

PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 1st Meeting of the 2020 Interim

February 24, 2020

Call to Order and Roll Call

The 1st meeting of the Public Pension Oversight Board was held on Monday, February 24, 2020, 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, Gerald A. Neal, and Wil Schroder; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, Russell Webber, and Buddy Wheatley; John Chilton, Mike Harmon, John Hicks, James M. "Mac" Jefferson, Sharon Mattingly, and Stephen Pitt.

Guests: David Eager, Executive Director, and Richard Robben, Executive Director, Office of Investments, Kentucky Retirement Systems; Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System; and Donna Early, Executive Director, and AC Donahue, Trustee, Kentucky Judicial Form Retirement System.

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

Approval of Minutes

Representative Wheatley moved that the minutes of the December 16, 2019 meeting be approved. Representative Pratt seconded the motion, and the minutes were approved without objection.

Investment and Cash Flow Quarterly Update – Kentucky Retirement Systems

Richard Robben, Kentucky Retirement Systems (KRS), provided a summary of investment performance ending December 31, 2019. He provided information from Wilshire Consulting for asset class performance, asset allocation bucketing that included growth, liquidity, and diversifying allocations, asset allocation median plans, and peer group analysis for the 1-, 3-, 5-, and 10-year time frames. Mr. Eager added that Wilshire Consulting reported that KRS was in the 38th percentile under the 5-year returns, which means 62 percent of the funds did worse than KRS. Standard deviation for the 5-year as a measure of risk placed KRS in the 7th percentile, and for Sharpe ratio under the 5-year, KRS was in 3rd percentile. This places KRS close to the top of the peer group in terms of risk avoidance.

Senator Higdon assumed the Chair.

In response to a question from Representative Miller, Mr. Eager confirmed that the numbers discussed were total numbers for the system. Representative Miller commented that there had been concern expressed about sub-optimization of returns for the County Employees Retirement System (CERS).

In response to a question from Representative Graviss, Mr. Robben stated that he believes there are 177 plans in the Wilshire Consulting peer group analysis.

In response to a question from Senator Neal, Mr. Robben stated that 90 percent of the return from a portfolio is driven by asset allocation.

Mr. Eager provided information on all systems under KRS for net of fee rates of return for the 1-, 3-, 5-, 10-, 20-, and 30-years for December 31, 2019, for pension and insurance plans.

In response to questions from Senator Higdon regarding the differences between investing for the Kentucky Employees Retirement System (KERS) and the CERS, Mr. Eager stated that the key for driving performance is largely asset allocation, and the allocation for each system was meaningfully different. He noted that the allocation to public equity for KERS is about 5 percent less than the allocation for CERS.

Representative Miller commented that when looking at CERS nonhazardous and KERS nonhazardous, the difference in the returns show that CERS is being invested more aggressively.

In response to questions from Senator McDaniel regarding selecting investments, Mr. Robben stated that KRS considers the funding ratio, cash flow, and the level of certainty of receiving the actuarially determined employer contribution (ADEC) each year as it evaluates the level of risk it may take. In response to a follow-up question regarding specific scenarios and estimates, Mr. Robben advised that KRS would know more after the end of its asset liability study, which is ongoing with Wilshire Consulting and should be available at the board of trustees' meeting in May.

In response to a question from Mr. Jefferson regarding the process involved in determining the allocation of each particular fund, Mr. Robben stated that KRS works with Wilshire Consulting who prepares sets of capital market assumptions that take into account correlation of how assets act together.

In response to a question from Representative Wheatley, Mr. Robben stated that he was unsure of how many of the 177 Wilshire Consulting public pension plans were run by one board versus multiple boards. Mr. Eager added that the National Association of State

Retirement Administrators (NASRA) does not have a list either, so any information is anecdotal only.

Representative Graviss requested all Kentucky Retirement Systems Administrative Subcommittee materials be provided to the Public Pension Oversight Board (PPOB). Representative Webber commented that the material will be made available to all PPOB members.

Mr. Eager discussed cash flow for December 31, 2019, compared to December 31, 2018. He began with the CERS' FY 2020 contribution inflows and outflows. He stated that the CERS plan still has liquidity issues with more money going out than coming in. Mr. Eager noted the net cash flow before gains/(losses) in FY 2020 was -32.0 million.

In response to a question from Representative DuPlessis, Mr. Robben stated that, if CERS nonhazardous invested more aggressively than 6.25 percent, it would have been enough to overcome the -32.0 million negative cash flow for FY 2020, but added that the calendar year before would have made it worse. In a follow up question from Representative DuPlessis, Mr. Eager stated that the insurance fund, which is better funded, will be examined in May for a more aggressive rate.

In response to a question from Senator McDaniel with regards to if CERS should expect a slight negative cash flow as more employees' begin participating in Tier 3, Mr. Eager stated that there would be an inflection point, where employer contributions would go down and investment returns would be expected to help offset any negative cash flow; however, he does not expect it anytime in the near future. Senator McDaniel commented that as the plan draws closer to that point, it is not necessarily a negative thing if net cash flow before gains/losses is relatively flat given the different risk profile for those new hybrid plan employees.

Mr. Eager continued with his cash flow discussion and stated that KERS and the State Police Retirement System funds are net positive. He noted that the KERS plans made a jump in contributions from 49 to 83 percent with a benefit of positive cash flow.

In response to a question from Representative Graviss, Mr. Eager stated in regards to a SB 2 status update that KRS has hired an attorney and are no longer relying on outside counsel for evaluating and redacting, as necessary, investment contracts are up to date on their posting requirements.

Mr. Harmon stated in regards to SB 2 compliance, that there were more concerns of posting carried interest with the Teachers' Retirement System (TRS). KRS had redacting issues, which are being addressed.

In response to a question from Representative Graviss, Mr. Eager stated that cash flow and liquidity are moving in the right direction for growth but added that the opportunity to earn is not available for the next 10 years.

Investment and Cash Flow Quarterly Update – Teachers’ Retirement System

Beau Barnes, TRS, began his presentation discussing the pension investment performance as of December 31, 2019. He discussed the benchmarks and gross and net returns for the quarter, fiscal-year-to-date, 1-, 3-, 5-, 10-, and 20-year trailing time periods. He stated that the 30-year compounded gross return is 8.15 percent. Mr. Barnes provided a slide that showed TRS’ investment performance above the average pension plan from 2008 to 2019, which resulted in an additional \$3.6 billion in excess returns.

In response to a question from Senator McDaniel, Mr. Barnes agreed that the average retiree is drawing benefits for about 27 years, of which approximately 5 years are paid by the employer and employee contributions, while the remaining 22 years are general covered by the interest and investment earnings generated over the member’s life. Mr. Barnes stated that is why investment performance is so important.

Mr. Barnes reviewed cash flow for the pension fund through December 31, 2019 compared to December 31, 2018. He pointed out cash inflows, outflows, and the total net plan assets across both time periods.

In response to a question from Senator Higdon, Mr. Barnes stated that the member contribution difference between FY 2020 and FY 2019 was attributable to one of its largest employers, which had a turnover in payroll personnel and had gotten behind in reporting contributions to the system. TRS has since met with the employer and have showed them how to correctly report contributions.

Mr. Barnes reviewed the cash flow for the health insurance fund through December 31, 2019, compared to December 31, 2018. He pointed out cash inflows, outflows, and the total net plan assets across both time periods.

In response to questions from Representative DuPlessis, Mr. Barnes stated that the increase in employer contributions/appropriations for FY 2020 was part of the \$70 million in surplus that the current budget provided. In response to a follow up question, Mr. Barnes stated administrative expenses are accounted for once a year, which is why the reported amount is zero for this reporting period. Mr. Barnes offered to get administrative expense information to Representative DuPlessis for FY 2019.

In response to a question for Senator Higdon, Mr. Barnes stated that the funded percentage of the health insurance trust fund was 46 percent as of June 30, 2019. In response to a follow up question regarding the health insurance trust fund’s actuarially required contribution (ARC) payment, Mr. Barnes stated that, as the funding percentage

has improved with the “shared solution” payments, the contributions have exceeded the ARC, which is one of the reasons why the funding ratio has grown from 3.5 to 46 percent.

In response to a question from Mr. Jefferson, Mr. Barnes stated that it is his understanding that the capital gains distributions in investment income falls under cash inflows. In response to a follow up question regarding the remedy for the \$150 to \$250 million in negative cash flow per year on the retirement annuity trust, Mr. Barnes stated that, appreciatively, TRS is receiving full funding in the budget, causing their investment strategy to no longer be constrained. He stated that TRS does have negative cash flow, although it is manageable.

In response to a question from Mr. Chilton regarding whether cash inflows were being used exclusively to pay benefits requiring all growth to come from investment income, Mr. Barnes stated that investment income, the sale of assets, and the rebalancing of the portfolio were all drivers for growth of the funding for the annuity trust. In response to a follow up question as to how TRS would recover additional market value when it is in a negative cash flow position, Mr. Barnes said that it could recover because the negative cash flow is not big enough that TRS cannot overcome it with TRS’ investment strategy and funding with the full ARC. Mr. Barnes agreed to Mr. Chilton’s request for TRS to provide risk statistics as they relate to allocations in the portfolio in future presentations.

In response to a question from Representative DuPlessis regarding TRS’ heavy investment in equity, Mr. Barnes stated that TRS is invested about 40 percent in domestic equity, 22 percent in international equity, 15 percent in basic traditional fixed income (bonds), some private equity, and real estate, all creating a diversified portfolio. In response to a follow up question, Mr. Barnes confirmed that TRS has more stock than KRS, and that the managing risk is very important, and TRS does a lot of due diligence to adjust to volatility.

In response to a question from Representative Miller, Mr. Barnes stated that TRS is due for an Experience Study for the period ending June 30, 2020, and as part of that study, TRS will consider a revision to payroll growth and longevity assumptions in mortality tables.

Investment and Cash Flow Quarterly Update – Judicial Form Retirement System

Donna Early, Judicial Form Retirement System (JFRS), joined by A.C. Donohue, Trustee, began her presentation with the performance overview for the defined benefit and hybrid cash balance plans for both the Judicial (JRP) and Legislators’ (LRP) Retirement Plans. She also provided a chart for each plan on asset allocation.

In response to a question from Representative Miller, Ms. Early stated that JFRS has two separate investment committees that report to one board.

Next, Ms. Early presented the cash flow for both JRP and LRP. She discussed the cash inflows, cash outflows, and net plan assets for FY 2020 and FY 2019.

In response to a question from Senator Higdon regarding how LRP did during the present budget with the absence of appropriations, Ms. Early stated that JFRS has been successful with the LRP due to having the money to invest, but this period is only a snapshot and a longer term should be considered. Mr. Donahue added that LRP did well, but wondered how much better it would have done with the ARC. Also, he added that when looking forward, where is the money lost in years to come. In response to a follow up question from Senator Higdon, Ms. Early stated that the current funded level of LRP is slightly less than 100 percent for the retirement fund and more than 100 percent for the insurance fund.

Mr. Chilton requested information on JFRS' asset allocations and risk profiles.

In response to a question from Representative DuPlessis, Ms. Early stated that if a legislator has a separation of service and then takes a job in another branch and participates in another system, such as KERS, the person would receive two separate pension checks, but the reciprocity that applies would enable the use of all salary to determine the benefit in each plan. Ms. Early explained that the reciprocity provision went into effect in 2005.

Senator Higdon commented that he was one of the few legislators that voted no on HB 299 in 2005.

Public Comment

Jim Carroll, President, Kentucky Government Retirees, appeared before the committee to comment on the reorganization presentation that was presented to the Kentucky Retirement Systems Administrative Subcommittee. Mr. Carroll stated the Kentucky Government Retirees had no involvement at any point within the last nine months with the idea that led to the bill draft presented. He stated that their concerns include that it looks to be a bureaucratic expansion bill that would increase annual costs for KRS from a range of \$3.6 million to \$6.7 million and would create a duplication of investment advisors, auditors, and actuaries. Mr. Carroll said that there is no tangible benefit for spending that money, and it increases the administrative burden to KRS, which is of great concern.

Representative Graviss requested a special meeting to review the information that Mr. Carroll has brought forth. Senator Higdon stated that the bill will go through the proper legislative process and that the PPOB will have plenty of time discuss any issues.

Mr. Carroll stated that he would like to hear KRS' concerns, and what it would take to implement this bill.

With no further business, the meeting was adjourned.