

PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 2nd Meeting of the 2020 Interim

June 1, 2020

Call to Order and Roll Call

The 2nd meeting of the Public Pension Oversight Board was held on Monday, June 1, 2020, at 1:00 PM, in Room 171 of the Capitol Annex. Senator Jimmy Higdon, 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, Dennis Parrett, Wil Schroder, and Mike Wilson; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, Steven Rudy, Russell Webber, and Buddy Wheatley; John Chilton, Mike Harmon, James M. "Mac" Jefferson, and Sharon Mattingly.

Guests: David Eager, Executive Director, and Erin Surratt, Director of Benefits, Kentucky Retirement Systems; Rebecca Stephens, Interim Executive Director, and Stephen LeLaurin, Board Member, Judicial Form Retirement System; and Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System.

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

Senator Higdon asked Senator Wilson to open the meeting in prayer given all that was occurring in the world. Senator Higdon also led a moment of silence in memory of Donna Early and asked that the board keep Breanna Taylor's family in their thoughts and prayers.

Approval of Minutes

Representative DuPlessis moved that the minutes of the February 24, 2020 meeting be approved. Representative Pratt seconded the motion, and the minutes were approved without objection.

Investment and Cash Flow Quarterly Update – Kentucky Retirement Systems

David Eager, Kentucky Retirement Systems (KRS), began by providing some actuarial projections provided by the systems actuary, GRS Consulting (GRS), based on current asset levels which included market value of assets, projected increase in employer contributions by percent and dollars, and funding levels projected out to June 30, 2025, for each of the plans.

Next, Mr. Eager provided a summary of the investment performance net of fees rates of return for pension and insurance ending April 30, 2020. For each plan, he provided a current market value of assets along with FYTD, 1-, 3-, 5-, 10-, and 20-year trailing returns compared to plan index performances.

In response to a question from Senator Higdon regarding March 2020 investment numbers, Mr. Eager stated he felt like the most current numbers would be more informative. Upon the request of Senator Higdon, staff provided a copy of a similar chart as of March 31, 2020, to members of the board later in the meeting.

In response to a question from Representative Graviss regarding if KRS could provide 30-year trailing returns, Mr. Eager stated the system would follow up with that information. Mr. Eager referenced the KRS summary annual financial report, which included a since-inception return, which is slightly greater than 30 years, of 9.15 percent for the pension fund. Senator Higdon agreed with Representative Graviss that KRS should include a 30-year return in their presentations going forward. In response to a follow-up question from Representative Graviss, Mr. Eager stated that less than 20 percent of the portfolio is private equity and specialty credit.

In response to a question from Representative Wheatley, Mr. Eager stated that KRS's actuarial committee is a subcommittee of the investment committee, which was created to handle the review of assumptions, make recommendations, or handle experience studies that are required by statute every five years. He noted the committee was created recently and only meets when needed or when assumptions require review.

Representative Miller commented on how pleased he was with the outcome of the decisions that the KRS board made leading up to the COVID-19 crisis, whereas KRS's losses were minimum and performed better than the benchmarks. He noted his own reluctance to allocate the assets so conservatively, but the recent market volatility has confirmed the KRS board's decisions were right.

In response, Mr. Eager referenced a handout provided by GRS, which provided a comparison of the funded ratio of 97 plans. He highlighted that the Kentucky Employees Retirement System (KERS) nonhazardous was the worse funded plan, but also highlighted that the County Employees Retirement System (CERS) nonhazardous was in the bottom quartile. He noted that when looking at some of the poorer funded plans, excluding KERS, it was interesting to find that many plans had higher assumptions than those plans with the highest funded levels.

In response to a question from Representative DuPlessis regarding whether the board's plan was to stay conservative or if the present time was a buying opportunity, Mr. Eager stated that detail would follow, but from a high level, the plan had added risk in February and March, and reduced that added risk in April. In a response to a follow-up

question, Mr. Eager opined that KRS could likely have closely matched their assumption projections had it not been for the COVID-19 crisis and commented that he believes national pension plan assumptions would continue to decline as KRS learns more after this pandemic.

Mr. Eager discussed a second handout that KRS provided, which was a recent update from the National Association of State Retirement Administrators (NASRA) on the latest return assumptions used across 128 pension plans. The data showed only two that were 8 percent or better. There were 20 that were between 6 and 6.9 percent, and Kentucky was the only one below 6 percent.

Mr. Eager discussed the investment updates as of March 31, 2020, and stated that the KERS nonhazardous was down 5.8 percent and as of April 30, 2020, KERS nonhazardous was down 1.1 percent. Mr. Eager added that the insurance plans were better funded in the 70 percent range.

Mr. Eager discussed a peer group analysis provided by Wilshire Consulting for the period ending March 31, 2020. The report included quartile analysis for 1-, 3-, 5-, and 10-year trailing periods for a universe calculated by Wilshire Consulting.

In response to a question from Senator Higdon, Mr. Eager stated that during the last 10-year period, KRS's ranking was in the 55th percentile of a peer group of 422 plans.

Mr. Eager discussed additional peer group analysis charts provided by Wilshire Consulting for the period ending March 31, 2020, that included investment return, standard deviation, and the sharpe ratio across 1-, 3-, and 5-year trailing periods. For the standard deviation, which is a measure of risk, KRS ranked in the 16th percentile over the past year, and in the 10th and 11th percentile over the past 3- and 5-year periods, respectively. Lastly, Mr. Eager also provided a Wilshire Consulting risk scattergram for the period of April 1, 2017, through March 31, 2020, which showed KRS below media risk, but above median returns.

Mr. Eager discussed the cash flow for the period of March 31, 2020, compared to March 31, 2019. He began by reviewing the KERS and State Police Retirement System's (SPRS) plans and noted that total contributions were slightly down as compared to FY 2019. Mr. Eager noted that the last two years KRS has had positive net contributions with FY 2020 being at \$64.2 million. Mr. Eager then discussed the CERS cash flow. He pointed out that the CERS phase-in to higher employer contributions was costing the plan about \$75 million in more contributions. Both plans experienced negative net cash flow, with CERS nonhazardous totaling \$153.3 thus far in FY 2020.

In response to a question from Senator Higdon regarding why administrative costs were twice as high for CERS as compared to KERS, Mr. Eager stated that administrative

expenses were allocated based on membership. CERS has a larger membership base, so the portion of administrative expenses allocated is higher.

In response to a question from Representative Graviss regarding if KRS had asked GRS to opine on market expectations, Mr. Eager stated that KRS did not confer with GRS on whether there was a V curve and he was not sure if they would have an opinion. However, Mr. Eager stated that GRS did affirm the board decision to leave assumptions unchanged.

Senator McDaniel emphasized that while the COVID-19 crisis should not be discounted, he cautioned anyone from becoming completely despaired over the current events given the long term nature of the pension problem. He encouraged everyone to focus on holding to the 5.25 percent benchmark and to understand that continued effort will be required.

Mr. Eager continued with a discussion of recent investment activities. He referenced Representative DuPlessis' earlier question and discussed rebalance transactions within the U.S. equity market conducted from January 31, 2020 to May 22, 2020. Mr. Eager noted that outcome added a significant amount of money to the fund.

Erin Surratt, discussed the services KRS is offering members during the COVID-19 pandemic. Personal member services had continued without much issue, with members utilizing online account access, the use of electronic signatures to avoid in-person meetings, and forms submitted via U.S. mail, fax, or document upload. In-person visits had not been allowed, but phone services continued to be very effective and without interruption. In addition, webinars were being conducted twice a week and staff was working to add video conference capabilities. The recent enhancements in self-service have been invaluable with the online retirement and document upload functionality. Lastly, she stated that KRS sees a new model with work-from-home options for employees, more self-service usage, electronic communications for members, and continued remote board and committee meetings.

Mr. Eager stated that Senator Higdon had asked him a few meetings ago if KRS would have fewer employees in the future because of Tier 3. He stated the system would, given the plan will be less complicated, but it will take years to get there. Mr. Eager added that KRS is limited on space, which hinders the safety of their employees. So, with fewer people working on-site, there will be more space available to social distance.

Senator Higdon commented that it sounded like KRS has managed the issue well. He emphasized that he always added that he is for lowering administrative costs and, with Tier 1 and Tier 2 employees decreasing over the years, the need for counselors will diminish, which will lower administrative costs.

In response to a question from Representative Graviss, Ms. Surratt stated that she feels that KRS has adequate software systems and developers and is constantly enhancing those systems.

Mr. Eager commented that KRS has formed a taskforce of five people for HB 484 with 20 people involved in reviewing issues and questions. He stated that the most significant issue will be with the new KERS/SPRS and CERS operating without a board, chief executive officers, bylaws, or policy. Mr. Eager stated that KRS recommends that within the first week of the 2021 session, if possible, these issues be taken into account for the April 1 restructure.

In response to a question from Representative Graviss, Mr. Eager stated that KRS can only make recommendations, but cannot set policy, such as appointing a CEO, and board members. In a follow-up question, Mr. Eager stated that KRS is operating under the Executive Order to have remote board meetings, but will need legislation to be able to continue once the order has lifted.

In response to a question from Senator Higdon, Mr. Eager stated that KRS is saving a lot of money on travel costs with the remote meetings.

In response to a question from Representative DuPlessis, Mr. Eager stated that the remote meetings are live streamed with public comment.

Investment and Cash Flow Quarterly Update – Judicial Form Retirement System

Stephen LeLaurin, Board Member, Judicial Form Retirement System (JFRS), began with an appreciation for Senator Higdon's moment of silence for Donna Early. He then introduced Rebecca Stephens as the Interim Executive Director and stated how delighted JFRS was to have her.

Mr. LeLaurin began with a brief review of the four plans in JFRS, which include two plans for judicial and two plans for legislators, each having a large legacy defined benefit plan and a small hybrid cash balance plan. JFRS has a little under \$500 million in total assets across all plans as of March 31, 2020. Mr. LeLaurin stated that JFRS is well funded and that their risk taking is a little different from a plan that has bigger challenges. He stated that JFRS does not use private equity or high yield bonds unlike most other plans, but instead, JFRS approaches risk by their equity allocation, which is currently about 78 percent. He stated that JFRS gives Hilliard Lyons Trust Company (Hilliard Lyons) the freedom to keep 60 to 80 percent in equities and 20 to 40 percent in fixed at their discretion. He stated that their current equities are about 77 percent for each plan with all four plans having separate portfolios.

Mr. LeLaurin discussed recent performance and stated the two defined benefit plans totaled \$382 million and \$112 million for the judicial and legislator plans, respectively. For the hybrid cash balance plans, JFRS does not buy individual securities due to the smaller plan size, but instead have Hilliard Lyons buy units of an exchange credit fund or a mutual fund that have identical benchmarks that are used in the defined benefit plans. Mr. LeLaurin stated that their portfolios have held up well during the pandemic and stock market challenges and discussed the fiscal-year-to-date, 1-, 3-, 5, 10- and 20-year totals. He also stated that the portfolios have rebounded some since the March 31, 2020 reporting.

Senator Higdon, with agreement of Representative Graviss, commented that the two of them would like to see the 30-year numbers at the next update.

Rebecca Stephens commented that she has enjoyed her time at JFRS for the past six weeks and that she had worked with Donna Early through her years working at KRS. She praised Ms. Early as the best record keeper. She then discussed the cash flow for the judicial and legislator plans for the quarter ending March 31, 2020. She discussed the inflows, outflows, net cash flow before asset gain/(losses), investment gains/(losses), and net plan assets for FY 2020 compared to FY 2019.

Ms. Stephens discussed JFRS's COVID-19 response and stated that as of March 16, 2020, there have been no in-person meetings and, while staff are periodically working simultaneously in the office, are maintaining a 6-foot distance and following healthy-at-work guidelines. She stated that members continue to make inquiries to update their records and request calculations with no interruption in service and that video conferencing has been routinely utilized by board members, JFRS staff, and investment managers/advisors to facilitate continued JFRS operations as normally and efficiently as possible.

In response to a question from Representative Miller regarding a significant increase in administrative expenses, Ms. Stephens stated that the administrative expense reflected for FY 2020 cash flow statements was not correct. She told members she would follow up with a corrected statement.

Investment and Cash Flow Quarterly Update – Teachers' Retirement Systems

Beau Barnes, Teachers' Retirement System (TRS), began his presentation by discussing investment performance for the pension fund as of March 31, 2020. He discussed gross and net performance for the quarter, fiscal-year-to-date, 1-, 3-, 5-, 10-, and 20-year trailing time periods. Mr. Barnes noted that it was a tough quarter for TRS, ranking in the 74th percentile, which was largely due to TRS having more public equities and stocks than other plans. Mr. Barnes added that all the numbers look better when looking at the April totals.

In response to a question from Senator Higdon regarding the net return over 30-years, Mr. Barnes stated that the 30-year net of fee value would not be much less than the

gross return of 7.64 percent. He stated current fees account for approximately 33 basis points, but that would not be the case for the full thirty years. He estimated that over the 30-year period, a net of fee return was probably closer to 7.5 percent.

Mr. Barnes reviewed cash flow for the pension fund through March 31, 2020, compared to March 31, 2019. He pointed out cash inflows, outflows, and the total net plan assets across both time periods.

In response to a question from Senator Higdon regarding if TRS had to sell assets to meet benefit payments, Mr. Barnes stated that TRS did sell assets to meet benefit payments, but those sales were intentional and include large bonds and fixed income assets. He stated that the plan did not have to sell stocks during the decline and staff has short-term fixed income on hand to handle cash flow.

In response to a question from Representative DuPlessis regarding how the plan will handle a continual net negative cash flow and member contributions that are not keeping up with benefit payments, Mr. Barnes assured the Public Pension Oversight Board (PPOB) that the negative cash flow does not include the investment gains and historically, long term, it is a positive for TRS. Representative DuPlessis expressed caution with the plans continued negative cash flow and expressed his belief that stakeholders needed to begin thinking and planning for a way to reform or adjust for future plan changes.

In response to a question from Mr. Jefferson regarding the unusual large decline in investment income in the current fiscal year, Mr. Barnes stated that it could be due to declining interest, but stated he would check with investment staff and report back to the board.

In response to a question from Representative James Tipton to recent retirement rates as a result of the pandemic, Mr. Barnes stated that TRS has not seen an increase in retirement rates, but rather a decline from previous years.

In response to questions from Representative Miller, Mr. Barnes confirmed that the TRS Board will be having an experience study this year. In response to a follow-up question regarding whether or not the board is going to change their investment assumption, Mr. Barnes stated that the investment assumption is what TRS anticipates will be the long term returns in the markets that TRS is able to achieve. Mr. Barnes added that TRS will evaluate its assumptions after the June 30, 2020 actuarial valuation. Representative Miller responded that he is talking about TRS' investment targets not the Experience Study, and Mr. Barnes replied that investment returns would be a part of the evaluation.

In response to a question from Senator Higdon regarding a recent meeting on the payroll growth assumption set by TRS, Mr. Barnes stated that TRS has not hit the 3.5

percent target for payroll growth since the 2008-2009 great recession, but has seen some increase recently.

Mr. Barnes continued with a review on cash flow for the health insurance fund through March 31, 2020, compared to March 31, 2019. 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 net return for the health insurance fund is negative, but will have to report back for the actual return.

In response to questions from Senator McDaniel regarding the experience study, Mr. Barnes stated that the experience study will begin after the close of the current fiscal year on June 30, 2020, and results will not impact the current valuation. In response to follow-up questions regarding how TRS anticipates their upcoming budget request to potentially change, Mr. Barnes stated that it is hard to project until the fiscal year has closed, the valuation to be conducted, and actual experience is compared to each assumption. Mr. Barnes stated that TRS assets were very close in December 31, 2019, but without knowing the future, it is hard to project a budget request.

In response to questions from Senator Higdon, Mr. Barnes stated that the health insurance fund is funded at 46 percent.

Mr. Barnes discussed TRS's response to COVID-19. He stated that TRS is continuing their duties to members with 90 percent of their staff working from home. He stated that TRS is offering website videos, webinars in place of their seminars that were done across the state. Members can file retirement applications through Pathway, and TRS is doing remote counseling. Finally, TRS is conducting board and committee meetings virtually with open access to the public.

Senator Higdon requested Mr. Barnes to add the PPOB members to their 72-hour meeting notices for possible attendance.

In response to a question from Senator Higdon regarding recent asset allocation changes by the board, Mr. Barnes stated that TRS did provide some flexibility to their asset allocation to provide more liquidity if needed, but continues to adhere to their traditional investment approach. He stated that TRS is about 85 percent publicly traded liquid assets and 15 percent in private equities. However, TRS continues to rebalance that portfolio.

In response to questions from Representative Graviss, Mr. Barnes stated that TRS meets the open meeting requirements for video conferencing by offering access to the meetings to the public through the TRS website and meeting notices. In response to a follow-up question, Mr. Barnes stated that TRS does allow public participation or questions.

Senator Higdon commented that he believes there needs to be serious discussion regarding the negative cash flow of TRS.

Representative Miller requested the LRC staff to combine the GRS funding ratio comparison and NASRA schedule on investment returns assumptions by quartile for funding ratios for those above 7.5 percent and those below 6.5 percent.

With no further business, the meeting was adjourned.