

Kentucky Teachers' Retirement System

2015



Introductory  
Section

## Chairperson's Letter

### Teachers' Retirement System of the State of Kentucky

**GARY L. HARBIN, CPA**  
*Executive Secretary*



December 9, 2015

Dear Members:

On behalf of the Board of Trustees and staff, I am pleased to present this Comprehensive Annual Financial Report of the Teachers' Retirement System of the State of Kentucky for the year ending June 30, 2015, the 75th year of operation of the System. The accompanying reports from the independent auditor and the consulting actuary substantiate the financial integrity and the actuarial soundness of the system.

KTRS closed the 2014-2015 fiscal year with \$18.8 billion net assets. The active membership totaled 72,246 and the retired membership was 49,822 with annual annuity and medical insurance benefits of \$2 billion.

The Board of Trustees is totally committed to managing the retirement system funds in a prudent, professional manner. Every effort will be made to ensure that the system continues to operate in a fiscally sound manner. Present and future members of the system deserve to be able to avail themselves of the best possible retirement as authorized by statute.

We appreciate the support and cooperation extended by the Governor and the Legislature. This cooperation allows the system to not only meet current challenges but to also make timely provisions for the future.

The Board of Trustees pledges to continue to administer the affairs of the Kentucky Teachers' Retirement System in the most competent and efficient manner possible.

Sincerely,

Arthur Green  
Chairperson  
Board of Trustees

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STATE TREASURER

## Letter of Transmittal



### Teachers' Retirement System of the State of Kentucky

December 9, 2015

Honorable Matthew G. Bevin, Governor  
Commonwealth of Kentucky  
Capitol Building  
Frankfort, Kentucky

Dear Governor Bevin:

It is my pleasure to submit the 75th Comprehensive Annual Financial Report of the Teachers' Retirement System of the State of Kentucky, a component unit of the Commonwealth of Kentucky, for the fiscal year ended June 30, 2015. State law requires the publication of this report; in addition, an annual audit and an annual actuarial valuation of the retirement system also are required. The Kentucky Teachers' Retirement System (KTRS) produced this annual report that provides you, the General Assembly and the public with information necessary to better understand KTRS. Contained within are numerous examples of how Kentucky teachers' future well-being is being provided for at a low cost with a great economic benefit for those educators and the state's businesses, which receive many of those retirement dollars as they are spent by retirees.

This report has been prepared in conformity with the principles of governmental accounting and generally accepted accounting principles. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with KTRS management. To the best of our knowledge and belief, the enclosed data is accurate in all material aspects and reported in a manner designed to present fairly the financial position and results of operations of KTRS for the year ended June 30, 2015. Discussion and analysis of net assets and related additions and deductions are presented in

Management's Discussion and Analysis beginning on page 18.

Management is responsible for maintaining a system of internal controls to establish reasonable assurance that assets are safeguarded, transactions are executed accurately and financial statements are fairly presented. There are limits inherent in all systems of internal control based on the recognition that the costs of such systems should be related to the benefits to be derived.

Management believes the System's controls provide this appropriate balance. The system of internal controls includes policies and procedures and an internal audit department that reports to the Executive Secretary and the Governance and Audit Committee of the Board of Trustees.

### Profile of KTRS

KTRS began operations on July 1, 1940 as a cost-sharing multiple-employer defined benefit plan. The primary purpose of the plan is to provide retirement annuity plan coverage for local school districts and other public educational agencies in the state. KTRS is a blended component unit of the Commonwealth of Kentucky. The plan is described in the notes to the basic financial statements on page 29. Also, the summary of the plan provisions starting on page 104 is useful in understanding benefit and contribution provisions. The population of KTRS membership is stated in the preceding chairperson's letter.

Each year an operating budget is prepared for the administration of the retirement system. The budget is approved by the Board of Trustees and submitted to the Kentucky General Assembly for adoption. KTRS's investment earnings pay for the agency's administrative expenses, which are among the lowest of its peers.

### Major Initiatives

The System continually seeks opportunities to better serve its membership. During the past year, KTRS has continued work on several major initiatives concerning funding and cost containment for retiree health care, the investment program and information technology.

[Implementation of the "Shared Responsibility" Solution for Funding Retiree Health Care, Careful Management of Medical Insurance Costs and](#)

### *Protecting Members From an Unfair Medicare Part B Premium Increase*

June 30, 2015 marked the end of the fifth year of the six-year phase in of the “shared responsibility” solution for prefunding retired teacher health care. The Board of Trustees and Staff are very pleased to report that \$3.1 billion in actuarial liability has been eliminated from the retired teacher health care plan through implementation of this solution. Another \$1.9 billion savings in actuarial liability was accomplished through careful management of health care costs. Thus, since implementing “shared responsibility” and other cost control measures, more than \$5 billion in actuarial accrued liability has been eliminated from the KTRS Medical Insurance Fund.

Elected officials have commended Kentucky’s education community for its strong leadership and hard work in developing and implementing the solution. Constituent groups – representing retired teachers, active teachers, school boards, school superintendents and the state – all worked on the consensus funding solution. The solution provides that all the groups share in the solution by investing a little more now to receive substantial returns later. After five years, and the \$3.1 billion in lowered liabilities by converting to a prefunded plan and other cost-saving measures, the “shared responsibility” solution is truly a significant accomplishment on the road to retirement security for current and future retired teachers. Kentucky is a national leader in prefunding retiree health benefits.

KTRS is efficient, effective and always working to improve the retirement security of Kentucky’s teachers. Eliminating more than \$5 billion in liability helps the financial condition of the Commonwealth and eases burdens on taxpayers.

The Board of Trustees of KTRS regularly reviews the health care plan to contain costs and maintain a meaningful benefit for retired teachers. The move to Medicare Advantage, now in our ninth year, continues to be stable and financially feasible for our members and the KTRS medical plan.

Some recent cost saving initiatives include moving the KTRS-sponsored Medicare drug plan from fully insured to a self-funded plan to achieve the greatest amount of federal subsidies for 2015.

Additionally, KTRS joined the KY Rx Coalition in 2012, which is spearheaded by the University of Kentucky. By joining the coalition, KTRS will achieve annual savings through leveraging greater prescription purchasing power and deeper drug discounts. As an added benefit, a dedicated staff of pharmacists with the KY Rx Coalition can help each member with their prescriptions and how to maximize their prescription dollars.

In the past year, KTRS played an integral role educating federal lawmakers about a proposed 52 percent Medicare Part B premium increase for our retirees and convincing Congress to approve a less draconian solution. With the assistance of U.S. Senate Majority Leader Mitch McConnell and other members of the congressional delegation, KTRS successfully helped our members avoid the worst of an increase that unfairly impacted our retirees while leaving most Medicare recipients at this year’s rate. Without the reform, our retirees would have paid the full brunt of a federally mandated Medicare Part B premium increase while recipients whose premiums are deducted from their Social Security benefit would have paid nothing additional (because SSI recipients are held harmless from proposed increases when there is no cost of living benefit adjustment.)

KTRS also has undertaken cost containment measures by seeking competitive bids for the Medicare Advantage program that resulted in premium reductions of more than \$13 million for plan year 2015.

The Board has contracted with Edumedics for disease management services for Medicare-eligible retirees with diabetes, hypertension and hyperlipidemia. Edumedics is a Kentucky-based company spun out from the University of Louisville. Edumedics is educating retirees with these conditions about nutrition, drug regime, exercise and other matters. These educational efforts are ongoing, involving routine face-to-face checkups with participating retirees. If deemed successful at the conclusion of a three-year pilot period in 2016, the Board will likely expand this program to other chronic diseases.

### *Investment Program*

For the twelve month period ended June 30, 2015, KTRS’s investment program produced a total return of 5.1%. This ranked in the top 6% of

returns for pension funds with over \$1 billion in assets. During the period including the last five years, KTRS's investment returns rank in the top 9%. Moreover, during the last 20 years, KTRS investment returns have averaged 7.6%, which meets the long-term assumed rate of return of 7.5%.

Because of KTRS's focus on fundamental value and risk control, it was able to continue a multiyear program of diversifying the portfolio. KTRS also continued to implement changes to the investment program based upon an asset liability modeling study and an analysis of the shared responsibility solution for funding retiree health care. These ongoing efforts are a continuation of a disciplined investment process and long-term focus on retirement security. This focus has generated exceptionally stable returns through the System's history, and we have every confidence that it will do so in the future. KTRS's investment program continues to be recognized as a leader in the public pension community for governance structure, trustee education and cost effectiveness.

### Information Technology

Members recently began accessing their account information online – available anytime from anywhere – with KTRS's Pathway information technology system. The members' portal is the final phase of a multiyear effort to modernize KTRS's information technology infrastructure. The vendor authorized by the Board to build and install the new system has been working with staff onsite at KTRS since September 2011. In July 2013, member enrollment, employer reporting, service credit purchases and related accounting functions were put into production. In January 2015, new modules for member benefits, insurance, and retiree payroll went live. To date, more than 95% of the overall project has been completed, and work has been proceeding according to schedule and within budget. The project is expected to reach completion by May. The objective of Pathway is to make it easier for members to answer their own questions about their retirement and insurance accounts while streamlining retirement processes and improving staff efficiency in providing services to retirees and active members. In developing Pathway, KTRS is redesigning and improving office processes and applying new web-based

technologies to these processes. This will increase staff productivity, provide seamless member account management, and simplify future system modifications. As KTRS continues to implement changes under Pathway, we expect that the new technology will help the System better serve its membership.

### Funding Work Group

Leaders from the Kentucky General Assembly and the education community met for the last five months of 2015 to find solutions to address pension underfunding as part of the KTRS Funding Work Group established by then-Gov. Steve Beshear. The Funding Work Group allowed all sides to present their cases and produced valuable information and findings that will aid the development of a solution in the 2016 legislative session. I am encouraged that a single solution can be found, and agreed upon, before the General Assembly convenes in January.

### Economic Condition

The economic condition of the System is based primarily on investment earnings. The Investment Section of this report starting on page 57 contains asset allocations, strategic target ranges for investments, discussion of the current year market environment and historical performance schedules, among others.

KTRS's investment portfolio outperformed its peers in a year when the markets challenged all investors. The entire pension portfolio gained 5.1% in 2014-15, where peers gained 3.1% – that difference of 2 percentage points shows KTRS's investments outperformed peers by 50 percent. The portfolio's 10-year annualized rate of return is 7.0% and the 20-year annualized rate of return is 7.6%.

The results show KTRS's investment team is meeting the goals set out in Board policy.

According to KRS 161.430 the KTRS Board of Trustees has the responsibility to invest the System's assets. The Board of Trustees delegates investment authority to the Investment Committee. The Investment Committee works closely with experienced investment counselors and the System's professional staff in evaluating and selecting investment allocations.

The investment objectives of the Board of Trustees are to ensure that funds shall be invested solely in the interest of its members and their beneficiaries and that investment income shall be used for the exclusive purpose of providing benefits to the members and their beneficiaries, while making payment of reasonable expenses in administering the Plan and its Trust Funds. The investment program shall also provide a reasonable rate of total return with major emphasis being placed upon the protection of the invested assets.

The investment portfolio experienced a decrease in value during the 2014-2015 fiscal year as the portfolio’s market value went from \$18,527,307,235 to \$18,447,494,794. The decrease in value of the portfolio was the result of negative cash flow for the pension fund and the compounded impact of lost opportunity due to underfunding. This decrease was offset partially by investment income that included interest income and dividends. Employer and employee contributions also provided significant income to the portfolio.

Investment income decreased to \$871,554,710 from the 2013-2014 fiscal year total of \$2,875,609,844 when the portfolio’s investments gained 18.1 percent. The major contributing factor of the decrease in return from the System’s investment portfolio resulted from the net appreciation in fair value of investments of only \$428,758,194 at June 30, 2015 compared to \$2,485,340,569 at June 30, 2014. It should be noted that KTRS annuities bolster the Commonwealth of Kentucky’s economy, as approximately 92% of retired teachers reside within the state. Total benefits (retirement, medical...etc.) paid during the fiscal year were nearly \$2 billion.

**Funding**

Based on recommendations of the Board of Trustees, the General Assembly establishes, by statute, the contribution levels that are to be made by members and employers to fund the liabilities of the System. Each year, an independent actuary performs a valuation to determine whether the current levels of contribution will be sufficient to cover the cost of benefits earned by members.

Since fiscal year 2008, the state has not paid the full recommended annual employer contribution

necessary to prefund the benefit requirements of members of the retirement system as determined by the actuary. Over this period of time, because of this failure to make the additional appropriation beyond salary-based contributions, the actuary says the state’s annual additionally required employer contributions have grown significantly from \$60.5 million (fiscal year 2009) to \$512.9 million (fiscal year 2018). The following schedule details the growth of the additional annual employer contributions payable by the state:

Fiscal Year	Cumulative Increase as a % of Payroll	Cumulative Increase of Annual Retirement Appropriations Payable by the State
2009	1.88	60,499,800
2010	2.46	82,331,200
2011	3.59	121,457,000
2012	5.81	208,649,000
2013	7.27	260,980,000
2014	8.02	299,420,000
2015	10.42	386,400,000
2016	12.97	487,400,000
2017	13.80	520,372,000
2018	13.49	512,883,000

*(Source: KTRS Report of the Actuary on the Annual Valuation Prepared as of June 30, 2015).*

The Board has always taken action as required by state law and recommended annual employer contributions payable by the state that would ensure that the state meets the contractual obligations to members.

The latest actuarial valuation was for the period ending June 30, 2015. This report reflects the System’s actuarial value of assets totaling \$17.2 billion and actuarial determined liabilities totaling \$31.1 billion. The funded ratio of actuarial assets to liabilities is 55.3%, which is an increase from the previous year and is primarily due to market appreciation of investments and smoothing of investment returns. The actuary reports: “In our opinion, the System is not being funded on an actuarially sound basis since the actuarially determined contributions are not being made by the employer. If contributions by the employer to the System continue to be less than those required, the assets are expected to become insufficient to pay promised benefits. Assuming that contributions to the System are made by the employer from year to year in the future at rates recommended on the basis of the successive

actuarial valuations, the continued sufficiency of the assets to provide the benefits called for under the System may be safely anticipated.”

Annual required employer contributions for the defined benefit plan are provided in the Schedule of Employer Contributions (on page 51). After 2015 the actuary recommends an increase in employer contributions of 13.49% of pay for the 2017-2018 fiscal year (as detailed on page 90). Annual required employer contributions for the Medical Insurance Fund are provided in the schedule of employer contributions (on page 53). The 2015 employer shortfall of contributions created a net Other Post-Employment Benefits (OPEB) obligation of \$1,480,595,898 (as detailed on page 122).

### KTRS Medical Insurance Plan

The shared responsibility solution for funding retiree health care, which went into effect on July 1, 2010, provides a method of prefunding retiree health care over a 30-year period. The System believes that the shared responsibility solution for funding retiree health care will help ensure the retirement security of the state’s teachers. An actuarial valuation of the Medical Insurance Plan for the fiscal year ended June 30, 2015 indicated that the fund has an unfunded liability of \$2.89 billion. The funded ratio of actuarial assets to liabilities is 18.09%, which is trending upward from past years. The actuary’s opinion is: “... if the State contributions to the Medical Insurance Fund continue to increase to the planned levels, the Retiree Medical Plan will begin to operate in a more actuarially sound basis. Assuming that required contributions to the Medical Insurance Fund are made by the employer from year to year in the future at the levels required on the basis of the successive actuarial valuations, the actuarial soundness of the Medical Insurance Fund to provide the benefits called for under the Retiree Medical Plan will improve.”

Additionally, the System believes continued steps must be taken to realize true cost containment through legislation on both the state and national levels. KTRS will continue to take measures to contain costs and increase revenues to the Medical Insurance Plan or may adjust coverage to meet existing revenues.

### Professional Services

Professional consultants are appointed by the Board of Trustees to perform professional services that are essential to the effective and efficient operation of KTRS. Certifications from the Board’s External Auditor and Independent Actuary are enclosed in this report. The System’s consultants who are appointed by the Board are listed on pages 54, 55, 79 and 85 of this report.

### National Recognition

The System was honored by two national professional organizations in regard to the administration of the retirement program.

#### GFOA Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Teachers’ Retirement System of the State of Kentucky for its Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2014. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. Such CAFR must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. KTRS has received the Certificate of Achievement for the last twenty-seven consecutive years (fiscal years ended 1988-2014). We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to GFOA.

#### PPCC Achievement Award

The Public Pension Coordinating Council (PPCC) awarded a Certificate of Achievement to the Teachers’ Retirement of the State of Kentucky for 2015 for implementing and maintaining high

professional standards in administering the affairs of the System. The award is based on compliance with principles judged to underlie exemplary retirement system achievements in the areas of benefits, actuarial valuation, financial reporting, investments and disclosure, and are widely acknowledged to be marks of excellence in the public pension industry.

In 2015, for the fourth consecutive year, KTRS was not awarded the PPCC Certificate of Achievement for funding. Failure to qualify for the award reflects the employer's continued underfunding of KTRS's retirement annuity plan.

The PPCC is a coalition of three national associations that represent public retirement systems and administrators. Combined, these associations serve retirement systems that provide pension coverage for most of the nation's 16 million employees of state and local government. The associations that form the PPCC are the National Association of State Retirement Administrators; the National Council on Teacher Retirement; and the National Conference on Public Employee Retirement Systems.

### Public Sector HealthCare Roundtable

KTRS is a member of the Public Sector HealthCare Roundtable, and I serve as its president and on its board of directors. The Roundtable is a national coalition of public sector health care purchasers that was formed to ensure that the interests of the public sector were properly represented during the formulation and debate, and now implementation of the Patient Protection and Affordable Care Act. Membership in the Roundtable is open to any statewide, regional or local governmental unit that provides health care coverage for public employees and retirees.

### **Our Gratitude**

Three elected members of the KTRS Board of Trustees left the board during the fiscal year. Dr. Tom Shelton served as an active teacher trustee from July 1, 2008 through December 31, 2014, including as chair of the board from June 1, 2012 through December 31, 2014. Ruth Ann Sweazy served as an active teacher trustee from July 1, 2003 through June 30, 2015, including as chair of the insurance committee from July 1, 2005 through

June 30, 2015. Laura Zimmerman served as an active teacher trustee from September 15, 2003 through June 30, 2015, including as chair of the board from January 1, 2015 through June 30, 2015. During their tenures, the retirement system's retiree health care program secured long-term funding – in addition to implementing cost reductions – that lowered its unfunded liability by more than \$5 billion. We thank them for their exemplary service and numerous contributions to the successful operation of the System.

### **Acknowledgements**

The preparation of this report reflects the combined efforts of the KTRS staff, under the leadership of the Board of Trustees. The report is intended to provide complete and reliable information that serves as a basis for making management decisions and for determining compliance with legal provisions. It is also used to determine responsible stewardship of the assets contributed by KTRS members and their employers.

This report is located at the KTRS web address <http://ktrs.ky.gov>, and is made available to all System employer members, whose cooperation continues to contribute significantly to our success, and who form the vital link between KTRS and its active members.

KTRS management and staff are committed to the continued operation of an actuarially sound retirement system. Your support is an essential part of this commitment, and we look forward to working with you.

Respectfully submitted,



Gary L. Harbin, CPA

**BOARD OF TRUSTEES**



**Arthur Green**  
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**Ronald L. Sanders**  
Lay Trustee  
Hodgenville



**Quin Sutton**  
Active Teacher Trustee  
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Georgetown



**Stephen L. Pruitt**  
Ex Officio Trustee  
Commissioner,  
Dept. of Education



**Todd Hollenbach**  
Ex Officio Trustee  
State Treasurer

**Kentucky Teachers' Retirement System**

479 Versailles Road  
Frankfort, Kentucky 40601-3800

**ADMINISTRATIVE STAFF**

**GARY L. HARBIN, CPA**

*Executive Secretary*

**ROBERT B. BARNES, JD**

*General Counsel and  
Deputy Executive Secretary  
Operations*

**J. ERIC WAMPLER, JD**

*Deputy Executive Secretary  
Finance & Administration*

**TOM SIDEREWICZ, CFA**

*Chief Investment Officer*

**PROFESSIONAL CONSULTANTS**

**ACTUARY**

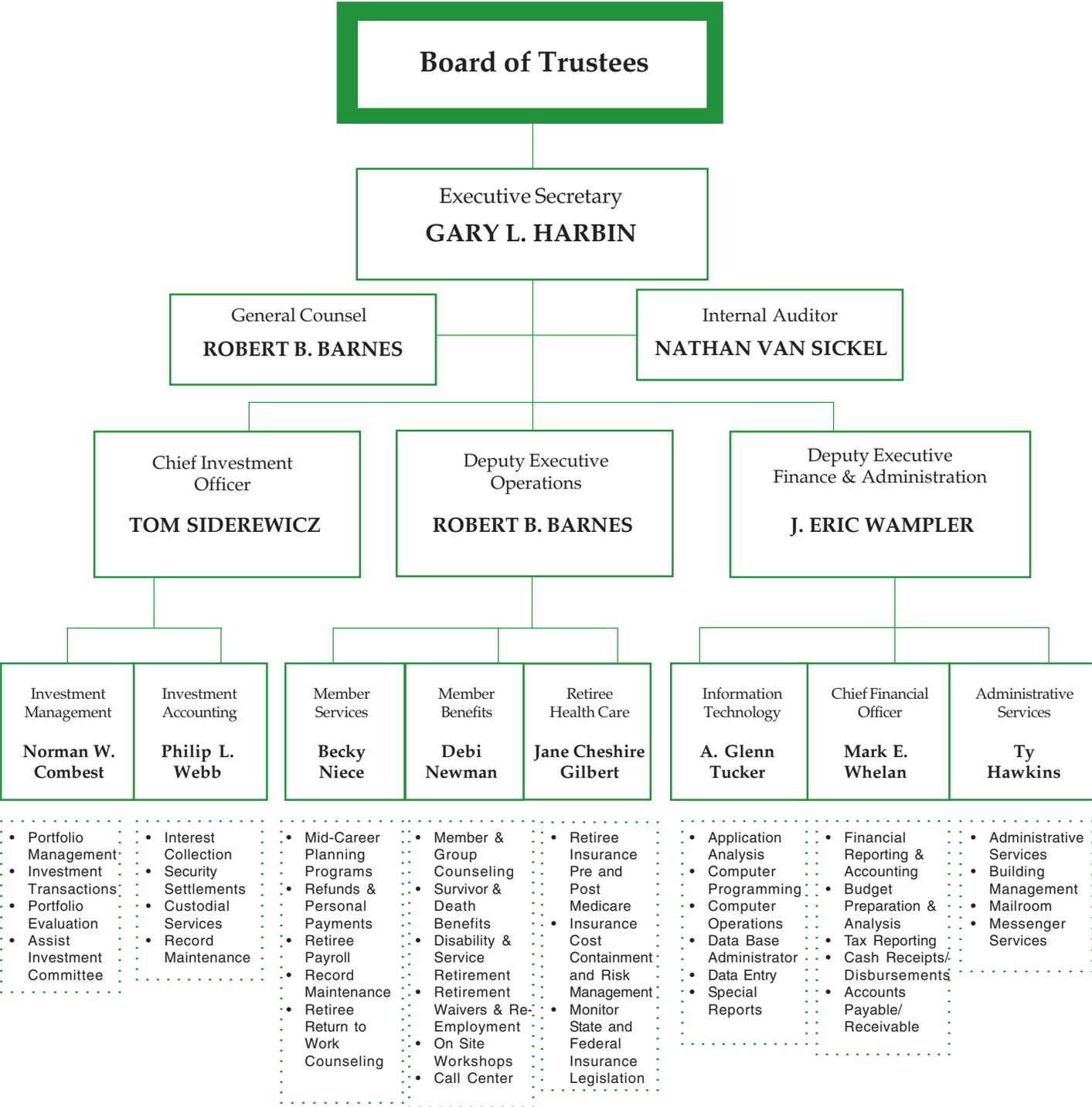
Cavanaugh Macdonald Consulting, LLC  
3550 Busbee Parkway, Suite 250  
Kennesaw, GA 30144

**AUDITOR**

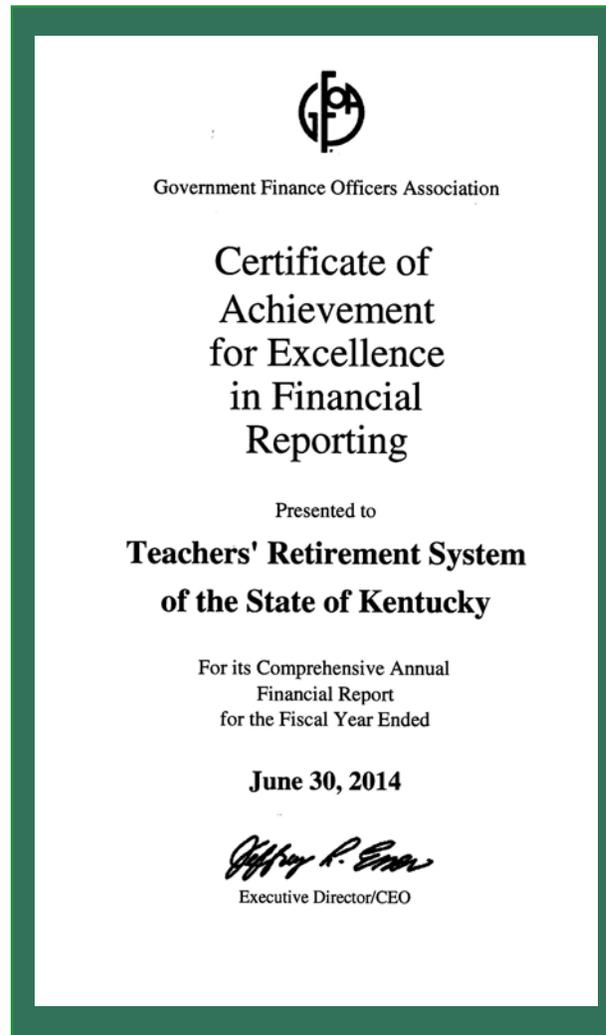
Mountjoy Chilton Medley LLC  
1000 Bluegrass Corporate Center  
333 West Vine Street  
Lexington, KY 40507

*\* See pages 79 and 85 of the Investment  
Section for investment consultants.*

**Kentucky Teachers' Retirement System  
Organizational Chart**



## GOVERNMENT FINANCIAL OFFICERS ASSOCIATION (GFOA)



*The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Teachers' Retirement System of the State of Kentucky. The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Teachers' Retirement System of the State of Kentucky. The KTRS has received the Certificate of Achievement for the last twenty-seven consecutive years (fiscal years ended 1988-2014).*

**PUBLIC PENSION COORDINATING COUNCIL  
PUBLIC PENSION STANDARDS**



**Public Pension Coordinating Council  
Public Pension Standards  
2015 Award**

Presented to

**Kentucky Teachers' Retirement System**

In recognition of meeting professional standards for  
plan design and administration as  
set forth in the Public Pension Standards.

*Presented by the Public Pension Coordinating Council, a confederation  
of*

National Association of State Retirement Administrators (NASRA)  
National Conference on Public Employee Retirement Systems (NCPERS)  
National Council on Teacher Retirement (NCTR)

A handwritten signature in cursive script that reads "Alan H. Winkle".

Alan H. Winkle  
Program Administrator

*The Public Pension Coordinating Council awarded a Certificate of Achievement to the Teachers' Retirement System of the State of Kentucky for 2015 for implementing and maintaining high professional standards in administering the affairs of the System. The award is based on compliance with principles judged to underlie exemplary retirement system achievements in the areas of benefits, actuarial valuation, financial reporting, investments and disclosure and are widely acknowledged to be marks of excellence for retirement systems. It represents the highest standards of excellence in the public pension industry.*

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