that argument. People across the Commonwealth identify with the percent of funding of each fund, which is not in the presentation. He would like to see it in the quarterly updates.

Representative Kay recommended that PPOB have a representative from the SEC and CFA to testify about their ethical standards.

Investment and Cash Flow Quarterly Update – JFRS

Ms. Early discussed the investment update and stated that the guidelines for both the judicial and legislators' plans are a 70/30 allocation, which is 70 percent equities and 30 percent fixed income with a 10 percent variance going either up or down for each plan. The judicial defined benefit plan's total portfolio market value as of June 30, 2018, was $396.5 million. The judicial hybrid cash balance plan's total portfolio market value as of June 30, 2018, was $864,484. The legislators' defined benefit plan's total portfolio market value was $117.6 million and the legislators' hybrid cash balance plan's total portfolio market value was $239,190. The judicial defined benefit and the legislators defined benefit plans fell a little short of meeting their benchmarks last year.

Ms. Early discussed the statement of changes in net position and stated that the judicial and legislators' plans ended in a positive net plan assets.

Senator Bowen said that he had been appointed to fill a vacancy on the Judicial Form Retirement System Board and that he had accepted the appointment.

With no further business, the meeting was adjourned. The next regularly scheduled meeting is Monday, September 24, 2018.