MARYLAND
STATE RETIREMENT
and PENSION SYSTEM

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Maryland State Retirement Agency
Testimony of R. Dean Kenderdine, Executive Director

Before the

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Senate Budget & Taxation Committee
February 10, 2015

Good afternoon, Chairman and members of the committee. As the Executive Director of the State Retirement Agency (SRA), it is my pleasure to present and discuss, on behalf of the System's Board of Trustees, the Agency's proposed budget for fiscal year 2016.

The SRA carries out two equally important business functions: the administration of member and retiree benefits, and the management of invested assets. The continued success of these two core processes is of critical importance to the more than 388,000 active, vested and retired state and local participating employees, teachers, police, judges, law enforcement officers, correctional officers and legislators whom we serve.

Before addressing the analyst's comments, I would like to briefly update the committee on some of the Agency's activities over the past year and the progress we have made.

Investment Management

The Maryland State Retirement and Pension System earned a net investment return of 14.37 percent in fiscal year 2014, nearly doubling the fund's 7.65 percent actuarial return target and exceeding the plan's policy benchmark of 14.16 percent by 21 basis points. This strong performance resulted in an increase in the market value of assets by approximately $5 billion, from $40.3 billion on June 30, 2013 to $45.4 billion on June 30, 2014 and lifted the fund's actuarial funded ratio from 65.5 percent in FY 2013 to 68.7 percent in FY 2014. The performance of the fund was driven mainly by strong returns in the public and private equity asset classes.

	1 year	2 year	3 year	5 year	10 year
Total Plan	14.37%	12.45%	8.27%	11.68%	6.46%
Policy Benchmark	14.16%	11.28%	7.49%	10.78%	6.23%

As of December 31, 2014, the System's total portfolio returned 0.20 percent on investments for fiscal year-to-date, exceeding the policy benchmark by roughly 125 basis points. The market value of assets as of December 31, 2014 was approximately $44.9 billion.

The System's investment performance during fiscal year 2014 is summarized in the following exhibit:

	FY 2014 SRPS Performance	FY 2014 Benchmark Performance	SRPS Allocation 6/30/ 2014	Target Allocation
Public Equity	22.1%		38.9%	35%
Custom Benchmark		23.1%		
U.S. Equity	26.1%		10.3%	
S&P 500		24.6%		
Russell 3000		25.2%		
International Equity	20.4%		12.1%	
MSCI ACWI ex. U.S.		21.8%		
MSCI EAFE		23.6%		
MSCI Emerging Markets		14.3%		
MSCI World ex U.S.		23.8%		
Global Equity	21.1%		16.5%	
MSCI AC World		23.0%		
Private Equity	19.6%		7.0%	10%
Custom State Street PE		18.6%		
Fixed Income	4.6%		14.8%	10%
Custom Benchmark		3.6%		
BC Intermediate Aggregate		3.5%		
BC Global Bond Agg 1-10		4.1%		
Credit /Debt Strategies	11.5%		10.0%	10%
Custom Benchmark		8.7%		
BC High Yield		11.7%		
BC Credit		7.4%		
JP Morgan GBI EM GD		3.9%		
S&P LSTA Leverage Loan		5.6%		
Real Estate	14.2%		6.8%	10%
Custom Benchmark		13.7%		
NCREIF		13.8%		
FTSE EPRA NAREIT		13.5%		
Real Return	7.0%		12.0%	14%
Custom Benchmark		6.0%		
Absolute Return	7.6%		9.4%	10%
Custom Benchmark		7.6%		
TOTAL FUND	**14.4%**	**14.2%**		

The **public equity portfolio** returned 22.1 percent, compared with a return of 23.1 percent for its blended benchmark. The program has three components: U.S Equity, International Equity and Global Equity.

The U.S. public equity portfolio returned 26.1 percent, outperforming the return of the Russell 3000 Index by 86 basis points. The international equity portfolio returned 20.4 percent compared to 21.8 percent for its benchmark, the Morgan Stanley Capital International (MSCI) All Country World ex-U.S. Index. The global equity portfolio returned 21.1 percent compared to 23.0 percent for its benchmark, the MSCI AC World Index, a broad measure of stock performance in the developed and emerging markets.

The **fixed income portfolio** returned 4.6 percent, compared to 3.6 percent for its blended benchmark: 80 percent Barclays Capital (BC) Aggregate Intermediate Index and 20 percent BC Global Bond Aggregate 1-10 Year Hedged Index.

The **credit/debt strategies portfolio** returned 11.5 percent compared to 8.7 percent for its blended benchmark:

- 50 percent BC High Yield Index
- 20 percent BC Credit Index
- 20 percent J.P. Morgan GBI Emerging Markets Global Diversified Index
- 10 percent S&P/LSTA Leveraged Loan Index

The **real return portfolio** returned 7.0 percent, compared to 6.0 percent for its blended benchmark, which consists of the following three components:

- 30 percent Dow Jones UBS Commodities Index (total return);
- 10 percent Consumer Price Index + 5 percent, with this second component having a maximum total benchmark return of 8 percent; and
- 60 percent inflation linked bonds (consisting of 50 percent BC U.S. Treasury Inflation-Protected Securities (TIPS) Index and 50 percent BC Global Inflation Linked (U.S. dollar hedged) Index).

The **absolute return portfolio** returned 7.6 percent, matching its customized benchmark: Hedge Funds Research, Inc. (HFRI) Fund of Funds Index. The **real estate portfolio** returned 14.2 percent versus 13.7 percent for its blended benchmark: National Council of Real Estate Investment Fiduciaries (NCREIF) ODCE Index and the Financial Times Stock Exchange European Public Real Estate Association (FTSE EPRA) /National Association of Real Estate Investment Trust (NAREIT) Global indices.

The **private equity portfolio** returned 19.6 percent, compared to the 18.6 percent return of its customized benchmark, the State Street Private Equity Index (one quarter lag). The program is still maturing and over time is expected to produce returns in excess of the public equity markets.

The System's **Terra Maria** program is comprised of smaller investment management firms—including many that are minority and/or women owned—focusing primarily on equity and fixed income investments. For fiscal year 2014, the program returned 19.6 percent, compared to 19.3 percent for its customized benchmark. While annualized performance for the three and five years ending June 30, 2014 have been slightly negative relative to it customized benchmark, the since inception return has added significant value. Since inception, the Terra Maria program has achieved an annualized return of 6.5%, compared to 5.1% for the benchmark.

The Investment Division regularly solicits input on investment opportunities and best practices from a number of sources. The System's investment consultants are broadly utilized across the total portfolio in assisting staff in sourcing new investment ideas that improve the risk/return efficiency of the fund. Consultants are also helpful in providing insight into new trends and ideas among other public pension funds. The System also belongs to a number of trade associations, and participates in selective investment conferences, that are useful in establishing peer contacts and gaining market insight. By attending conferences that focus on emerging managers, the System is able to meet, and provide access to, promising smaller managers that might not be identified in the normal search process. Existing and prospective investment managers are also a valuable source of information in terms of market trends and investment opportunities.

Information Systems

The Agency's baseline technology platforms continue to operate reliably with little production downtime. Information Systems' staff is completing some budgeted hardware replacements in the coming months, which should improve performance and manageability. The Maryland Pension Administration System, or MPAS, operates reliably and its technical design has proven itself capable of handling changes to programs, regulations, and calculations. We are embarking on a planned effort to replace the MPAS business rules engine, which is no longer supported by its software manufacturer, and we are upgrading a number of MPAS components to bring them current on vendor releases as part of routine maintenance operations.

The Agency's programmers continue to work in collaboration with the Business Operations Office's business analyst providing quality control support for on-going operations and maintenance activities and the MPAS-2 initiative (Improving Data Integrity). In fiscal 2014, an over-the-target request was approved to support a business initiative to improve the quality and consistency of electronic member data processed through MPAS and submitted by employers to the Agency over the past 40 years. The Agency continues to progress in linking disparate records and reducing data conflicts and anomalies to meet our MPAS-2 objectives of improving the quality of service and salary data, anticipating completion after the close of fiscal year 2016. Following this initiative's completion, work can begin on offering more member services securely over the Internet and further improving Agency pension administration business processes.

Our executive team has devoted considerable energy to scoping and prioritizing technology initiatives. Availability of additional programmer resources coupled with knowledgeable business unit analysts continues to represent a very real constraint on how rapidly the Agency is able to complete and test application software improvements. One initiative that is nearing completion is replacement of the file upload utility used by many of the employers we serve, to submit their payroll information to the Agency, along with enhancements to the programs that manage the police and correctional officers' deferred retirement option program.

All that stated, the Agency's technology infrastructure, including the security of its network and hardware platforms, continues to be a focus and continues to be an important performing asset. A significant hardware failure of our storage area network device this past November provided us an opportunity to successfully test some of the Agency's disaster recovery plan and back-up strategy. We improved our secondary data center in fiscal 2015, which now supports voice technology capabilities in addition to data technology in the event of an unplanned service disruption. Both the primary and secondary data centers will undergo independent testing in the coming 12 months, to verify the reliability and security of these resources.

Benefits Administration

The Agency saw a slight increase in active membership in the System. Active membership was up almost half a percent from fiscal year 2013. We continue to see increases in the number of annuitants. By the end of fiscal year 2014, the number of retirees and beneficiaries receiving benefits increased 3.6 percent to 142,887 compared to 137,925 in the previous year. Our current number of retirees and beneficiaries receiving monthly allowances is more than 145,925 as a result of new retirements since July 1, 2014. The total number of annuitants continues to increase year after year at a consistent rate.

The Benefits Administration Division continued to struggle with a high number of vacancies throughout the entire fiscal year. Despite this challenge, the division remained focused on its performance goals for retirement processing and in the call center. A full discussion of this issue follows in the agency's response to the analyst's comments below.

There were four (4) vacancies in the Member Services Unit that directly impacted the unit's ability to meet its performance goals for the fiscal year. The Agency ended fiscal year 2014 with a 7.02% percentage of abandoned calls above the goal of 6%. The 1:45 average speed of answer performance goal was also missed by 18 seconds—finishing the fiscal year with an average speed of answer of 2:03. There were 115,190 calls made to the call center and specialists answered 107,061 of those calls. The Agency continued to conduct pre-retirement seminars and daily one-on-one counseling sessions in our Baltimore office. Field counseling sessions were conducted in the fall but suspended in the spring to focus on the call center. Our monthly survey results continue to affirm that our members are satisfied with our customer service. We received a positive performance evaluation from 94 percent of our customer satisfaction survey respondents.

The Maryland Pension Administration System (MPAS) continues to function very well and the Agency has consistently met its monthly payroll. Fiscal year-end and calendar year-end activities, as well as daily operations of MPAS continued to be tested and corrected throughout the fiscal year. Specifically, the division identified several changes required to our internal processes and associated MPAS programs related to the reporting of payments to payees on the Internal Revenue Service's 1099-R tax document and processing and administration of Domestic Relations Orders.

The Benefits Administration Division also maintained its ongoing initiative to review and update the regulations affecting the operations of the division. Several regulations were reviewed and amended and submitted for approval by the Board of Trustees and the AELR during the fiscal year. Additionally, staff has worked throughout fiscal year 2014 to develop an improved payroll reporting system for our participating employers. It is anticipated that the new system will be launched later this fiscal year.

Responses to Analyst's Comments:

Call Center Performance Struggled in Fiscal 2014, Then Rebounded

The analyst's observations of the performance of the call center are accurate. The unit carried multiple vacancies throughout the fiscal year which hindered their ability to meet their performance goals.

In June of 2014, the unit hired four new Retirement Benefits Specialists. The training associated with being able to handle calls independently is 3-6 months. A senior Retirement Benefits Specialist conducts the training which means one less specialist on the phones. Therefore, fiscal year 2015 had a rough start. Performance improvements have been noted beginning in November 2014. As the analyst mentioned, the member services unit is fully staffed as of January with the arrival of two new Retirement Benefits

Specialists and, barring any unforeseen issues, we anticipate reaching our performance goals more consistently.

Backlog in Processing Retirement Benefit Estimates Has Grown

SRA is asked to explain the reasons for the accumulation of a backlog of requests over the past year and a half and to provide the committees with a plan for reducing the backlog.

The processing backlog for estimates has slowly crept up over the past year and half. This is mostly due to a higher volume of requests for retirement estimates, continual vacancies in the unit and the need for the same staff to balance the processing of the final applications for retirement versus the processing of estimate applications. The volume of estimates has increased most recently due to retirement incentive programs being offered by several of our participating governmental agencies.

Because staff in the unit processes the applications for both retirement estimates and finals, the manager must constantly shift the processing priority between the two processes. Retirement applications must be completed by a certain day each month in order for the individuals to be paid in the month of retirement. This shift in assignment is done knowing we have an estimate request backlog of individuals that need their notice of benefits to make the retirement option decision. This is a balancing act each and every week of the year.

The processing of a retirement estimate is still a very manual process that has many steps.

The Agency receives member contributions, hours worked and payroll data on each member throughout their career. It is only at the time of retirement that a member's account is audited to ensure proper awarding of service credit and contributions. All initial retirement estimates require a complete audit of the member's entire record before an estimate can be processed. If there are issues, staff must communicate with the employer to reconcile suspect data and then process any corrective actions through MPAS to correct the member's record.

Once the audit is complete, staff applies the law in the manual calculation of the Average Final Salary and the projection of transit contributions and corresponding interest as well as service credit until the actual date of termination of employment (date of retirement).

The completed applications are batched and the total expected values as to the inputted data and record counts are calculated and delivered to the data entry unit. That staff keys the work and transmits the keyed data for input values required for processing by the automated system. Once keyed, benefits staff submits a data processing request for MPAS calculation processing. MPAS generates detailed reports of the accounts processed and generates reports needed for reconciliation along with the automated mailing member notices to advise the individual of their benefit allowances under each optional form.

The volume of requests and the manual nature of the process are impacted greatly by any vacancies in the unit. The unit has steadily carried 1-2 vacancies from September 2013 through today. Currently, there are seven (7) full-time positions assigned to process retirement estimates and finals. Benefits Processing staff with the help of several "trained" staff from Member Services worked more than 1,500 hours of overtime in FY14 just to keep backlogs at current levels which we agree are too high.

The Agency anticipates a volume of 7,200 new finals and 17,000 new estimates over the next 12 months. Although, the number of estimates may be much higher depending upon the number and scope of additional early incentive options being considered by employers participating in the System.

It is critical to understand that each application creates two units of production for the Agency because for quality control purposes, the worksheets created by staff are prepared by one staff member and reviewed and approved by a second staff member. Therefore, 7,200 final applications and 17,000 retirement applications result in 48,400 units of production.

The Agency has a very well defined and monitored performance standard for employees who are assigned to the Sections responsible for processing finals and estimates applications. Each employee has a performance standard of working or checking 30 applications (finals or estimates) each day.

Assuming that each staff member works 210 days per year (365 days less weekend, holidays, annual, personal, and sick leave days) the Agency can expect that each staff member will produce 6,300 units of production each year. Therefore, the Agency would need approximately 8 full-time employees (48,400 / 6,300) to keep up with the incoming work over the next 12 month period.

With the addition of any new position comes the need and ability to be able to fill it quickly. The Agency's turnover rate has an impact on hiring ability. Prioritization of the position(s) would have to be given and authorization from the Department of Budget & Management through the freeze exemption process would need to be granted to begin recruitment as quickly as possible.

Addressing and overcoming this backlog is one of the Division's greatest challenges and one of its top priorities. The plan is to get staff levels at capacity, continue the use of overtime and re-assign staff from other units with a focus of not creating a different disruption in service.

SRA should comment on the appropriateness of the system's 35% target for public equities in light of persistent underperformance relative to large state pension funds.

The Department of Legislative Services notes in its report that the State Retirement and Pension System's fiscal 2014 return of 14.37%, net of fees, ranked toward the bottom of an independent assessment (Trust Universe Comparison Service) that compares Maryland to other pension funds with at least $25 billion in assets. The simple explanation for this ranking has to do with asset allocation. Public equity has been the top-performing asset class over the last five years, and the System's exposure to this asset class is lower than the peer group. However, to focus solely on the fund's ranking compared to its peers and attribute this ranking simply to the fund's current asset allocation without placing the decisions for the current portfolio structure in some context to past and potentially future market events, fails to provide a broader and more meaningful context. While TUCS has its value as a source of information, it should not be used to drive asset allocation decisions due to the vast differences in the plans that comprise the universe.

Before beginning any analysis of the fund's current asset allocation, it should be stressed that the fiscal 2014 return of 14.37% almost doubled the fund's assumed rate of return of 7.65% and also exceeded the fund's policy benchmark of 14.16%. The policy benchmark represents what the fund would have earned if the System had been managed 100 % passively. In addition, while the fund's allocation to public equity may be lower than most other funds, it still represents the fund's largest exposure by a wide margin with a long-term target of 35%. The next largest allocation is real return (e.g., treasury bonds, commodities, energy, timber) at 14%. The table below shows the returns of a public equity index (MSCI/ACWI) as well as the net returns of the System's total fund as of June 30, 2014.

Performance as of June 30, 2014

	1 Year	2 Years	3 Years	5 Years	10 Years
MSCI ACWI	22.95	19.72	10.25	14.28	7.46
Total Fund	14.37	12.45	8.27	11.68	6.46

* Performance longer than one year is annualized

To offer an adequate explanation of the rationale for the fund's current asset allocation, it would be helpful to first provide a historical overview of the fund during the 2008-2009 financial crisis. In the fall of 2008, the Board made a significant change to its long-term target allocation for public equities, reducing the allocation from 65% to 37%. Because any change of this magnitude must take place gradually and the time required for comprehensive research on new investments, the fund's equity exposure was 56.4% as of June 30, 2009. In fiscal year 2009, the fund returned -20%, with public equity sustaining the greatest losses. These losses were not entirely unexpected, inasmuch as the Agency recognized that, historically, public equity is one of the riskiest, most volatile asset classes. However, in the aftermath of these losses, the System was compelled to assess how much the fund could reasonably lose in future market crises and still recover.

This introspective analysis was necessary given that recovering from steep losses requires either extraordinary investment gains, increased contributions from the employer and employees, or both. As a simple example, a loss to the fund of 50% in asset values requires a gain of 100% just to get back to where the fund started. In acknowledging the need for contribution rate stability, coupled with the immense risk posture in which the fund potentially could be placed in the event of another market downturn, the System continued in its earlier decision to reduce its long-term target allocation to public equities to 35% over the 2011-2013 time period, accepting that it would likely represent an underweight to this asset class relative to the fund's peer group. The table below shows the extent of public equity losses during the two most recent recessions.

	S&P 500 Peak to Trough Return
Tech Bubble (March 2000 – October 2002)	-49%
Financial Crisis (October 2007 – March 2009)	-56%

During a time period when public equities generate unusually high rates of return, as they have for the last five years, the fund can be expected to underperform its peers who have higher allocations to public equities. However, during inevitable periods of market stress, the fund should exhibit lower downside risk and outperform those peers who have greater exposure to public equity. To illustrate this scenario, the Board's recently hired general consultant analyzed the performance of the current asset allocation under various economic scenarios compared to the performance of the average asset allocation of a peer group. As illustrated in the table below, the fund's asset allocation as of June 30, 2014 would have underperformed its average peer during periods of strong equity markets, but conversely, it would not have sustained as great a loss in times when the equity market was weak.

Historical Scenario Analysis
(Cumulative Return)

Scenario	**MSRPS Return**	**Average Peer Return**
Calendar Year 2013	10.9%	15.9%
Calendar Year 2008	-23.0%	-25.5%
Global Financial Crisis (4Q07 through 1Q09)	-25.3%	-29.2%
Interest Rate Spike (1994)	3.7%	3.3%
Crash of 1987 (September through November 1987)	-9.2%	-11.8%
Popping of the dot.com Bubble (2Q00 through 3Q02)	-10.0%	-16.6%
Strong US Dollar (1Q81 through 3Q82)	2.2%	1.8%
Weak US Dollar (January 1986 through August 1987)	27.3%	29.3%
Stagflation (January through March (1980)	-5.5%	-5.8%
Stagflation (1Q73 through 3Q74)	-16.8%	-27.5%

Source: Meketa Investment Group, November 2014

Recognizing that asset allocation is the main driver of performance, the System reviews asset allocation on an annual basis with extensive input from the board's general consultant and investment staff. To ensure a fresh perspective and asset allocation tools, the System periodically puts the general consultant contract out for bid through a competitive RFP process. Such a process was completed in the first half of 2014. As a result, the board hired a new general consultant in Meketa Investment Group, Inc. in July of last year. Since then, Meketa has been reviewing the current asset allocation and investment policies, and will play a critical role in the next scheduled asset allocation study in May 2015. The appropriateness of the current public equity allocation of 35% will be considered at that time. However, Meketa has not expressed any major objections to the current allocation to date. Additionally, at the request of the board, Meketa also has completed a peer fee analysis. The results of this analysis indicate that the fees paid by the System are competitive with peer funds of similar size, and in many cases are lower.

The System's Disability Benefit Structure and Process Have Not Been Reviewed in Almost 15 Years.

SRA understands the analyst's recommendation and is fully prepared to support a joint study of disability benefits.

Recommended Actions:

Delete 1.0 full-time equivalent administrative specialist III (new position). The agency has been holding an identical position in the same unit vacant since July 2014.

Respectfully Disagree – The Agency is greatly appreciative of the Governor's allowance which provided for this new position in a unit with an incredibly high workload. This position was specifically designated for estimates and finals processing unit within Benefits Processing. And, as stated above, each Administrative Specialist III has a performance standard of working or checking 6,300 units of production each year. Without his position forward progress on the backlog would be hampered.

It should be noted that the Division's vacant positions are reviewed and prioritized each time a vacancy can be filled. Unfortunately, other more senior positions – like the Director of Data Control, the Manager of Payroll Reporting and four Retirement Benefits Specialists – have had to take priority over filling the much needed Administrative Specialist III in this unit.