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Nebraska Retirement Systems Committee  
March 27, 2008

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The Committee on Nebraska Retirement Systems met at 12:00 noon on Thursday, March 27, 2008, in Room 1525 of the State Capitol, Lincoln, Nebraska, for the purpose of conducting a public hearing. Senators present: John Synowiecki, Chairperson; and Russ Karpisek. Senators absent: Tom White, Vice Chairperson; Philip Erdman; Lavon Heidemann; and LeRoy Louden.

SENATOR SYNOWIECKI: Good afternoon. I'd like to welcome you, first, to the Nebraska Retirement Systems Committee. Today the committee will be receiving two annual reports. We'll be receiving the report from the Public Employees Retirement Board and as well, the State Investment Officers' annual report. Members of the committee hopefully will be coming in as we progress through the receiving of the reports. Those that are here: Right to by immediate right is Jeremy Nordquist. He is the committee research analyst, and Laurie Vollertsen is the committee clerk. And as members come in, we'll have them announced. We will start the hearing by receiving the annual report from the Public Employees Retirement Board. Phyllis, how are you doing this afternoon? [Annual Reports]

PHYLLIS CHAMBERS: (Exhibit 1) Good afternoon, and I apologize for my voice. [Annual Reports]

SENATOR SYNOWIECKI: You've got that bug now? [Annual Reports]

PHYLLIS CHAMBERS: I kind of have laryngitis. I feel fine, but I just don't sound very good, so. I believe you all have a report that has been provided to you. It looks like this. [Annual Reports]

SENATOR SYNOWIECKI: Yes. [Annual Reports]

PHYLLIS CHAMBERS: It's my pleasure to talk to you today about the Nebraska Public Employees Public Retirement System and bring you up to date. First of all, I'd like to thank the committee for all of their support during this past year and to let you know that things are in excellent shape. Our funding status for the plans: With the teachers we have increased our funding status to 90.5 percent, the State Patrol is at 95.8 percent, and the judges plan is at 107 percent funded status. And according to a Pew report for the states, the average state plan funding status is 82 percent. So we're well above the average, and I think you can be pleased that we are doing well and continuing to fund the necessary costs of the plans. I'd like to highlight for you today our accomplishments for 2007. I think this can be...the last year has been a year of progress at the agency. On page 15 I've listed a number of accomplishments. First and foremost, I think, to point out that the most important work we do is serving our members in the plan, and we have six retirement plans. We have the schools, judges, state, county, State Patrol, and

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we have a deferred compensation plan. And of all of those, the total plan members this year grew to 104,599, and a record \$9.2 billion of total assets in those plans. Hello, Senator Karpisek. [Annual Reports]

SENATOR KARPISEK: Hello. [Annual Reports]

PHYLLIS CHAMBERS: All of the...throughout the year we've had...our 49 employees have been very active servicing those plans. Last year we had 38,000 phone calls responded to in our call center. We only have four people in the call center, and those four people also do appointments that come into our office. We had over 700 visitors to our office last year with appointments and also those without appointments. And it's very gratifying to see retirees coming in with their spouses, coming in together to go over their retirement plans and plan what they're going to be doing in their retirement years. And it's also gratifying to see the smiles on their faces because they're very excited about retirement, for the most part. It's kind...I kind of relate it to working in a wedding shop, and the brides come in and they're all real excited to buy their wedding dresses. And being in the retirement business, in a lot of respects, is one where people are really happy and pleased with what they've accumulated over the years, and they're ready to relish in the fruits of their labors, so. We also processed 1,300 teacher retirements last year. We did an estimated 600 purchase-of-service estimates for school employees, and those...not all of those people actually purchased service. Many of them will come back and ask again the next year, and the next year, or they find out that it's not something they really want to do. But that still takes a lot of our time. We processed 45 QDROs, Qualified Domestic Relations Orders, or divorces. Joe Schaefer, our legal counsel, is involved with those, the legal work on those, and we had 169 death claims that we processed in taking care of the beneficiaries of our plan members. We also distributed over \$366 million in benefits to our plan members, in all six plans. The majority of that went to our teachers. We paid out over \$276 million in benefits to our school plan members. And of those, 90 percent of that income stays right here in the state of Nebraska, as a tremendous economic engine our economy and the state. Our Data Services Department was very busy transferring microfilm and paper documents into electronic images. We finished a three-year project and of those, throughout the year we also sent out 49...or we received 49,000 pieces of mail, sent out over 385,000 pieces of mail, and we scanned over 429,000 documents--beneficiary forms and all the necessary documents for verifying employment and verifying salaries and so forth. We are in the middle of our conversion of our technology project. We're seven months into the project. We are being monitored by the Office of the CIO. We have the RIT manager is from the Office of the CIO, as well as our project manager. We also are working with a quality assurance team from the University of Nebraska, and we have input from the Nebraska Information Technology Commission. So we have a lot of eyes working on our project that is scheduled to take a total of two years, and so far we are within our budget and also following our scheduled time period, so we're pleased that things are moving along. We also did an RFP and rehired Buck Consultants for another three-year

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term, our actuary. And we, according to LB665, we gave the state and county employees another opportunity to switch to the cash-balance plan, and at the end of this year, of this past year, there were 1,574 employees who transferred to the cash-balance plan. We now have 64 percent of our employees, of the state employees, in the cash-balance plan. Excuse me--64 percent of our county employee in the cash-balance plan; 61 percent of the state employees are in the cash-balance plan. And of course, all new employees are in that plan. We paid a dividend. The board awarded a 2.7 percent dividend to the employees as of...that had a balance as of December 31, 2006. We have made major progress on our reconciliation project with the recordkeeping services that occurred...the change for the state and county plan that occurred in 2006. We've reviewed over 1,200 accounts and we're in the final stages of that. I keep saying that every month, but we're getting closer all the time and our goal is to have that finished by the end of this fiscal year. Our Finance and Accounting Department has done an excellent job of taking care of our agency expenditures and our financial reporting, and we have no major problems with the auditors. And our financial reporting, our financial statements look terrific, so I'm pleased to report that. We've also done a lot to improve our relationships with the State Auditor this past year and worked with them on how we can streamline our audits and work together better with them, and I think we're making great strides in that area. We did process the 85 percent Purchasing Power Floor that was passed last year, and that took place in July of last year for those employees receiving the COLA in the school plan. And we conducted the law enforcement survey of which you are dealing with right now, with pending legislation. I'd like to report that we had over 75 different retirement plan seminars and presentations to members and to employers, reaching out to over 3,400 of our plan members and employers that our Education Services people travel throughout the state, and so we were busy doing that. We'll continue doing that in the coming year, as well. And we had 339 hits on our Web site--339,000, excuse me, which demonstrates that there's a large number of people using our Web site, and also, there's so much information on our Web site. We have all of our annual reports, we have all of our newsletters, all of our board minutes, all of the plan booklets, plan criteria and rules. Everything is on there, as well as plan performance, so it is an excellent Web site, one that has been very beneficial and also helps our call center. If people can go to the Web site and get that information, those are fewer calls that we have to answer. I would like to point out that the actual report contains much of the information that you've received in the past. In the appendix, Appendix A, we have included a new page, which is on page 36. And this shows our cash-balance option and it shows the credit rates that we've had, our historical credit rates, and also the dividends that have been paid out since the plan started in 2003. We thought that might be helpful to you to know the history of what has happened. [Annual Reports]

SENATOR SYNOWIECKI: What page is that on, Phyllis? [Annual Reports]

PHYLLIS CHAMBERS: That is on page 36, and it's in Appendix A. And with that, I'd be

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happy to answer any questions that you have. [Annual Reports]

SENATOR SYNOWIECKI: Well, appreciate the report. Nicely done, thank you. Senator Karpisek has joined us. I was just going through this. It's kind of amazing how much of these pension benefits stay in the state of Nebraska on some of these charts you're showing, you know, that particularly... [Annual Reports]

PHYLLIS CHAMBERS: And it also...it does show by county, so counties can see. [Annual Reports]

SENATOR SYNOWIECKI: I seen that, as well. Yeah, um-hum. [Annual Reports]

PHYLLIS CHAMBERS: And then also there's a state by state, and there's...some of the money even goes to Mexico and to the Armed Services, but for the most part it's right here in Nebraska. [Annual Reports]

SENATOR SYNOWIECKI: Any questions from the committee? Thanks, Phyllis, appreciate it. [Annual Reports]

PHYLLIS CHAMBERS: Okay, thank you. [Annual Reports]

SENATOR SYNOWIECKI: Any additional...well, we don't take any testimony, I don't think, unless at the end of this, we can accept public testimony on the reports filed. But next we'll hear from the State Investment Officer on the annual report. I think at the conclusion, Dave, of your report the committee will accept any public testimony. [Annual Reports]

DAVID BOMBERGER: (Exhibits 2 and 3) Chairman Synowiecki and members of the Retirement Committee, my name is David, D-a-v-i-d, Bomberger, B-o-m-b-e-r-g-e-r. I've been the Nebraska state investment officer since July 1, 2006. It's my pleasure to present the Nebraska Investment Council's 2007 annual report for your consideration. You've got two pieces in front of you from me. The full report, spiral-bound, and I guess as I was doing this last year, I found it a little bit awkward flipping...having you flip through pages here, so I put together a PowerPoint presentation to address some of the highlights. We certainly can drill down into much greater detail in the annual report, if you'd like. 2007, as you all know, was a challenging year in the financial markets. The economy achieved reasonable growth during the first half of the year, but that was interrupted by the subprime mortgage crisis that came along. Bolstered by strong returns during the first half of the year, most major asset classes produced positive returns during 2007. The only exception was small cap equities, which had a slightly negative return. International equities did significantly better than U.S. equities, and fixed-income investments did produce positive returns during the year. Slide 2 shows you a summary of the various portfolios that the Investment Council is responsible for.

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The assets that we oversee grew to \$15.3 billion at the end of 2007. There was about \$450 of net new contributions to the plan and nearly \$1.1 billion of investment earnings. At \$15.3 billion, the Nebraska Investment Council is one of the five largest investment organizations in the state of Nebraska. The biggest contributor to the growth in net contributions was the college savings plans, with net contributions in excess of \$256 million. That plan grew to over \$2 billion at the end of the year. That's about a 22 percent increase from prior year end and reflects not only positive investment performance but the incentive that was created from Nebraska savers by increasing the tax deduction. Slide 3 presents the investment performance of the defined benefit plan assets. That's the biggest pool of assets that we're responsible for and totaled about \$7.5 billion at the end of 2007. And as you can see from this chart, the return that the NIC has produced on these assets is about 10.5 percent but has generally only matched the indices returns over that period of time. Certainly, at 10.5 percent it's more than adequate to help you all keep the plans fully funded, but we're concerned that going forward, returns will be lower, and we'll talk about that in a few minutes, some of the things we're doing to address that. Slide 4 shows the asset allocation for the defined benefit plans. That's unchanged from when I met with you last year. We are in the middle of completing an asset/liability study, which Ennis Knupp will present at the April 8 Investment Council meeting, and we may have changes in asset allocation for the council to consider after that presentation, and we certainly will report to you if and when those changes are made. Slide 5 shows the actual allocation of investments, and all of our balances are within the tolerances that we've established for each of the ranges. We did benefit from being slightly overweight in international equities versus other asset classes during the year. Slide 6 gives you a summary of the state and county retirement plan, both defined contribution and deferred compensation plan. Those assets now total \$1.8 billion, \$1.2 billion of that is in the defined contribution and deferred comp plans, and about \$600 million is in the cash balance benefit. The cash balance benefit grew to just over \$600 million at the end of last year, and on Slide 7 you can see the policy asset allocation, and it's substantially identical to the defined benefit asset allocation. And Slide 8 shows the actual allocation and as was the case with the DB plan, the cash balance benefit actual asset allocation is substantially in line with our targets. Slide 9 shows the performance of the cash balance benefit assets, and they were slightly ahead of the defined benefit, more as a function of holding some cash during the second half of the year, when many of the asset classes had negative performance. But over a longer period of time, the return on these assets are substantially the same as the DB assets. During...and if you'll turn to Slide 10, during 2007 the Investment Council added 13 new investment managers to the manager lineup, and to give you an order of magnitude of significance, we had 20 managers at the end of 2006. So a very substantial increase in the number of investment managers that we're overseeing. The first move we made was to...we did a domestic equity policy review and concluded that we were overweight in small cap value stocks, and so we replaced the small cap value manager with a small mid-cap growth manager, Turner Investment Partners. That decision added about 1,000 basis points of additional return

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during the six-month period that the new manager was in place. We also added six new private equity funds to the lineup, starting with Sun Capital down through Wayzata Opportunities Fund. We added four new private real estate funds, PRISA II through Rock Point Real Estate Fund III, and we also added two...commitments to two distressed mortgage funds. Our fixed income managers went through the year with very modest, if any, exposure to subprime mortgages, and so we had excellent performance, and because we weren't addressing problems in our fixed-income portfolios, we felt there were return opportunities available to us by committing to this opportunistic asset class. The defined contribution and deferred comp balances are presented on Slide 11, \$1.2 billion. Over half of the balances in those funds are in the four premixed options that we have available. Slide 12 shows you the array of asset allocations, and I'm sorry that the pie charts are quite small there, but across...the three across the top are conservative to moderate to aggressive. That allows the participant to choose a risk profile for their investments. The Investor Select Fund, which is the pie chart at the bottom of this slide, is the fund that was introduced a couple of years ago that was intended, to the extent that we are able, to replicate the asset allocation that the Investment Council has implemented for the defined benefit plans. Slide 13 shows a summary of the investment performance of those premixed funds and the market values of balances in them. The moderate premixed fund has the lion's share of the assets, and not surprisingly, the returns are higher for those premixed funds that have...that take more investment risk. I'd also mention to you that during the year we completed a review of the investment menu for the Hartford deferred compensation plan. That menu had not been reviewed for some time, and we're very pleased that we were able to make significant improvements in that lineup and reduce costs for those participants, and those changes were implemented earlier this year. Slide 14 shows a bit of history, and I think I shared with slide with you when I was testifying on LB1143. The point here is the assets the council oversees have quadrupled over the last 12 years. Slide 15 shows a history of investment returns. There are only two periods over the last 12 years where returns were negative. In 2007 investment returns were \$1.1 billion. That's down a bit from \$1.5 billion in 2006 but still a very significant contribution to the financial health of the state. Total investment returns over this period of time have totaled \$7.7 billion, and I apologize--my note at the top says \$7.6 billion, and in fact, it's \$7.7 billion. Contributions to the various plans are summarized on Slide 16. As you can see, the last several years, very significant contributions were reflecting the introduction of the College Savings Plan, and significant increases in the Operating Investment Pool. During 2007 there were net contributions to the College Savings Plans of \$256 million and net contributions to the OIP of \$223 million. Securities Lending is a tool that the Investment Council employs to make sure that the assets are working as hard as they possibly can. Securities Lending added \$2.8 million of investment return in 2007. That's up a million dollars from 2006, and over the four years that we've presented here, it's added \$6.8 million of investment return. Now we talked about returns up to this point, but we're talking about net returns, and so investment expenses are a very significant component of those net returns. The pie chart on page 18 shows the composition of the

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approximately \$25 million that was spent to manage the state's assets in 2007. A little over \$21 million or just over 85 percent of that \$25 million was paid in fees to investment managers, external investment managers. About \$2.3 million was paid to our custodian who holds securities on behalf of the state, and about \$1.4 million or less than 5.5 percent of the expenses incurred during the year were incurred directly by the agency. The slide on page 19 gives you some perspective about the direction of expenses over time. Over the last 12 years total investment expenses have increased slightly, less rapidly than the growth of assets--375 percent compared to north of 400 percent. And the gold...I'm sorry. The green bar measures these costs in basis points. The basis point cost, total cost of managing the assets, was 19 basis points last year, reflecting some increase in that average cost reflecting our investments in private equity and private real estate funds. Breaking down the three components of total investment expenses, the chart on Slide 20 presents the history of external investment management fees. Those fees have grown at about 3.5 times over this 12-year period, compared to a 4 times increase in assets, and we choose this period because it was about the beginning of this time period where the Investment Council made the decision to begin outsourcing substantially all of the investment management activity. It had previously been substantially managed internally. Slide 21 presents a history of the custodian fees, and the news here is that these expenses have grown more rapidly than assets, reflects the contract that was negotiated several years ago, and frankly didn't contemplate the growth in assets that we've experienced. The good news is that that contract expires this September. The Treasurer's Office and our office has been in the process of conducting a request for proposal for a global custodian, and we expect to have very substantial savings that we'll achieve through the renegotiated contract--lower fees, a higher securities lending stream of income, and a broader array of services. And then the last component of investment expenses is the portion that we manage directly through our budget. Those expenses have grown at about a sixth of the rate of asset growth, and about a fifth of the rate of the growth of total investment expenses. In wrapping up I wanted to comment a little bit about our view of the future. The slide on page 23 present Ennis Knupp, the councils general investment consultant's outlook for returns over the next 15 years, and you can see that these returns are substantially lower than the returns that we've achieved over the last 25 years. And the message here is that we will have to work a lot harder. We'll have to look at a lot of new, more complex investment strategies to achieve the returns that are required by not only the defined benefit plans, but by the other constituents that we invest for. We will need to look for ways to generate more excess return. We'll have to allocate to new...and this...I'm on page 24. We'll have to look at new asset classes, nontraditional asset classes, and really aggressively manage a broader array of investment risks to maintain the same general risk profile on an overall basis for the assets we manage. I thought it was important to give the committee a sense, and if you'll turn to page 25, a sense for potential cost if we don't achieve the 8 percent return. And to pick an extreme example, I asked the state's actuary what would the additional contribution requirement be if we invested 100 percent of the assets in fixed income, and Slide 23 projected the return to

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be 5 percent. If we would only achieve 5 percent over the next 15 years, it would require an additional contribution from the state of \$203 million per year. So the risk of not trying to achieve the return is very significant to the state. Tried to, in the next couple of slides, attempt to project what the future will look like. I've tried to begin to prepare a 10-year projection for growth of assets and the resources that will be required to manage those. I've used some fairly simple projection techniques. I've grown the assets 8 percent, 10 percent, 11.5 percent, and 12 percent each year, straight-line growth. I chose 11.5 percent because that's what we've achieved historically, over the past 10 or 12 years. So there wasn't anything magic about 11.5 percent, other than that's what we've achieved. In fiscal 2017 the assets that the council is responsible for, based on these projections, will grow to somewhere between \$30 million and nearly \$50 million, so at least a doubling and perhaps a tripling of assets over the next 10 years. And as we spend more time investing in alternative investments like private equity and private real estate, we've tried to project how many funds we'll need to invest in to achieve the diversification necessary to have an appropriately constructed portfolio. In the projection on page 27, I've assumed that we continue five private equity funds a year, two private real estate funds a year, for the next three or four years, increased to three real estate funds and eight private equity funds. And we end up with nearly 150 partnerships that we're managing by fiscal 2017. And with that, I'd be happy to respond to any questions that the committee might have. [Annual Reports]

SENATOR SYNOWIECKI: Thanks, Dave, for the report. What is the basis of your future...the lower returns that are predicted. What are basing... [Annual Reports]

DAVID BOMBERGER: Well, I think one, there's a lower...a starting point is an inflation expectation. [Annual Reports]

SENATOR SYNOWIECKI: Um-hum. [Annual Reports]

DAVID BOMBERGER: And that is lower than these projections have used in the past. We're starting with a 2.3 percent expected inflation over this period of time. We think the economy has gone through a long spurt of growth, and we believe that earnings...that the economy will grow more slowly, that corporate earnings will grow more slowly, and we're not projecting that there will be a significant increase in the price/earnings multiple, and that's effectively how a stock is priced. It's the multiple of its current earnings, is what determines the price. We believe we've been through a historically abnormal period of returns, and we expect returns will revert to the mean, and over the next several years be significantly lower. We shared with the Investment Council and with the PERB board in November Ennis Knupp's paper as they described all this, and I'd be happy to get a copy of that to Jeremy to share with all of you. Their track record in terms of the accuracy of this forecast, with the exception of the bubble period in the late nineties, has been very impressive. [Annual Reports]



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SENATOR SYNOWIECKI: Um-hum. [Annual Reports]

DAVID BOMBERGER: So we hope we do a whole lot better, but we want to manage our own expectations, and we want to manage our constituents' expectations. [Annual Reports]

SENATOR SYNOWIECKI: Um-hum, yeah. What caught my attention a little bit was the...in excess of \$20 million that we pay in fees. I know you're aware that we've got some legislation. Maybe we can take a better look at that. I think some states have dramatically changed course and have more direct management over the funds, to lessen the impact of these fees. Do you want to comment on that,... [Annual Reports]

DAVID BOMBERGER: Well, I think... [Annual Reports]

SENATOR SYNOWIECKI: ...where we're at on that? [Annual Reports]

DAVID BOMBERGER: The only fund we manage internally, Senator, is the Operating Investment Pool, and our cost for managing...well, our internal...if we take the \$1.4 million and spread it across the \$15 billion that we manage, is less than one basis point. And so I think we've demonstrated that we can effectively manage that fund. I think the challenges we have are changing course, and building an internal investment management team isn't something that I can wave a wand and have a group here overnight. [Annual Reports]

SENATOR SYNOWIECKI: Um-hum. [Annual Reports]

DAVID BOMBERGER: I think it's a...we look to our neighbors in South Dakota. They internally manage substantially all of their investments except for private equity and private real estate, and their costs of managing those internal monies is about seven basis points. And that compares to our 19 basis points reflects a very significant portion that is in index funds that are very low cost. [Annual Reports]

SENATOR SYNOWIECKI: Um-hum. [Annual Reports]

DAVID BOMBERGER: If we would look at our active management fees, Senator, I would think that our average external manager fee is 35 to 40 basis points. So I think that's one anecdote to compare the cost component of internally managing with having substantially all of the assets outsourced. [Annual Reports]

SENATOR SYNOWIECKI: Well, I just want to congratulate you on hitting the benchmarks as you laid out here, and you weren't there but particularly, when we had the downturn in '01-'02, I know our state was not as severe as other states, in terms of their public plans and public funds, and so forth, that took a hit. So I think we're very

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fortunate with the way we do business, and the Nebraska Investment Council and its leadership since I've been in the Legislature, the entire seven years, even the downturns. We're not as severe as other states experienced, and I appreciate that. [Annual Reports]

DAVID BOMBERGER: The downturns weren't fun to go through,... [Annual Reports]

SENATOR SYNOWIECKI: I know. [Annual Reports]

DAVID BOMBERGER: ...but I think they were...the folks that have come before me did a very fine job in managing the way through those. [Annual Reports]

SENATOR SYNOWIECKI: I agree. Any other additional questions from the committee? Okay, thanks, Dave. [Annual Reports]

DAVID BOMBERGER: Thank you, Senator. [Annual Reports]

SENATOR SYNOWIECKI: Appreciate the report. Thanks for coming in, taking your time. The committee will entertain any public testimony on the reports at this time, if there's any public testimony. Seeing none, that will conclude the Nebraska Retirement Systems Committee hearings for today. Thank you again for your attendance, and thank you. [Annual Reports]

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Chairperson

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Committee Clerk