# MINUTES OF THE JOINT MEETING
# OF THE BOARD OF TRUSTEES OF
# THE KENTUCKY JUDICIAL FORM RETIREMENT SYSTEM,
# THE INVESTMENT COMMITTEE FOR THE
# KENTUCKY JUDICIAL RETIREMENT FUND,
# AND THE INVESTMENT COMMITTEE FOR THE
# KENTUCKY LEGISLATORS RETIREMENT FUND

**October 22, 2021**

The Board of Trustees of the Kentucky Judicial Form Retirement System (JFRS), the Investment Committee for the Kentucky Judicial Retirement Fund, and the Investment Committee for the Kentucky Legislators Retirement Fund, convened at the Administrative Office of the Courts, 1001 Vandalay Drive, Frankfort, Kentucky 40601 on Friday, October 22, 2021, at 10:00 a.m. All Board members were present.

JFRS staff present included Bo Cracraft, Executive Director, and Rebecca Stephens, Retirement Programs Administrator. Guests attending the meeting included Stan Kerrick, Lexington Investments, Don Asfahl and John Watkins of Baird Trust Company, and Wesley Wickenheiser of Findley, Inc. Mr. Matthew Widick of Findley, Inc. also participated via Microsoft Teams video-conferencing.

Chairman Grise called the meeting to order at 10:04 a.m. He began by recognizing and introducing the Boards newest trustee, Mr. Ben Allison, who had been appointed by the Governor in late August.

The trustees considered the adoption of the previously distributed *Minutes* from the July 23, 2021 meeting. Upon motion by Mr. Stephen LeLaurin, seconded by Justice Daniel Venters, the Board unanimously approved the *Minutes* of the July 23, 2021 meeting.

The next item for consideration was the election of Chairs of the Board and Investment Committees. The trustees considered the election of Chair of the Board of Trustees and the Chair of the Chairs of the Judicial and Legislative Investment Committees. Upon a motion by Mr. Stephen LeLaurin, seconded by Rep. Scott Brinkman, the Board unanimously elected Judge John Grise as Chairman of the Board for the Judicial Form Retirement System.

Upon a motion by Judge Doughlas George, seconded by Judge Daniel Venters, the Investment Committee for the Judicial Retirement Fund unanimously elected of Mr. Stephen LeLaurin as Chair of the Investment Committee of the Judicial Retirement Fund.

Upon a motion by Mr. Stephen LeLaurin, seconded by Rep. Scott Brinkman, the Investment Committee for the Legislators Retirement Fund unanimously elected Senator Joe Bowen as Chair of the Investment Committee of the Legislative Retirement Fund.

The next order of business was the report of Lexington Investments LLC. Chairman Grise recognized Mr. Stan Kerrick. Mr. Kerrick distributed to the trustees Lexington

Investments' *Report of the Kentucky Judicial & Legislators Retirement Funds* as of September 30, 2021, dated October 22, 2021. In accordance with Board policy, the System maintains a copy of the *Report*.

Mr. Kerrick began with a compliance statement and noted that both Plans were within their prescribed asset allocation guidelines. He also highlighted Microsoft as a current equity position that had reached an 8% weighting in both the LRP and JRP portfolios. Next, Mr. Kerrick examined performance over multiple periods as outlined in the Performance Analysis for each fund. He noted that performance from the most recent quarter was flat in absolute terms, but the portfolios did exceed their benchmarks and continue to provide attractive relative returns over the long term. He discussed the various economic influences affecting performance. Mr. Kerrick reviewed the Portfolio Statement, Cash Reconciliation Report and the Brokerage Fees Report for each fund.

In response to a question from Senator Bowen regarding the current inflationary environment, Mr. Kerrick responded that recent activities both politically and economically reminded him a lot of the 1970s. Elections, rising oil prices, supply and demand issues, and expectation of rising interest rates. Mr. Kerrick noted time would tell how permanent some of these pressures would ultimately be, but it definitely had slowed growth in the first quarter of the JFRS fiscal year.

Chairman Grise welcomed Baird Trust Company (formerly known as Hilliard Lyons Trust Company), who arrived and joined the meeting at 10:55 a.m. Mr. Cracraft had previously distributed copies of Hilliard Lyons' *Investment Review for Kentucky Judicial Retirement Fund and Kentucky Legislators Retirement Fund* dated October 22, 2021. In accordance with Board policy, the System maintains a copy of the *Investment Review*.

Mr. John Watkins began the quarterly review with a few comments regarding Baird's most recent quarterly Market Commentary, titled "The Hidden Cost of Overtrading." Mr. Watkins noted most of the article was not applicable to JFRS given their tax-exempt status, but it did highlight the long-term, patient model that is applied by the team and can lead to extended periods where few changes are made in the portfolio. He reiterated the team continued to research new ideas and review current holdings, but will not trade just to trade.

In response to a question from Mr. Ben Allison related to the team's patience and how long is too long on an idea not working and ultimate sell decisions, Mr. Watkins stated they are probably more patient that most managers. He admitted there have been times this has hurt performance, but more often than not, that patience has been rewarded. He pointed to a focus on buying very strong businesses, which gives them more confidence even when that company faces stiff headwinds. As it relates to selling a company, Mr. Watkins pointed to three primary factors that might lead the team to sell. First, a change in the company's assessment, such as change in strategy, turnover, or new competition, could change their long-term assessment and make the company less attractive. Secondly, management change or other organization turnover can lead to a sell. Third, the team might sell a company because there is a better opportunity that they would like to introduce into the portfolio.

Mr. Asfahl discussed several economic indicators, including employment levels, consumer pricing levels, and recent GDP growth. He stated the economy still appears strong, even with some mixed signals. Unemployment levels are still higher and rates have increased, but GDP continues to grow, demand remains high, and personal savings still at all-time highs.

Mr. Asfahl reviewed the current asset allocation, annual estimated income, and the current yield on the JRP legacy portfolio. He discussed the fixed income portfolio and schedule of maturities. Mr. Watkins reviewed a snapshot of the portfolio, which included relative sector weightings, top performers and largest holdings. He noted that sector allocation was different from the index, but that was by intent as the team seeks to materially outperform. However, he did stress that sector weightings were not the result of a macro or top-down decisions, but completely driven by the underlying stocks selected.

In response to a question from Mr. Stephen LeLaurin regarding utilities and their use by many managers to gain exposure to dividend, Mr. Watkins stated the investment team tends to focus more on free cash flow and how management uses it. While in many cases large free cash flow will led to dividends, Baird also likes to own companies that will reinvest that cash flow and grow the business. Mr. Watkins also pointed to regulator and pricing issues that make utilities less attractive to the team.

In response to a question from Judge John Grise regarding what had changed for General Electric, which was the best performing equity holding over the past year, Mr. Watkins pointed to a change in management as the ultimate catalyst. In the short term, the company had benefited from the recent rebound in their aviation business, but that outsized growth is really the product of work done by new CEO, Lawrence Culp. An example of patience, Culp has spent much of the past couple years cleaning up the company's balance sheet. Currently, you see a much more attractive company that is seeing their primary business grow as the economy comes out of the shutdown.

In response to a question from Mr. Scott Brinkman regarding inflationary and pricing power concerns, Mr. Watkins did express some concern. He emphasized that the team does not try to predict inflation, but instead has purchased companies that they believe will be successful in either outcome and have tried to focus on businesses that do have ability to raise prices in that event.

In response to a question from Mr. Ben Allison, regarding how the team evaluates current holdings, Mr. Watkins stated the team is reassessing often and does incorporating recent performance. In some cases, that will lead the team to reduce a position or even add to, but the idea is the team is "buying the portfolio" each day or week.

Mr. Asfahl highlighted the portfolio's current weighting in Microsoft, which had reached the 8% policy threshold. He stated the team was monitoring carefully and would evaluate again if it continued to grow.

Lastly, Mr. Asfahl concluded Baird's presentation with an update of recent activity in the Cash Balance portfolios, which was related to a discussion held during the July meeting where the Board expressed a desire to add active management to the smaller, but growing portfolios. He stated the equity portion of this transition was completed and both portfolios held a basket of securities that look identical to the larger portfolios. On the fixed income side, Mr. Asfahl outlined a proposed plan to utilize a mix of two exchange-traded funds (ETFs) to synthetically create a similar level of exposure.

Mr. Cracraft informed the Board that Mr. Asfahl had held off on transitioning the fixed income portion of the portfolio due to a few minor policy items, which staff planned to introduce later in the meeting. Mr. Stephen LeLaurin also addressed and expressed confidence in the plan proposed by Baird.

The meeting recessed for lunch at 11:55. Mr. John Watkins departed the meeting.

The meeting reconvened at 12:20 p.m. Mr. Asfahl departed the meeting. Mr. Wesley Wickenheiser of Findley, Inc. joined the meeting in person, while Mr. Matthew Widick of Findley, Inc. joined the meeting virtually via Microsoft TEAMS.

Chairman Grise recognized Mr. Cracraft, who reported on several administrative matters. The trustees discussed the items and took action when noted.

(B) <u>2021 Actuarial Valuations.</u> Mr. Cracraft introduced recognized Mr. Wesley Wickenheiser and Mr. Matthew Widick of Findley, Inc., who had joined the meeting to present results of the System's July 1, 2021 actuarial valuations.

Mr. Wickenheiser began with a broad review of the process Findley followed in producing the biennial valuations, while also pointing out a few changes made since the last valuation. First, he highlighted the recent decision to consolidate the legacy defined benefit and new cash balance tiers from an actuarial standpoint, which would result in two overall reports rather than the four received in prior years. He noted that assets would no longer be separated, however a breakdown of liability by each tier would be provided so recent trends and associated costs could be known. Secondly, he stated that the projections included in each valuation were for a total of 30 years compared to 20 years in the past. This change was a result of legislation that also created a common template that Findley will use when evaluating proposed bills. Third, he reviewed a few assumption changes from the 2019 valuations, which included the plans' discount rates, medical trend rates, retirements, administrative expense load, and mortality rates.

In response to a question from Representative Brad Montell regarding administrative expenses, Mr. Cracraft stated that both plans were paying a portion of the agencies administrative expenses based on total membership in the plan. In addition, Mr. Wickenheiser noted the impact of projected administrative expenses on each plan's actuarial required contribution (ARC) was available and he referenced a summary page in the full valuation report that included the expense as a separate line item.

Next, Mr. Wickenheiser continued to discuss the assumptions used and actuarial methods followed and highlighted two items he believed the Board should be aware of. First, he pointed out contributions and assets of the health insurance plans could not be used for pensions. However, he noted that the current 1% contribution for the hybrid plan was exceeding the actual cost of providing those benefits, which is driving much of the improvement in funding for those plans. Secondly, he cited the plans' statutorily required unfunded accrued liability (UAL) amortization policy that requires a fixed rate plus interest each year. He suggested the Board consider seeking a legislative change to this language and emphasized that without huge unexpected gains from investments and other actuarial assumptions, this funding policy would not fully amortize the plans' liability.

In response to a question from Senator Joe Bowen regarding the 1% insurance contribution, Mr. Cracraft confirmed any change in how those funds were collected or allocated would require a statutory change.

Next, Mr. Matt Widick reviewed GASB results as well as contribution requirements for the upcoming budget biennium. He noted recent trends in the plans' funded ratio and how the asset smoothing method utilized on the funding side would gradually recognize gains. Lastly, he reviewed current membership counts for both plans and pointed out how cash balance members were continuing to grow, especially the LRP plan.

In closing, Mr. Wickenheiser noted recent asset performance significantly improved the GASB disclosures and are projected to have a similar impact on the funding side as recognized. Given the strong funding position of both plans, he suggested the board may consider modest changes to asset allocation and targeted asset returns to remove some risk from each plan. Alternatively, the plans could also shift some of the risk through an annuity market or potentially seek liability driven investment strategies.

Mr. Wesley Wickenheiser and Mr. Matt Widick departed the meeting at 1:54 p.m.

Next, Mr. Cracraft revisited the discussion prior to lunch with Baird Trust Company regarding a few minor investment policy concerns raised by Don Asfahl regarding the diversification and transition of the cash balance portfolios. Mr. Cracraft indicated that he and the Investment Committee chairs were planning to revisit the full investment policies during the January 2022 Board of Trustee meeting; however, Baird asked for a temporary reprieve in the interim to allow for the portfolios to be transitioned.

Mr. Stephen LeLaurin expressed confidence in the plan proposed by Baird and agreed to work with Mr. Cracraft on drafting temporary policy allowances until the full Board could review and approve an updated policy.

Following a discussion, Judge John Grise made a motion, which was seconded by Mr. Steven LeLaurin to provide Baird Trust Company more clarity and short-term authorization with regard to a proposed plan to hold a basket of Fixed Income ETFs in the Plans' hybrid cash balance portfolios until the Board of Trustees adopt revised Investment Policies in January 2022.

(A) Public Pension Oversight Board (PPOB). Mr. Cracraft gave a summary of PPOB meetings since the July JFRS Board meeting.

> **August 30, 2021** – JFRS was not on the agenda, but the board did discuss KRS 7A.250, which requires the PPOB to conduct actuarial audits of each system once every 5 years and will impact JFRS. The Board agreed to search for an actuary that would conduct audits during the FY2023. In addition, staff from the Kentucky Public Pension Authority and Teachers Retirement System discussed HB 8 implementation and Sick Leave/Payment information.
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> **September 21, 2021** – Each state-administered retirement system provided preliminary budget requests for the 2022-24 biennium. Mr. Cracraft, Mr. LeLaurin, and Mr. Allison attended.
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> **October 19, 2021** – JFRS was not on the agenda. The Board discussed the topic of COLAs for current retirees and also heard a LRC staff report with regard to actuarial audits as they plan to meet the statutory requirement outline in KRS 7A.250

(C) 2022 General Session. Mr. Cracraft referenced the *2022 Regular Session – Budget Request and Housekeeping Bill* memo from staff included in the Board materials. He began by reviewing staff's proposed budget request, which was driven by the actuarial valuations reviewed by Findley, Inc.

Mr. Cracraft also reviewed proposed administrative expenses, compared to prior fiscal years and as budgeted through the next two fiscal years. He noted expenses were expected to increase modestly, which was expected as staff continue to implement new systems and technology.

Following a discussion, Judge Doughlas George made a motion on behalf of the Investment Committee for the Judicial Retirement Plan, which was seconded by Mr. Stephen LeLaurin, to adopt staff's 2022-2024 proposed budget request for the Judicial Retirement Plan. Representative Scott Brinkman made a motion on behalf of the Investment Committee for the Legislators Retirement Plan, which was seconded by Mr. Stephen LeLaurin, to adopt staff's 2022-2024 proposed budget request for the Legislators Retirement Plan.

Next, Mr. Cracraft continued to review staff's memo and discussed a few legislative changes he was recommending the Board pursue in a housekeeping bill. Most notably, he referenced the Board's last housekeeping bill in 2020, which tried to update and modernize the unfunded liability amortization policy. He noted that Findley was in support of this change and that it would likely have a minimal impact from an actuarial cost standpoint. The proposed policy would be very similar to the Commonwealth's other retirement plans. Mr. Cracraft also discussed pursuing language that would be primarily technical in nature but would clarify statutes with current operations.

Following a discussion, Senator Joe Bowen made a motion, which was seconded by Representative Brad Montell, to authorize the JFRS Executive Director to pursue a housekeeping bill on behalf of JFRS for the 2022 Regular Session.

(D) APA Fiscal Year 2021 Audit. Mr. Cracraft provided a brief update of the audit, which he stated should be completed in the first week or November. He discussed the detailed nature of the audit and comprehensive review and expected there would be several recommended improvements in the final report. He was hopeful there would be no material or significant findings in the final report, but advised the Trustees would receive a copy via email as soon as it was received.

(E) Medical/Fiduciary Liability Insurance Update. Mr. Cracraft gave an update to follow up on the July meeting.

First, as it relates to insurance premiums for the Kentucky Employees Health Plan (utilized by retired members and benefitciares who are not Medicare eligible), Mr. Cracraft informed the Board that monthly premiums did increase slightly, but less than expected.

Second, with regards to the System's Fiduciary Liability Policy, Mr. Cracraft informed the Board that the final premium increase was just over 3% compared to an estimate that was much higher.

(F) Pension Administration Software. Mr. Cracraft provided an update about the Request for Proposal that was approved during the July meeting. He stated that RFP had been posted and the bidding period had closed. Staff was excited to receive bids from multiple firms and hopes to begin the process of evaluating during the Month of November.

There being no further business, the meeting adjourned at 2:29 p.m.

Judge John R. Grise, Chairman
Judicial Form Retirement System Board of Trustees

Stephen F. LeLaurin, Chairman
Judicial Retirement Fund Investment Committee

Joe R. Bowen, Chairman
Legislators Retirement Fund Investment Committee

Bo Cracraft, Executive Director