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## KENTUCKY RETIREMENT SYSTEMS INVESTMENTS

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TO: Kentucky Retirement System Board of Trustees

FROM: David Peden, Interim Chief Investment Officer

DATE: September 11, 2014

SUBJECT: Investment Committee Quarterly Report

The Investment Committee held its regularly scheduled meeting on August 5, 2014. The purpose of the meeting was to evaluate investment activities, program structure, management, controls, and performance results of the Pension and Insurance Funds, for the quarter ending June 30, 2014, along with various other subjects.

The meeting began with approval of the minutes for the previous Investment Committee meeting held on May 6, 2014.

KRS Investment Staff and consultant Albourne recommended an investment of \$65 million in Taurus Mining Finance Fund for the KRS real return asset class. All five pension systems and all five insurance systems will receive an allocation to this investment. This recommendation was approved by the KRS Investment Committee. No placement agents were used to source this investment.

KRS Investment Staff and consultant Albourne recommended an investment of \$50 million in BTG Pactual Timberland Fund I, LP for the KRS real return asset class. All five pension systems and all five insurance systems will receive an allocation to this investment. This recommendation was approved by the KRS Investment Committee. No placement agents were used to source this investment.

KRS Investment Staff and consultant Albourne recommended an investment of \$50 million in Oberland Capital Healthcare LP for the KRS real return asset class. All five pension systems and all five insurance systems will receive an allocation to this investment. This recommendation was approved by the KRS Investment Committee. No placement agents were used to source this investment.

KRS Investment Staff and consultant RV Kuhns recommended changing the benchmark for the Internally Managed TIPS portfolio to the Barclays 1-10 Year TIPS Index from the Barclays 30 Year TIPS index. This recommendation was approved by the KRS Investment Committee and the portfolio will be appropriately rebalanced to match the new benchmark.

KRS Investment Staff and consultant PCA recommended an investment of \$60 million in Crestview Partners III LP for the KRS private equity asset class. All pension systems except KERS Non Hazardous and all five insurance systems will receive an allocation to this investment. This recommendation was approved by the KRS Investment Committee. No placement agents were used to source this investment.

KRS Investment Staff and consultant PCA recommended an investment of \$100 million in Duetsche Bank Secondary Opportunities Fund III LP for the KRS private equity asset class. CERS Non Hazardous and CERS Hazardous Pension and all five insurance systems will receive an allocation to this investment. This recommendation was approved by the KRS Investment Committee. No placement agents were used to source this investment.

KRS Investment Staff and consultant PCA recommended an investment of \$50 million in Vista Equity Partners V LP for the KRS private equity asset class. All pension systems except KERS Non Hazardous and all five insurance systems will receive an allocation to this investment. This recommendation was approved by the KRS Investment Committee. No placement agents were used to source this investment.

KRS Investment Staff and consultant Albourne discussed the termination of an investment with MKP Capital Management, which was an absolute return manager. No action was needed by the investment committee.

KRS Investment Staff and consultant RV Kuhns discussed the termination of an investment management agreement with Geneva Capital Management. Geneva was a manager with a mid cap equity growth mandate. No action was needed by the investment committee.

RV Kuhns presented a formal proposal to conduct an asset liability study for all five pension systems and all five insurance systems and the proposal was approved by the investment committee.

Erica Bradley, the KRS Compliance Officer, presented two audits, which she had completed and presented to both the investment committee and the audit committee. The first was a public equity and fixed income manager audit. Refer to the memo attached to this summary document for the audit recommendations and the investment staff's response. The investment committee heard the audit recommendations and staff's response, but had no further comment for the audit committee. Investment staff will discuss and work with the investment committee to incorporate the changes recommended by the audit committee. The second audit presented was an audit of the Statement of Investment Policy, the Investment Transaction Procedures Policy, and the Securities Trading Policy for Trustees and Employees. Refer to the memo attached to this summary document for the audit recommendations and the investment staff's response. The investment committee heard the audit recommendations and staff's response and had no further comment for the audit committee. Investment staff will discuss and work with the investment committee to incorporate the changes recommended by the audit committee.

Erica Bradley presented the Quarterly Compliance Report. The investment performance for the fiscal year end was discussed by David Peden, Interim CIO. It was also noted that all the standard

reports were included in the board books and that if there were any questions, staff was available anytime via phone or email to discuss those reports. The standard quarterly reports include the Monthly Performance Update, Investment Division Budget Report, quarterly Manager Meeting and Related Expense Tracking Report, Internally Managed Portfolio Asset Report, Internally Managed Portfolio Transactions Report, Securities Lending Report, Domestic Equity Commissions Report, Global Equity Commissions Report, and Securities Litigation Report.

One addition to the Approved Broker Dealer List was reviewed and approved by the Investment Committee.

At various points throughout the meeting each consultant present was given an opportunity to describe their due diligence process, explain what a consultant recommendation actually means, and give details of their on-going manager monitoring process.

Staff gave the investment committee an update on the status of Camelot Acquisition Partners LP. The fund formerly known as Camelot Acquisition Partners LP is now known as CN Growth Partners I, LP and is managed by Ken Latz of Conway MacKenzie.

The investment committee also discussed if it's possible to reduce the length of the investment committee meetings. No conclusions were reached and the topic will be discussed further.

***Please see the next page for a summary of the Pension and Insurance performance information ending June 30, 2014.***

<b>Pension Funds Performance Overview</b>								
<b>Rates of Return (%) as of June 30, 2014</b>								
	<b>One Year</b>		<b>Three Years</b>		<b>Five Years</b>		<b>Ten Years</b>	
	<b>Fund</b>	<b>Index</b>	<b>Fund</b>	<b>Index</b>	<b>Fund</b>	<b>Index</b>	<b>Fund</b>	<b>Index</b>
<b>Equity</b>	22.45	22.96	10.06	10.43	14.66	15.18	7.17	7.03
<b>Fixed Income</b>	7.05	5.20	5.85	4.22	7.16	5.42	5.52	5.21
<b>Private Equity</b>	22.71	22.71	15.43	15.43	17.18	20.20	10.79	9.99
<b>Real Estate</b>	8.06	12.74	9.16	11.99	9.11	6.31	N/A	
<b>Absolute Return</b>	8.46	5.08	7.03	2.71	N/A		N/A	
<b>Real Return</b>	8.99	5.67	6.62	4.91	N/A		N/A	
<b>Cash Equivalents</b>	0.61	0.04	0.38	0.05	0.58	0.08	2.12	1.54
<b>Total Fund</b>	15.55	14.91	8.59	8.84	11.97	11.91	6.78	6.84

<b>Insurance Funds Performance Overview</b>								
<b>Rates of Return (%) as of June 30, 2014</b>								
	<b>One Year</b>		<b>Three Years</b>		<b>Five Years</b>		<b>Ten Years</b>	
	<b>Fund</b>	<b>Index</b>	<b>Fund</b>	<b>Index</b>	<b>Fund</b>	<b>Index</b>	<b>Fund</b>	<b>Index</b>
<b>Equity</b>	22.25	23.05	9.84	10.34	14.21	14.79	6.94	6.71
<b>Fixed Income</b>	6.52	5.20	5.62	4.22	6.57	5.88	5.84	5.41
<b>Private Equity</b>	22.07	22.07	14.60	14.60	17.88	20.36	8.95	9.35
<b>Real Estate</b>	7.07	12.74	8.34	11.99	9.11	6.31	N/A	
<b>Absolute Return</b>	8.37	5.08	6.95	2.71	N/A		N/A	
<b>Real Return</b>	8.56	5.65	6.10	4.90	N/A		N/A	
<b>Cash</b>	0.22	0.04	0.30	0.05	0.29	0.08	1.94	1.54
<b>Equivalents</b>								
<b>Total Fund</b>	14.89	15.03	7.48	8.71	12.10	13.02	6.28	6.50

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RECOMMENDATION: The Board is requested to ratify the actions of the Investment Committee.



## KENTUCKY RETIREMENT SYSTEMS INVESTMENTS



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To: Erica Bradley, Compliance Officer  
Connie A. Davis, CIA, Director, Director of Internal Audit

From: David Peden, Interim Chief Investment Officer

Date: August 5, 2014

Subject: Audit Response: Public Equities and Fixed Income Audit

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I have reviewed the Public Equities and Fixed Income Audit Report referenced in the subject line and have responded to the three recommendations as follows.

### Findings and Recommendations

#### **Recommendation 1:**

The insurance contracts renew annually. Investment personnel should work with managers to ensure deductibles on the renewed policies are reduced and that additional coverage is obtained for the manager that needs it. Furthermore, insurance coverage should be reviewed as a regular function of the KRS Investment Director's annual manager review.

**Response:** Investment Staff agrees that the review of the E&O insurance policies of each manager should be part of the annual review process and should be documented in the annual reviews.

#### **Recommendation 2:**

The Compliance Officer noted regarding target allocations at the manager level; given the securities market fluctuations, it would be a better practice to have the investment committee approve investments with external managers as a percentage of total portfolio rather than a set dollar figure. Additionally, investments staff should maintain a list of managers with their approved investment percentages and monitor the assets KRS invests with each manager.

**Response:** The Investment Staff agrees that as part of the initial approval process for a manager by the KRS Investment Committee, that a percentage of total fund be approved and not a specific dollar amount for each manager. This is because of the time lag between approval and the actual funding date and the value of the total portfolio may have significantly changed. The investment staff currently does maintain a list of targets for each investment manager and uses that to assist in the rebalancing process. The

Investment Staff does not agree that this approved percentage should apply in the future. Given the nature of the rebalancing process at the asset class and manager level, there needs to be more flexibility than a static percentage. This responsibility has always fallen to the CIO to manage the ongoing exposures of each manager.

**Recommendation 3:**

Investment personnel should work with managers to make certain they establish and maintain sufficient controls around the “most favored nation” provision review.

**Response:** It is difficult to force a manager to adopt an internal process after we have invested. Investment staff can incorporate into its due diligence process a question regarding how a manager tests for compliance with MFN provisions it has agreed to with other clients. Investment Staff will also require a specific statement from each manager to be included in annual compliance letters stating the manager is in compliance with the MFN provision as spelled out in the IMA.

**Audit’s Conclusion**

Based on the review of KRS’ external Public Equity and Fixed Income managers, it was concluded that overall, the majority of the managers are complying with the terms of the contracts and have adequate controls established given legal and regulatory obligations. The deficiencies noted in this review create a concern regarding the monitoring of contracts and their terms with external investment managers. It is recommended that investment personnel work with the managers to ensure the managers are compliant with contracted provisions and establish appropriate controls over insurance and MFN coverage. It is recommended that controls be established at KRS so that contracts with external investment managers are continually monitored.

**Response:** The Investment Staff receives a compliance letter from most, if not all, equity and fixed income managers annually. The content and format of those letters vary from each manager. Staff will work with the managers to develop an annual compliance letter that specifically addresses items such as E&O insurance and MFN status among other key items addressed in the IMAs. Staff will also put in place a process for ensuring receipt of said compliance letters from each public equity and fixed income manager.



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## KENTUCKY RETIREMENT SYSTEMS INVESTMENTS



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To: Erica Bradley, Compliance Officer  
Connie A. Davis, CIA, Director, Director of Internal Audit

From: David Peden, Interim Chief Investment Officer

Date: August 5, 2014

Subject: Audit Response: Investment Policy, Personal Trading Policy, Investment Transaction Policy

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I have reviewed the Audit Report referenced in the subject line and have responded to the three recommendations as follows.

### Findings and Recommendations

#### Recommendation 1 – Statement of Investment Policy:

- A. Language be amended or added to the policy to reflect the impact that 2013 Kentucky Senate Bill 2 had on the governance of Kentucky Retirement Systems.
- B. Language should be added to this policy specifying the statutory language pertaining to limiting investment manager to fifteen percent (15%) of the assets in the pension and insurance funds. Additionally, it is recommended that language be added to state the total assets assigned to any external manager shall not exceed twenty-five percent (25%) of that external manager's total asset under management and the assets invested in public markets shall not exceed forty percent (40%) of the external manager's total assets in that strategy, unless specifically waived by the investment committee.
- C. The Chief Investment Officer, Deputy Chief Investment Officer and Director of Equity work together to develop formal, written governing plan documents for internally managed domestic equity index accounts.

#### Response:

A) Investment staff has attempted to update the IPS in prior updates with the SB2 language and if further changes need to be made to fully update with SB2 changes staff will make those changes.

B) The fifteen percent limit to any money manager is a state statute that investment staff is aware of and monitors. Staff has no problem adding it to the IPS. Staff is supportive of a twenty five percent limit to an external manager's total assets under management and a

twenty five percent limit to any comingled investment vehicle, such as a mutual fund, comingled fund, or limited partnership. Investment staff would prefer to not have a limit at the manager's strategy level if KRS's assets are held in a separate account at BNY Mellon because of the customization process between the external manager and KRS regarding those relationships.

C) The Chief Investment Officer and the asset class Director will be responsible for developing internal guidelines for any strategies managed in-house and getting those approved by the Investment Committee. Those guidelines will be included in the Investments Transactions Policy and a reference to that policy will be included in all appropriate places in the IPS. It should be noted that both strategies currently managed in-house are passive mandates with full replication being the primary strategy, but investment staff agrees this is a good policy change and appropriate for any active portfolio management that may occur in the future.

#### Recommendation 2 – Securities Trading Policy for Trustees and Employees:

- A. Language should be added to the policy to address OFAC considerations and prohibit OFAC violations. It is also recommended that an OFAC compliance program, tailored to KRS' risk profile should be established that would include specific, cohesive policies, procedures and controls. The program should implement policies that clearly identify KRS Trustees or Employees with authority and accountability for OFAC compliance.
- B. Language should be added to address KRS employees and trustees establishing a "good until canceled", limit or open order in their personal trading accounts. It is recommended that as long as the KRS Employee or Trustee does not have actual knowledge of a manager's transaction in a security, there should be the option to have the open order approved in pre-clearance.
- C. Language surrounding remediation should be strengthened so that it clearly state that KRS Employees and Trustees cannot participate in a determination of whether he or she violated this policy, that KRS Employees and Trustees cannot pre-clear their own transactions and that violating any portion of the policy is taken seriously and consequences may occur.
- D. Language surrounding pre-clearance should be amended to require all investment committee members to pre-clear personal transactions in non-exempt securities and require Trustees subject to pre-clearance to provide brokerage statements disclosing the names and type of each of their securities holdings and holdings of family members as a first-line of defense to identifying potentially problematic trading behavior.

#### Response:

- A) Investment staff is supportive of incorporating OFAC compliance into the personal trading policy.
- B) Investment staff is supportive of the recommendation regarding personal Good-Until-Canceled orders.
- C) Investment staff is supportive of the recommendations regarding self pre-clearing trades and remediation if a violation occurs.

D) Investment staff is supportive of any person that has possible direct knowledge of trading activity in the KRS portfolio being covered by the Personal Trading Policy. If the Investment Committee defines trustees as those with possible knowledge of trading activity, then investment staff is supportive of KRS Trustees being covered in the Personal Trading Policy.

Recommendation 3- Investment Transaction Policy:

Language should be added to assigning responsibility for regulatory filings to Investment Directors along with updating “Investment Manager” to “Investment Director” to align with KRS job titles language.

Response: Investment staff is supportive of adding language to the Investment Transaction Policy defining responsibility for regulatory filings and agrees to the use of the title Investment Director when referring to those with specific asset class responsibilities.

Conclusion:

Certain investment policies could be improved to better adhere to laws and provide guidance and compliance on pertinent investment issues.

Response: Investment staff agrees that better coordination with all of the investment policies and state statutes will improve the governance of the investment program and reduce the possibility of staff or an external manager overlooking a compliance item. It should be noted that in every investment management agreement that staff references all policies and state statutes as a requirement for the manager to comply with, in addition to the specific language in each investment management agreement.