MINUTES OF MEETING
COUNTY EMPLOYEES RETIREMENT SYSTEM
SPECIAL CALLED INVESTMENT COMMITTEE MEETING
AUGUST 25, 2021 AT 10:00A.M.
VIA LIVE VIDEO TELECONFERENCE

At the August 25, 2021 Investment Committee Meeting, the following members were present: Dr. Merl Hackbart (Chair), William O'Mara, George Cheatham, Jerry Powell, and Dr. Milkman. Staff members present were David Eager, Steven Herbert, Rebecca Adkins, Erin Surratt, Michael Board, Victoria Hale, Jared Crawford, Steve Willer, Anthony Chiu, Joseph Gilbert, Carol Johnson, Sherry Rankin, Crystal Smith, Shaun Case, Phillip Cook, and Glenna Frasher. Also in attendance were Chris Tessman and Craig Morton from Wilshire, along with Danny White and Janie Shaw from GRS.

Dr. Hackbart called the meeting to order.

Ms. Hale read the Legal Public Statement.

Ms. Johnson called roll.

Dr. Hackbart introduced agenda item *Public Comment.* Ms. Johnson stated that no public comments were submitted.

Dr. Hackbart introduced agenda item *Approval of Minutes – July 14, 2021.* Mr. Powell made a motion and Mr. O'Mara seconded to approve the minutes as presented. The motion carried.

Dr. Hackbart introduced agenda item *Actuarial Stress Test.* Mr. White and Ms. Shaw from GRS provided the 2020 Stress Test for the County Employees Retirement System. Mr. White began by stating that this was something that had been in the works for a while. It had been brought up by legislators at the Public Pensions Oversight Board meeting about this time last year. He stated that at that time Mr. Eager indicated that the agency was taking the stress test seriously and GRS was here to present the findings of that review. Mr. White stated that a stress test is an analysis designed to determine the ability of a given financial institution to deal with an economic crisis or certain stressors. The purpose of a stress test is to identify the stressors in the system, to monitor and possibly adjust policies and procedures in order to improve sustainability, and to educate stakeholders of those potential risks. Mr. White reviewed the process of the test to identify the outcomes to be tested and modelled, and the use of appropriate projection analyses to identify potential outcomes. These analyses include contribution risk, investment return volatility, stochastic simulations, deterministic projections and outcome based events. Mr. White indicated that two risks that affect all of the systems are the legislative risk and the practice of resetting the amortization periods about every five or so years. Ms. Shaw reviewed key takeaways from their review to point out areas they feel CERS should focus on. She began with the CERS Non-Hazardous Pension Fund, reiterating that the stress test only includes the pension fund and does not include the insurance trust fund. Ms. Shaw reported that compared to the KERS Non-Hazardous and SPRS Pension Funds, the CERS Non-Hazardous Pension Fund has materially more investment risk, as measured by the change in contribution rate, because it is significantly better funded. The unfunded liability is currently expected to increase for another four years before beginning to decrease. It could increase beyond its current level with investment volatility under "more likely than not" scenarios. Mr. Eager asked if it was fair to say that if the Trustees were not comfortable with the range that they would be able to revisit their asset allocation and portfolio to make changes that would produce an outcome that is more satisfying. Ms. Shaw answered yes, the Trustees do have options, with asset allocation and assumptions. However, the Board cannot make changes to the Funding Policy, as that is set by statute. Mr. White indicated that if you wanted to tighten the bands shown in the chart, it would just cost more to do so. Mr. Eager stated he just wanted the Trustees to know that the information in this stress test can be used to make decisions. Ms. Shaw continued to state that absent investment volatility and future gains or losses, the fund is expected to the 100% funded in 2049. A continuing considerable risk to the fund is the pattern of resetting the amortization period. This occurred back in 2019 by legislation. A one-time reset will not affect the Plan. It is the resetting of the amortization period several times, such as every five or six years, that will negatively affect the Plan. Mr. White indicated that the legislators have done this twice, in 2014 and 2019. Mr. O'Mara had a question about the Distribution of Unfunded Accrued Liability Chart where the Baseline Valuation and the Payroll

Growth for 10 Years line seemed to mirror each other, and he was thinking there was a 2% growth assumption. He wanted some clarification on what those two lines represent. Ms. Shaw indicated that is the lines were a product of the Funding Policy and if those same lines were examined on the Contribution Rates, they would look differently. Essentially, the assumption is that if a percentage of the payroll received is still increasing the unfunded liability is paid down, because of the Funding Policy. Mr. George Cheatham wanted some clarification and explanation regarding the comment about "tightening the band would increase costs." Mr. White answered that about the comment involved investment volatility at the high level. If a Plan wantedto lower the volatility in investment returns, to the Plan should expect lower returns, which translates to a higher cost. Mr. Herbert indicated that Mr. White's statement was correct. If a Plan wants zero volatility, that is basically cash. Therefore, volatility equals risk; the higher the volatility, the more it costs. Mr. Cheatham indicated that he thought that "costs" here meant "management costs". Mr. Herbert responded that because the expected return number was going down, that the Plan would have to make that up in some other area, i.e., out of pocket. Mr. Eager stated that the costs would be contributions. Dr. Hackbart indicated that supplemental funding would be another way of saying it. Mr. Cheatham indicated that everyone appeared to be in agreement, that the more volatility the less likelihood that the Plan was going to achieve the goal of erasing the deficit in the remaining 29 years. The Plan needs to shoot for a more consistent return around the 6 ¼ mark. Mr. Herbert responded that the 6 ¼ mark brings volatility into the investment portfolio. Mr. Herbert indicated that over time, the investments are shooting to get a return of 6 ¼ plus, but it is not likely to get that 6 ¼ every time period. Mr. White referred to the information provided in the material regarding volatility, and in this last year, volatility paid off tremendously for the CERS funds. Mr. White reminded the Committee that the information provided does not reflect the investment returns made in FY 20-21. Mr. Herbert stated as a reminder that the projected discount rate, which is also tied to the projected investment rate of return, is done through the asset allocation. It is much like a weather report, in that the Plan does not know if we are going to hit that projected return. There are several allocations that will get the Plan there, this is just a general idea along the risk return spectrum of what the Plan is going to need. There are 3 pieces: the contributions coming in as part of the funding, the returns as part of the funding, and taking a nominal approach instead of percentage. In theory, the more contributions that come in and the higher the returns, then the better off the Plan is. Mr. White followed up by stating that regarding the return assumption, CERS is in the conservative spot, well below median compared to other, large state-wide retirement systems. But CERS' starting point is better than other systems, and the funded status needs to improve, but the assumptions themselves that will get funding policies where they need to be, has CERS in a much better spot. Mr. Cheatham asked to what extent GRS was taking into account CERS' assumptions that they are still cash flow negative, and are using some of the returns to pay benefits. Mr. White indicated that does come into play. With CERS' current contribution rates, they are much less cash flow negative than other plans. He said that most state-wide retirement systems are not in a situation of being cash flow negative. In Kentucky the extreme is KERS non-hazardous which is not cash flow negative, and that is because they are only 14% funded. Based on the projections over the next 5 to 10 years, it does not appear that negative cash flow will be much of a concern for CERS. Mr. Eager mentioned that projections show that CERS should be at positive cash flow in about 2 years. Mr. O'Mara asked whether that was a function of the limit on how much of employer contributions can go up per year until it reaches the actuarial amount. It is legislated to be increased in segments over the next few years. Mr. White acknowledged that as being true. He indicated that in the legislative session in 2018, the General Assembly put a phase-in provision that limits the increase in the contribution rate for both CERS funds to 12%. He indicated that they are projecting for FY 2023, that the limit will be fully recognized for the CERS Non-Hazardous fund and unless something extraordinary occurs, it will be fully recognized in FY 2024 for the CERS Hazardous fund. Mr. O'Mara stated that, as a Board, it should not be a surprise that the unfunded liability does migrate to a higher amount over those 2 to 3 years while the phase-in is going in. Mr. White indicated yes, that it is a big ship to have to turn.

Ms. Shaw then discussed the CERS Hazardous Pension fund. She indicated that the potential volatility in future contribution rates for the CERS Hazardous Pension fund is higher than the Non-Hazardous fund because it has a higher leverage of liability to payroll. The CERS Hazardous fund has $9.6 versus the CERS Non-Hazardous fund having $5.7 in liability for every $1.00 in covered payroll. Ms. Shaw stated that similar to the CERS Non-Hazardous fund, the unfunded liability for the CERS Hazardous fund is currently expected to increase for another four years before beginning to decrease. Ms. Shaw indicated that absent investment volatility and future gains or losses, the fund is expected to be 100% funded in 2049. Ms. Shaw then stated that similar to the CERS Non-

Hazardous fund, unfunded liability for the CERS Hazardous fund is no longer effectively being financed if the amortization period continues to be reset back to 30 years. Mr. White spoke and indicated that the biggest risk GRS sees is the contribution risk. It is the not getting the contributions, whether due to the resetting of the amortization period by the legislators, or whether the employers will make efforts to reduce their covered payroll in order to reduce their pension costs, which in a cost-sharing plan, just means that someone else has to pay. After the presentation, Ms. Pendergrass stated that she would like for Mr. Foster, Mr. Owens, and herself to meet and to add this particular report to an Actuarial Committee Meeting for additional discussion.

Dr. Hackbart introduced agenda item *Review of FY 2021 Investment Results*. Mr. Steven Herbert began by indicating that this a view of the quarterly and monthly review prior to the split and these reports are specifically for the County Employees Retirement System. The reports are still a work in progress and he is hopeful that he will be able to bring better robust reporting going forward. Mr. Herbert reviewed the following: Total CERS Non-Hazardous and CERS Hazardous: Asset Allocation vs Targets as of June 30, 2021, and then, Total CERS Non-Hazardous and CERS Hazardous: Risk Categorization Summary as of June 30, 2021. Ms. Pendergrass asked a question about where the information about CERS long-term yields, 5, 10, 20 years was. Mr. Herbert indicated that this was the first reporting completed since the split and that reporting will be included in the future reports going forward. Dr. Hackbart asked if it would be ready by the next meeting or before. Mr. Herbert responded that it should be complete prior to the next meeting. Mr. Herbert then reviewed the Total CERS Non-Hazardous and CERS Hazardous: Risk Categorization Performance as of June 30, 2021; the Total CERS Non-Hazardous and CERS Hazardous: Detailed Performance as of June 30, 2021; the Total CERS Non-Hazardous and CERS Hazardous: Asset Allocation Over Time as of June 30, 2021; and the Total CERS Non-Hazardous and CERS Hazardous: Summary as of June 30, 2021. Mr. Herbert then reviewed the same reports for the Insurance Trust Funds. Mr. Herbert stated that it was a decent quarter and good year.

Dr. Hackbart introduced agenda item *RMS Platform Development.* Mr. Herbert introduced the new Research Management Software. It is a software application that will allow staff to centralize their research, from documents and notes to commentary and reviews. The main features of this platform is to centralize the manager research assets, bring efficiency to the research process, educate the Board, compliance governance, to track activity, capture interactions and it is linked to eVestment data. Mr. Herbert then shared a few slides of what the program wall would look like and how this tool will be beneficial to the Investment team. Dr. Hackbart asked if this will be up and running by January of next year. Mr. Herbert indicated that yes, as of right now staff has all of the current managers in there, in terms of their strategies and returns and staff is working hard on inserting the guidelines. Mr. Herbert is hoping to have that complete by the end of this year. Dr. Milkman asked as a Board member, would they have access to this program. Mr. Herbert indicated that he would be able to share read-only documents if needed. Dr. Hackbart asked if Mr. Herbert was to get a question, if he could provide a document to the Trustees as a response to the question. Mr. Herbert indicated that yes, it could be done.

Dr. Hackbart introduced agenda item *Public Equity Manager Search.* Mr. Herbert began by indicating that he learned the day before the meeting that the President of Axiom Investors is leaving the company at the end of 2021. The reason given for his departure is for personal reasons and the company has agreed to let him leave at the end of the year and search for other employment opportunities. He was brought in back in 2014 to provide management relief to the CEO and his duties were not tied to the investment management portion of the company, but rather operational and administrative in nature. Staff are continuing to analyze the information to see if it would have any effect on the investment management areas, and staff thinks it will not, but are following this closely. Will it affect the overall firm? Staff are looking at that, as well. Staff feels they should proceed with the presentation and proceed to seek the approval for hire. Instead of the usual Board presentation and selection process, it was suggested that CERS could do one of three things. Staff could bring this item back to the CERS Board at their November meeting for reaffirmation of the decision to engage Axiom, or continue the review process as listed on the agenda, or dropAxiom from consideration altogether. Mr. Herbert turned the presentation over to Mr. Gilbert to continue the review process. Mr. Gilbert gave a presentation of the External Manager Search and recommendation on the retention of an investment manager of the Non-US Small Cap Equity mandate. This search was completed in conjunction with Wilshire Associates. The recommendation of staff is to fund an actively managed Non-US Small Cap Equity mandate to be managed by Axiom Investors pending successful investment management agreement negotiations. This investment will be funded through liquidation of current Non-US Small Cap

Equity mandates. Mr. Gilbert indicated that the report contains a review of the competitive search process utilized by staff in accordance with the Investment Policy Statement and the Investment Procurement Policy in the pursuit to improve market access with the Non-US equity allocation. Mr. Gilbert indicated that there was a vast number of managers, and in order to reduce the numbers that would be reviewed, screening criteria was set up between staff and Wilshire Associates. The preliminary screening provided a broad candidate list of 83 potential strategies. Additional screening reduced the list down to 11 firms, who then received a Request for Information. From these, a short list of 5 firms were chosen for further review. These final candidates were allowed to host presentations, and from there, additional discussions with the front-runner was held prior to the final decision.

Mr. Gilbert provided an overview of Axiom, which was founded in 1998 and is headquartered in Greenwich, Connecticut. It is a 100% employee owned company whose focus is on global, international and emerging market strategies. Ms. Pendergrass asked a question about how much of the company did the president own. Mr. Gilbert did not know that answer to that question, and was not sure that the company would release that information. He indicated that he would inquire about, and if he gets a response, he will certainly report to the Board his findings. Mr. Gilbert reviewed Axiom's Investment Philosophy and Investment process. Dr. Milkman asked how long does Axiom typically keep a company before they would sell it off. Mr. Gilbert indicated that it seems they would review a company after a 2 year period of time. Dr. Hackbart asked about their client base, in other words, do they manage any other pension funds. Mr. Gilbert responded that pension funds make up about 28% of their client base. He reported that 55% of their clients have been with them for 5 years or more. Mr. Gilbert reviewed Axiom's performance charts over a 5 year period of time. Mr. Gilbert then reported on the Implementation and Sizing, Management Fees, and Third Party Provider and Placement Agent Disclosure. The recommendation is to engage Axiom Investors in the International Small Cap Equity Strategy with the initial funding of approximately $159.2 million (3.2%) with the option to grow or add to total 5% of the Non-US Equity allocation. The primary funding is to come from the existing Northern Trust (Pension) and BlackRock (Insurance) Non-US small equity mandates. Dr. Hackbart asked if someone with Wilshire Associates was present at the meeting. Ms. Johnson indicated that Chris Tessman and Craig Morton were present. Mr. Gilbert announced that Mr. Tessman was his main point of contact with Wilshire during this search process. Mr. Tessman stated that from a qualitative perspective, Axiom, is on Wilshire's focus list for the International Small Cap Equity Managers. Mr. Tessman wanted to answer a few questions that had been asked during Mr. Gilbert's presentation. One of those being about the ownership aspect of Axiom. Mr. Tessman reported that there are 20 owners across Axiom, with the largest owner being the CIO. It is typical business practice for an individual such as the President to not hold a very large percentage of ownership. He expressed his willingness to try and get that information for the Board if that information should be made available. Mr. O'Mara wanted to express his thanks to Mr. Gilbert for going through such a detailed explanation of the due diligence and research on this matter. He also stated that as a new Board member he has found this very educational and informative for the type and depth of the research completed in order to bring this presentation before the Board. Mr. O'Mara then stated that from the presentation, there were 2 strategies that scored very high and he wanted to know what set Axiom apart from the other strategy that also scored high. Mr. Gilbert then stated that all 5 of the finalists are quality managers and firms and he feels that there would not be any issues working with any of those firms. Mr. Gilbert explained that Axiom's strategy was more in line with what the KPPA investment team felt would be a better fit. Mr. Eager asked to provide a few comments. He began by indicating, for the newer Trustees, that he has spent his whole career in institutional investments, so he does have some background in these types of matters. Mr. Eager stated that it is not uncommon for the President of an investment management firm, particularly mid-size or larger firms, to be a non-investment person. This is essentially a non-event, and even though it does not have an effect the investments, the outcome cannot be predicted. Mr. Eager gave his perspective that if the Committee liked the presentation, and wanted to proceed with a vote on the recommendation, the Board should do that. However, since there are unknowns, the Board could bring it back for a vote at the November meeting. The risk of waiting would be if Axiom outperforms the current small cap equity mandates in place. The risk of going ahead is unknown. Mr. Eager indicated that from his perspective, the proper decision is to wait, but affirm the vote today. Mr. Gilbert wanted to address statement of the president of the company leaving as being a non-event. He indicated that he does not deem it material. Mr. Gilbert indicated that most of these firms require their portfolio managers to invest in the portfolio they manage, so the likelihood of the portfolio managers leaving the firm for another, is highly unlikely. Mr. Gilbert wanted to reiterate that even with a vote today, it will take months to get the funds moved and staff can certainly monitor the outcome, if any, from the news received regarding the resignation of the president of Axiom. Mr. Eager responded that should the committee so yes, the contract negotiations could then begin, not execute it, but there are some things we can do in the meantime. Mr. Gilbert indicated that there are several things we can do, we can begin to work on the IMA and get funds moved to be in a position once the agreement is finalized, all based on the Board's direction. Mr. Gilbert expressed his concerns about how long the process would stretch out. Mr. Herbert stated that Axiom is the recommendation. If the Committee votes on it, Mr. Herbert recommends voting to approve the recommendation, pending an update at the November meeting, on this issue if the Committee were to vote yes. Ms. Hale indicated that the Board would then ratify the action of the Investment Committee at the next meeting. Mr. Cheatham had a concern or question regarding the size of Axiom, and not knowing the size of their other clients, what kind of risk there is should they be forced to sell out of a particular asset in order to meet redemptions should a client be looking to get out for this reason, or another one. Mr. Gilbert answered that the size of the company does not matter as all of the firms are investing the same, otherwise, they would not be in the small cap equity market, they would have to move to the large cap or other market. Mr. Herbert indicated the risk is actually the opposite, and that small cap managers with too many assets under management can detract from performance (causing them to creep up the cap scale). Mr. Gilbert indicated that we do monitor for the rise in the amount of funds the firm is handling. If it gets to be too high, then the question becomes if they can effectively manage our investment. Dr. Milkman made a motion and Mr. O'Mara seconded to retain Axiom Investors as the manager for the Non-US Small Cap Equity mandate, subject to final approval at the November meeting and successful contract negotiations. The motion carried.

Dr. Hackbart introduced agenda item *Investment Policy.* Mr Owens indicated that the CERS Investment Policy is still being edited and revisions are still ongoing. This policy will be brought forth at a later meeting for consideration.

Mr. Powell made a motion and Dr. Milkman seconded to adjourn the meeting. The motion carried.

Copies of all documents presented are incorporated as part of the Minutes of the Special Called County Employees Retirement System Investment Committee meeting held August 25, 2021.

CERTIFICATION

I do certify that I was present at this meeting, and I have recorded the above actions of the Committee on the various items considered by it at this meeting. Further, I certify that all requirements of KRS 61.805-61.850 were met in conjunction with this meeting.

Recording Secretary

I, as Chair of the Investment Committee of the Board of Trustees of the County Employees Retirement System, do certify that the Minutes of Meeting held on August 25, 2021 were approved by the Committee on November 3, 2021.

Committee Chair

I have reviewed the Minutes of the August 25, 2021 Investment Committee Meeting of the Board of Trustees of the County Employees Retirement System for content, form, and legality.

Office of Legal Services