PSRS-PEERS Board of Trustees Report
February 10, 2020
By Otto Fajen

Trustees present

Aaron Zalis, Chair
Jason Hoffman, Vice-Chair
Yvonne Heath
Scott Hunt
Sharon Kissinger
Beth Knes
Jason Steliga

SYSTEM OPERATIONS

The Board meeting started at 9:00 a.m. The Board approved the minutes from the December 9, 2019 meeting and established the order of business. The Board welcomed newly appointed Trustee Sharon Kissinger, a financial adviser from Poplar Bluff, to the Board.

INVESTMENTS

Investment Performance Report - Craig Husting and Barry Dennis from Verus Investments reviewed the December 31, 2019 investment update. Calendar year 2019 was a high investment performance year, particularly in equity sectors. Private equity figures are affected by a pricing lag and don't fully reflect fourth quarter growth in 2019.

The second quarter of FY 2019 showed continued growth, leaving the Systems with an updated overall investment return of 5.2% for the fiscal year estimated through December 31, 2019. The Systems have an overall return of 9.0% for the calendar year. Included in that are significant increases in U.S. equity markets and non-U.S. equity markets. The Systems seek to capture most, but not all, of the market upside while mitigating loss during declines, so performance is purposely lower relative to benchmarks in these high growth conditions.

Small cap companies have lagged certain big companies. Technology companies have shown particularly strong performance. The markets did show growth in January 2020, and the Systems show an overall return of 5.6% for the fiscal year as of January 31, 2020.

Anti-Terrorism/Economic Sanction Policy **-** The Board heard a report on the Systems' Anti-Terrorism/Economic Sanction Policy. The Systems' use federal guidance and require investors to certify compliance. Accordingly, the Systems comply with the policy.

Affirmative Action Policy – All traditional, U.S.-domiciled money managers must have an affirmative action plan in place. The staff report that the Systems and money managers comply with affirmative action requirements.

U.S. Equity Portfolio – U.S. equity is about 27% of the Systems' portfolio. Large cap assets are the larger share of this category. This is an efficient market, so investment costs and fees must be kept to a minimum. Also, reward for risk is less in this sector. The large size of the Systems' investments helps keep cost down. The Systems maintain a long-term focus in this sector. The Systems' goals are to provide efficient exposure, produce a return similar to the Russell 1000 index, outperform benchmarks over the long term while also maintaining risk management. The Systems maintain a mix of passive and actively managed U.S. equity.

Alpha overlay portfolio – This is a wider strategy to search for alpha with low beta exposure. The goals are to provide additional active returns, outperform the S&P 500 while maintaining risk management. Staff reported on new large cap managers used by the Systems and the future path of the large cap U.S. equity portfolio. The alpha overlay is about 20% of the Systems' investment in large cap U.S. equities.

Small Cap U.S. Equity – The goals of the program are to provide efficient access to markets, outperform Russell 2000 index over long term and provide risk management. This is the smaller portion of the U.S. Equity portfolio.

Non-U.S. Equity Portfolio – The program is intended to provide long-term capital appreciation and dividend income in excess of inflation through exposure to global stocks. The long-term portfolio target allocation is 15%, while the current allocation is 15.94% or $6.6 billion.

Asset/liability study – This study evaluates the stability of the plan, cashflow and liquidity and downside risk. Current allocation is very good, so potential changes are minor. The advisors are focused on a ten-year horizon. Also, current predictions for market returns are conservatively realistic. Board members had already been surveyed as to their investment priorities and concerns, and the report reviewed the survey results. The survey results showed that the Board and staff generally share the same priorities and concerns.

The report reviewed the history of prior studies, the calendar for action Items, the Systems' investment philosophy, capital market assumptions, return projections, asset allocation themes, and the liquidity study. The report also presented asset allocation recommendations and the assumed rate of return.

The current target asset allocation has a forecasted 10-year return (with alpha) of approximately 6.7%. Assuming 7.5% return, the Systems will be fully funded in 20 years. At 7.1% assumed return, the Systems would reach 92% funding in that time. However, significant losses in early years have a very negative effect on system status over time. The report showed the range of outcomes based on various possible future outcomes.

The allocation discussion recommends reducing public credit and TIPS (treasury insured) while increasing private equity. Regarding public credit, the Systems have been under-weight in global equity.

The liquidity study tests the Systems' ability to meet cash flow needs include benefit payments and capital calls under negative investment assumptions. The study shows that the Systems' current allocation has more than enough liquidity to meet cash flow needs over the next five years even in the worst-case scenarios. The Systems could add up to 10% more in private markets without materially impacting the ability to meet cash flow needs, if a significant allocation to safe assets is maintained.

The report considered four asset allocation options. One would increase safe assets, two versions increased private investments and one version increased public investments. The report estimates assumed rate of return under these various options. The report suggests that an option with 35% in private assets would have an expected return of 7.3%, with approximately a 47.5% probability of reaching the 7.5% assumed rate of return over a 10-year horizon. The report suggests that the Systems should consider reducing the assumed rate of return towards 7.25% over time.

The board is interested in exploring intermediate options, such as removing a few percent from safe assets, rather than going all the way down to ten percent. Options that increase private investment appear to offer the best combination of increasing expected return while also reducing the volatility and range of expected return outcomes.

MANAGEMENT REPORT

Board Governance - The Board reviewed and discussed the Board Governance Report prepared by Cortex Applied Research, INC. This Report is presented each year during the February Board of Trustees' meeting. Overall, Cortex found the policies and charters to be appropriate. Cortex made one recommendation that the Board approve a minor revision affecting four of the governance charters and policies by changing the term "Pending Issues List" to "Annual Tactics List." The Board approved the recommendation unanimously.

Facility Renovation - The Board reviewed the construction timeline for the second part of the project. The second part of the project has begun and includes the new addition and renovation of the existing building. This second portion will last approximately 24 months. This includes about one year for the addition and then another year for the renovation of the existing building. First floor renovations are scheduled to begin in August 2020 and the new addition is scheduled to be tied in November 2020. Offsite board meetings will occur during renovation from August 2020 through August 2021.

Member Services – Disability Retirement Program Review - The purpose of the review is to ensure that the disability programs provide adequate protection to members and a sufficient level of financial assistance, ensure eligibility and benefits are comparable to similar plans and identify needed program controls. Disability retirees make up about 2% of retirees. PSRS disabilities retirees receive an average of 75% of the benefit of PSRS service benefit retirees. PEERS disabilities retirees receive an average of 63% of the benefit of PEERS service benefit retirees.

The Systems' management has approved two policy enhancements. One policy change is to use multiple medical advisors in the disability application approval process. The Systems currently have one medical adviser and could hire a second medical adviser. The second policy change adds income verification to the annual recertification process for members under age 60.

The Systems will consider regulation changes regarding disability retirement at the April meeting. The first regulation currently states the Board decides the allowable earned income limit for disability retirees. This limit was set at $18,000 in November of 2003. The proposed regulation would use the Social Security Administration Substantial Gainful Activity Limit (Non-Blind Disabilities). For 2020, this limit is $15,120 annually. There are currently eight PSRS disability retirees earning over $15,120 annually who could be affected by this change.

The other regulation change will remove automatic approval PEERS disability retirement based on Social Security award. Impact of the removal of the automatic approval. Under the new rule, all applications and medical records will be reviewed by the Systems' medical advisors. For FY 2019, 11 applications were approved through SSA prior to applying for PEERS disability.

The statutory changes that will be presented at the April meeting will modify eligibility requirements, implement duty-related disability plans, modify disability benefit calculations and modify working after disability retirement restrictions.

Actuarial Services – PricewaterhouseCoopers (PwC) was hired in 2008 and contract is about up. The Systems has used six actuaries since 1947. The Board reviewed the current scope of services provided by the actuary. The Systems use Cavanaugh MacDonald to perform an actuarial audit as required by law. The actuary performs the required experience study every five years. Recommendations are that staff negotiate new contract terms with the current actuary. Board will review negotiated terms in April 2019 and either renew the contract or issue an RFP.

Legislative Report – Maria Walden and Jim Moody gave the report. Moody gave a revenue update. The General Revenue budget is about $10 billion. There is no Consensus Revenue Estimate between House, Senate and Governor. After the end of January, revenues were up $280 million, but revenues grew $471 million at the end of last year due to larger tax remittances required because of incorrect withholding the prior year. Moody thinks the remaining five months will not equal the last five months of last year. Moody forecasts about $525 million shortfall over the next two years. Assuming $4.2B in last five months, this results in no net growth for the fiscal year. A part of this reduction is due to the reduction of the top tax rate from 5.9% to 5.4% due to recent legislation.

The Governor budgeted all the cash in next year's budget, so if there is a shortfall, this will require withholding or cutting next year's budget. The Senate may use the Governor's forecast, since they would otherwise have to cut if they assume a lower figure.

Maria Walden discussed the PSRS Benefit Resolution, Investment Resolution and COLA Resolution and mentioned that PSRS is tracking 215 bills that would affect the Systems.

HB 1298 (Dinkins) would reinstate the 2.55% multiplier for 31+ years of service. The actuary will provide an updated cost estimate for this change. Prior versions have been estimated to produce a small savings for the Systems. The bill hasn't been heard in committee. Prior cost studies have shown a savings to the system and reduction of contribution rate of 0.21%.

HB 1934 (Wiemann) and SB 755 (Sater) provide that information on salaries and benefits of System staff shall be public information.

HB 2174 (Pollitt) and SB 830 (Cunningham) make changes to PSRS/PEERS Critical Shortage Statute. The bills extend the maximum full-time retirement employment option under the critical shortage statute from two years to four years. The bill also allows a PSRS retiree to be employed under critical shortage as a superintendent after a one year waiting period. The total number of retired members working for a school district shall not exceed the lesser of 10% of the total number of employees for that district or 10 employees. The Systems are waiting on a cost statement from PWC.

HB 1432 (Kendrick) would require all public pension plans to provide certain information to members of the plan. This bill would not impose any requirements not already met by the Systems.

HB 362 (Roeber) would increase WAR limit from 550 hours to 700 hours. The actuary hasn't yet given a cost determination, but prior estimates indicate significant cost to the system.

HB 2291 (Black) extends the maximum full-time retirement employment option under the critical shortage statute from two years to four years. The Systems are waiting on a cost statement from PWC.

HB 1266 (Bangert) requires the Governor to maintain and regularly update a list of each state board, commission, committee, or council that contains members appointed by the Governor.

HB 1366 (Ellebracht) allows records or meetings of governmental bodies that include descriptions of discussion about security procedures, including evacuation and lock down procedures, to remain confidential and closed to the public.

HB 1311 (Shull) establishes the "Missouri Workplace Retirement Savings Plan," which is a multiple-employer retirement saving plan treated as a single plan under Title I of The Employee Retirement Income Security Act of 1974 (ERISA) under 401(a), 401(k), and 413(c) of the Internal Revenue Code, in which multiple employers may voluntarily choose to participate regardless of whether any relationship exists between and among the employers other than their participation in the plan.

HB 2165 (Ross) and SB 955 (Walsh) change the membership on the Department of Transportation (MoDOT) and Highway Patrol Employees' Retirement System Board of Trustees by lowering the number of members on the Board from the Highways and Transportation Commission from three to one.

<u>CPI update/COLA review</u> – The Board reviewed the COLA policy. The CPI-U for 2018-2019 increased by 1.6485%. Current CPI-U for 2019-2020 was 0.3244% through December 31, 2019. The total cumulative CPI-U over the period is 1.9729%. Under current policy, the Board will make a COLA for eligible retirees for next year if the cumulative figure at the end of this fiscal year exceeds 2.0%.

<u>Public Comment</u> – Otto Fajen from MNEA spoke to the Board. He mentioned that interest continues in the tactic of attacking DB pension plans by suggesting employees opt out of the plan in exchange for higher pay. While a bill like Rep. Taylor's HB 864 from 2019 has not yet reappeared this session, MoDOT requested funding for a pilot program to begin the same sort of scheme for MoDOT employees. Governor Parson did not recommend funding for this scheme and it is not contained in the filed version of the MoDOT budget bill, HB 2004.

The meeting adjourned at 1:05 p.m.