

MEMORANDUM

To: House Committee on Pensions and Benefits

From: Alan D. Conroy, Executive Director
Elizabeth B. A. Miller, CFA, Chief Investment Officer

Date: January 20, 2016

Subject: Investment of 2015 Pension Obligation Bond Proceeds

The purpose of this memo is to report on how the System invested the proceeds of the 2015 pension obligation bond issue, in the total amount of \$1.0 billion, which were received on August 20, 2015.

It is important to remember that the decision regarding the timing of the issuance of the Pension Obligation Bonds was not made by the Retirement System. The timing of the bond issuance was driven by KDFA, the regulatory filing requirements for a bond issuance, and the conditions in the municipal bond market. Therefore, the System's task was to invest the proceeds of the bond issue in a timely and prudent manner upon receipt. As discussed with the Retirement System's Board members at the May 21, 2015 Investment Committee meeting, the System's staff and general investment consultant recommended that the most prudent course of action was to invest the bond proceeds so that the current, strategic asset allocation targets were maintained. The System did not intend to engage in tactical "market timing" with the investment of the bond proceeds. Rather, the timing of the investment of the Pension Obligation Bond proceeds was driven by the timing of the issuance of the bonds, and the investment of the cash proceeds into the System's publicly-traded asset classes occurred as soon as practical and prudent upon receipt.

As planned, the bond proceeds were fully invested within a few days after receipt in a diversified mix of publicly-traded stocks and bonds, so as to keep the actual asset allocation mix as close to the target asset allocation mix as possible, with one exception. The exception was domestic equity, which held an overweight relative to the current asset allocation target, in order to offset the underweights in private equity and real estate. We plan to gradually reduce the overweight to domestic equity, as capital is called for the System's private equity and real estate investment commitments, in order to fully fund those asset classes prudently over time. The Investment Division implements an annual pacing plan for the private equity and real estate portfolios in the fall of each year, which guides the System's new commitments in those asset classes for the next year. The 2016 pacing plans for private equity and real estate were presented to the Board in November, 2015, and the 2016 pacing plans reflected the impact of the 2015 pension obligation bond proceeds.

As discussed with the Board, and coordinated in advance with the System's external investment managers and custodial bank, the bond proceeds were invested quickly and prudently upon receipt. Approximately 45% of the bond proceeds were invested in the System's public equity portfolios. The remaining 55% of the bond proceeds were invested in the System's core plus fixed income, yield driven fixed income, and real return fixed



income portfolios. The exact timing of the investment of cash by each investment manager varied slightly, depending on the investment vehicle and the investment strategy utilized by each of the discretionary investment managers. The bond proceeds were incorporated into the System's highly diversified, long term investment portfolio, which is designed to provide the investment returns and assets necessary to fund benefits for the System's participants.

While it is too early in the process to judge the performance of the System's assets relative to the interest cost of the 2015 pension obligation bonds, the 2004 pension obligation bond issue provides a good case study. The 2004 pension obligation bonds were issued at an interest cost of 5.39%. As of November 30, 2015, the Retirement System's assets have earned an average annualized total return of 7.03% during the time period in which the proceeds of the 2004 bond issue were invested, resulting in a difference of \$161,993,418 between the interest cost and the investment earnings on the bond proceeds.