Kansas Public Employees Retirement System

Alternative Investments

Presentation to Kansas Legislature, 2012 Session

HISTORY

Background

- In 1992, the Kansas legislature amended K.S.A. 74-4921 to define and govern "alternative investments" made by the Kansas Public Employees Retirement System.

- In 1997, the Board contracted with Portfolio Advisors LLC, and initiated a private equity investment program.

- By the end of 2000, commitments of $1.0 billion were made to 52 partnerships, managed by 36 general partners. Invested capital totaled $413 million with a market value of $446 million, or 4.5% of the total fund. These private equity investments represented the majority of KPERS' "alternative" investments.

- The steep equity market correction of 2000-2002 reduced the value of the KPERS total fund to a degree that the value of the private equity investments exceeded the 5% maximum, ultimately rising to a high of 5.95% in March 2001. This phenomenon is commonly referred to as the denominator effect.

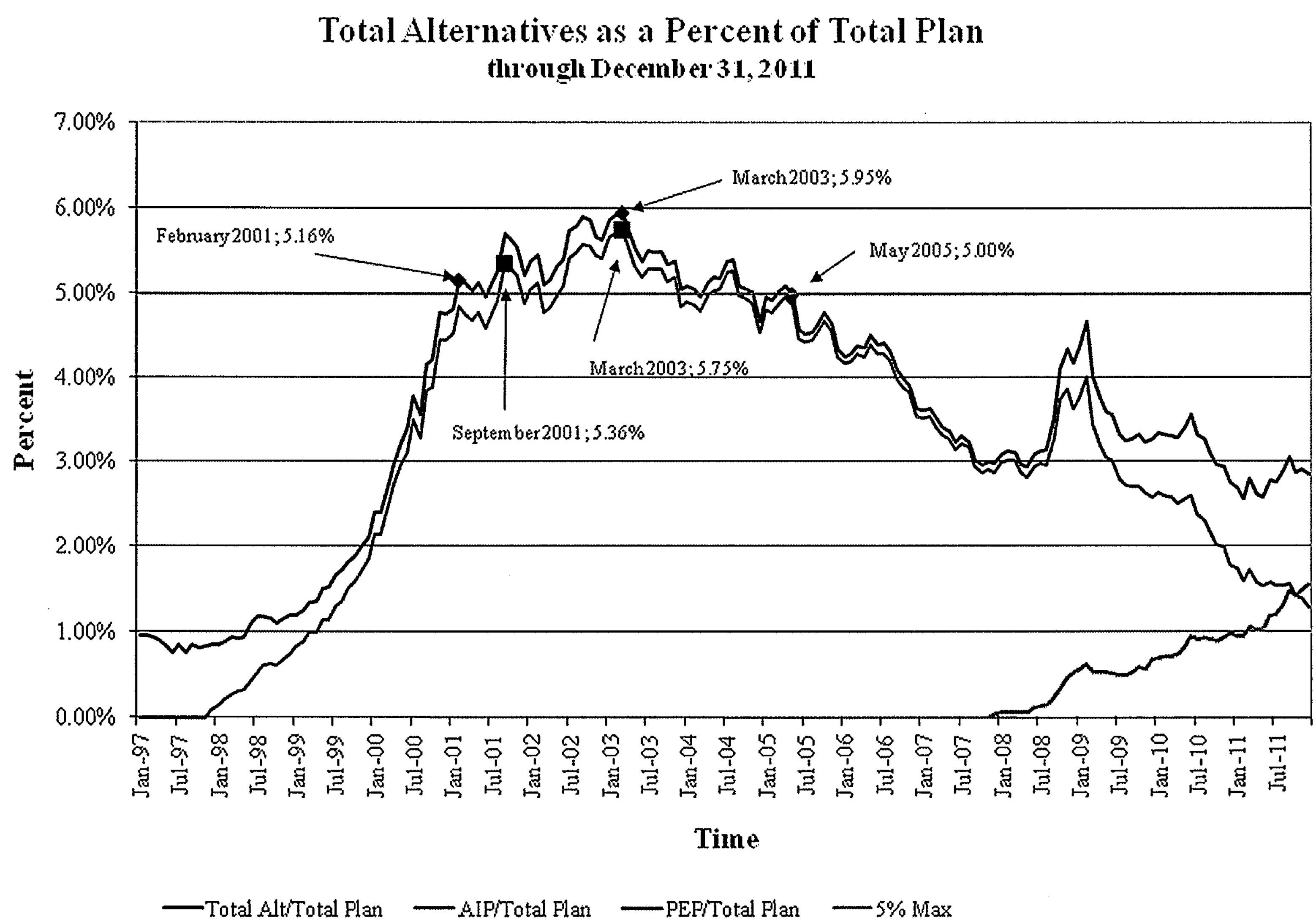
- New commitments to private equity were halted in February 2001 due to the allocation exceeding the 5% statutory cap of total plan assets.

Background, cont.

- In the Fall of 2003, KPERS requested that the Joint Committee support a bill to lift the 5% limit. After debate and discussion, the Joint Committee introduced a bill changing the 5% cap to a 1% annual limitation on alternative investments, which passed in the 2004 session.
- In the 2004 asset/liability study, the Board confirmed its 5% allocation to private equity.
- In November 2007, the Board approved its first new private equity commitment since the halt in February 2001. The value of the Board's alternative investments (primarily private equity) stood at $428 million or 3.0% of the total fund.
- In January 2008, the Board hired LP Capital Advisors to advise on rebuilding the private equity program, and raised the target for private equity investments to 6% of the total fund.
- In 2011 as a result of the asset liability study, PCA recommended a target of 5% for private equity investments to be phased in over time.
- As of December 31, 2011, KPERS had committed to 21 different funds totaling $504 million of commitments (PEP only) resulting in an aggregate private equity allocation of 2.8% of the total fund.

EXPERIENCE

Background, cont.



DEFINITIONS

What is an "Alternative Investment"

- K.S.A. 74-4921(5)(b)(viii) states:
  - For purposes of this act, "alternative investment" means nontraditional investments outside the established nationally recognized public stock exchanges and government securities market. Alternative investments shall include, but not be limited to, private placements, venture capital, partnerships, limited partnerships and leveraged buyout partnerships.
- Historically and presently, KPERS' direct investments made pre-1991 and private equity partnerships and related investments are accounted for together as "alternative" investments. Private equity partnership investments made from 1997-2001 continue to represent the majority of these assets. Other investments that have characteristics similar to the definition of "alternative" investments, but are held in the publicly-traded portion of the portfolio, are monitored against the limits to "alternative" investments imposed by K.S.A. 74-4921(5)(b)(i).
- Real estate and timber investments are separately provided for in K.S.A. 74-4921(5)(c) and are not included as "alternative" investments.

PRIVATE EQUITY

The Primary Alternative Investment: Private Equity – What is it?

Privately negotiated investment transactions that typically result in a significant minority or majority ownership stake in companies where the manager exerts significant influence on the company

- Investments are typically made directly into private companies
- Buyouts of public companies often result in a delisting of the entity's public equity

Legal structure of the investment vehicles ("funds") is most often comprised of limited partners and a general partner

- Accredited investor and/or Qualified Institutional Buyer (QIB) status is generally a requirement that must be met
- Long holding periods that typically extend from 10 to 15 years

Types of Investments

- Venture Capital – Financing of newly formed entities, or those with limited to no revenue or earnings
- Growth equity – Typically minority investments (< 50% ownership) in higher growth companies
- Buyouts – Acquiring a controlling (> 50% ownership interest) in more mature private companies or public companies
- Distressed debt – Purchasing debt securities trading at significant discounts to par value
- Mezzanine debt financing – Providing subordinated debt to a company

Investment Vehicles

- Direct investments / Co-investments – Utilized by sophisticated investors to invest directly into companies, typically alongside a private equity manager
- Fund investment – Vehicle formed by a single manager (the "GP") and other institutional investors (the "LPs") to make underlying investments into companies at the GPs discretion
- Fund of Funds – Vehicles formed to invest in other single manager private equity funds, typically reserved for niche markets or investors with limited resources

REQUIREMENTS

Statutory Requirements and Staff Procedures Applied to Private Equity

Process-oriented Requirements

"[T]he system has received a favorable and appropriate recommendation from a qualified, independent expert in investment management or analysis in that particular type of alternative investment." – K.S.A. 74-4921(5)(b)(iv).

- *The private equity consultant provides a written report of due diligence results, analysis and recommendation for each new investment or reinvestment. In addition, they restate the System's statutory requirements and provide a response to each.*

"[T]he alternative investment is consistent with the system's investment policies and objectives as provided in subsection (6)." – K.S.A. 74-4921(5)(b)(v).

- *The System's Statement of Investment Policy, Objectives, and Guidelines is provided to and approved by the Board of Trustees annually, as prescribed by statute. Staff and our consultants understand and comply with the Statement.*

"[T]he board has received and considered the investment manager's due diligence findings submitted to the board as required by subsection (6)(c)." – K.S.A. 74-4921(5)(b)(vii).

- *The private equity consultant's written due diligence report is provided to the Investment Committee or the Board of Trustees prior to making a commitment.*

"[P]rior to the time the alternative investment is made, the system has in place procedures and systems to ensure that the investment is properly monitored and investment performance is accurately measured." – K.S.A. 74-4921(5)(b)(viii).

- *KPERS staff has successfully implemented revised processes and procedures. Specifically, a new monitoring and investment performance measurement system (Private I) through our custodian. Further, KPERS private equity consultant, LP Capital Advisors, independently gathers partnership data in order to produce both monitoring reports and quarterly performance reports. Staff in turn reconciles multiple reports produced by these two independent entities.*

LIMITATIONS

Statutory Requirements and Staff Procedures Applied to Private Equity, cont.

Investment Limitations

"[I]f in addition to the system, there are at least two other sophisticated investors, as defined by section 301 of the securities and exchange act of 1933." – K.S.A. 74-4921(5)(b)(ii).

- *As part of the due diligence process, the private equity consultant and staff verify that institutional investors, including public pension plans of similar size or larger than KPERS have made commitments to the proposed fund.*

"[T]he system's share in any individual alternative investment is limited to an investment representing not more than 20% of any such individual alternative investment." – K.S.A. 74-4921(5)(b)(iii).

- *The 20% limitation is calculated for each partnership commitment when the commitment is made and again at final closing. However, this requirement seems to reference direct placement or co-investments in which the System does not currently participate.*

"The total of such alternative investments made . . . in any one individual multi-investor pool shall not exceed more than 20% of the total of alternative investments made by the system pursuant to this subsection." – K.S.A. 74-4921(5)(b)(vi).

- *The 20% limitation is calculated for each partnership commitment when the commitment is made and again at final closing. KPERS Private Equity Program invests in individual multi-investor pools. As such this requirement is applicable and may be substituted for Subsection 5(b)(iii) as presented above.*

"[T]he individual alternative investment does not exceed 2.5% of the total alternative investments made under this subsection. If the alternative investment is made . . . in a multi-investor pool, the 2.5% limitation . . . is applied to the underlying individual assets of such pool and not to investment in the pool itself." – K.S.A. 74-4921(5)(b)(vi).

- *The 2.5% limitation is calculated based on KPERS' share of the underlying assets in the multi-investor pool.*

PROCESS

Private Equity Due Diligence Process

Sourcing
- Independent sourcing by LPCA and KPERS

Initial Screening
- Independently review and score
- Discuss potential fit with the PE strategy and allocation targets
- Monthly discussion to identify funds to move into preliminary analysis

Preliminary Analysis
- Calls or meetings with management
- Identification of potential overlap with existing strategies
- Independently written summaries from LPCA and KPERS staff
- Assess timing of closes in our decision to move a fund to detailed due diligence

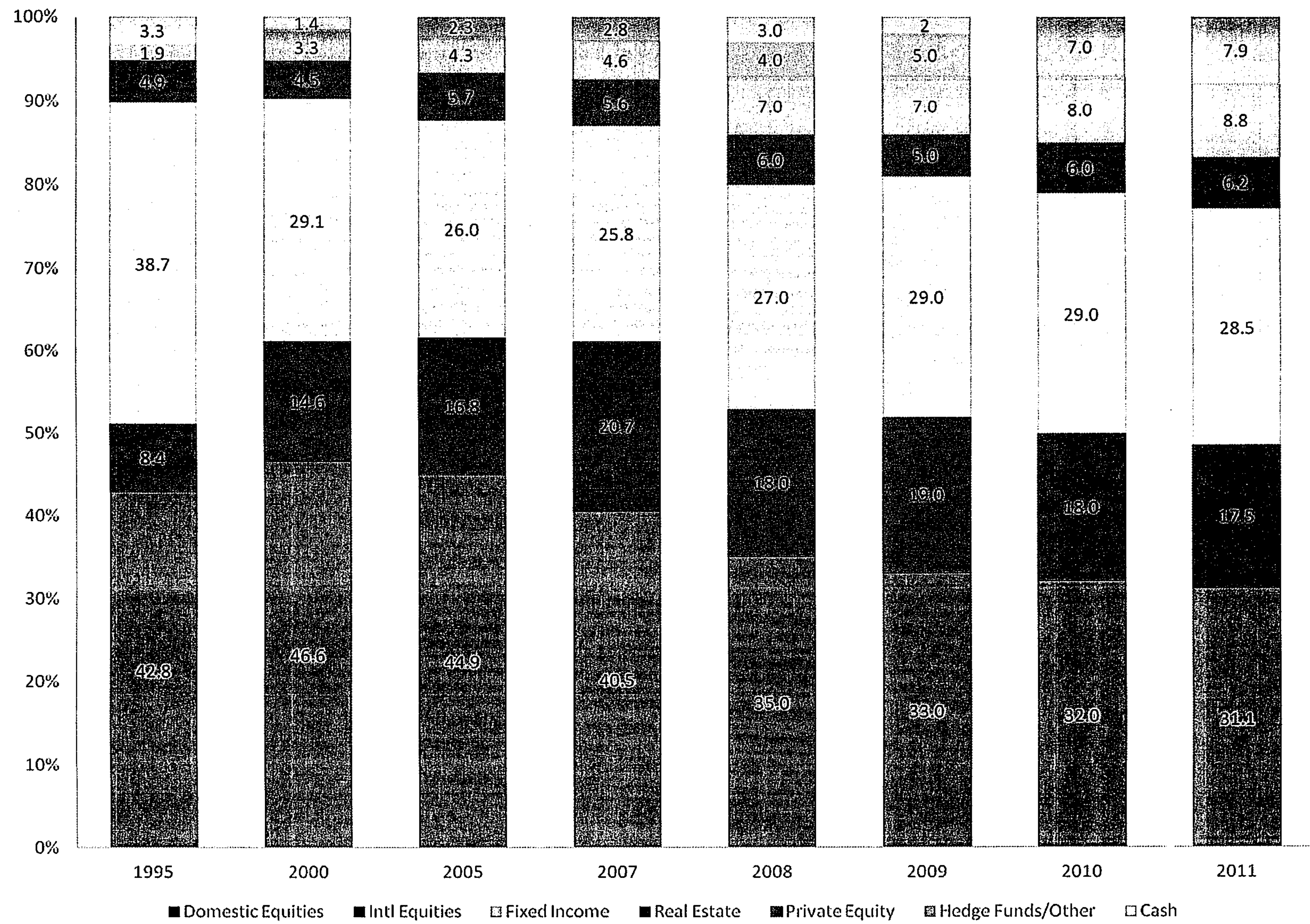
Detailed Due Diligence
- Site visit
- Review of PPM and supporting documents
- Reference calls
- Performance analysis
- Identify potential conflicts of interest or litigation

Legal Review
- Compliance with statutes
- External legal counsel review of legal documents and agreements

Monitoring
- Quarterly calls with fund mgmt
- Quarterly performance reports
- Annual meeting attendance
- LPCA monitoring reports

PEER UNIVERSE

How Are Other Investors Like Us Allocated?



Source: PCA, Greenwich Associates, Wilshire, Journal of Pension Economics and Finance

PERFORMANCE

AIP and PEP Return History Over Various Time Periods

Returns as of June 30, 2011				
	1 yr	**3 yr**	**5 yr**	**10 yr**
Time-weighted[1]	24.9%	7.5%	10.9%	8.4%
Dollar-weighted[2]	21.6%	6.1%	10.7%	7.3%
KPERS Alternative Investment Benchmark[3]	35.4%	7.1%	6.4%	6.9%
S&P 500	30.7%	3.3%	2.9%	2.7%

1 Time-weighted return as reported in KPERS Investment Performance Report.

2 Dollar-weighted return, also known as internal rate of return (IRR), is used as the industry standard for reporting. IRR calculation is based on the compounded return of a series of cash flows. IRR calculations based on June 30, 2011 valuations, if available as of September 21, 2011, or cash-adjusted valuations based on March 31, 2011 valuations. There can be no assurance that the indicated valuations for unrealized investments accurately reflect the amount for which the subject investments could be sold.

3 The current KPERS Alternative Investment Benchmark is the Russell 3000 Index + 3%. From July 2000 to March 2008 the benchmark was an age-weighted average of the Russell 3000 Index + 4% and the Merrill 0-1 Year Treasury Index. From July 1995 to June 2000 the benchmark was the S&P 500 Index + 4%.

SUMMARY

Summary of Issues

- Opportunities in alternative investments have grown significantly since the statutes governing these investments were passed and revised; allocations to these assets by public pension funds like KPERS have risen.

- Private equity, in particular, has become nearly as prevalent in portfolios similar to KPERS' as real estate.

- Statutory "cap" limits on these growing assets have proven difficult to manage. The 5% cap of the original statute amendment was exceeded when the equity markets corrected deeply in 2000-2002 and shut down the Board's first attempt at a private equity program; the newer 1% per-year limitation effectively limits total private equity exposure to approximately 4% of the total portfolio.

EFFECT OF LIMITATIONS

What Happens if the 1% Limitation is Not Increased?

- Private equity investments would likely never exceed 4% to 4.5% of assets. Regardless of the success of the private equity portfolio, an allocation of this size cannot drive portfolio returns in a meaningful way.
- The asset liability study and resulting target portfolio mix is sub-optimized as the model unsuccessfully seeks investments with a similar risk and return profile to private equity.
- PCA Investment Advisors' analysis indicates that increasing exposure to private equity and decreasing exposure to publicly traded equity could increase total portfolio expected return by as much as 30 basis points (0.3%), while maintaining a similar level of risk (standard deviation of return) to the current target portfolio. In addition, lifting the restriction on alternative investments increases the number of possible portfolio asset mix outcomes, resulting in a more efficient portfolio.
- Portfolio diversification is enhanced by reducing the global equity allocation and spreading the asset allocation more evenly across the portfolio, while portfolio return is enhanced by the higher expected return from the private equity asset class.

APPENDIX

Statutory Language: Suggested Changes

Definition of Alternative Investments

Original Definition

For purposes of this act, “alternative investment” means nontraditional investments outside the established nationally recognized public stock exchanges and government securities market. Alternative investments shall include, but not be limited to, private placements, venture capital, partnerships, limited partnerships and leveraged buyout partnerships.

Possible Revisions

For purposes of this act, “alternative investment” includes a broad group of investments that are not one of the traditional asset types of public equities, fixed income, cash or real estate. Alternative investments are generally made through limited partnership or similar structures, are not regularly traded on nationally recognized exchanges and thus are relatively illiquid, and exhibit lower correlations with more liquid asset types such as stocks and bonds. Alternative investments generally include but are not limited to private equity, private credit, hedge funds, infrastructure, commodities and other investments which have the above characteristics.

APPENDIX

Definitions

Committed Capital (Commitment)

A specified amount of capital a Limited Partner agrees to commit to a private equity investment over a specified period of time. This amount represents a maximum amount an LP agrees to invest.

Called Capital

Upon finding suitable opportunities to invest, the General Partners will drawdown capital against limited partners' committed capital to fund the investment opportunity. These drawdowns will occur over a pre-specified period, typically around 5 years, to fund investment opportunities as they arise. The difference between the committed capital and called capital is the unfunded commitment, or the amount of remaining capital the general partner can invest on behalf of the limited partner.

APPENDIX

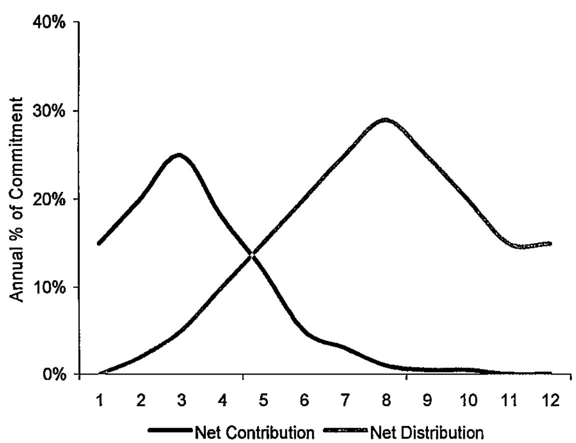
Committed and Called Capital

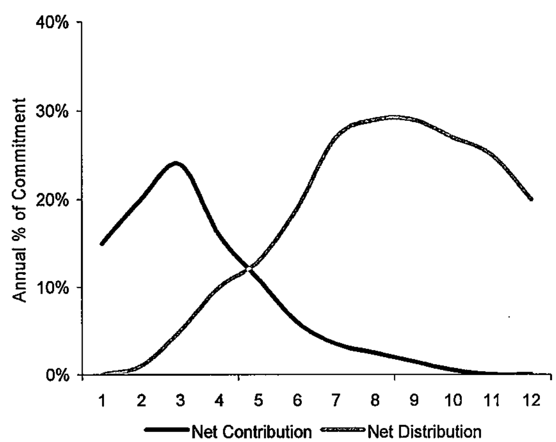
- Capital Call and drawdown pacing

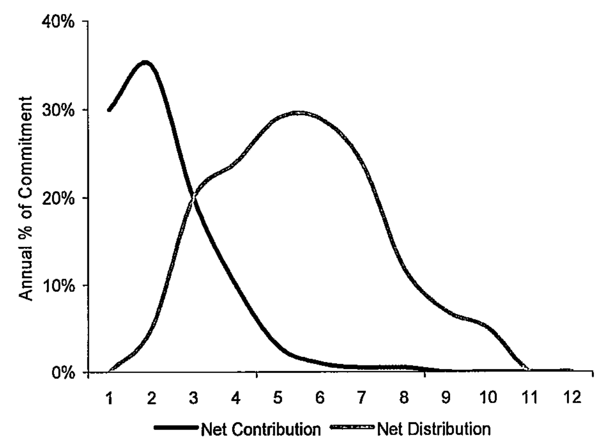
  Cash flows vary by fund style

  Annual net contribution and distribution estimated as percentage of the total fund commitment for each of the three styles based on historical experience blended with an assessment of current market conditions

Projected Net Contributions and Net Distributions by Fund Type







Source: LPCA model

Note: Projected cash flows reflect LPCA expectations based on historical trends, which may change in the future.

APPENDIX

Qualified Institutional Buyer (QIB)

Definition as stated in Rule 144A of the Securities Act of 1933:

Any of the following entities, acting for its own account, or the accounts of other qualified institutional buyers, that in aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers not affiliated with the entity:

1. Any insurance company as defined in section 2(a)(13) of the act
2. Any investment company registered under the Investment Company Act of 1940
3. Any small business investment company licensed by the U.S. SBA
4. Any plan established by a state, its political subdivisions, or any agency for the benefit of its employees
5. Any employee benefit plan with in the meaning of the ERISA Act of 1974
6. Any trust fund whose trustee is a bank or trust company and whose participants are exclusively plans of the types identified in section (a)(1)(i)(D) or (E) of this section
7. Any business development company as defined in the Investment Advisors Act of 1940
8. Any organization described in section 501(c)(3) of the IRS Code
9. Any Investment Advisor registered under the Investment Advisors Act of 1940