Utah Retirement Systems

Legislative Audit Response: Presentation to the Retirement and Independent Entities Interim Committee

June 24, 2015

Presentation Outline

- **Background**
- **Key Points of the 2015 Legislative Audit**
- **Detailed Points about URS' Investment Objectives, Asset Allocation, and Performance**
  1. **Fiduciary Duties**
  2. **URS Goals & Objectives**
  3. **Audit Recommendation**
  4. **Asset Allocation**
  5. **Alternative Investments**
  6. **Performance Summary**
- **Conclusion**

Background

The Utah Retirement Systems (URS) serves more than 200,000 participants and about 470 public employers, including the State, local governments, school districts, higher education, and more.

The Office of the Legislative Auditor General recently completed a detailed review of Utah Retirement Systems.

The audit report finds URS' management and investment practices satisfactory in most of the areas it examined and offers recommendations related to transparency and asset allocation.

The audit report was presented to the Legislative Audit Subcommittee on May 5 which referred the report to two legislative committees: the Executive Appropriations Committee (presented on May 19) and the Retirement and Independent Entities Committee (being presented today).

Key Points of the 2015 Legislative Audit

The Retirement Board is qualified and experienced.

The report examines the experience and background of Utah State Retirement Board members, determining they have sufficient investment experience. "The board members who represent the investment community collectively hold over 150 years of investment experience," it states (Report page iii). "Furthermore, URS' board has more investment experience compared to other peer retirement systems' boards." (Report page iii).

URS' administrative costs are lower than peer systems.

URS' operating costs are "well-managed" and administrative costs "have been fairly consistent" (Report pages 35-36). Specifically, the audit shows that URS annual administrative costs were $19 lower per member than the median of peer retirement systems (Report page 36).

Processes to select and retain investment managers for the Defined Contribution (DC) Plans are satisfactory.

The report says URS' processes of selecting and monitoring DC plan investment managers are well-established, have adequate controls, and are executed according to policy (Report pages 51-55).

URS has become more transparent and will take additional steps.

The report examines URS' transparency practices, stating, "URS has made a considerable effort to become more transparent through its website and is compliant with Senate Bill 59, passed in the 2014 General Session." (Report page i). It recommends additional steps to become more transparent and improve information practices. URS has committed to working with the Legislature to accomplish this.

New investment advisory program.

URS advisor staff are found to be qualified to offer investment advice through the new investment advisory program (Report pages 45-50).

Investment performance has exceeded the assumed investment rate of return.

URS' 7.5% assumed investment rate of return is described as "reasonable" (Report page 7). Since 2004, the 20-year average return has exceeded the assumed investment rate of return by an average of 0.56%. (Report page 7, Figure 1.7) URS' investment performance is "about average compared to peer groups" (Report page 30).

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Allocation of alternative investments is higher than peers but helps meet the long-term obligations of the Fund.

The report observes that URS' allocation of alternative investments is higher than peers (Report pages 30-31). As the report notes, URS believes its current asset allocation is the best model to meet long-term obligations (Report page 27). URS is urged to review asset allocation concerns and anticipated market conditions as it makes future adjustments (Report page 33), which URS has committed to do.

Implementation of the audit.

URS management has presented the audit report to the Board and is working to facilitate the implementation of recommendations, consistent with URS' purpose and fiduciary responsibilities.

Detailed Points about URS' Investment Objectives, Asset Allocation, and Performance

In reviewing the performance of the URS investment portfolio it is critical to understand the context of the duty URS has regarding investments.

Utah Prudent Investor Rule:

"A trustee shall invest and manage trust assets as a prudent investor would, by **considering the purposes, terms, distribution requirements, and other circumstances of the trust**. . . A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as part of an overall **investment strategy having risk and return objectives reasonably suited to the trust**."

Utah Code Ann. §75-7-902 (1) (2) (emphasis added)

1. Fiduciary Duties

- **Contribution Rate Setting Process**
- **Assumed Rate of Return – 7.5%**
- **Tech Bubble – 49-11-301(5) indicates preference for low volatility**
- **Tier 2 – "Defined Contributions" of 10% or 12% indicates preference for low volatility**
- **Low volatility is part of URS' fiduciary obligation**

Volatility of returns in the Defined Benefit Plan ("DB Plan") increases volatility in contribution rates, adding volatility to the budgets of participating employers.

URS seeks a target return over the long run with the goal of minimizing risk and volatility.

- **Recommendation**

  We recommend that URS consider our investment consultant's concerns and anticipated market conditions as URS makes future asset allocation adjustments (Report page 33).

- **URS Response**

  Approximately every five years, a formal liability and asset allocation study is conducted. The study reviews and revises liability expectations and capital market expectations. The asset allocation is assessed relative to liabilities, the target rate of return, and risk. The following organizations contribute:

  - **Gabriel Roeder Smith & Co (actuary)**
  - **Callan Associates (investment consultant)**
  - **URS Investment Staff**

  Information is also gathered and analyzed from numerous other sources.

  In practice, asset allocation and risk are reviewed regularly by the Board, Investment Staff, and Consultants.

Asset Allocation:

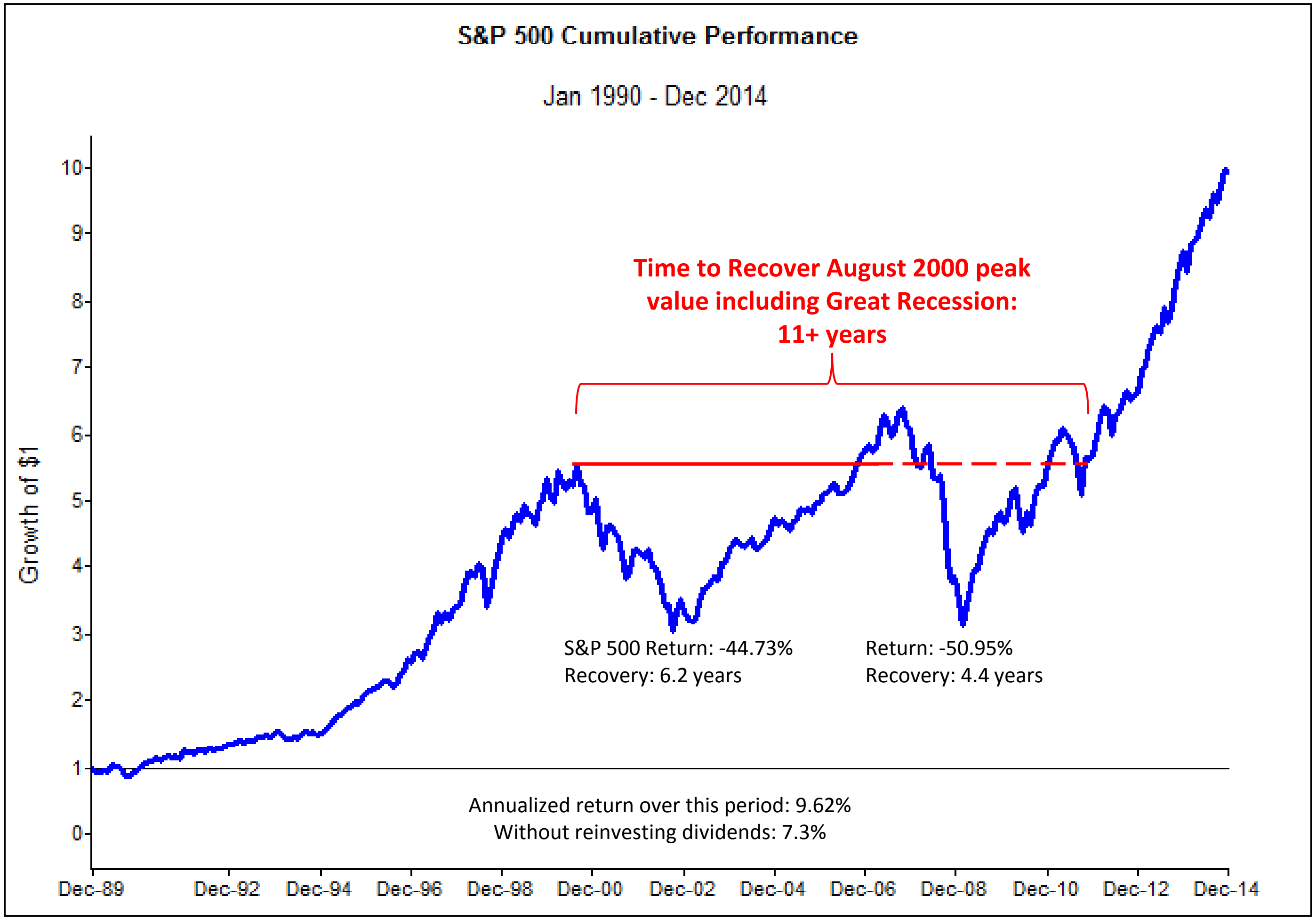
Why is the current asset allocation the way it is?

The DB Plan asset allocation is designed to:

1. Generate target returns over the long run
2. Minimizing risk and volatility (particularly vulnerability to equity market downturns) by being more diversified than a traditional asset allocation

4. Asset Allocation

The graph below illustrates S&P 500 bear markets and recovery. Higher allocations to public equities create higher portfolio risk and can lead to higher volatility in contribution rates.

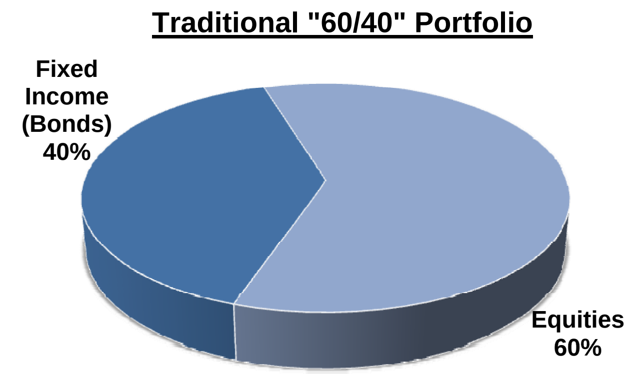


URS recognizes that investment in public equities creates wealth over the long run (it is also the largest asset allocation in the DB Plan).

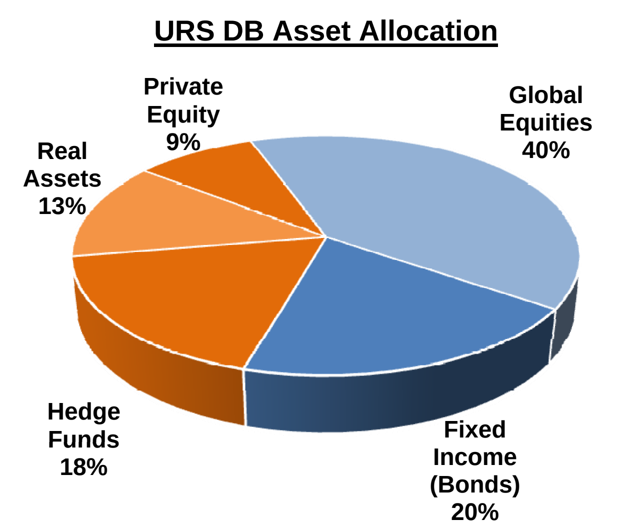
URS also recognizes there are periods where public equities generate large losses and require long recovery times.

4. Asset Allocation

In a traditional asset allocation, equity securities primarily provide returns through capital appreciation. Bonds add a second source of returns through income, but also provide the important role of diversification and reduce the risk of equity securities.



As an Institutional Investor, URS has more options to generate returns and diversify equity risk than a traditional asset allocation.



Portfolio Design: Economic Environments

The DB Plan asset allocation takes a long-term perspective and is designed to anticipate a variety of different economic environments. The asset liability study, asset class strategic plans, and tactical plans enable the DB Plan to respond to changing market environments.

The primary factors that drive the economic environment and financial asset returns are:

1. Growth
2. Inflation
3. How these factors interact

4. Asset Allocation

Economic Environments

Inflation

		Low	High
Growth	High	Growth Economy	Inflation
	Low	Recession (economy contracts)	Stagflation

Economic Environments: Traditional Investments

Growth \ Inflation	Low	High
High	Growth Economy **Credit (Bonds)** **Public Equities**	Inflation **Public Equities** (long term) **Inflation-Linked Bonds**
Low	**Treasury Securities** Recession	**Inflation-Linked Bonds** Stagflation

4. Asset Allocation

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Economic Environments: Traditional Investments + Alternative Investments

Growth \ Inflation	Low	High
High	Growth Economy **Private Credit** **Private Equity** **Credit (Bonds)** **Public Equities**	Inflation **Energy** **Timber** **Real Estate** **Agriculture** **Public Equities** (long term) **Inflation-Linked Bonds**
Low	**Hedge Funds** **Treasury Securities** Recession	**Energy** **Timber** **Agriculture** **Inflation-Linked Bonds** Stagflation

Traditional + Alternative Investments

To achieve return and risk objectives, the DB Plan utilizes additional sources of both return and diversification not accessible through traditional asset classes.

Expectations for Alternative Assets:

- **Private Equity: enhance returns over the long run**
- **Real Assets: enhance returns over the long run, inflation protection, diversification**
- **Hedge Funds: generate attractive returns relative to fixed income, provide diversified sources of return and downside protection, and reduce DB Plan risk**

5. Alternative Investments

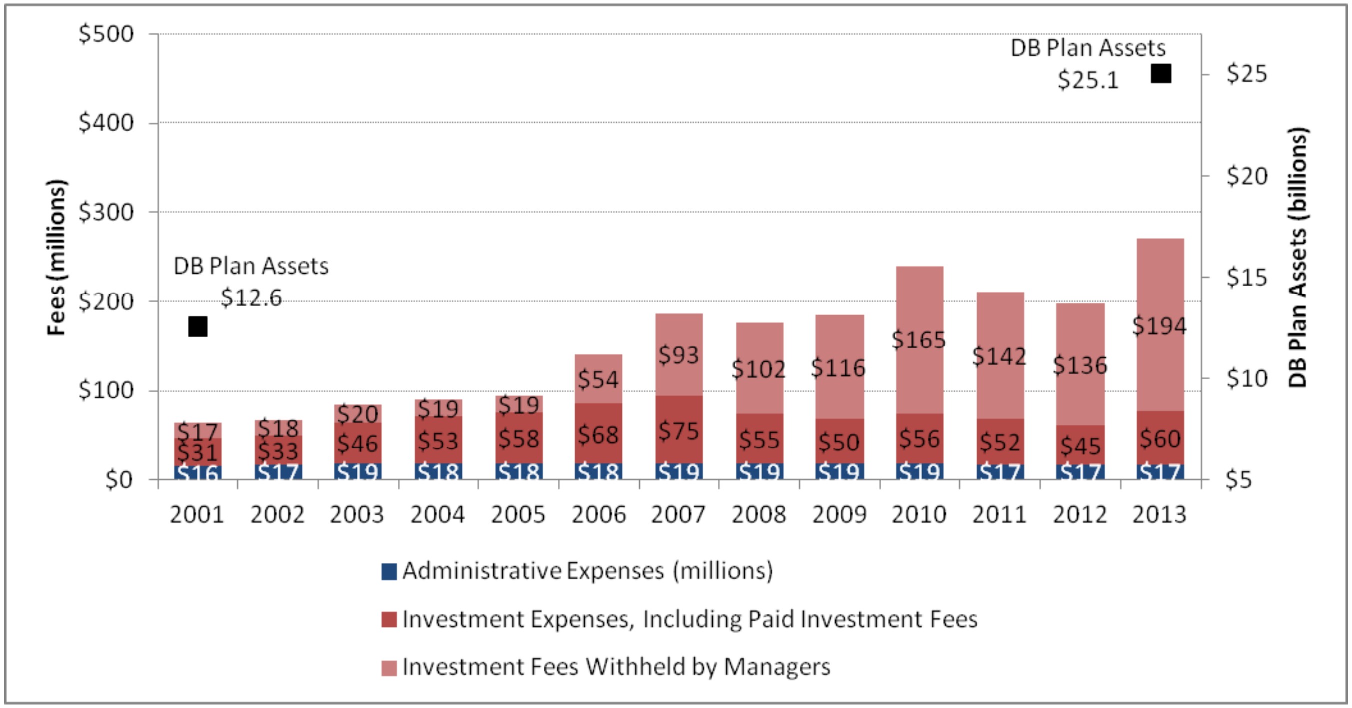
For the 10 years ending in 2013 (audit period) and 2014 (updated below), <u>net of fees</u> the alternative investments were the best performing asset class in the DB Plan and outperformed both domestic and global equities.

	10 yr annual returns ending 12/31/2013	2014	10 yr ending 12/31/2014
Alternative Assets (returns net of fees)	**+8.87%**	**+11.61%**	**+8.53%**
S&P 500 (gross return)	+7.41%	+13.69%	+7.67%
Global Equities (gross return) *Russell Global Equity Index*	+7.42%	+3.94%	+6.22%

5. Alternative Investments

The legislative audit discussed fees. Fees have increased due to:

1. **Increased assets in DB Plan**
2. **The increased allocation to alternative investments**
3. **Value created through strong performance**



"Investment Fees Withheld" include performance fees, which are frequently deferred in order to align fees with performance over time. Decreased performance would result in lower fees.

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URS has been recognized by the Wall Street Journal for effective and innovative negotiations of alternative investment fees with its investment managers.

In addition to fee negotiations, URS is recognized in the industry for its Alignment of Interests initiatives and seeks investment managers whose long-term philosophy, strategy, fiduciary responsibilities, and ownership interests align with those of URS.

THE WALL STREET JOURNAL.

It's Pension Funds vs. Hedge Funds
Officer of Utah Retirement System Rallies Peers to Fight for Concessions
"It's a laudable effort and it's the right time to do it…"
"serves as a blueprint for what type of changes to pursue…"
WSJ March 6, 2009

Institutional Investor Awards

Public Fund Investor of the Year (2009)
Outstanding Contribution to the Hedge Fund Industry (2009)
Best Retirement Plan Design (2014)

URS began investing in carefully selected, high quality hedge funds in 2006.

The URS Hedge Fund portfolio is highly customized and seeks to:

- **Reduce overall DB Plan portfolio risk through diversification**
- **Preserve capital and provide downside protection in periods of market stress (measured by losses and recovery), particularly in relation to equity markets**
- **Generate attractive returns not available through traditional investments (relative to equities and fixed income)**

Each hedge fund is subject to a rigorous due diligence selection process by both URS Investment Staff as well as an external, independent consultant (Albourne Partners). Following investment, each hedge fund is regularly monitored, including a monthly risk monitoring and review process.

5. Alternative Investments: Hedge Funds

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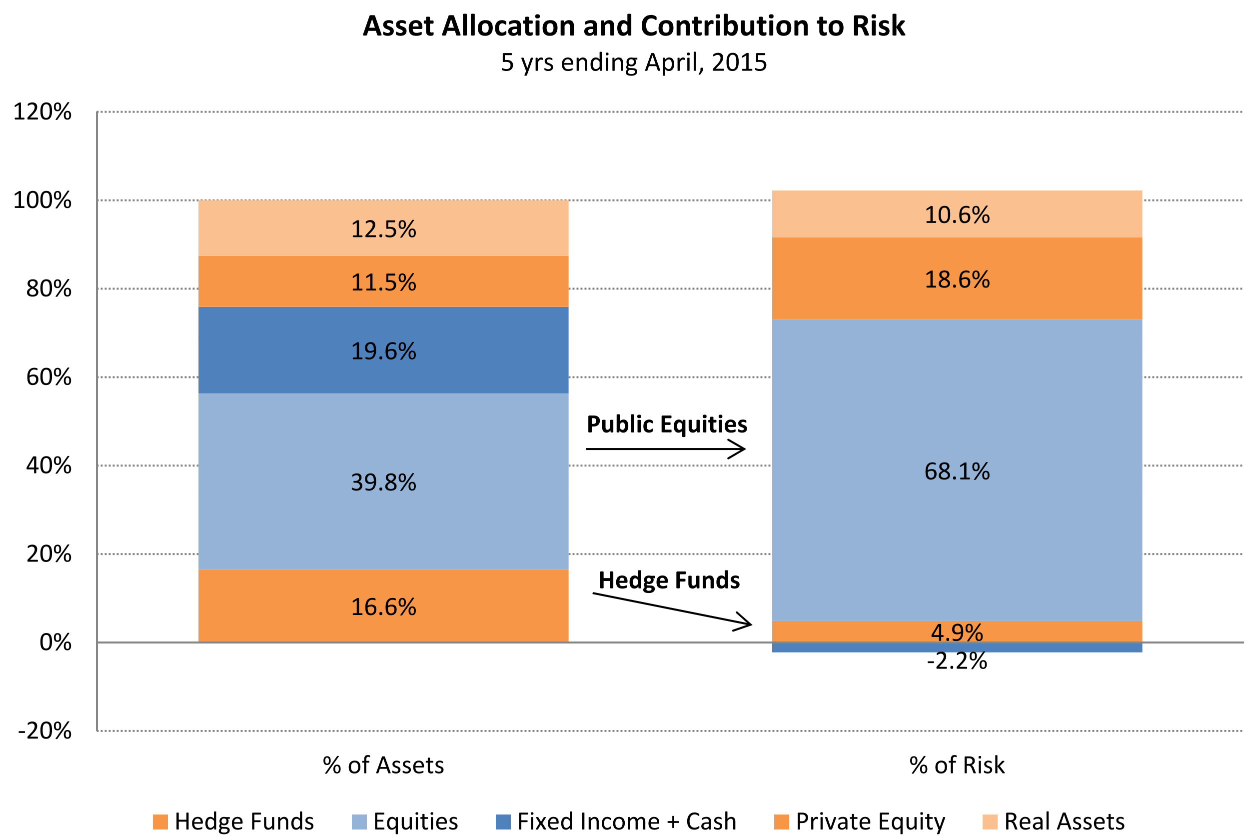
The Hedge Fund portfolio is designed to generate better returns than fixed income over time while also providing downside protection relative to public equities. The data below highlight performance relative to fixed income and public equities during the most recent downturn for each market.

	Recent Downturn	Performance	URS Hedge Funds Performance
Fixed Income[1]	2013	-2.02%	+10.03%
S&P 500	2008	-38.49%	-14.44%

1 – Barclays US Aggregate Bond Index

5. Alternative Investments: Hedge Funds

Public equities account for 40% of DB Plan assets and 68% of portfolio risk
Hedge Funds account for 17% of DB Plan assets and 5% of portfolio risk
The chart below compares asset allocation to risk contribution



Expectations for DB Plan Performance

- **Negative markets: preserve capital**
- **“Normal” public markets: perform well**
- **Strong public markets: perform well, but do not expect to outperform portfolios with higher allocations to public equities**

Performance Summary

Risk has decreased, without a matching decrease in returns. This is evidenced by the DB Plan’s increased Sharpe Ratio, a common investment metric for measuring quality of returns because it measures returns relative to risk taken.

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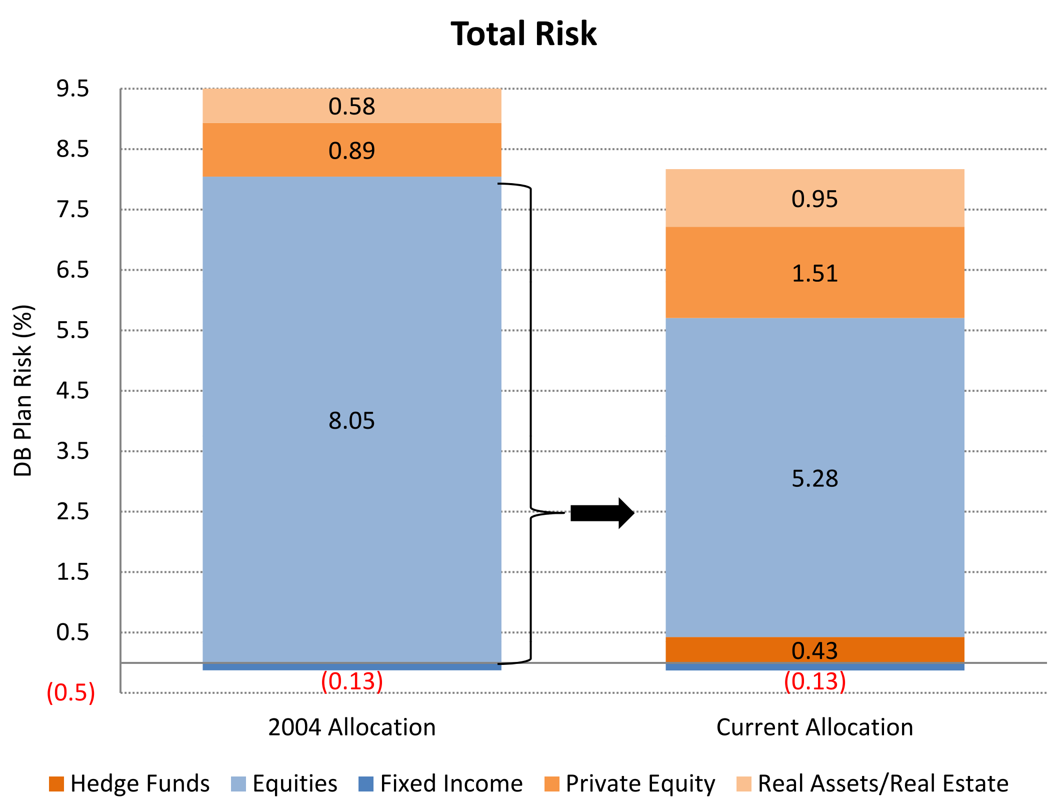
The DB Plan risk has decreased as alternative investments have increased. The chart below compares contribution to total risk by asset class for both the 2004 and current asset allocations.

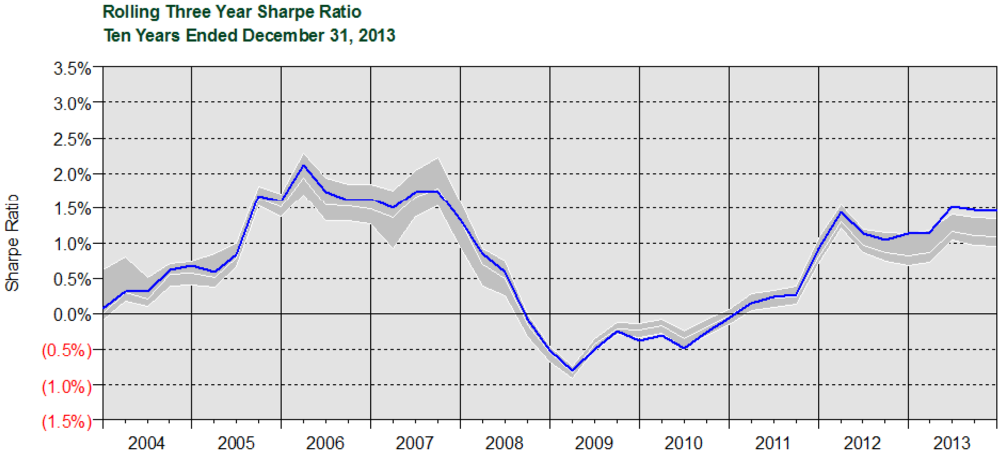


Overall risk has decreased.

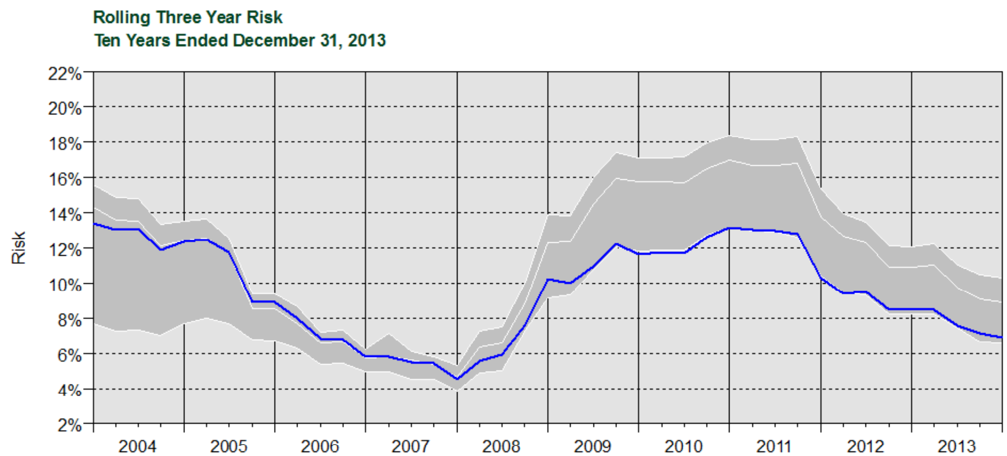
Public equity contribution to risk has dropped by 1/3.

6. Performance Summary

The URS DB Plan's Sharpe Ratio has increased (top chart). This is a result of risk decreasing (bottom chart) without a matching decrease in returns. The charts below compare the URS DB Plan (solid blue line) to peers (public pension funds $10+ billion).



The blue line reflects return relative to risk over time. Higher is better.



The blue line reflects risk over time. Lower is better.

Data independently produced by Callan Associates

Conclusion

The DB Plan asset allocation is designed to achieve the actuarial rate of return over the long term with reduced risk.

As noted in the legislative audit report, URS has met or exceeded the return objective over long-term periods (see audit report pages 7 and 30).

Figure 1.7 URS Historic Rates of Return. The 20-year average market return has exceeded the investment return assumption for the past ten years.

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Investment Return Assumption	8.00	8.00	8.00	8.00	7.75	7.75	7.75	7.50	7.50	7.50
20-Year Average Return	10.5	9.86	9.86	10.0	8.12	7.94	8.45	7.53	7.93	7.79
Difference	**2.50**	**1.86**	**1.86**	**2.01**	**0.37**	**0.19**	**0.70**	**0.03**	**0.43**	**0.29**

Shown as percentages.
Source: URS CAFRs 2004-2013, Auditor Analysis

Since 2004, the 20-year average return has exceeded the current assumed rate of return by an average of 0.56 percent.

Alternative investments have successfully helped the DB Plan to achieve its return objective while reducing risk.

URS is willing to discuss questions or concerns with legislators, whether related to this audit or about other retirement-related issues.

Please contact:

- **Dan Andersen, Executive Director**
  Mobile/text: 801-558-3297

- **Dee Larsen, Legal Counsel**
  Mobile/text: 801-643-5257