

Utah Retirement Systems' Agency Response to A Performance Audit of URS' Management and Investment Practices

Utah Retirement Systems (URS) recognizes the thorough analysis conducted by the Office of the Legislative Auditor General in performing this audit. For eight months, several auditors have conducted the in-depth review of URS required to address the many questions presented under the broad scope of this legislative audit request. These auditors took the time and effort to understand the complexity of the issues, reviewed numerous documents, and met repeatedly with URS staff to discuss issues. URS also made every effort to fully cooperate with the auditors and ensure they were provided all available information requested in a timely manner.

The scope of this audit covered four separate areas regarding URS management and investment practices and the report also provides an introduction with an agency overview. While the performance audit itself provides valuable information and discussion, URS believes that some additional information, background, and context will be useful for this report. Accordingly, this agency response will address:

- Introduction
- Transparency Concerns
- Investment Asset Allocation
- Fiduciary Responsibilities
- Defined Contribution Plan Investment Manager Selection and Retention Processes

Chapter I: Introduction

The status of the Utah Retirement Systems (URS) is unique. The Utah State Legislature, by statute, established URS as an independent agency free of management and control from the executive branch of state government. Unlike almost all other entities which may be deemed state agencies or quasi-state agencies, URS does not operate on state General Fund money or other state appropriations. URS' unique governance was also established in recognition that URS is not engaged in traditional governmental functions, but performs business and investment activities on behalf of a defined group of beneficiaries.

The URS systems, plans, and programs are maintained on an actuarially sound basis under the management of a board of directors, the Utah State Retirement Board (Board). The funds for the various systems and plans are administered as a common trust fund, known as the Utah State Retirement Investment Fund (Fund), exclusively to provide benefits to qualifying beneficiaries. Trust funds may not be diverted or appropriated for any other purpose. The Board members are the trustees of the Fund and exercise their duties pursuant to statutory and common law fiduciary responsibilities.

One key purpose of making the Board independent and separate from state management and control is to limit the liability of the State of Utah concerning the Fund and the Board's fiduciary activities. The state's obligation to URS, like other participating employers, is making the employer contributions for its own employees each pay period. This helps ensure that the state, except for its role as a participating employer, has limited legal responsibility for the obligations, contracts, activities, expenses, and debts of URS.

Eligible public employees are the beneficiaries of the Fund. Benefits, such as monthly retirement allowances and death benefits, are paid according to statutory provisions. The Legislature sets Utah retirement policy, plan design, and benefit specifications in statute. URS is the administrator of the systems, plans, and programs established under Utah Code Title 49, Utah State Retirement and Insurance Benefit Act.

Assets of the Fund generally come from three sources: employer contributions, member contributions, and investment earnings. However, investment earnings are the most significant source of the additions to the retirement systems. Income from the Fund accumulates for the advantage of the participating employers, which are the state and its political subdivisions. The greater the earnings from Fund investments, the smaller the amount the participating employers must pay as employer contributions—the Board certified rate expressed as a percent of the salary of active employee members—to URS to maintain the systems and plans on a financially and actuarially sound basis, as required by statute.

Employer contributions may be “public money” until the monies are contributed to URS, at which time the monies become fiduciary trust funds rather than public monies. Funds are accumulated to meet current and future benefit obligations to retirees and beneficiaries. Payments are made from the Fund for benefits for qualifying beneficiaries. Administrative expenses are paid exclusively out of investment earnings and no state or other public funds are appropriated to meet any administrative costs.

To meet its current and future obligations as a pension plan, URS must follow industry best practices for long-term investing, which include using sound investment processes, disciplined strategy, a sound asset allocation model, diversification, monitoring current market conditions, anticipating future markets, and adjusting the portfolio asset allocation based on various risks. URS' objective and fiduciary obligation is to meet the assumed investment rate of return, ideally with the lowest amount of risk and volatility possible.

Although URS is independent from the state management and control applicable to many other agencies, it has significant legislative oversight. URS regularly interacts with a legislative committee, the Retirement and Independent Entities Committee, which is principally focused on retirement policy and URS' administrative, financial, and investment issues. Working on an ongoing basis with legislators who develop and maintain legislative expertise in URS issues facilitates coordinated oversight of retirement policy and administration during General Sessions and throughout each interim.

Chapter II: Transparency Concerns

In this chapter, the legislative audit team reviewed a number of transparency-related questions relating to information practices and meetings. In short, the audit found that URS is in compliance with all statutory requirements.

The audit report affirmatively recognized that URS has made a considerable effort to become more transparent. One important development is the creation of the website, newsroom.urs.org, a forum URS uses to provide information for policymakers, media, and the public. This facilitates online access to more detailed financial information and reports. URS also opened its administrative Board meetings to the public beginning in October 2013. The minutes and agendas for these meetings are also posted online via the newsroom.

URS strives to be in front of transparency requirements and seeks ways to provide information that is important for stakeholders to see and understand. One example of this came from the changes arising from Governmental Accounting Standards Board (GASB) Statements 67 and 68. These Statements significantly change the accounting and financial reporting of pensions by pension plans and state and local governments. The audit report notes, "URS provided information beyond what GASB required to assist employers in their pension reporting obligations, such as the employers' proportionate share of the plan pension expense." URS implemented its part of the new GASB rules a year earlier than required in order to allow state and local governments in Utah an opportunity to review, by participating employer, Net Pension Liability and other information before they will be required to report that information in their own financial statements in the future. The GASB Director of Research and Technical Activities sent a letter to URS in February 2015 expressing appreciation of URS' early implementation of the new pension standards and noting that URS had been complemented by officials from many states. The letter stated, "when an entity like URS demonstrates leadership by implementing those standards, not only do the users of their financial statements benefit from this effort, but many other governments benefit. . . . Thank you for being a leader in the pension arena."

In general, transparency relating to governmental entities serves global public policy considerations, such as open government and the accountability of public finances. It is important to consider that URS has unique status as an independent agency and is not engaged in traditional governmental functions. Instead, URS performs business and investment activities on behalf of a defined group of beneficiaries. This means that transparency for URS will be different in some respects from other governmental entities.

Any changes relating to URS transparency should be consistent with and adequately protect the Board's fiduciary role and responsibilities, including its capacity as the trustee of the Fund. This helps ensure that the State of Utah is not liable for the obligations, expenses, debts, and liabilities of URS beyond the responsibility to pay the employer contributions for state employees. Also, appropriate transparency measures preserve URS' competitive business position regarding investments and the Public Employees Health Program (PEHP). Finally,

privacy protections for members and participants' personal information in retirement, defined contribution plan, and health insurance records must be maintained.

URS management will work with the Board and explore ways to facilitate the implementation of the auditor's transparency recommendations, consistent with URS' purpose and fiduciary responsibilities.

Chapter III: Investment Asset Allocation

In this chapter, the legislative audit team analyzed certain issues relating to the asset allocation of the Investment Fund. As noted in the audit report, "As trustees of the Utah State Retirement Investment Fund, the two most important functions of the board are the establishment of the DB asset allocation and the authorization of investment policies."

As a pension plan, URS is responsible to meet its current and future obligations to members and beneficiaries. This requires URS to follow industry best practices for long-term investing, which include using sound investment processes, monitoring current market conditions, anticipating future markets, and adjusting the portfolio asset allocation based on various risks.

The Board members are the trustees of the Fund and exercise their duties pursuant to statutory and common law fiduciary responsibilities. For example, Utah Code Section 75-7-804 requires, "A trustee shall administer the trust as a prudent person would, by considering the purposes, terms, distributional requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution."

URS' objective and fiduciary obligation is to meet the actuarially assumed investment rate of return of 7.5% with the least amount of risk in the portfolio. URS seeks to achieve consistent investment returns, which facilitates meeting the actuarially assumed investment rate of return over the long-term. To this end, the Board has worked with its investment staff and consultants to examine a wide array of potential asset allocations. There are many valid viewpoints among investment professionals around the world regarding appropriate asset allocations.

The URS Board has developed a conservative asset allocation designed to meet the assumed investment rate of return over the long-term in order to provide the associated long-term retirement benefits to URS members and their beneficiaries. Using sound investment processes, disciplined strategy, a sound asset allocation model, and diversification, URS' portfolio has been designed to emphasize downside protection.

While cognizant of the asset allocations of other plans, URS seeks first to construct an asset allocation that fits its needs and specific circumstances. URS does not seek to be a top performer in terms of investment returns; it does not chase the highest returns possible with disregard of risk to its portfolio. An asset allocation designed to produce high rates of return will often experience offsetting low returns. Those who try to hit home runs in their investment portfolio will often strike out; losses have a significant negative impact on long-term

compounded returns. The URS asset allocation is designed to minimize losses in down markets, allowing URS to take advantage of compounding returns on a larger asset base going forward.

The URS asset allocation is designed to have lower risk while meeting the assumed investment rate of return. Callan Associates, an independent professional investment consulting firm and the primary investment consultant for URS, indicates the URS investment portfolio has low risk compared to the Callan peer group. The volatility of the URS portfolio, as measured by the standard deviation of its investment returns, ranks as one of the lowest among the peer group. URS' risk-adjusted rates of return, as measured by the Sharpe Ratio, are in the top decile in recent years compared to its peers. The Sharpe Ratio is commonly used in the investment industry to compare risk-adjusted returns among investment portfolios.

The URS asset allocation has produced investment rates of return that meet the assumed rate of return of 7.5%. As noted in the audit report, the URS 10-year rate of return is 7.52%. URS also regularly monitors rolling 10-year returns. Rolling 10-year periods allow investment performance to be viewed over market cycles, which contain a wide variety of market environments and risks. URS' average investment returns over rolling 10-year periods are at or above the median of the Callan peer group for each of the 10-year periods reviewed in the audit. In addition, URS' 20-year average investment returns exceed the 7.5% assumed rate of return each year during the period analyzed in the audit.

Acting in its fiduciary capacity, the Board makes the final decision regarding the asset allocation of the Fund. The Board approves an asset allocation it believes will maintain the retirement plans and programs on a financially and actuarially sound basis. As noted in the audit report, the Board collectively has over 150 years of investment experience, and has more investment representatives than any other public employee retirement system surveyed. The Board also reviews and approves URS investment policies.

URS engages Callan Associates to conduct a detailed Asset Allocation and Liability Study every three to five years. An Asset Allocation and Liability Study helps determine an appropriate asset allocation that will support the retirement benefits payable to members and beneficiaries over both the short-term and long-term. The most recent Asset Allocation and Liability Study was conducted in 2013 and reaffirmed the current URS asset allocation. In addition, a Callan memo dated March 10, 2015, states, "we believe the asset allocation adopted by the Board and concurred with by Callan represents a reasonable and well thought out investment program intended to meet the assumed rate of return requirements of URS with relatively low corresponding levels of risk."

The Office of the Legislator Auditor General employed a consultant who expressed some concerns about the URS asset allocation. The auditor has recommended that URS consider the investment consultant's concerns and anticipated market conditions as URS makes future asset allocation adjustments. The URS management and investment staff consistently monitor investment performance and market conditions across asset classes. In its investment board meetings, which are usually held monthly, the Board, URS management, and investment staff

review the asset allocation and anticipated market conditions and will consider the consultant's analysis and opinion.

Chapter IV: Fiduciary Responsibilities

This chapter of the audit report examined if URS sufficiently meets its fiduciary responsibilities to its members in regards to three areas: 1) URS Operating Costs and Investment Fees; 2) Board Qualifications; and 3) Staff Qualifications to Offer Investment Advice to URS Members.

URS Operating Costs and Investment Fees

URS operating costs are divided into two categories: administrative costs and investment costs. The audit report noted that URS administrative costs are lower than peer retirement systems. Specifically, the audit determined that URS annual administrative costs were \$19 lower per member than the median of peer retirement systems. CEM Benchmarking Inc., in its Defined Benefit Administration Benchmarking Analysis, found that URS annual defined benefit administrative costs were \$18 lower per member than its peer benchmark. In addition, CEM noted that URS has a more complex system than its peers, in part due to administering eight different defined benefit pension plans and four different defined contribution plans with various rules and regulations.

Investment costs are primarily incurred to pay investment management fees which vary by asset class. Traditional equity and fixed income investment management fees are lower than alternative investment management fees. As noted previously, the diversified URS investment portfolio has been designed to emphasize downside protection and capital preservation while generating sufficient returns while meeting its actuarially assumed investment rate of return with the lowest amount of risk possible. As part of its initial and ongoing investment due diligence reviews, URS negotiates investment contracts, including investment fees, to obtain the best terms possible. The audit report indicates that URS controls its investment fee rates better than peer systems. CEM Benchmarking Inc., in its Investment Cost Effectiveness Analysis, shows that URS' assertive investment management practices attained proportionately lower investment fees than the fees charged for similar investments by peer systems. In fact, URS investment fees were 11% lower than the fees charged for similar investments by peer systems in the CEM analysis. As noted in the audit report, URS was recognized by the Wall Street Journal in 2009 for its effective negotiation of alternative investment fees with its investment managers. In conjunction with its judicious fee negotiations, URS is recognized in the industry for its Alignment of Interests initiative and seeks investment managers whose long-term investment philosophy, strategy, fiduciary responsibilities, and ownership interests align with those of URS.

The audit report noted that a portion of investment fees are withheld by the investment manager before distributing investment earnings. This is a standard industry practice which is also followed in the mutual funds industry. In accordance with GASB accounting rules, withheld investment fees are not reported with other investment fees paid by URS. Withheld investment fees are included in the calculation of the investment rate of return, and URS investment rates

of return are reported net of all fees. This allows an evaluation of investment returns after all fees have been deducted, including any fees withheld by managers. It is important to note that all investment fees, including withheld investment fees, are reported to the Board monthly.

As noted in the audit report, URS' operating costs are well-managed. URS will continue to closely negotiate and monitor its operating costs as part of its commitment to meet current and future obligations to members and beneficiaries.

Board Qualifications

The legislative auditors examined whether or not the Board has sufficient investment experience and found that the Board collectively has over 150 years of investment experience, and has more investment experience than other retirement boards within a peer group comparison. URS agrees with the audit report's conclusion that the Board has sufficient investment expertise and adds that the Board and its staff take their responsibilities regarding the investment portfolio very seriously; they fulfill their fiduciary obligation to exercise reasonable care, skill, and caution.

Staff Qualifications to Offer Investment Advice to URS Members

The legislative auditors were also asked to determine if the URS advisory staff are appropriately qualified to provide advisory services. URS appreciates the auditor's assessment that the advisory staff at URS have adequate education and training—including the completion of a qualifying exam—to fulfill their advisory responsibilities.

The new URS investment advice program was established in response to member requests for services beyond the distribution of publications and online information to members. Beginning with its March 2015 launch, URS members may get access to customized professional advice from qualified URS investment advisors at no charge. This program will provide individualized education about retirement savings and investments for URS members. Initial feedback indicates high demand for the available sessions.

The creation of this program had the approval of the Board and has taken much time and planning under the direction of URS management. Importantly, this process included obtaining a no-action letter from the Utah Division of Securities to clarify and address potential investment advice and licensing issues. A key fact is that the scope of advice provided to plan members by the URS advisors is narrowly tailored to the investment offerings in the URS defined contribution and defined benefit plans.

Advice given will be in the best interest of plan members in consideration of members' individual situations and needs. This requires using a process to assess a member's financial circumstances, risk tolerance, and retirement needs, and then making professional recommendations about URS investments and retirement planning in light of those considerations.

The following table, which can be accessed under the “Financial Advice” tab at www.urs.org, provides a summary of the types of and topics covered in the individual counseling sessions.

New URS Counseling Sessions

We're here to help you plan for a better future. URS offers two types of individual counseling sessions, customized to meet your needs:

SESSION A – Basic Questions and Recommendations

This session is for you if you want information or advice on any of these topics:

- **Pension benefits:** What are my payout options and which one is right for me?
- **Savings plans (401k, 457, IRAs):** Should I invest in a 401(k) or Roth?
- **Service purchases:** Should I purchase additional pension service credit?
- **Tier 2 decision:** Should I choose the Hybrid or Defined Contribution Plan?
- **Investment options:** Which one is right for me?
- **Other basic questions**

SESSION B – Comprehensive Retirement Plan

This session is for you if you want to develop a comprehensive plan for a better retirement. After reviewing all of your potential retirement income sources, we develop a snapshot of your overall retirement situation and assess what adjustments you should make to help reach your retirement goals. We will determine:

- Where you are now in terms of retirement readiness
- Where you want to be
- And how to get there

As this new program develops, URS understands that there will need to be ongoing monitoring, review, and adjustment to ensure that the program effectively meets its objectives to serve members. URS is committed that the program will be well-managed with adequate oversight through appropriate policies, processes, and controls.

Chapter V: Defined Contribution Plan Investment Manager Selection and Retention Processes

In the final chapter, the legislative auditors were asked to determine whether URS' Defined Contribution Plan investment manager selection and retention processes have satisfactory documentation and controls. URS concurs with the audit report finding, “In summary, our review found that the URS processes to select and monitor DC Plan investment managers are well established, have adequate controls, and are executed according to policy.”

Conclusion

This audit report and its recommendations involve both administrative and policy matters relating to URS. URS will discuss the audit report with the Board and explore ways to facilitate the implementation of recommendations, consistent with URS' purpose and fiduciary responsibilities. Also, URS will work with legislative committees and individual legislators to address any questions or concerns.

URS is confident that these actions will help ensure the continued success of URS and its systems and plans into the future.