Wyoming

RETIREMENT SYSTEM

PARTNERING TO BUILD FINANCIAL SECURITY FOR MEMBERS AND THEIR FAMILIES

Report to the JAC

December 4, 2017

Wyoming Retirement System

Partnering to Build Financial Security for Members and their Families

Matt Mead
Governor

Ruth Ryerson
Executive Director

December 4, 2017

Senator Bruce Burns, Co-Chairman JAC
Representative Bob Nicholas, Co-Chairman JAC
VIA EMAIL
c/o Legislative Service Office

Dear Senator Burns and Representative Nicholas:

To accompany WRS' budget request, we are submitting this report which conveys recent recommendations from the WRS Board and responds to the latest requests from some of our legislative liaisons.

The WRS Board voted to support the recommendation from the Governmental Spending & Efficiency Commission's report pertaining to making benefit payments through WRS' custodial bank rather than the State Auditor's Office. We believe we have an opportunity for better service, efficiency and cost savings by making this change.

The WRS Board voted to recommend the legislature go forward with a modest 0.50% increase to contributions for the Public Employee Plan, to be split equally between the employer and the employee, and also adjust the refund provision in all pension plans to allow a refund of only the amount actually paid by the employee plus interest. We believe these are prudent steps to take at this time and will be meaningful towards reaching 100% funded status in 30 years. WRS plans to also launch a study to evaluate methods to better position WRS to achieve its long-term pension plan goal of full funding. We anticipate the study will be available in mid-summer 2018 and will bring the results forward at that time.

WRS seeks to provide superior long-term investment returns and believes an important aspect to our ability to do that is increased budget flexibility and additional tools to enhance our ability to attract, retain and reward talent. There are several potential ways to accomplish these goals. Along these lines, some of WRS' legislative liaisons requested WRS provide information about a plan for performance compensation and we have included that in this report.

We have included a copy of a recently developed brochure highlighting key differentiators for Wyoming's pension plans. We look forward to having a discussion when WRS meets with the JAC on December 6.

Sincerely,

Laura Ladd
Board Chair

Ruth Ryerson
Executive Director

Cc: JAC committee members and staff

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Purpose of Report

The purpose of this report is to inform the JAC of recommendations of the WRS Board, describe additional system needs and to meet statutory reporting requirements.

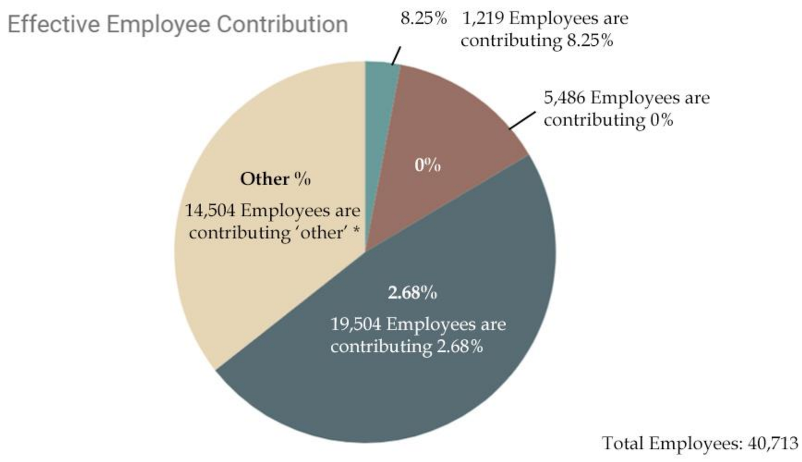
Recommendations

Response to Governmental Spending & Efficiency Commission's Report: The WRS Board voted in November to support the recommendation made in the report pertaining to having WRS's custodial bank issue retirement benefit payments rather than SAO. WRS found this to be the method used by many other pension systems. The report references a potential cost savings to the system of approximately $250,000 to $300,000, which is credible. WRS also believes making deposits directly to its custodial bank would allow WRS to keep money invested longer, which could increase earnings for the retirement fund. In order to implement this recommendation, a change to W.S. 9-3-408(a) would be necessary and we would rely on LSO to determine if there are any other statutory changes that should be considered in order to implement this recommendation.

Contribution Increase: The WRS Board voted in November to recommend the legislature implement a modest increase of one half of one percent to contributions for the Public Employee Plan, split evenly between employee and employer, starting July 1, 2018. WRS believes this amount of increase will be beneficial to plan funding under any circumstances, and it is most impactful when initiated sooner rather than later.

Change to Refund Provision: The WRS Board voted in November to recommend the legislature adjust the refund provision in all pension plans to allow an employee who has separated from service to be able to refund only the amount actually paid by the employee plus interest. It is estimated this change would reduce the contribution rate for the Public Employee Pension Plan by nearly one half of a percent.

Currently, a refund consists of the entirety of the employee's "member account," which includes the members' contributions plus interest, regardless of whether the employer "picked up" some or all of the member's contributions. See W.S. 9-3-412(c)(iii) for reference. Most participating employers pick-up at least part of the members' contribution, as shown in the following figure:



*Other: Employee contribution plans may vary based on employer policy

WRS recommends that any change to the account balance for refund purposes be prospective only and not impact existing member account balances, currently defined as the member contribution plus interest. WRS further recommends that any potential change to the definition of "member account" not impact pre-retirement death benefits, which are based on an amount equal to twice the member's account balance, nor benefit calculations for members eligible for a money purchase calculation, which is based on account balance. Members will also retain the right to leave their monies invested in WRS and receive the benefits they have earned. WRS stands by to work with LSO staff on the necessary statutory changes required in order to implement this recommendation.

Evolving Organizational Needs

The legislature and the Governor, having a material stake as funding partners of Wyoming's pensions, share in WRS' mission – *Partnering to Build Financial Security for Members and their Families.* The strength and stability of the fund is a top objective in executing on the mission. Maximizing investment return, which supports keeping contribution rates for employers and employees low, is our primary mechanism to meet this objective. We believe that the executive branch, the legislative branch and the WRS Board all share this objective.

In light of our shared goals, the WRS Board believes that a key component to maximizing returns is stabilizing and investing in an effective investment program. Although the WRS Board is authorized by W.S. 9-3-406(a) to fix compensation for WRS employees, that determination is subject to confirmation and approval by the personnel division of A&I and by the Committee. WRS appreciates the opportunity to explore with this Committee opportunities that would allow the WRS Board more flexibility in setting individual salaries but with appropriate safeguards for the legislature to ensure aggregate costs of the program are competitive and reasonable. The WRS Board believes this structural change will better position the System to deploy resources for the greatest impact, better positioning the System for long-term stability and success.

Aggregate Budget Authority: WRS believes that a budget model that would entrust the expenditure of System funds to the WRS Trustees for the investment function of WRS, in a gross amount subject to legislative oversight, would be in keeping with current statutory requirements and allow the WRS Board to better fulfill its fiduciary responsibilities.

WRS is three years into its 5-year plan implemented to build out and improve its investment function. As detailed in the Performance Compensation section of this report, longer tenure of investment staff improves the likelihood of outperforming the benchmark and better peer rankings. WRS annualized performance over the first three years of the five-year plan (2014-2016) was 3.9%, slightly below the custom benchmark performance of 4.0%. Performance of the trailing one and two-year periods over that time was greater than the custom benchmark. WRS has been successful in hiring some very talented investment professionals to fill its senior roles, and has built a positive relationship with the University of Wyoming to hire interns and analysts from Wyoming that help round out the team with professionals committed to the state. Yet, WRS believes it is time to expand upon the efforts noted in the 5-year plan.

Wyoming's salaries for investment staff are among the lowest when compared to peers. According to the 2017 McLagan Pension Funds Compensation Survey, WRS' Chief Investment Officer's compensation is below the lowest quartile and WRS ranks 33 out of 39 comparable positions. Senior Investment Officer compensation is at the lowest quartile and WRS ranks 19 out of 26 with comparable positions. In addition, WRS is continually exposed to the risk of losing investment staff because there is no ability to incrementally adjust compensation after staff gain experience or pass the Chartered Financial Analyst (CFA) exam (the consummate credential for investment professionals). In the event WRS has an open investment staff position, flexibility to accommodate personal preferences is needed to attract qualified individuals as we compete with endowments, insurance companies and other private sector employers.

Budgetary flexibility for WRS can be achieved while still meeting the oversight and reporting responsibilities shouldered by the legislative and executive branches of state government. Similar to the approach used for the University of Wyoming, Business Council and, most recently, the Treasurer's investment group, aggregate budget authority would enable the WRS fiduciaries to establish an employment and compensation program designed to create stability in this unique sector of state employment and maximize return from the $8 billion of retirement assets.

WRS' request for the Investment Unit in the 2019-2020 biennium budget of $4.3 million equates to approximately 3 basis points (0.003%) of total assets under management. (WRS' overall administrative expenses were 9 basis points in 2016, compared to 14 basis points nationally). A simplified and prudent approach would be to allow WRS aggregate budget authority for the Investment Unit not to exceed a pre-determined percentage of assets, competitive with the marketplace, with final approval for expenditures by the WRS Board. WRS would work with JAC and A&I to develop a reporting structure to meet the needs of the JAC and the Personnel Division for information and oversight.

The investment industry has a practice of aligning incentives with compensation based on performance. As would be expected, individuals in investment occupations are accustomed to this being a component of compensation. Acknowledging this expectation, our legislative liaisons asked WRS to provide a methodology for a performance compensation program.

Performance Compensation: Performance compensation is a type of compensation based on the investment performance of an entity, and is only earned for outperformance relative to specific measures. Performance compensation plans are designed to attract and retain key employees and align interests of employees and the state.

WRS' performance has likely been negatively impacted by high staff turnover, due in part to uncompetitive compensation. As a point of reference, neighboring states' average CIO salaries are ~37% higher than WRS (Exhibit A). Better staff stability should increase the potential for improved performance. For example, with relative stability within the investment team over the last three years, there has been a 77% improvement of returns over the basic 60/40 global benchmark (60% MSCI All Country World Index/ 40% Barclay's Global Aggregate Bond Index) when compared to the previous three-year period.

When constructing the WRS performance compensation plan, we have used the basic structure South Dakota uses to develop a conceptual framework. South Dakota has created a best-of-breed program relative to its peers and is logical to use as a model. We have also referenced other peer pension plans, and have had discussions with pension executive search professionals as well. Relative to the South Dakota plan, *we have made all of the terms either neutral or less attractive to the investment staff.* Based on these initial proposed terms, the maximum potential performance compensation of $735,000 would only be earned by the investment team if WRS earned at least $63,000,000 of additional value over its custom benchmark (Exhibits B and D).

Performance Compensation Terms

Economic Terms			
Term	**Peer Programs (See Exhibit C for details)**	**South Dakota**	**WRS Proposal**
Total Team Base Salary	Almost all based on public peer median pay. Several include private portion, which is higher	70% of private regional investment firms - significantly higher than peer median	While based on median peer compensation, it's currently bottom 3rd and 4th quartile
Max % of Base: CIO: Sr. Inv. Officer: Inv. Officer: Analyst:	 30-125% 30-125% 20-85% 5-45%	 200% 200% NA NA	 **100%** **75%** **50%** **25%**
Percent of Base Pay Earned (Linearly) Based on Hurdles Below: Hurdles (% outperformance relative to custom benchmark) 0.00 % 0.25 % 0.50 % 0.75 % 1.00 % 1.20 % 1.40 %	0-8% 0-50% 50-100% 50-100% 50-100% 100-125%	40% 70% 103% 122% 157% 187% 200%	**0%** **33%** **66%** **100%**
Max % Payout in Year 1 as % of Base (includes impact of vesting)	25-125%	200%	25%

Other Terms			
Term	**Peer Programs**	**South Dakota**	**WRS Proposal**
Vesting	Few (2-3 years)	None	**3 years**
Qualitative Portion	Most pay some. ~20% of total	None	**20%**
Quantitative Portion	All do. ~80% as quantitative	100%	**80%**
Peer Performance Comparison Portion	Almost none do	No	**No**

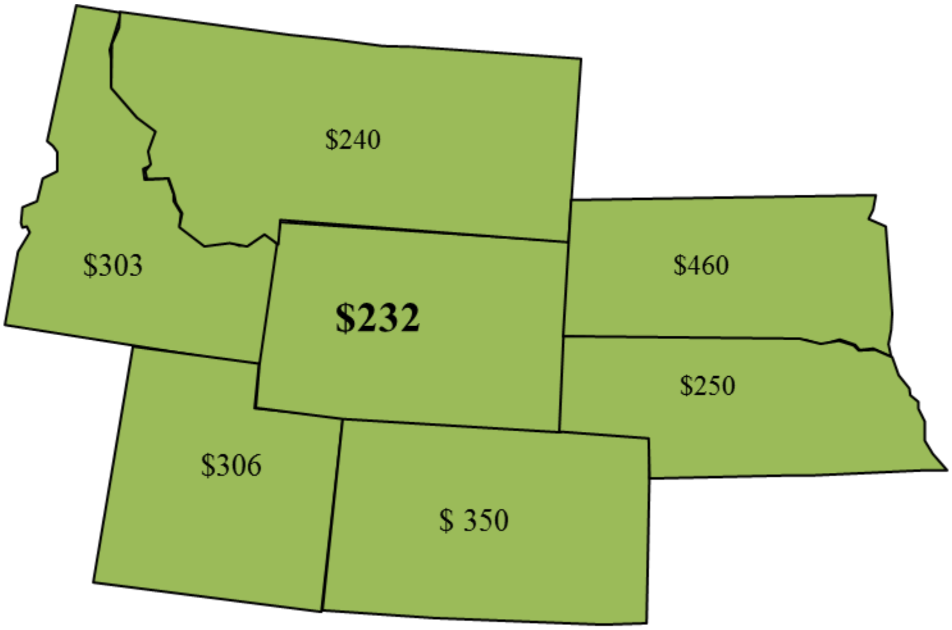
Performance Calculation Methodology	Varies, but generally 1, 3 and 5 years	For the first year of measurement, the 1, 4 and 10-year returns are all based on all available performance (1 year). For the second year, the 4, 10-year performance is based on the first two years annualized, and so on.	**The same as S. Dakota but based on 1-, 3-, and 5-year, similar to peers**
Stretch Comp	None, except South Dakota	Earned	**None**
Paid in down years	Yes	Yes	**Yes**
Performance Clawback	No	No	**No**

Benchmark Measures: Performance compensation will be based on the portfolio's custom performance benchmarks, which will be agreed upon by the general consultant. The breakpoints, or hurdles (outperformance over the custom benchmarks), have been determined in part by comparing the historical difference between the top quartile and the median performance for an appropriate peer set. On average, since 2012, this difference has been approximately 0.4% on a quarterly basis, and a 1.0% difference for the top 5% of peers.

Historical Performance: WRS annualized performance over the first three years of the five-year plan (2014-2016) was 3.9%, slightly below the custom benchmark performance of 4.0%. Performance of the trailing one and two-year periods over that time was greater than the custom benchmark. The WRS peer performance ranking over the three-year period was 61%, which was an improvement over the five-year and ten-year rankings of 63% and 79% respectively.

Conclusion: An effective performance compensation plan must provide for competitive compensation, yet still be cost-effective. Based on the proposed terms in this memo, WRS will only pay performance compensation if the plan outperforms its custom benchmarks. A functional performance compensation plan must be simple, predictable, material, and easy to understand. The terms proposed in this memo would achieve all of these goals and provide a better alignment of interests in order to better serve WRS' beneficiaries.

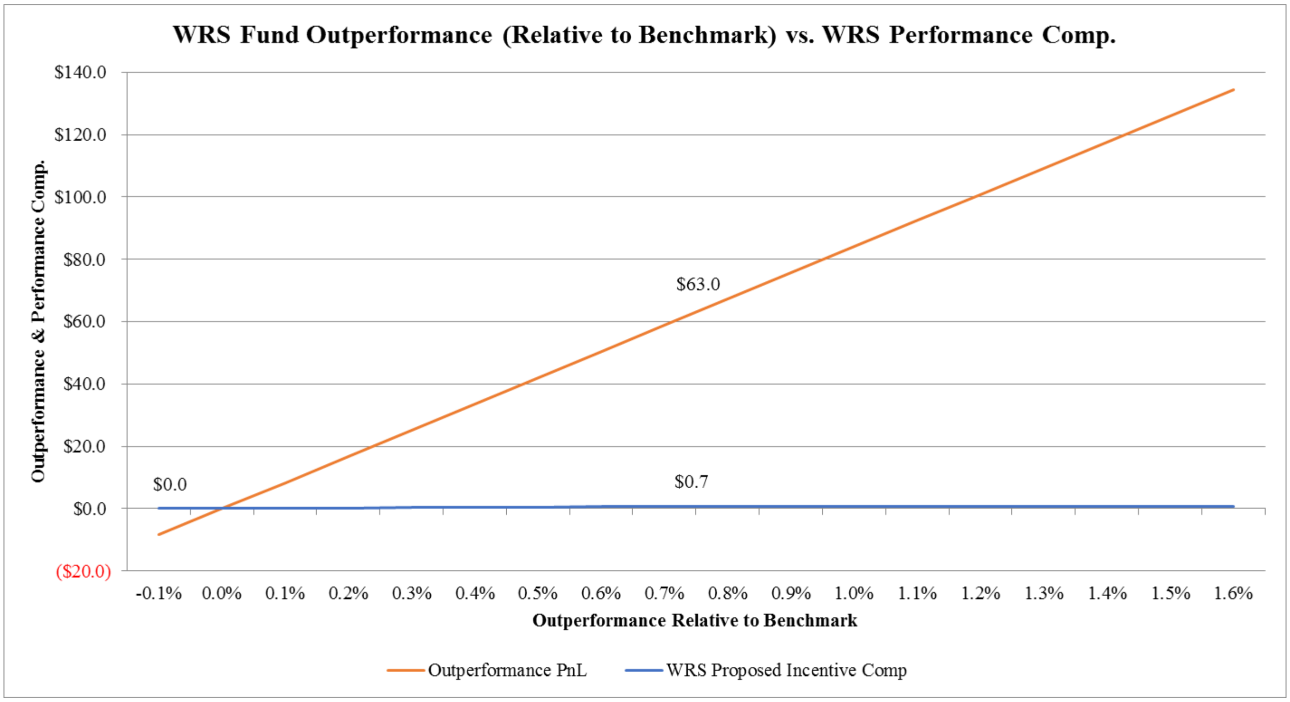
Exhibit A - State Pension Plans' CIO Base Pay



Legend (in $ Thousands)

Exhibit B - Performance Compensation Comparison Charts

Based on the discussion terms, this chart shows that potential WRS performance compensation would be a small fraction of the value added. At no point would it represent more than 1.2% of total value added by the investment team. At a maximum performance compensation payout hurdle of 0.75%, the team would have added $63,000,000 in value, and only received $735,000 in performance compensation.



Outperformance	-0.10%	0.00%	0.20%	0.40%	0.60%	0.75%	0.80%	1.00%	1.20%	1.40%	1.60%
Outperformance PnL ($ mm)	($8)	($0)	$17	$34	$50	$63	$67	$84	$101	$118	$134
WRS Proposed Performance Comp ($ mm)	$0.0	$0.0	$0.2	$0.4	$0.6	$0.7	$0.7	$0.7	$0.7	$0.7	$0.7
Performance Comp As a % of Total Outperformance	0.0%	0.0%	1.2%	1.2%	1.2%	1.2%	1.1%	0.9%	0.7%	0.6%	0.5%

Exhibit C – Peer Performance Compensation Plans

Plan	Party Determining Comp Level	Base Pay Determination	Incentive Comp. as a Percent of Base Comp.[1]					
			CIO	SIO/Sr. PM	Investment Officer	Senior Analyst	Analyst	Other
Conclusions	**All overseen by Boards**	**Blend of public pension and private investment firms**	**30-125%**	**30-125%**	**20-85%**	**15-65%**	**5-45%**	**N/A**
Arizona RS	ASRS Director, with board oversight	Unclear	25%	25%	25%	25%	25%	N/A
FPPA (Colorado Fire and Police)	Board	Unclear	50% of Base	30% (Director)	20% (Officer)	15% - Analyst	10%	20% (risk)
CalPERS (California)	Board of Admin., Consultant, CIO can increase	Blend of private/public. Quartile determined by Committee; mix of leading US/Canadian public funds, private sector asset management of similar size including: investment man/advisory firms, insurance companies, and banks	0-40%	0%-75%	0-60%	0-45%	Unclear	CFO, Actuary, Legal - 40%
KPERS	Board	Unclear	25%	22.5%	15%	10%	7.5%	N/A
OPERS (Ohio)	Administrator preps, Board oversees	Unclear	100% of Base	90% (Senior PM)	75% (Manager)	Assistant Man. - 65%	45% - 25%	N/A
RSA (Alabama)	Internal, present to board for approval	Unclear	30%	35%	35%	35%	35%	10% - Cash
SDIC (South Dakota)	Internal, present to IC for approval	70% of Private Regional	200% of base max	200% of base max	200% of base max	200% of base max	200% of base max	N/A
TRS (Texas)	Board	Board approves. Salary Schedules of General Appropriations Act, Chapter 659 of Texas Gov. Code. Increases determined by Exec. Director	125%	Director 110-125% Senior Inv. Mgr. 90%	Investment Manager - 85%	35-65%	15-25%	N/A
VRS (Virginia)	Internal, approved by Board	75th percentile of peer group (75% public and 25% private).	70%	Director - 60%	30%	25%	5%	N/A
COPERA	Board	75% public funds and 25% private by title	60%	60%	40%	40%	35%	N/A

[1] Summary ranges exclude South Dakota because it is an outlier.

Plan	Quantitative Portion	Qualitative Portion	Performance hurdles relative to benchmark	Performance hurdles relative to peers	Performance portion based on total plan return	Performance portion based on asset class	Blend of the two?
Conclusions	**~80%**	**~20% (generally progressively higher for more JR staff)**	**All**	**Mostly no**	**All**	**Mostly (typically for asset class heads)**	**Almost all**
Arizona RS	75%	25%	Yes	None	25%	Yes, 25% for most of team	Yes
FPPA (Colorado Fire and Police)	60%	40%	Yes - completely upon IPS customized benchmarks	None	Yes - all of it	No	No
CalPERS (California)	70%, multiplied by factor	30%, multiplied by factor	Yes	None	Yes	Yes	Yes
KPERS	100%	0%	Yes - 50%	None	Yes 50%	None	No
OPERS (Ohio)	80%	20%	Yes - 80%	None	Yes	Yes	Yes
RSA (Alabama)	100%	0%	Yes - 100% for analysts by asset class, 25% for CIO	Yes - 25% for CIO/CEO only	Yes for CIO, no for Analysts/Directors	Yes	Yes
SDIC (South Dakota)	100%	0%	Yes	None	Yes	Yes - Global Equity	Yes
TRS (Texas)	80%	20%	Yes 50%	Yes, 30%	Yes	Yes	Yes
VRS (Virginia)	80%	20%	Yes	None	Yes	Yes	Yes
COPERA	100%	0%	100%	None	20%	Yes	Yes

Plan	Period of measurement	Deferral if total fund has a negative returning year?	Breakpoints for max incentive at total fund level?	Vesting	How is Incentive Comp determined at initiation of program/Employee	Clawback
Conclusions	**Most 1-3 years. Some with 5-year**	**Most**	**35-150**	**Some**	**Generally start with record after employee starts**	**None Performance based**
Arizona RS	Half on 1 year, half on 3 year	No, but total fund portion only paid if total fund performance > 0	40 bps	None	Unclear	None noted
FPPA (Colorado Fire and Police)	1, 2, 3, 4, 5 years mix depending on tenure.	Yes, 50% deferred, rest paid in positive year, No payment if fired/quit.	50 bps	3 years - ⅓ each year paid	Yr 1: 100% 1 year. Yr 2: 25% 1 year, 75% 2 year. Yr 3: 25% 1 year, 75% on 3 year. Yr 4: 25% 1 year, 25% 3 year, 50% 4 year. Yrs 5 and on: 25% 1 year, 25% 3 year, 50% 5 year.	None noted
CalPERS (California)	Inv. return - 5 yr, portfolio - 1 year	Yes, subject to board, and a positive year	35 bps	None	IO - 100% on 1 year, 5 year, regardless of when the individual begins.	Yes, if violates incentive policies. Within 3 years.
KPERS	50% - 1 yr, 50% 3 yr	No deferral, but no pay if the overall	100 bps	None noted.	Unclear how new employees earn in. 25% 1 year fund BM, 25% 3 year fund BM, 25% 1 year vs. assumed rate, 25% 3 year vs. assumed rate	Yes, if unethical behavior
OPERS (Ohio)	Total Fund: 25% current yr, 75% 3 yr rolling, Portfolio: 100% curr. yr	Unclear	41 bps 1 year, 43 bps 3 year	None (see payout date)	Year 1: 100% 1 year, Year 2: 50% 1 year, 50% 2 year, Year 3: 25% 1 year, 75% 3 year. Portfolios: always 1 year.	None noted
RSA (Alabama)	1 year	Unclear	150 bps	1 fiscal year	Unclear	None noted
SDIC (South Dakota)	1, 4, and 10 years	No - Rolling system	140 bps - 4/10 yr, 120 - 1 yr	None noted	Yr 1 max potential: 200% year 1, Yr 2: 33% on 1 year, rest based on 2 year, Yr 3: 33% on 1 year, rest on 3 year, Yr 4: 33% on 1 year, rest based on 4 year	None noted
TRS (Texas)	1 & 3 year (33% 1yr, 67% 3yr)	Yes - defer up to 3 years	100 bps	2 years: 50%, 50%	Year 1: 100% 1 year, Year 2: 50% 1 year, 50% 2 year, Year 3 and on: ⅓ 1 year, ⅔ 3 year	None noted
VRS (Virginia)	3-, 5-year	Participants deferred accounts earn based on overall fund return	60 bps	None, 50% is moved into a DC plan.	3 and 5 year 50/50, no mention for a new employee	Possible if malfeasance, not performance related.
COPERA	1 & 3 for public equity, 5 for RE, 10 for PE	Yes – board can defer for 1 year	40 bps	50% in May/June, 50% the following Jan/Feb	Shorter for newly eligible employees	None

Exhibit D - Sample Performance Comp

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Title	Max Incentive as a % of Base	Investment Team Max Incentive Pay ($ Thou)	
CIO	100%		
SIO	75%		
Senior Analyst	50%		
Analyst	25%		
WRS Investment Team	73%	$735.3	
Max Hurdle:	0.75%		
Fund Value ($ Thou)	8,400,000		
	Year 1	Year 2	Year 3
WRS Performance	7.5%	1.0%	8.0%
Benchmark	7.0%	1.5%	7.0%
1 Year Outperformance	**0.5%**	**-0.5%**	**1.00%**
Incentive Earned (% Base)*	48.9%	0.0%	45.1%
Incentive Paid Out (% Base)	16.3%	16.3%	31.3%
Incentive Earned ($ Thou)	$490.2	$0.0	$452.1
Incentive Paid Out ($ Thou)	$163.4	$163.4	$314.1

Annualized Returns	1 Year	2 Year	3 Year
WRS	7.5%	4.2%	5.5%
Benchmark	7.0%	4.2%	5.1%
Outperformance	0.5%	0.0%	0.3%

*All performance compensation calculation periods (1, 3 and 5-year) begin upon initiation of the program. Year 1 performance compensation is based on the one-year relative outperformance for all three measures. The Year 2 amount is based one-third on Year 2's one-year outperformance, and one-third on each of the rolling three-year and five-year outperformance, both of which are based on the two-year trailing annualized outperformance. Year 3 is determined in the same manner as Year 2, except the three-year and five-year amounts are based on the annualized three-year outperformance.