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TO: Public Pension Oversight Board Members

FROM: LRC Staff

DATE: May 23, 2015

RE: Calendar Year 2015 Investment Performance Update

Summary

Returns from each of the state administered plans struggled to keep pace with actuarial assumptions during the 2015 calendar year. As shown in the table below, the two Judicial Form Retirement System (JFRS) plans posted the strongest returns of 3.5% and 3.8%, which also exceed their respective benchmark returns. The Kentucky Teachers Retirement System (KTRS) also performed well relative to its benchmark, but posted a return of only 0.5% for the year. The Kentucky Retirement Systems (KRS) portfolio was basically flat for the twelve month period, which fell short of its policy benchmark return.

Taking a longer-term approach, the plans have posted strong returns over the past 3- and 5-year periods, but only the Legislative and Judicial Retirement Plans have exceeded their return assumption over the past 10-year period.

	1YR	3YR	5YR	10YR
KERS Pension	**0.2%**	**5.7%**	**5.8%**	**5.1%**
Policy Benchmark	1.3%	6.6%	6.3%	5.5%
KERS-H Pension	**-0.2%**	**5.6%**	**5.7%**	**5.1%**
Policy Benchmark	0.3%	6.3%	6.2%	5.5%
SPRS Pension	**-0.2%**	**5.7%**	**5.8%**	**5.1%**
Policy Benchmark	0.1%	6.3%	6.1%	5.4%
CERS Pension	**-0.5%**	**5.6%**	**5.7%**	**5.1%**
Policy Benchmark	0.2%	6.3%	6.1%	5.4%
CERS-H Pension	**-0.5%**	**5.4%**	**5.6%**	**5.1%**
Policy Benchmark	0.1%	6.3%	6.1%	5.4%

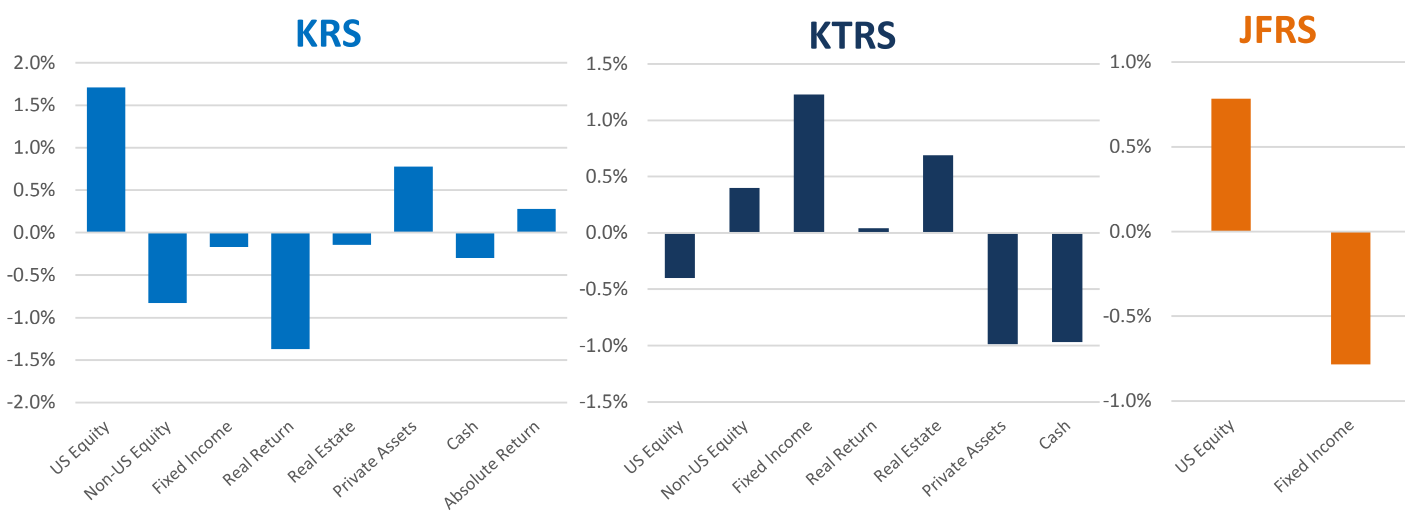
	1YR	3YR	5YR	10YR
KRS Pension (COMBINED)	**0.0%**	**5.8%**	**5.8%**	**5.2%**
Policy Benchmark	0.6%	6.5%	6.3%	5.5%
KTRS Pension	**0.5%**	**9.1%**	**8.3%**	**6.3%**
Policy Benchmark	(0.3%)	8.0%	7.7%	-
LRP Pension	**3.8%**	**14.0%**	**12.5%**	**8.0%**
Policy Benchmark	1.5%	10.9%	9.6%	6.6%
JRP Pension	**3.5%**	**13.8%**	**12.4%**	**7.9%**
Policy Benchmark	1.5%	10.9%	9.6%	6.6%

Peer Groups	**1YR**	**3YR**	**5YR**	**10YR**
LRC Calculated *38 Plans*	0.4%	7.5%	7.4%	5.8%
BNY Mellon Total Public Fund *117 Plans*	0.2%	-	7.0%	5.9%
TUCS Public Fund > 1 Billion	0.4%	7.8%	7.4%	6.0%

There were no significant changes to the asset allocation of any of the three systems since the end of the 2015 fiscal year. The charts below show the percentage change for each asset class, which were largely due to market movements or cash flow activity over the six-month period.

% Change in Asset Allocation

Since June 30, 2015



The KRS Board of Trustees has approved new target allocations for all five underlying plans and each portfolio will be rebalanced during early 2016. Most notably, the allocation to public equities, both U.S. and abroad, will increase slightly, while traditional fixed income assets will serve as a primary funding source. KRS intends to continue utilizing a healthy allocation to alternative assets, but will slightly reduce most plans allocation to real return assets.

Market Review

The calendar year of 2015 proved to be a tough year for investors. The median return of the BNY Mellon Public Plan Universe was just 0.16% gross of fees for the twelve month period. Traditional assets, such as public equities and fixed income, were significantly impacted by a tough third quarter. Bright spots were limited and quite dependent on the market cap or a few stocks. A few key themes for the 12-month period are below:

- While the S&P 500 rose 1.4% during the year, the index's price only return (removing dividend yield) was relatively flat at 0.7%. Taking a deeper dive into performance, you find that the Top 10 stocks produced an average return of 23.4%, while the remaining 490 stocks averaged a loss of 2.0% for the year. Most notably, a handful of technology stocks, known in the industry as FANG (short for Facebook, Amazon, NetFlix, and Google) posted an average return of 83% and were all in the Top 10 performers of the S&P 500 index.
- Real Estate, both privately owned and publically listed (REITS), continued to perform well and was one of the few bright spots during the year. Private real estate continued its recent run of 24 consecutive quarters of gains, posting a total return of 15.1%[1] for the year. Publically listed real estate, while not as strong, finished the year up 4.2%[2].
- Historically low inflation expectations lead to sharp declines for assets that were correlated or tied to commodities, the U.S. dollar, or exports. Commodities, as measure by the Bloomberg Commodity Index, was the worst performer during the year (down 24.7%). Treasury Inflation Protected Securities (TIPS) also struggled during the period, falling 1.4%.
- In a period with higher volatility within public equities, bond markets did not provide the relief one might expect. The Barclays U.S. Aggregate Bond Index, which measures the investment grade, US dollar-denominated, fixed-rate taxable bond market, was up only 0.6% during the year. Below investment grade and global bonds fared worse, as the Barclays US Corp High Yield index fell 4.5% and the Citigroup World Government Bond fell 3.6%.

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[1] As measured by the NCREIF ODCE – Real Estate Index

[2] As measured by Wilshire U.S. Real Estate Investment Trust (REIT) Index

Below is a summary of returns for each of the underlying retirement plans.

Kentucky Retirement Systems:
The combined KRS portfolio was effectively unchanged for the period, posting a net of fee total return of -0.02%. This trailed the return of its policy benchmark return of 0.64%. Plan level returns ranged from 0.20% (KERS) to -0.50% (CERS). A few contributing factors to the relative underperformane were:

- Manager performance from several asset classes:
  - U.S. Equity – KRS domestic equity portfolio fell -0.95% for the period, which trailed the benchmark return of 0.48%. The underperformance was driven by the funds allocation to external managers, most notably within the funds large and mid-cap market cap allocations.
  - Real Return – Outside of emerging market equites, real return was the worst performing asset class for KRS, posting a return of -6.0% and trailing its benchmark return of -4.1%. Two of the portfolio's largest positions, the PIMCO All Asset Fund (-7.9%) and a Magnetar Energy fund (-15.6%) drove the majority of relative performance.
  - Real Estate – The funds real estate portfolio was one of the strongest performing assets classes for KRS, posting a return of 8.9%, however this trailed the index return of 13.9%.

At the individual plan level, the KERS fund was notably the only fund to provide a positive return during the calendar year. While the return did not meet the higher benchmark hurdle, a lack of emerging market equity (down 14.6%) and lower global equity (down 3.5%) served to benefit the plans total return when compared with the other 4 plans.

Kentucky Teachers Retirement System:
The KTRS pension portfolio posted a total return of 0.5% (gross of fees) for the period, exceeding the return of its policy benchmark return of -0.3%. The above benchmark performance was largerly driven by:

- Manager performance from several asset classes:
  - Non-U.S. Equity – While Non-U.S. equity markets fell during the calendar year, the KTRS portfolio of managers collectively protected the fund against the negative returns. KTRS's portfolio fell only 2.4%, compared to the -5.3% return from the MSCI All Country World Ex-US Index.
  - Real Estate – Both the non-core and core portfolios of KTRS provided strong, above benchmark returns. The non-core portfolio, which consists of seven real estate limited partnerships, was the funds best performing group of assets, posting a return of 24.0% versus 13.3% from its index. The Core portfolio, which is managed by Prudential Real Estate Investors also performed nicely, earning 16.1% and outperforming is index by just over 1%.
  - Timberland – Although a small allocation, the portfolio's timberland portfolio was only outperformed by real estate. KTRS's portfolio posted a return of 10.6% over the calendar year, which more than doubled the NCREIF Timberland Index.
  - Direct Lending and Global Distressed Debt – Some of the portfolio's more recent allocations to European debt and lending strategies served to partially offset negative returns from the portfolio's alternative credit and high yield portfolios.
- These positive factors were partially offset by underperformance from U.S. equity managers (-0.1% versus 1.0 index return) and performance from the portfolio's alternative credit allocation.

Judicial Form Retirement System:
Both of the JFRS funds posted strong returns during the period, in excess of 3.6% (gross of fees), which outperformed the 1.5% return from their policy benchmark. The excess performance was entirely driven by the following factors:

- Manager Outperformance – All JFRS assets are managed by Hilliard Lyons, who manages a Large Cap equity and investment grade bond portfolio. Over the 12 month period, both of the portfolios performed above their benchmark, which served to add excess value. Most notably, the Large Cap equity portfolio earned 4.0% for the period compared to 1.4% from the S&P 500. On the bond side, JFRS assets grew 1.8% compared to 1.1% from the Barclays Gov/Credit interim Bond index
- Overweight to U.S. Equity – Both the JRP and LRP portfolios held approximately 75% of assets in large cap equity assets, which is slightly above their target of 70%. Large Cap equities (1.4%) outperformed bonds (1.1%) during the year, so having more assets allocated to the higher returning asset class also served to add some value over the calendar year.