PSRS-PEERS Board of Trustees Report
February 11, 2019
By Otto Fajen

Trustees present

Aaron Zalis, Chair
Jason Hoffman, Vice-Chair
Chuck Bryant
Yvonne Heath
Scott Hunt
Beth Knes (via conference call)
Jason Steliga

BUDGET AND AUDIT COMMITTEE MEETING

Prior to the meeting of the Board of Trustees, the Budget and Audit Committee met to a proposed Budget Amendment for $696,000 for architectural services for design of facility renovations. The Budget Amendment was approved by the Committee and referred to the Board of Trustees.

SYSTEM OPERATIONS

The Board meeting started at 9:00 a.m. The Board approved the minutes from the December 10, 2018 meeting and established the order of business.

INVESTMENTS

Investment Performance Report - Craig Husting and Barry Dennis from Verus Investments reviewed the December 31, 2018 investment update. Calendar year 2018 was a low investment performance year in nearly all market sectors.

The second quarter of FY 2019 showed a lot of volatility, leaving the Systems with an updated overall investment return of -3.0% for the fiscal year estimated through December 31, 2018. The Systems have an overall return of -1.0% for the calendar year. Included in that are significant declines in U.S. equity markets and non-U.S. equity markets. The Systems did manage to have higher returns than the policy benchmarks.

Strong performance in private equity markets helped compensate for low performance of the public equity markets. The Systems' strong market "alpha" in private equity markets helped boost the returns.

The markets did show growth in January 2019, and the Systems show a overall return of +1.0% for the fiscal year as of January 31, 2019.

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 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 – 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 also the future path of the large cap U.S. equity portfolio.

Small Cap U.S. Equity – 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. The current benchmark is 100% MSCI ACWI ex-U.S. (Net). Like most market sectors, 2018 was a downward year. The Systems are at -8.85% for the fiscal year, but 1.99% above the benchmark due to the Systems' excellent performance. The Systems' current positioning takes a modestly negative view on Europe and will continue to maintain underweight investment relative to the benchmark. Meanwhile, the Systems maintain overweight allocation in emerging markets due to higher expected growth and emerging middle class.

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 and identified only minor issues and improvement opportunities.

The Board discussed Cortex's recommendation regarding the Executive Director Charter. Cortex recommended adding language specifically affirming the Executive Director's authority over senior management including selecting, appointing, directing, and evaluating senior management. The recommendation suggested that the Board reconsider whether the Executive Director should be authorized to select and appoint specialty and asset class consultants rather than having to obtain Board approval. The current process relies on the Executive Director, Chief Investment Officer and the asset class adviser to make manager selections, subject to Board review. The Board decided to have staff bring more information and give this matter further consideration at the next meeting. The Board approved all other recommendations provided by Cortex.

Pensions study – A recent NIRS Study shows that teachers are better off with a Defined Benefit (DB) plan versus a 401(k) Defined Contribution (DC) plan. The basis of comparison is how much DC balance needed to equal DB plan. DB plans are better in supporting retention, retirement security and lower cost. The DB plan serves to keep experienced teachers in the classroom. Nearly 80% of Missouri's career teachers vest and stay until retirement age. These are important factors that must be considered in evaluating any retirement options that may be proposed. NIRS finds that 82% of Missouri teachers are better off with the DB plan than an equivalent DC plan, even with no mistakes. The benefit value at retirement of our DB plan is much higher than a comparable 401(k).

DC plans reduce retirement security and pre and post retirement income. DC plans require higher contributions to generate the same retirement income, primarily due to the accrued benefit of the efficient investment pool investing over the length of a career. The NIRS study confirms that traditional pension benefits are designed to encourage and reward long service, help schools retain experienced teachers, and allow older teachers to retire with sufficient income when they are ready to retire.

Actuarial Services – PricewaterhouseCoopers (PwC) was hired in 2008 and contract is about up. System has used 6 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 current actuary. Board will review negotiated terms in April 2019 and either renew the contract or issue an RFP.

Facility Renovation/Construction Management at Risk – Staff discussed High level timeline, construction approaches, the construction manager and the new Parking Lot. Currently staff are working on schematics. Design development will begin in March 2019.

The staff recommend using a Construction Manager At Risk (CMAR) or general contractor who will oversee all subcontractors, rather than the design/build approach. The CMAR lets the designer and contractor to work together as a team, work on phasing, get more accurate cost estimates and improve transitions as new spaces become available. The approach has been allowed for public entities since 2016. The Board reviewed standards for selecting the CMAR. The timeline would allow for the selection of the CMAR prior to the April meeting.

Budget amendment – The committee approved a budget amendment of $696,400 to continue architectural services from Simon Oswald on the facility renovation project. The Board approved the budget amendment unanimously.

Legislative Report – Maria Walden and Jim Moody gave the report. Moody mentioned that state general revenue for FY19 is currently down 7% or about $380M compared to FY18, while the state budget is built on an assumed rate of growth of 1.7%, which creates a gap of $550M. If correcting the reduced withholding of income tax brings in $150M, there is still a shortage of $400M for the current year thus far. Federal tax changes in 2017 reduced deductibility of state and local taxes. The first SB 509 (2014) income tax cut started Jan. 2018, the second SB 509 cut started Jan 2019 along with additional income tax cuts from HB 2540 (2018). Moody predicts FY19 general revenue will end up in the range -1.5% to -3.5%.

Maria Walden discussed the PSRS Benefit Resolution and COLA Resolution and mentioned that PSRS is tracking 144 bills that would affect the Systems.

HB 69 (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. Cost study shows a savings to the system and reduction of contribution rate of 0.21%.

HB 77 (Black) and SB 17 (Romine) would address the impact of SB 892 (2018) on community college teachers. SB 17 has been passed by the Senate, HB 77 has been approved by the committee of origin. SB 892 changes the Working After Retirement (WAR) provisions for PSRS retirees working in school positions for which a DESE certificate is not required. SB 892 changed the WAR limit for this non-certificated employment from 550 hours to annual earnings of $15,000. An unanticipated impact of this bill was that it also affects PSRS retirees employed as community college teachers, since those teachers are not required to have a DESE certificate. HB 77/SB 17 would switch the limitation for such community college teaching employment back to the 550-hour limit applied to other teaching positions. The Board supports HB 77/SB 17 and similar bills; provided that the bills do not provide any refund of pension amounts to previously affected members. This type of refund is not allowed under federal law for a public pension system and could threaten the Systems' federal tax status.

HB 201 (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 459 (Washington) was another fix for CC teachers and WAR, but is not moving forward.

HB 723 (Pike) revises the survivor popup option for a divorce under certain criteria and would allow options for divorces prior Sept. 1, 2017. The provisions may require a revised divorce decree to show spouse waives rights to the pension. The Board voted unanimously to support the bill.

HB 864 (Taylor) allows all teachers to make an irrevocable choice to select a DC plan option rather than current DB plan. This option will save little for participants, is likely to provide less retirement income and security for those choosing a DC option and will be financially devastating for the current DB system. The Board voted unanimously to oppose the bill.

SB 18 (Romine) revises the gubernatorial appointment process. This bill does not directly target PSRS, and concerns all board appointments. The reforms in the bill reflect an effort to prevent any future attempts by a Governor to manipulate the appointment process by removing properly appointed members without just cause.

<u>CPI update/COLA review</u> – The Board reviewed the COLA policy. The first half FY 2019 CPI-U figure changed by -0.30%. Under current policy, the Board will not make a COLA for eligible retirees when CPI-U declines.

Public Comment – Charles Rorex from Farmington, MO spoke to the Board. He started teaching in 1951 and retired in 1986. He expressed appreciation for the work of the Board and staff. He discussed system improvements since he’s retired. In 2018, he and his wife have had a lot of medical expenses. His request is that the Board to consider retired teachers who have reached the 80% COLA cap and make less than $50,000 per year. He introduced Peggy Ropelle from Mineral Area Community College.

The meeting adjourned at 12:40.