

PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 1st Meeting of the 2021 Interim

February 22, 2021

Call to Order and Roll Call

The 1st meeting of the Public Pension Oversight Board was held on Monday, February 22, 2021, 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, Robby Mills, Dennis Parrett, and Mike Wilson; Representatives Jerry T. Miller, Jason Petrie, James Tipton, and Buddy Wheatley; John Chilton, Joseph Fawns, Mike Harmon, John Hicks, James M. "Mac" Jefferson, and Sharon Mattingly.

Guests: David Eager, Executive Director, David Harris, Chair, Board of Trustees, Steven Herbert, Executive Director, Office of Investments, Kentucky Retirement Systems; Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System; and Bo Cracraft, Executive Director, and Stephen LeLaurin, Chair, Judicial Retirement Investment Committee, Judicial Form Retirement System.

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

Representative DuPlessis welcomed Senator Mills and Representative Tipton as new members on the Public Pension Oversight Board (PPOB).

Approval of Minutes

Senator Parrett moved that the minutes of the December 14, 2020 meeting be approved. Senator Higdon seconded the motion, and the minutes were approved without objection.

Investment/Cash Flow Update and Board Chair Comments – Kentucky Retirement System

David Eager, Kentucky Retirement Systems (KRS), started off by introducing David Harris, KRS Board of Trustees, and the new CIO, Stephen Herbert. Mr. Eager announced that Mr. Harris is leaving his position as Chair of the board. Mr. Harris spoke about his time with the KRS board over the last five years. He commended the PPOB in the oversight job it does. As to next steps for the board, he suggested more level dollar

funding and that actuarial assumed rates of return should be set at 4 percent above a 30 year U.S. Treasury bond coupon rate.

Senator Higdon commented that he appreciated Mr. Harris' service to the Commonwealth. He agreed that the PPOB has been good for understanding the retirement systems and educating the General Assembly and the public.

Representative Miller thanked Mr. Harris for his service with good advice and a steady course to recovery.

Representative DuPlessis seconded Senator Higdon and Representative Miller's comments and stated that Mr. Harris has been wonderful for the PPOB and has had a hand in the upward path of the pension systems. In response to a question from Representative DuPlessis, Mr. Harris stated that today's return on the 30-year Treasury Bill (T-Bill) is 2.16 percent.

Mr. Eager discussed the FY 2021 YTD highlights. He stated that asset levels in all 10 plans rose a total of \$2.5 billion in the first 6 months of FY 2021.

Mr. Herbert discussed the pension and health investment updates as of December 31, 2020. He discussed the net of fees rates of return for the 1-, 3-, 5-, 10-, 20-, and 30-year periods for all plan systems along with their plan index. He indicated that three risk factors – inflation, downward pressure on bond prices, and an equity correction – are being actively considered and mitigated by the investment team.

Mr. Eager discussed cash flow updates. He stated that the total for all plans, KRS was negative \$103 million in contributions less benefits and expenses. He added that KRS is up \$2.4 billion in asset level with a total increase (less the -\$103 million) is \$2.469 billion, which is about 12 percent.

In response to a question from Representative Miller regarding the unfunded ratio for County Employees Retirement System (CERS), Mr. Eager stated he would have to follow up with an answer. Mr. Harris stated he believes CERS is around 57 percent.

In response to a question from Representative Tipton regarding what is the 30-year average going to be 10 years from now, Mr. Herbert stated that from an actuarial point of view, KRS is targeted to do 5.25 percent. Representative DuPlessis asked if the 30-year, 8.31 percent, is factored by years 29 and 30 and that it is likely to see a fall in a couple years. Mr. Eager agreed. Mr. Herbert added that treasury rates during the early years of the 30-year period were likely double or more than what they are now, thereby influencing the 30-year returns of over 8 percent.

Mr. Eager continued with his cash flow overview on the sources of funding, which are employee and employer contributions, and investments, and gave a summary of contribution percentages between a typical pension, Kentucky Employees Retirement System (KERS) nonhazardous, and CERS nonhazardous.

In response to a question from Representative DuPlessis regarding Mr. Harris' thoughts on HB 8, Mr. Harris stated that, when rehiring employees, the liability is booked the day hired, then when the employee leaves and is not replaced, the payroll goes down. However, the liability is still there as if the employee had worked 10 or more years. Mr. Harris stated that it is a flawed design to have contribution rates based on payroll as a percentage. The payroll can change, but the liability will not necessarily correlate. He stated that under current law it is considered under percentage of payroll funded, which incentivizes employers to limit headcount by outsourcing. Representative DuPlessis commented that the liabilities are shifted to the taxpayers when an agency hires someone from an outside agency to get away from paying their liabilities. Mr. Harris agreed, and stated that the level dollar/fixed dollar allocation is the last fix needed for the system.

In response to a question from Senator McDaniel regarding whether the actuarial company was at a malpractice level to be so incorrect on the 3.5 percent payroll growth assumption when Mr. Harris first started with the KRS board, Mr. Harris stated he believed that an actuary should catch unsuitable assumptions.

Investment/Cash Flow Update – Teachers' Retirement System Beau Barnes, Teachers Retirement System (TRS).

Mr. Barnes responded to a question from Representative Wheatley regarding a statement made by Mr. Eager on how KRS was funding 40 percent of an actuarially inaccurate number resulting in many years of underfunding by the General Assembly, and if had anything similar occurred for TRS in which it did not receive full funding. Mr. Barnes stated that TRS was not receiving full funding to implement the funding plan to pay off the unfunded liability until FY 2017. In FY 2017 and every year following, TRS has received full funding. He stated that there is 24 years left of the 30 year amortization period and that TRS is receiving the funding according to their current actuarial assumptions. He added that TRS is currently undergoing an experience study, and it should be ready by June 30, 2021.

In response to a question from Representative DuPlessis in regards to Mr. Harris' comment that over the last 75 years across the country, the average rate of return is about 4 percent above the T-Bill, Mr. Barnes stated that he believes TRS has been doing better in recent years with extremely low interest rates.

Mr. Barnes began his presentation with investment performance as of December 31, 2020, and discussed the gross and net performance for the quarter, fiscal-year-to-date, 1-

3-, 5-, 10-, 20-year trailing time periods, and the 30-year compounded gross return of 8.49 percent. Mr. Barnes added that from 2008 to December 2020, TRS investment returns totaled a net \$18.2 billion, compared to the average plan's \$13.4 billion. This outperformance generated \$4.8 billion to the benefit of Kentucky's teachers.

Mr. Barnes reviewed cash flow for the pension fund FYTD 2021 compared to FYTD 2020. He pointed out the cash inflows, including member contributions, employer contributions/appropriations, and investment income. He explained that the investment income declined between the comparative period due in part to the pandemic and the decline of assets in the alternatives.

In response to a question from Representative DuPlessis, Mr. Barnes stated the increase in member contributions could be due to additional teachers, payroll increases, and/or report timing.

Mr. Barnes continued with outflows, investment gains or losses, and the total net plan assets across both time periods. The result for the 2021 six-month period was a negative cash flow of \$291.2 million, which is still manageable and does not impede TRS' ability to invest.

In response to a question from Representative DuPlessis, Mr. Barnes stated that the percent funded is an actuarial number that was 58.4 percent June 30, 2020, and is anticipated to show some progress if there was an actuarial measure of valuation available for December 31, 2020.

Representative Miller commented that he is troubled by TRS' continual decline in net cash flow numbers, while KRS has been fairly solid as they tend to stagger their actuarial assumption changes from year to year. He stated that TRS' payroll growth assumptions are obscenely wrong and does not understand why the TRS board will not recommend changing at least the payroll growth assumption. Mr. Barnes stated that in the last experience study, the actuaries did recommend TRS to lower their payroll growth from 4 to 3.5 percent. Representative Miller followed up that he urges Mr. Barnes and TRS' Executive Secretary to recommend to their board to not wait five years on every single assumption.

Representative DuPlessis commented that he believes Representative Miller makes a good point to continue to adjust assumptions. Mr. Barnes replied that TRS has a statute that states the actuary shall provide those assumptions and the board shall ratify. Representative DuPlessis commented that TRS can let the General Assembly know if there is legislative assistance needed for more flexibility in making assumption changes.

Representative Tipton commented that he would like for TRS to provide a chart on the sources of funding percentages for the pension system that would include employee, employer, and investments for the last 5 to 10 year average.

Representative DuPlessis commented that he would like for the three pension systems to organize a common presentation format for the cash flow updates.

Mr. Barnes responded to Representative Tipton's comment in stating that TRS does have a slide that goes back to July 1, 1985, that shows contributions from members, contributions from employers, investment income expenses, and benefits paid out. Representative Tipton responded he would like it if TRS could highlight the period of the full ARC payments.

Mr. Barnes continued with a review of cash flow for the health insurance fund through FYTD 2021 compared to FYTD 2020. He pointed out cash inflows, outflows, investment gains or losses, and the total net plan assets across both time periods. Cash flow remained positive.

Senator Higdon commented that he was surprised to learn that the assumed rate of return on the health insurance trust was 8 percent and believes that, once the experience study is completed, the assumed rate of return will drop considerably. Mr. Barnes replied that TRS' actuary did a sensitivity analysis that indicated there would be no contribution increase if the assumed rate of return was adjusted to 7 percent. However, such an assumption change would push the 100 percent funding amortization period out 2 years from 2026 to 2028.

Mr. Barnes concluded his presentation with the cash flow update on the insurance trust.

In response to a question from Senator McDaniel, Mr. Barnes stated that the PPOB should have the experience study, by Cavanaugh McDonald, in hand by mid-June. Senator McDaniel stated that he is concerned that TRS is continuing to use the same actuary it has used for 5 years for its experience study, since that actuary could possibly be unwilling to indict their own performance or admit errors. In response to a follow up question regarding what the TRS board is going to do to make sure the results from Cavanaugh McDonald are accurate, Mr. Barnes stated that TRS has actuarial audits completed.

In response to a question from Senator Mills, Mr. Barnes stated that he strongly believes in order to put the Commonwealth in the most secure position of avoiding any future budget pressures, the goal is to be 100 percent funded in both pension and health.

Investment/Cash Flow Update – Judicial Form Retirement System

Bo Cracraft and Stephen LeLaurin, Judicial Form Retirement System, began their presentation with Mr. LeLaurin discussing the system's portfolio design. He stated that it includes four plans for the judges and legislators, requires a simpler investment policy, has a small administrative staff, and requires caution on risk taking.

Mr. LeLaurin discussed the investment performance overview that included the market value, 1-, 3-, 5-, 10-, 20- and 27-years for the judicial and legislators' defined benefit and hybrid cash balance plans period ending December 31, 2020.

Mr. LeLaurin provided an overview of the asset allocation by plan as of December 31, 2020. He discussed the investment policy targets and defined benefit portfolios rebalanced in January 2021.

Before presenting their cash flow data, Mr. LeLaurin offered and Representative DuPlessis confirmed his request for the three pension systems to organize a common presentation format for the cash flow updates.

Lastly, Mr. Cracraft discussed the cash flow for the judicial and legislators' retirement plans, which included the cash inflows, cash outflows, net cash flow before asset gain/(losses), realized/unrealized investment gains/(losses), and net plan assets for the period ending December 31, 2020.

With no further business, the meeting was adjourned.