MEMORANDUM

To: House Committee on Pensions and Benefits

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

Date: September 12, 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. The overweight to domestic equity has been gradually reduced, 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.

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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.

The Retirement System's custodian calculates investment performance on a monthly basis. Investment performance results for time periods ending August 31st are not yet available. We will be able to provide an analysis of the difference in the return on the System's assets and the cost of the 2015 pension obligation bonds for the first year of experience once the August 31st investment performance results become available.

While one year of experience 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 continues to provide a good case study with over twelve years of experience. The 2004 pension obligation bonds were issued at an interest cost of 5.39%. At the end of fiscal year 2016, the Retirement System's assets have earned an average annualized total return of 6.86% during the time period in which the proceeds of the 2004 bond issue were invested, resulting in a difference of $155,929,452 between the interest cost and the investment earnings on the bond proceeds. Given that the 2015 pension obligation bond issue carries a lower interest cost of 4.688%, over the long term the return on the System's assets is expected to outperform the interest cost of the 2015 pension obligation bonds.