PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 8th Meeting
Of the 2019 Interim

October 28, 2019

Call to Order and Roll Call

The 8th meeting of the Public Pension Oversight Board was held on Monday, October 28, 2019, 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 Christian McDaniel, Dennis Parrett, and Wil Schroder; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, Russell Webber, and Buddy Wheatley; J. Michael Brown, John Chilton, Timothy Fyffe, Mike Harmon, and James M. "Mac" Jefferson.

Guests: Bo Cracraft, Legislative Research Commission; Beau Barnes, Deputy Executive Secretary of Operations and General Counsel, Teachers' Retirement System; and Richard Robben, Executive Director, Office of Investments, Kentucky Retirement Systems.

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

Approval of Minutes

Senator Higdon moved that the minutes of the September 23, 2019 meeting be approved. Representative Webber seconded the motion, and the minutes were approved without objection.

Semi-Annual Investment Review

Bo Cracraft, Legislative Research Commission, provided a semi-annual investment review. He began by providing a summary of total assets managed across the Kentucky Retirement Systems (KRS), Teachers' Retirement System (TRS), and Judicial Form Retirement System (JFRS). Collectively, total pension and insurance assets exceeded $40 billion as of June 30, 2019, which was an increase of $1.3 billion since the same timeframe last year.

Next, Mr. Cracraft discussed performance across various investment markets and provided index returns for several major asset classes. The fiscal year did see positive returns in many markets, but returns were not quite as strong as experienced during the prior two fiscal years.

In response to a question from Representative Miller, Mr. Cracraft stated the return information provided represented index returns.

In response to a question from Mr. Chilton regarding how the return values are determined for less public markets like real estate or private equity, Mr. Cracraft stated there were index providers in both asset classes that aggregated data of underlying managers and were considered industry leaders. He did note that private equity is a tough asset class to benchmark and that many public plans utilize a public equity index approach to measure performance.

In response to questions from Representative DuPlessis and Representative Graviss, Mr. Cracraft noted the return information he was discussing was related to markets as a whole and not specific to any of the Kentucky plans. He stated the purpose of providing the index return information was to give members a sense of what asset classes worked and did not work over the 12 month period.

Mr. Cracraft moved on to a discussion of plan specific performance for KRS, TRS, and JFRS. First, he began with a slide that displayed annual fiscal year performance over the past 23 years. Each of the plans have generally moved together, with each having periods of outperformance, and pointed out how trailing period returns were going to be impacted by 2019 results. Secondly, he reviewed a slide that provided trailing 1-, 3-, 5-, 10-, and 20-year performance for each plan relative to their assumed rate of return and policy benchmark, as well as three peer groups. He noted the trailing 20-year returns had declined slightly from the prior year, while the 10-year returns had improved.

Mr. Cracraft discussed asset allocation and explained how a plan allocates assets has historically driven 90 percent of its returns. He discussed several of the asset classes and noted that multiple strategies and opportunities exist within each class. One slide showed current allocation percentages for each state plan along with a LRC-calculated peer group at the end of the fiscal year. Differences could be seen between several of the plans, but little had changed from the previous year.

In response to a question from Representative DuPlessis regarding the allocation of the County Employee Retirement System (CERS) plans, Mr. Cracraft referenced the plans' assumed rate of return target as compared to KERS and TRS. He noted that CERS did have less equity than TRS, but was also seeking a lower target of 6.25 percent (versus 7.5 percent). He added KRS staff would seek to set an asset allocation that took the least amount of risk, but still met its target.

In response to a question from Representative Miller regarding the real return asset class, Mr. Cracraft stated the asset class was hard to measure with index returns. He noted that several asset types might be included in this allocation, such as timber, inflation-linked assets, or risk parity.

In response to questions from Representative Graviss regarding the amount of alternative or higher risk investments of KERS, Mr. Cracraft stated that, when measured by volatility of returns, most alternative strategies are lower risk than public equities, which can experience swings from month to month. Given that volatility, many plans have allocated to alternatives, especially plans that have less tolerance for asset loss. In addition, more specific to the KERS nonhazardous plan, he noted no new private equity investment had been made since 2011, but given the plans declining asset base, the allocation to private equity appeared to be a bit higher compared to peers.

In response to a question from Representative DuPlessis regarding the equity exposures of the Kentucky plans relative to the LRC peer group, Mr. Cracraft noted that each plan's targeted asset allocation is set by their board and is driven by periodic asset liability modeling studies that are conducted. In the case of the TRS and JFRS boards, the asset allocation adopted by the board does have an above average allocation to equity when compared to the peer group, while KRS tends to be below that average.

Mr. Cracraft finished up the discussion on asset allocation with a peer comparison of the equity, fixed income, alternatives, and cash allocations of the plans. He noted that relative weights were pretty similar to the prior year. He referenced KRS' declining exposure to absolute return had lowered the plans' exposure to alternatives below the average.

Next, Mr. Cracraft provided a review of investment fees for the three retirement systems. He noted management fees on the pension side were provide by asset class, while the insurance information was consolidated. With regards to other fees and incentives, such as carried interest, he noted KRS does provide this information and reports it as a separate line item. TRS had been notified by its managers that carried interest information is proprietary and cannot be publicly reported, and JFRS does not utilize alternatives, so, carried interest is not applicable.

In response to questions from Senator McDaniel regarding TRS not reporting carried interest, Mr. Cracraft stated that the carried interest reporting was required in SB 2, but TRS does not view carried interest as a fee and believes it is exempt from having to disclose the information under KRS 161.250. In response to a follow-up question regarding how KRS interpreted carried interest, Mr. Cracraft stated that he did not know how KRS viewed carried interest, but that they were disclosing the information.

In response to a question from Mr. Harmon, Mr. Cracraft agreed that the total fees reported in his presentation for TRS did not include any carried interest.

In response to a question from Senator Higdon regarding other states disclosing carried interest, Mr. Cracraft referenced a slide in his presentation as well as some attachments that had been provided to the members. Research shows that reporting carried interest is not the norm, but more and more plans are starting to report carried interest either through their annual reports or in the form of board reports. In response to a follow-up question regarding common partnerships across states that had disclosed carried interest, Mr. Cracraft stated there were common general partners with plans who were disclosing carried interest.

In response to a question from Mr. Jefferson regarding common managers between KRS and TRS and differences in disclosure, Mr. Cracraft stated there was not a lot of overlap between the plans and, even when employing the same manager or general partners, it often was not in the same exact strategy. In the instances of overlap at the manager level, KRS was reporting carried interest, while TRS was not. In response to a question as to whether plans worked together to negotiate fees, Mr. Cracraft noted no formal procedure was in place, but staff did have informal conversations, like they would with other state plans, when considering similar managers or strategies.

In response to a question from Representative Graviss with regards to what “other” fees represented, Mr. Cracraft stated that “other” fees represent additional expenses to the partnership, such as accounting fees for annual tax filings or legal fees required to close financial transactions to purchase or buy out underlying portfolio companies. These fees are generally related to alternative strategies or strategies that are structured as partnerships. In response to a follow-up question regarding whether incentive fees are generally tied to certain asset classes, Mr. Cracraft stated incentive fees are very normal for alternative asset classes, but less likely in the public asset classes.

Representative Graviss expressed some concern with the lack of disclosure of carried interest and asked members of any potential action or rulings with regards to disclosure. Senator Higdon indicated that recommendations would be adopted and made by the PPOB in December for legislators to work on developing an agreement in regards to the conflicting legislation between KRS 161.250 and SB 2 in the upcoming 2020 Regular Session.

Senator Schroder commented that the General Assembly could avoid having to develop a legislative fix to the issue of carried interest disclosure, if TRS would negotiate with their investment managers and express to them the importance of disclosure. He stated that TRS should impress upon its managers that disclosure is important to TRS’ members and the citizens of the Commonwealth and should require disclosure of carried interest going forward.

Representative DuPlessis agreed with Senator Schroder and called Beau Barnes, TRS, to the testimony table to respond. Mr. Barnes stated that, in regards to disclosing carried interest, TRS had investment staff reach out to its general partners, and the response was the information is considered proprietary and the partners do not want their competitors knowing how much is made on investments. Mr. Barnes stated the statute allows the systems to exempt data from being disclosed publicly and on the website, including carried interest, if this information is either confidential or proprietary and/or if it compromises TRS' opportunity to invest. Mr. Barnes stated that TRS does not want to put something on their website that could potentially be a litigation risk.

In response to questions from Representative DuPlessis regarding whether or not fees would be higher if carried interest were not paid, Mr. Barnes stated the nature of the enterprise is to split profit and, if that was not the case, he was unsure if the partnerships would exist.

Representative DuPlessis commented that he was uncomfortable with investments that do not disclose all the funds that are being paid in the form of fees and/or profits. He stated that it is unacceptable for the board not to see this information.

In response to a question from Representative Graviss regarding if the carried interest could be made available to the board, Mr. Barnes stated that Senate Bill 2 in 2017 specifically provided that TRS could share confidential information with certain entities with a signed nondisclosure agreement.

Mr. Harmon stated that his office did have access to the confidential information. However, the problem is that the statute states that carried interest is supposed to be disclosed publicly.

Representative DuPlessis called Rich Robben, KRS, to the testimony table. In response to a question from Representative DuPlessis, Mr. Robben stated that KRS has not seen any push back from managers in the private equity space or other managers in regards to their fee reporting.

Representative Miller commented that he believed TRS could report carried interest at an asset class level in aggregate across all managers without compromising the underlying manager data and urged Mr. Barnes to encourage the TRS board to include asset class information in their upcoming Comprehensive Annual Financial Report.

Senator Schroder commented that TRS is a customer to those managers who are threatening litigation that could ruin future contracts of doing business. He believes that TRS can negotiate for business with full transparency.

Mr. Cracraft finished the discussion with regards to investment fees with a review of the recent trend in expenses. He reviewed total fees in terms of dollars and basis points for KRS, TRS, and JFRS for fiscal years 2015 through 2019.

Next, Mr. Cracraft transitioned to a discussion of net cash flow, which was a research topic requested of staff. Historically, plan health had focused on actuarial valuations and funding levels, but more recently, both at the local level and beyond, the topic of cash flow has gained awareness. A reason for the increased attention to cash flow was the fact that many plans are currently dealing with negative cash flow, or a situation where net contributions received no longer cover total dollars being paid out of the plan in the form of benefits and expenses. He stated that negative cash flow is not just specific to Kentucky, citing recent research conducted by the National Association of State Retirement Administrators (NASRA) that reported a median cash flow across the industry of negative 2.8 percent. Mr. Cracraft stated that NASRA and many actuaries review and measure cash flow as a percent of plan assets and suggested this measurement might be a more useful means of considering a plan's cash flow, rather than just in terms of dollars. He noted that as a plan's negative cash flow grew, it should lead to a change in investment strategy and expected returns, which would lead to revised assumptions and contribution rates. While there was no specific standard as to what level of negative cash flow becomes unmanageable, Mr. Cracraft stated research had indicated a range of 3-5 percent negative. He reviewed an example, using the TRS plan experience, and also provided current cash flow characteristics for each of the plans as of June 30, 2019.

To close, Mr. Cracraft discussed several other statutory items required during his review, which included a review of current policies, benchmarks, and securities litigation activities.

In response to questions from Mr. Chilton regarding cash flow, Mr. Cracraft stated that over time, as long as there are positive markets and a continuance of growth above an assumed rate of return, a plan like TRS can manage negative cash flow and grow assets. However, as that negative cash flow grows, more reliance is being placed on asset growth above and beyond the assumed rate of return, and the risk of a market correction or extended period of muted returns becomes more problematic. In response to a follow-up question, Mr. Cracraft suggested plans need the majority of negative cash flow to be offset by the income being generated.

In response to a question from Representative Graviss regarding adding more information on a plan's cash flow to the chart, Representative DuPlessis stated that he believed it would help to give a total cash flow with investment income to show if it was positive or negative. Representative Graviss also asked LRC staff to look at the maturity rate of retirees under current plan cash flows.

With no further business, the meeting was adjourned.