KANSAS

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

KPERS Testimony on HB 2411

House Committee on Pensions & Benefits

January 25, 2012

Chairman Holmes and Members:

Thank you for the opportunity to appear today and provide testimony on HB 2411.

HB 2411 would require the Retirement System to identify all investments in "scrutinized companies," which are defined as companies defined as having "with actual knowledge, on or after August 5, 1996, made an investment of $20 million or more in Iran's petroleum sector which directly or significantly contributes to the enhancement of Iran's ability to develop the petroleum resources of Iran." Once those companies are identified, the System would be required to engage the "scrutinized companies," encouraging them to cease their scrutinized business activities or make them inactive, in order to avoid divestment by the System. If the "scrutinized companies" fail to do so within 90 days, the Board would be required to divest of those investments within twelve months. House Bill 2411 requires the Board to file a report with the Joint Committee on Pensions, Investments and Benefits listing the "scrutinized companies" within 30 days after the list is created, and annually thereafter, detailing the activities taken with respect to "scrutinized companies," and listing all investments which were divested and all investments remaining in "scrutinized companies."

It is important to note at the outset that the Retirement System does not invest in any Iranian companies or in debt securities issued by the government of Iran. The Retirement System has no desire to support terrorism or states that sponsor terrorism. However, in considering the potential effects of a requirement that KPERS proceed with divestment of scrutinized companies as well, there would be both costs to KPERS and fiduciary implications for the KPERS Board of Trustees.

Cost to KPERS.

HB 2411 is expected to increase the System's costs in several ways:

(1) Administrative costs for subscriptions to third party research services to assist in identifying the "scrutinized companies" from which to divest;

(2) Administrative costs in terms of investment staff time required to identify the "scrutinized companies," correspond with the companies, communicate required divestment to investment managers, prepare and present reports to the KPERS Board and the Joint Committee, and monitor investment holdings;

(3) Transaction fees for the sale of investments in "scrutinized companies," and reinvestment in alternative investments; and

(4) Potential opportunity costs from lost investment opportunities due to the inability to invest in "scrutinized companies."

We are unable to provide precise estimates of each of these costs. However, we do understand that the cost to subscribe to a third party research service would be over $10,000 per year. We expect that the investment staff time required to comply with the System's existing Sudan divestment requirements as well as new Iran divestment requirements could be as much as 0.25 FTE for an investment analyst. One of the System's international equity managers has estimated transactions costs at 6 to 7 basis points for the international equity portfolio, which could make the transactions costs significant, depending on the extent of the divestment activity needed to comply with HB 2411. The impact on the System's total investment losses or gains resulting from divestiture cannot be estimated at this time. However, one of the System's passive international equity index managers has estimated the tracking error that results from Sudan divestment requirements at 0.25% to 0.30% of the total indexed international equity portfolio. Estimates of total opportunity costs range as high as 0.50% to 0.60% of total investments per year. As you can see, these costs are difficult to estimate and highly variable. However, we do expect that they will be significant and could cost the System millions of dollars.

Fiduciary Implications.

Perhaps more importantly, we question whether public pension funds are the appropriate place for attempts to influence foreign policy. KSA 74-4901 requires that the assets of the System be invested to preserve capital and solely to provide benefits to members and their beneficiaries. The Board of the Retirement System has a fiduciary duty to invest the assets of the System for the exclusive benefit of the participants in the System, and is held to a prudent expert standard of care. However, the participants in the Retirement System, and current and future taxpayers in the State of Kansas, will bear the costs of divestment requirements. Restrictions which limit the System's ability to invest in particular assets reduce investment opportunities and can result in less efficient investment portfolios (lower expected return and/or higher investment risk). Constraints which limit the System's investment opportunities in order to achieve foreign policy goals cause the Board to deviate from the principal of producing maximum total returns at a prudent level of risk.

Investment restrictions such as Iran divestment increase the System's administrative and investment costs, and may result in significant additional costs for participants and taxpayers. Targeted divestiture could be a "slippery slope" opening the System's assets to a wide variety of special interest calls for divestiture of particular asset types. While each initiative in isolation may seem relatively benign, the cumulative impact of several statutory divestment requirements could be quite material in nature.

Thank you for your thoughtful consideration of my testimony on HB 2411. I would be happy to answer any questions which you may have.

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