TEACHERS' RETIREMENT SYSTEM
of the State of Kentucky

TRS KENTUCKY

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August 21, 2019

The Honorable Mike Harmon
Auditor of Public Accounts
209 St. Clair Street
Frankfort, KY 40601

Dear Auditor Harmon:

The Teachers' Retirement System of the State of Kentucky (TRS) appreciates the work by the staff of the Auditor of Public Accounts in preparing this report and the opportunity to respond. TRS as an agency of the Commonwealth of Kentucky must comply with state law. TRS has complied with the letter and spirit of Senate Bill 2 (RS 2017) and other applicable laws and sought changes where needed. Therefore, with respect, TRS provides the following responses.

TRS Response to Finding 4: TRS follows the law consistent with SB 2 regarding contracts and contract information for fund of funds

SB 2 and the Kentucky Open Records Act support TRS's handling of investment contracts and fund of funds contract information. The law provides separate protections for certain investment information – first, to protect teachers' ability to invest competitively and, second, to protect proprietary investment information. This approach gives teachers access to the best investments to obtain the best returns.

The legislative history of SB 2 confirms TRS's compliance – including as amended by HB 489 (RS 2019), which reaffirmed teachers' ability to invest competitively.

SB 2 as introduced in 2016 did not include protections for information that is proprietary and that allows teachers to invest competitively. TRS advised the sponsor that this effectively would eliminate partnership investments as an asset class. The sponsor revised the bill in the committee substitute, which included the protections and passed the Senate (the bill did not pass the House). The 2017 SB 2 that became law maintained the protections (see KRS 161.250(5) and 61.878) from the 2016 Senate-passed measure.

In 2018, the Public Pension Oversight Board (PPOB) staff reviewed SB 2 compliance. The protections of sensitive information mentioned above were discussed during at least two PPOB meetings that year dealing with the compliance review. Subsequently, the legislature amended SB 2 in 2019 through HB 489, which eliminated an impediment that was causing TRS to be denied access to new partnership investments. That 2019 legislation kept the 2017 law's proprietary and competitive protections.

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Although partnerships account for a large number of overall investment contracts, they are about 11% of the TRS portfolio assets. TRS discloses substantive information about partnership investments (see attachment to Appendix C titled Investment Summary) consistent with Kentucky law. Additionally, TRS follows the common national norms for administering and reporting on partnership investments.

Without the protections reaffirmed by SB 2, TRS's ability to invest in partnerships for the benefit of teachers and taxpayers would be impaired. Teachers would be excluded from an asset class that diversifies their portfolio and has provided some of the best asset class net returns in recent years.

Partnership investments include many partners, including the general partner and numerous limited partners. Each partner has legal duties to the other partners. For one partner to disclose proprietary information unilaterally could breach the contract, harming the value of the investment for all partners and exposing the disclosing partner to penalties.

Disclosing the specific individual underlying managers or partners within a fund of funds investment telegraphs the strategy to everyone, negating its competitive advantage that is the foundation of business.

<u>TRS Response to Finding 5: TRS follows the law on carried interest consistent with SB 2</u>

The terms of SB 2 and the Kentucky Open Records Act support TRS's handling of carried interest. The law says certain information about investments may be withheld to protect both teachers' ability to invest competitively and proprietary investment information. This approach gives teachers access to the best investments to obtain the best returns.

Every general partner has asserted that carried interest is proprietary and confidential, the protection of which is a longstanding provision of Kentucky's Open Records Act that SB 2 affirmed. Because of this TRS is not required to report carried interest under SB 2.

If TRS disclosed carried interest, teachers' ability to competitively invest – something the legislature repeatedly has protected – would be impaired because teachers would be excluded from this high-performing asset class.

Carried interest for investments in private equity, real estate, energy, natural resources and infrastructure represents the general partner's share of the partnership's profits. This typically is

20% for the general partner, while 80% of the profits are for limited partners such as TRS. Generally, before the general partner takes profits, limited partners must be paid back their capital investment, interest on the capital investment (e.g., between 7 and 9%) and management fees.

The protections afforded by SB 2 make sense because carried interest is neither a fee nor an expense of TRS – it is the general partner's share of the profits. The profits TRS receives from partnerships are reported in financial reports according to accepted accounting principles. To consider carried interest a fee or an expense would be against generally accepted accounting rules and inflate both investment income and expenses.

TRS reports all fees in aggregate and by manager quarterly and in the CAFR regardless of whether the fees are paid directly from the trust funds or netted against investment income at the partnership level.

For one partner to disclose carried interest unilaterally when the general partner has asserted its confidentiality could breach the contract, exposing the disclosing partner to penalties.

Other comments and conclusion

The report discusses TRS's contact with a former staff attorney with the Office of the Attorney General who specialized in open records. In its March 28, 2019, response to the APA, TRS made clear that those contacts were over many years regarding open records issues relating to private equity investment and other matters. That response did not reference SB 2.

TRS reports every dollar paid out of teachers' retirement funds, including investment fees and expenses. So that the fees remain among the lowest in the country and returns remain among the highest in the country for teachers and taxpayers, the formulas behind the fees and other details are not released except as provided by law.

Kentucky's teachers need these partnership investments to diversify and help ensure their retirement security. Disclosing confidential contract terms, such as carried interest, risks potential litigation. Above that cost, the greater damage for teachers and taxpayers would be the exclusion of TRS from future investments in this asset class. These investments are a small but powerful engine producing significant investment income. TRS's private equity portfolio netted 10.18% (preliminary) for fiscal year 2019, which followed net returns of 18.98% in 2018, 9.61% in 2017, 2.7% in 2016, 11.66% in 2015 and 18.55% in 2014. This is part of a gross 10-year return of 13.41%.

Sincerely,

Gary L. Harbin, CPA
Executive Secretary