MARYLAND
STATE RETIREMENT
and PENSION SYSTEM

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Maryland State Retirement Agency

Testimony of R. Dean Kenderdine, Executive Director

Before the

Senate Budget & Taxation Committee
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&

House Public Safety and Administration Subcommittee
February 5, 2016

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 2017.

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 394,000 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 2.68 percent in fiscal year 2015. This return exceeded the policy benchmark of 0.86 percent, but fell short of the fund's 7.55 percent actuarial return target. The market value of the fund increased from $45.4 billion as of June 30, 2014 to $45.8 billion as of June 30, 2015, resulting in a funded ratio of 69.7 percent as of June 30, 2015 compared to 68.7 percent at the end of fiscal year 2014. The top-performing asset classes for the year were private real estate and private equity.

Net Returns as of June 30, 2015

	1 year	2 year	3 year	5 year	10 year
Total Plan	2.68%	8.37%	9.10%	9.36%	5.77%
Policy Benchmark	0.86%	7.30%	7.70%	8.52%	5.30%

According to preliminary performance reports as of December 31, 2015, the System's total portfolio returned -2.33 percent on investments for fiscal year-to-date, exceeding the policy benchmark by roughly 44 basis points, or 0.44%. The market value of assets as of December 31, 2015 was approximately $44.2 billion.

The System's investment performance during fiscal year 2015 is summarized in the following exhibit:

	FY 2015 SRPS Performance	FY 2015 Benchmark Performance	SRPS Allocation 6/30/ 2015	Target Allocation
Public Equity	3.65%		37.6%	35%
Custom Benchmark		0.60%		
U.S. Equity	6.35%		10.2%	
S&P 500		7.42%		
Russell 3000		7.29%		
International Equity	-0.29%		11.0%	
MSCI ACWI ex. U.S.		-5.26%		
MSCI EAFE		-4.22%		
MSCI Emerging Markets		-5.12%		
MSCI World ex U.S.		-5.28%		
Global Equity	4.82%		16.4%	
MSCI AC World		0.71%		
Private Equity	13.17%		8.0%	10%
Custom State Street PE		7.62%		
Fixed Income	1.96%		12.9%	10%
Custom Benchmark		1.93%		
BC Intermediate Aggregate		1.89%		
BC Global Bond Agg 1-10		2.09%		
Credit /Debt Strategies	-0.81%		9.7%	10%
Custom Benchmark		-3.05%		
BC High Yield		-0.39%		
BC Credit		0.93%		
JP Morgan GBI EM GD		-15.39%		
S&P LSTA Leverage Loan		1.82%		
Real Estate	12.12%		7.4%	10%
Custom Benchmark		10.40%		
NCREIF ODCE		13.45%		
FTSE EPRA NAREIT		-0.36%		
Real Return	-5.18%		13.2%	14%
Custom Benchmark		-6.61%		
Absolute Return	0.74%		10.7%	10%
Custom Benchmark		2.71%		
TOTAL FUND	**2.68%**	**0.86%**		

The **public equity portfolio** returned 3.65 percent, compared with a return of 0.60 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 6.35 percent, trailing the return of the Russell 3000 Index by 94 basis points. The international equity portfolio returned -0.29 percent compared to -5.26 percent for its benchmark, the Morgan Stanley Capital International (MSCI) All Country World ex-U.S. Index. The global equity portfolio returned 4.82 percent, outperforming the 0.71 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 1.96 percent, compared to 1.93 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 -0.81 percent compared to -3.05 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 -5.18 percent, compared to -6.61 percent for its blended benchmark, which consisted 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 0.74 percent, trailing its customized benchmark: Hedge Funds Research, Inc. (HFRI) Fund of Funds Conservative Index. The **real estate portfolio** returned 12.12 percent versus 10.40 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 13.17 percent, compared to the 7.62 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 2015, the program returned 1.83 percent, compared to 2.15 percent for its customized benchmark. While annualized performance for the five years ending June 30, 2015 have been slightly negative relative to it customized benchmark, the return since inception has added significant value. Since inception, the Terra Maria program has achieved an annualized return of 5.88 percent, compared to 4.70 percent 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.

Benefits Administration

Active membership remained constant from fiscal year 2014 to fiscal year 2015, holding steady at 193,600. We continue to see steady and consistent increases in the number of annuitants. At the end of fiscal year 2015, the number of retirees and beneficiaries receiving benefits increased 3.5 percent to 147,850 compared to 142,887 in the previous year. Over a ten year period the total number of annuitants has grown 30 percent from 103,831 in fiscal year 2006 to the 147,850 in fiscal year 2015. Our current number of retirees and beneficiaries receiving monthly allowances is more than 151,000 as a result of new retirements since July 1, 2015.

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.

In addition to the vacancies throughout the division, there were two other "events" that impacted meeting performance goals. The first was the installation of a new phone system and within it, a new Interactive Voice Response (IVR) system in the call center in December 2014. The agency did initially incur issues with the new telephone system that affected the performance of the Member Services unit. Subsequently, Member Services encountered problems where the system was dropping incoming calls. The Agency experienced programming and functionality issues with the IVR and had several system resets due to system bugs and upgrades. As the analyst indicates in his presentation, these latter telephone issues were attributed to problems with Verizon's service into the Agency and have been corrected.

The biggest impact the new telephone/IVR system had on our performance was the number of incoming lines increased from 20 lines under the old system to 45 lines with the new system. Staffing in the phone unit has remained constant at 10 which means there could be up to 35 callers in queue. Having more calls in queue lengthened the average speed of answer as well as the abandonment rate as many would hang up after learning they were caller 25 or higher.

The second impact on division performance goals was the implementation of the Governor's Voluntary Separation Program (VSP) in February 2015. At the start of the program, the Agency prioritized all VSP processing as first priority, even above priority processing requested by other participating employers offering separate voluntary separation programs. Based on previous VSP experience and its impact on workload, the Benefits Administration Division proactively developed an automated solution to generate over 9,000 unaudited pension benefit projections for members eligible for an early or normal service retirement.

To assist with estimate processing, the Agency assigned five experienced Retirement Benefits Specialists which seriously impacted the telephone response unit. The result has been an abandonment rate of nearly 18%, far exceeding its goal of less than 6%. Other specialists needed to devote time to schedule and participate in the VSP seminars, suspending other planned counseling sessions for non-state members.

It was only through suspending processing in several areas and assigning other staff that the Agency was able to meet the demands and reduce the turnaround time to process member requests during the VSP participation period. However, work backlogs increased as the Agency entered the final stage of processing the actual VSP retirements and payment of the member accumulated contributions to those ineligible for retirement or a future vested benefit. The Agency successfully implemented the program ensuring that every VSP retiree received their pension payment in the month of retirement.

The Agency ended fiscal year 2015 with a 10.29% percentage of abandoned calls, above the goal of 6%. The 1:45 average speed of answer performance goal was also missed. The average speed of answer for the fiscal year was 2:59. There were 115,745 calls made to the call center and specialists answered 103,485 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 have been suspended 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 over 92 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.

The Benefits Administration Division continued 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 the fiscal year to develop an improved payroll reporting system for our participating employers. Testing on the new payroll reporting is underway and it is anticipated that the new system will be fully launched in 2016.

Information Systems

The Agency's baseline technology platforms continue to operate reliably with little production downtime.

The specific platforms supporting the Maryland Pension Administration System, or MPAS, have been nearly completely upgraded encompassing hardware, software, and utilities. In addition, the Agency is well along in identifying anomalies in MPAS data, and then flagging or correcting them. These data have been submitted to the Agency from over 150 separate employers for over 40 years. This "data cleansing" initiative—begun in FY 2014—has been successful in meeting its stated goals to date, and its full benefits are expected to be realized over the coming years. Also, the Agency is now more than half-way through a significant initiative to replace the MPAS business rules engine, a maintenance project begun in March of 2015, and is on track for scheduled completion in May of this year.

We are pleased to report that the Agency begins this month offering self-service document reprints to members over its website, starting with the 2015 retiree 1099R forms and employee Personal Statement of Benefits. This new service will handle some of the thousands of requests the Agency receives in Member Services this time of year for 1099R reprints. This represents a start toward eventually having a more robust self-service Internet portal for our members.

Last year, the Agency reported that its employer payroll reporting software, used by many employers throughout the state to upload data to the Agency, was slated to be replaced. We can report that the replacement program has successfully gone through pilot testing and is being implemented this spring.

In January of 2015, the Agency replaced its voice technology, encompassing the telephone switch, Call Center functions, call recording, voice mail, and the Interactive Voice Response system. Voice technology was also added to our Disaster Recovery site. This was a significant effort, requiring active management and collaboration among numerous staff units and outside contractors. We can report that the new equipment is functioning to specification in a more integrated and cost-effective manner, and with more Member Services features than the prior equipment offered.

In the current FY 2016 budget year, the General Assembly approved replacement of two contractor Programmer/Analyst resources with four permanent state employee positions, having a neutral dollar impact, to ensure that Agency-critical business applications (such as MPAS) were supported at least partly by in-house staff. Going back more than a decade, approximately 80 percent of systems development resources have been contractors, including the entire staff complement supporting pension administration applications. Starting last July, the Agency initiated the employee recruitment process. That recruiting process has been deliberate and focused, conducted collaboratively with the Department of Budget and Management. In the first round of recruiting in the fall, an insufficient number of qualified applications were received, even after a posting extension. Consequently, the Agency re-worked and expanded the posting with DBM, and a second round of recruitment is currently under way.

These recruitments will still leave the Agency with a significant backlog in applications development, which has accumulated through numerous prior years of budget reductions, combined with expanding regulatory and business user requirements. To address this backlog beginning with this FY 2017 budget submission, the Agency has requested over-the-target increases in systems development and maintenance resources. Based on the size of the existing backlog, these staffing complement increases are expected to be needed for several additional years into the future.

In our budget testimony last year, the Agency mentioned that it planned to test both Disaster Recovery (DR) and IT security in FY 2016-17. The Agency tested its DR capability by successfully changing MPAS processing to the Disaster Recovery site and concluding a payroll run using equipment and software at the DR site, staffed by personnel both on-site at the Annapolis business continuity location and logging in remotely over the Internet. In addition, the IT security testing contract was awarded and rigorous testing is occurring at this time.

In sum, the Agency's information technology continues to operate reliably, securely, and efficiently to serve our membership and staff.

Responses to Analyst's Comments:

DLS recommends cutting 1 new benefit specialist position, leaving 1 of the new positions in place to help the call center meet its performance goals more regularly.

The analyst accurately states that the Call Center did not meet its performance goal of 6% abandonment rate or its average speed of answer performance goal of 1 minute 45 seconds for fiscal year 2015. The analyst also identified the three contributing factors that impacted staff's ability to meet these performance goals: the Governor's Voluntary Separation Program (VSP) which required the re-assignment of staff resources, the challenges of the implementation of a new phone and Interactive Voice Response (IVR) system, and the multiple vacancies in the unit throughout the fiscal year.
The Agency concurs with the analyst's recommendation to cut one of the two new Retirement Benefits Specialist position. However, it should be noted that while the overall call volume did not increase year over year, our customer base does grow year over year. The number of active and retired members we serve increases by 3% each year; however, the number of staff (without vacancies) remains constant. The complexities of the System are vast and it takes a full year before a Retirement Benefits Specialist is

trained sufficiently to make an impact toward the performance goals in the Call Center. The Agency may request additional staff in future budget years to address the growing base of members and annuitants.

DLS recommends cutting the new allocation [to add 2 additional IT contractors] in half, to $190,000, leaving funding for 1 additional contractor as a contingency in the event that the new positions are not filled. DLS further recommends that the entire complement of IT staff be reassessed prior to 2018.

It remains, as it has been, that application programmer workload adjusts to the amount of available resource. There has consistently been a backlog of maintenance in all MSRA applications, but in recent years, that backlog has grown significantly, with several non-discretionary requirements. There are three main causes for this backlog: (1) reductions in prior year contractor staffing budgets; (2) imposition of requirements from external parties (e.g., the Internal Revenue Service, state and federal government, etc.); and (3) the desire to capitalize on the ability of the Maryland Pension Administration System (MPAS), implemented in 2010, to accommodate incremental improvements. It had long been anticipated that the investment in MPAS would lead to two subsequent phases: improving the integrity and consistency of data collected from employers over the past 40 years, which has been proceeding successfully; and then design/implementation of more automated processing by employers and members.

Specifically, the proposed reduction will very likely have the direct result of delaying implementation of the following major applications maintenance items:

1. IRS tax reporting changes for foreign individuals that have not been addressed;
2. Programs to enforce rules created by the Pension Reforms of 2011;
3. Legislative changes yet-to-be implemented, including:
    a. Membership rules after a 45-day break in service, currently handled manually;
    b. Changes due to new tiers established in plans for legislators, correctional officers, judges, and other employees; and
    c. Combinations of prior service, currently a manual process.
4. Re-design of Domestic Relations Order processing, currently resulting in over-payments and tax reporting errors;
5. Sick leave re-certification, currently handled manually;
6. Cancel and re-credit processing;
7. Automated calculation of Average Final Compensation, currently a manual process;
8. Implementation of transactional features in future Secure Member and Employer portals; and
9. Automated estimation of benefits, using options other than the Basic Allowance, and based on actual data for each individual that the individual can review online.

For many years, requested programming resources have been reduced. These resources support benefit payment administration as well as develop and maintain all other Agency applications.

The proposed legislative reduction will result in further delays in achieving the anticipated return on the investment that the state made in MPAS, a ROI already delayed because of enactment of pension reforms, reprogramming due to end of vendor support for the MPAS rules engine, the state's Wellness Program, and the state's Voluntary Separation Program, none of which were planned but all of which were mandatory. Given the extent of the accumulated backlog, some of these items may take an additional decade or more to achieve at proposed staffing levels.

On the related topic of approved conversion of contractor positions to state employee "PINs," the Agency is in the process of implementing this solution. To date, the Agency has not replaced any contractors with internal staff. MSRA is diligently and intensively working to achieve this strategic objective, together with the Department of Budget and Management. Even if this staffing initiative is successful, though, there will still be a significant resource shortfall. The further reduction recommended, at a time when the Agency and the state are looking to advance the goal of automation along with member and employer self-service, should be re-considered.

DLS recommends reduced funding for postage; the Agency used surplus funds in fiscal 2015 to prepay postage. The amount of the proposed reduction is $250k.

The Agency requests a reconsideration of this recommended reduction. The proposal reduces the postage provision in the FY2017 budget to $285,000. As a result of a year-end appropriation surplus for FY2015, the Agency was able to prepay postage prior to the FY2015 close. This balance was attributable to office rent savings resulting from the renegotiation of the Agency office lease, as well as two procurements which were delayed into FY2016. This current fiscal year's circumstances will not afford a similar opportunity at current fiscal year-end. Postage costs incurred to date already approximate $214,000. Therefore, the Agency will not be able to prepay postage for FY2017. The DLS analysis suggests a carryover of the 2015 surplus into FY2017. The Agency does not believe such an outcome at the end of the current fiscal year to be at all likely.

A three-year average of postage costs (FY2013-FY2015), adjusted for the FY2015 year-end prepayment is $464,000. This amount is driven largely by the cost of the postage permit, which by itself averages $285,000 per year over the three-year range. Also, as stated in the analysis, two Board of Trustee (BOT) elections are scheduled for FY2017. Postage typically approximates $65,000 per election; therefore, approximately $130,000 will be required for the elections alone, if they take place. Please also note that in FY 2014, when there were no BOT elections, postage costs exceeded $430,000.

The postage reduction of $250,000 recommended by the analyst leaves a postage budget that would be one-half of the costs incurred in FY2015 (exclusive of the prepayment). This risks the Agency's ability to fund postage costs adequately in FY2017. Postage costs were $417,000 in FY2013, $433,000 in FY2014, and $724,000 (inclusive of the prepayment) in FY2015. Given the increasing trend of these costs, the Agency has serious concerns regarding its ability to satisfy its postage requirement, given the proposed reduction by DLS. The Agency requests a reconsideration of this reduction.

DLS recommends reduced funding for equipment; the Agency used surplus funds in fiscal 2015 to purchase additional equipment.

The Agency concurs with the analyst's recommendation

Report on Alternatives to Board of Trustees Elections Is Delayed

The analyst is correct when he points out that the report studying the election process for certain trustees on the Board of Trustees for the State Retirement and Pension System was to be completed by January 31, 2015. However, the analyst suggests that due to the legislature not receiving the report during the 2015 session, it did not have an opportunity to consider implementing any of the suggestions for change included in the Agency's analysis. While the Agency apologizes for the delay in submitting this report, it is important to note that due to a trustee election cycle that was already underway by the start of the 2015 session, any legislative changes made to the current trustee election process could not have been implemented until the conclusion of the 2015 trustee election (i.e. fiscal 2016 or later).

Moreover, the analyst also suggests that because the Joint Committee on Pensions did not receive this report during the 2015 interim, the Agency now has made it problematic for the legislature to enact legislation changing the trustee election procedures that could result in savings as much a $200,000 during the next election cycle beginning in December 2016. The committee should be aware that there are currently two bills that have been introduced by the Joint Committee on Pensions at the request of the Agency that would provide the committee with the means necessary to implement any legislative changes it believes are necessary to the System's trustee election process (i.e. House Bill 381 and Senate Bill 321). These cross-filed bills (State Retirement and Pension System – Board of Trustees – Designee Appointments and Fiduciary Duties) authorize the Treasurer, Comptroller, and Secretary of Budget and Management to appoint either a deputy or chief of staff as their designees. Additionally, the bills also amend the definition of "fiduciary" to include members of all committees of the board. Inasmuch as these bills address the composition of the Board of Trustees, the Committee readily could amend this proposed legislation to include changes to the board's election processes.

The Board of Trustees and SRA are asked to comment on the findings from the NEPC analysis, and to discuss the prospects for fiscal year returns, particularly the probability of improved comparative returns.

The NEPC analysis was a broad affirmation of the work of the Board and the current and former consultants on the allocation for the MSRPS. The key elements that have differentiated the allocation employed by Maryland and allocations employed by the average pension plan have been a lower allocation to public market equity and within that allocation, a balanced allocation between U.S. and foreign equity markets. The study affirms that the Board's focus on the volatility as well as the level of returns is appropriate for the health of the fund and the ability to meet its return objectives over the longer run.

The study did have some interesting aspects and points of differentiation. While NEPC believes that the allocation would promote the long term ability to achieve the required return, the near term return expectations are muted because of the low interest rate environment and relatively full equity valuations in the U.S. Their 5-7 year expectation was for 6.6% return for the plan under the existing asset allocation or under their slightly different recommendation, the "NEPC Best Ideas" allocation.

The "NEPC Best Ideas" allocation differs from the Maryland allocation in a number of small ways. The key areas of difference are a reformulation of the credit allocation to include a focus on Private Debt and a dedicated allocation to Risk Parity strategies.

Room for these recommendations was created by small changes throughout the rest of the allocation that offset part of the dedicated allocation. For example, the dedicated allocation to Risk Parity (portfolios that attempt to balance the risk among asset classes through the use of leverage) would have the effect of increasing the equity allocation, increasing the bond allocation, and increasing the commodities allocation. These sectors were reduced in the "NEPC Best Ideas" portfolio. Equity exposures were reduced 2%, Long Government exposures 3% and commodities exposure 3%. The NEPC portfolio rearranges the risks in the existing allocation to create a slightly more efficient portfolio.
NEPC did not consider the implementation of the Maryland program when creating its "Best Ideas" portfolio. They worked from the Investment Policy Statement and did not review the System's current investments. The actual implementation of the existing asset allocation has elements of the "Best Ideas" recommendation. Private debt is employed in the credit portfolio and risk parity is employed by one of the existing managers.

With respect to returns for the fiscal year, 7.55% will only be achieved with a significant recovery in global equity markets. Through the end of January, stock returns for the fiscal year are down seven to nine percent for U.S. stocks, over thirteen percent for developed market stocks and over twenty four percent for emerging country stocks. Fiscal year-to-date, the continued relative outperformance of U.S.

stocks will have offset some of the return advantage for the system based on its lower allocation to equity overall. However, the system is still likely to be performing better on a relative basis than in the past. Between now and the end of the end of the fiscal year, the market and the fund will do better or worse based on the performance of China and oil. Continued weakness in one or the other will make it difficult for asset prices to recover the losses incurred to date. Still, markets have corrected substantially and offer better valuations than at the beginning of the period and the U.S. economy and financial system are more robust than in previous periods of uncertainty so the risk of a substantial, long lasting impairment are low and lower valuations provide a good starting point for improved returns over time.