KPERS Testimony on HB 2461

House Committee on Pensions & Benefits

January 25, 2012

Chairman Holmes and Members:

The Retirement System has requested the introduction of House Bill No. 2461, which contains changes to the statutory language governing the System's alternative investments. Specifically, we are asking for a change in the statutory language that would allow annual net new investments (contributions minus distributions) in the alternative investment portfolio that do not exceed 5% of the total market value of the investment assets of the System (as measured at the end of the preceding calendar year). Currently, the statutory restriction is at the 1% level. For example, at the end of 2010, the System's total net asset value was $12.86 billion, which meant that the statutory limit on new alternative investments was $128.6 million for 2011. Although the Board approved commitments at that level in 2011, because capital is typically called by general partners in stages over multiple years, actual capital invested was approximately $87 million. In addition, distributions from existing partnership investments totaled nearly $134.2 million in 2011. Therefore, net cash flow (contributions minus distributions) from the alternative investments portfolio was a negative $47.18 million in 2011. We are requesting an increase in the annual limit from 1% of the total portfolio value to 5%. In 2011, that would have raised the annual limit on net new commitments to alternative investments from $128.6 million to $643 million.

All of the other current statutory restrictions on alternative investments would remain in place, including the requirement that there be at least two other institutional investors. We are asking that this statutory language be updated from "sophisticated investors" to "qualified institutional buyers" in accordance with the current language in rule 144A in the Securities Act of 1933. Other statutory restrictions include: a limit on the System's investment to 20% or less of the total partnership; the requirement that the System has received a favorable recommendation from a qualified, independent expert; the investment must be consistent with the Board's written investment policy; and the investment must not exceed 2.5% of the total alternative investments. In addition, the Board must have received and considered the investment manager's due diligence findings on the investment, and the System must have policies and procedures in place to ensure that the investment is properly monitored and investment performance is accurately measured.

The KPERS Board of Trustees recently received an analysis from the System's general investment consultant, PCA Investment Advisors. PCA determined that the current 1% limit is so small that, even if the System invests the entire 1% allocation each year, the allocation is unlikely to grow to a meaningful percentage of the total fund level that would positively impact portfolio returns. The current 1% limit disadvantages the fund as the Board seeks to prudently achieve the 8% actuarial return target at the lowest level of risk. Because of the 1% constraint, the portfolio is compelled to invest heavily in publicly-traded equities in order to provide the majority of portfolio growth. (Current equity targets are 30% domestic equity and 29% international equity, for a total allocation target of 59% global equity.) Raising the restriction on alternative investments from 1% to 5% per year in net new commitments would allow the Board to increase its target allocation to alternative investments, which would result in a more efficient investment portfolio. A meaningful increase in the alternative investments allocation would improve diversification and lower the total risk of the portfolio, while also raising the probability of achieving the 8% return assumption.

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

Elizabeth B. A. Miller, CFA
Acting Executive Director & Chief Investment Officer
Kansas Public Employees Retirement System