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# Introductory Section

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for Fiscal Year ending June 30, 2012

## Chairperson's Letter

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

GARY L. HARBIN, CPA  
*Executive Secretary*



December 28, 2012

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, 2012, the 72nd 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 2011-2012 fiscal year with \$15.2 billion net assets. The active membership totaled 75,951 and the retired membership was 46,094 with annual annuity and medical insurance benefits totaling \$1.7 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 insure 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,

Dr. Tom Shelton  
Chairperson  
Board of Trustees

#### BOARD OF TRUSTEES

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STATE TREASURER

## Letter of Transmittal



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

December 28, 2012

Honorable Steven L. Beshear, Governor  
Commonwealth of Kentucky  
Capitol Building  
Frankfort, Kentucky

Dear Governor Beshear:

It is my pleasure to submit the 72nd 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, 2012. State law provides the legal requirement for the publication of this report; in addition, an annual audit and an annual actuarial valuation of the retirement system are also required. Kentucky Teachers' Retirement System (KTRS) has produced an annual report that will provide you, the General Assembly, and the general public, with information necessary to gain a better understanding of KTRS.

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, 2012. Discussion and analysis of net assets and related additions and deductions is presented in Management's Discussion and Analysis beginning on page 15.

Management is responsible for maintaining a system of internal controls to establish reasonable assurance that assets are safeguarded, transactions are accurately executed 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 KTRS'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 24. Also, the summary of the plan provisions starting on page 97 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 legal adoption. The KTRS investment earnings fund the administrative budget appropriations.

#### Major Initiatives

KTRS 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 and Careful Management of Medical Insurance Costs**

June 30, 2012 marked the end of the second 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.

The Governor and Legislative leaders have commended Kentucky's education community for their 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 two years, and \$3.1 billion in savings by converting to a pre-funded plan, the "shared responsibility" solution is truly a significant accomplishment on the road to retirement security for current and future retired teachers.

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 the seventh year, continues to be stable and financially feasible for members and the KTRS medical plan.

Some recent cost saving initiatives include moving the KTRS sponsored Medicare drug plan to an insured Employer Group Waiver Prescription Drug Plan with a commercial wrap in the drug coverage gap to achieve the greatest amount of federal subsidies for 2012. 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.

Other cost containment measures communicated to the membership in 2012 for an effective date of 2013 involved the elimination of the future risk of adverse selection with our Medicare eligible spouses of retired teachers; and assisting those retirees and their spouses who are Medicare eligible, but under the normal Medicare age, to join the Medicare plan in 2013 achieving future savings for our members, the KTRS retiree medical plan, and the Commonwealth of Kentucky. KTRS is also exploring the industry best practice of utilizing a high performance formulary for 2014 with our drug plan.

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.

### **Investment Program**

KTRS's investment program was in the top 26% of returns for pension funds with over \$1 billion in assets with positive returns of 2.4%. Additionally, because of

KTRS's focus on fundamental value and risk control, it was able to continue a multiyear program of broadening the portfolio's diversification. This included new opportunistic investments that took advantage of dislocated financial markets. KTRS also continued to implement changes to the investment program based upon an asset liability modeling study, which included an analysis of the shared responsibility solution for funding retiree health care and receipt of the proceeds of bonds in the KTRS retirement annuity and medical insurance funds. 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**

KTRS staff has continued working on a multi-year project planning, designing, and constructing a new information technology system known as the "Pathway System." Last year, the Board took action and authorized hiring a vendor to begin building and installation of the new system.

The vendor has been working with staff on-site at KTRS since September 2011. The focus of work has been developing and constructing the first major component of the new system. The design work for internet based functions including member enrollment, employer reporting, service credit purchases, and related accounting functions, was completed in the spring of 2012. Based upon the design work, the construction of member enrollment and employer reporting was completed and extensive testing of those components has begun. More than 33% of the overall project has been completed and work has been proceeding according to schedule and within budget.

The objective of the Pathway System is to streamline retirement processes and improve staff efficiency in providing services to retirees and active members. In developing the new system, KTRS is redesigning and improving office processes and ultimately will be applying new internet 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 to the information technology system under the Pathway System, we expect that the new technology will help the System better serve its membership.

## Economic Condition

The economic condition of the System is based primarily on investment earnings. The Investment Section of this report starting on page 51 contains asset allocations, strategic target ranges for investments, discussion of the current year market environment and historical performance schedules among others.

The investment portfolio experienced a decline in value during the 2011-2012 fiscal year as the portfolio's market value decreased from \$15,547,900,381 to \$15,133,117,118. The decline in value of the portfolio and of the overall market was primarily due to turmoil in the international financial markets. This decline was offset with investment income that included interest income and dividends. Employer and employee contributions also provided significant income to the portfolio. However, because benefits paid out exceeded contributions to the System, the portfolio's market value decreased.

Investment income, including depreciation of asset values, net of investment expenses, for the 2011-2012 fiscal year was \$312,233,315. The major contributing factor of the positive return from the System's investment portfolio resulted from the net depreciation in fair value of investments in the amount of \$75,746,538 which was offset by investment income receipts. The largest earnings component, \$220,176,938 was the result of interest income. Other income, net of expenses, of \$167,802,915 was generated from dividends, rent and securities lending.

According to the KRS 161.430 the Board of Trustees has the responsibility to invest the assets of the System. 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. While the entire portfolio earned a total return of positive 2.4% in 2011-12, the portfolio's ten-year annualized rate of return is 5.5%, the twenty-year annualized rate of return is 7.2% and the thirty-year annualized rate of return is 9.5%.

KTRS annuities have a bolstering impact on the Commonwealth of Kentucky's economy, as approximately 92% of retired teachers reside within the state. Total benefits (retirement, medical insurance, life insurance, and other benefits) paid during the fiscal year were approximately \$1.7 billion.

## Funding

Based on recommendations of the Board of Trustees, the General Assembly establishes by statute the levels of contribution 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.

The latest actuarial valuation was for the period ending June 30, 2012. This report reflects the System's actuarial value of assets totaling \$14.7 billion and actuarial determined liabilities totaling \$27 billion. The funded ratio of actuarial assets to liabilities is 54.5%. The actuary reports: "...In our opinion, the System is not being funded on an actuarially sound basis since the actuarially required 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 the 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 43). After the 2012 employer contributions there remains a net pension obligation of \$436,123,560 (as detailed on page 91). Annual required employer contributions for the Medical Insurance Fund are provided in the schedule of employer contributions (on page 44). The 2012 employer shortfall of contributions created a net OPEB obligation of \$1,413,736,073 (as detailed on page 114).

The sustained decline in the funded ratio is from the cumulative effect of the employer failing to make actuarially required contributions. Also contributing to the reduced funded ratio are market fluctuations that are being recognized using actuarial smoothing over a five-year period and the changing demographics of the retirement system.

KTRS expects that the shared responsibility solution for funding retiree health care will help improve the funded status of the pension fund in the future by stopping the redirection of contributions from the pension fund to pay for the costs of current retiree health care. As well, on August 26, 2010, KTRS received \$465 million in proceeds from a bond issued by the state. This bond issue was approved by the Governor under the authority of legislation enacted by both chambers of the General Assembly during the 2010 Regular and Special Sessions. The proceeds of this bond issue were deposited in the KTRS retirement annuity fund in repayment of retirement contributions that had been redirected by the state to pay retiree health care from fiscal year 2005 through fiscal year 2010.

### **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 insure the retirement security of the state's teachers. An actuarial valuation of the Medical Insurance Plan for the fiscal year ended June 30, 2012 indicated that the fund has an unfunded liability of \$3.3 billion. The funded ratio of actuarial assets to liabilities is 9.4%. The actuary reports: "...if the State contributions to the Medical Insurance Fund are increased 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 Retiree Medical Plan 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 the 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 45, 46, 73 and 78 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, 2011. 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-four consecutive years (fiscal years ended 1988-2011). 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 System of the State of Kentucky for 2012 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 2012, for the first time, 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. 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.

**NCTR Executive Committee**

Gary L. Harbin is the Past-President of the National Council on Teacher Retirement (NCTR). NCTR is a national, nonprofit organization whose mission is to promote effective governance and benefits administration in state and local public pension systems in order that adequate and secure retirement benefits are provided to educators and other plan participants. NCTR membership includes 68 state, territorial, local and university pension systems with combined assets of almost \$2 trillion, serving more than 19 million active and retired teachers, non-teaching personnel and other public employees.

**Public Sector HealthCare Roundtable**

Mr. Harbin also serves on the Board of Directors and as President of the Public Sector HealthCare Roundtable. 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**

At the regular quarterly meeting of the Board of Trustees on June 18, 2012, Mr. Robert M. Conley announced that he was resigning from the Board effective June 30, 2012. In 1988, Mr. Conley was elected as a lay member of the Board. In 1991, Mr. Conley was appointed vice chair of the Investment Committee and served in that role for 15 years. Thereafter, he served as chair of the Investment Committee until his resignation. He had a significant oversight role in modernizing and diversifying the investment program and during his service assets under management increased from \$3.3 billion to \$15.6 billion. We would like to thank Mr. Conley for his exemplary service and numerous contributions to the successful operation of KTRS.

**Acknowledgments**

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 [www.ktrs.ky.gov](http://www.ktrs.ky.gov), and is made available to all employers 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  
Executive Secretary

## BOARD OF TRUSTEES



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Chairperson  
Teacher Trustee  
Lexington



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Vice Chairperson  
Lay Trustee  
Hodgenville



**Charles Ludwig**  
Teacher Trustee  
Louisville



**Hollis Gritton**  
Lay Trustee  
Union



**Barbara G. Sterrett**  
Retired Teacher Trustee  
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**Ruth Ann Sweazy**  
Teacher Trustee  
Taylorsville



**Laura Zimmerman**  
Teacher Trustee  
Lexington



**Dr. Terry Holliday**  
Ex Officio Trustee  
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Dept. of Education



**Todd Hollenbach**  
Ex Officio Trustee  
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**Kentucky Teachers' Retirement System**  
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**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*

**PAUL L. YANCEY, CFA**  
*Chief Investment Officer*

**PROFESSIONAL CONSULTANTS**

**ACTUARY**

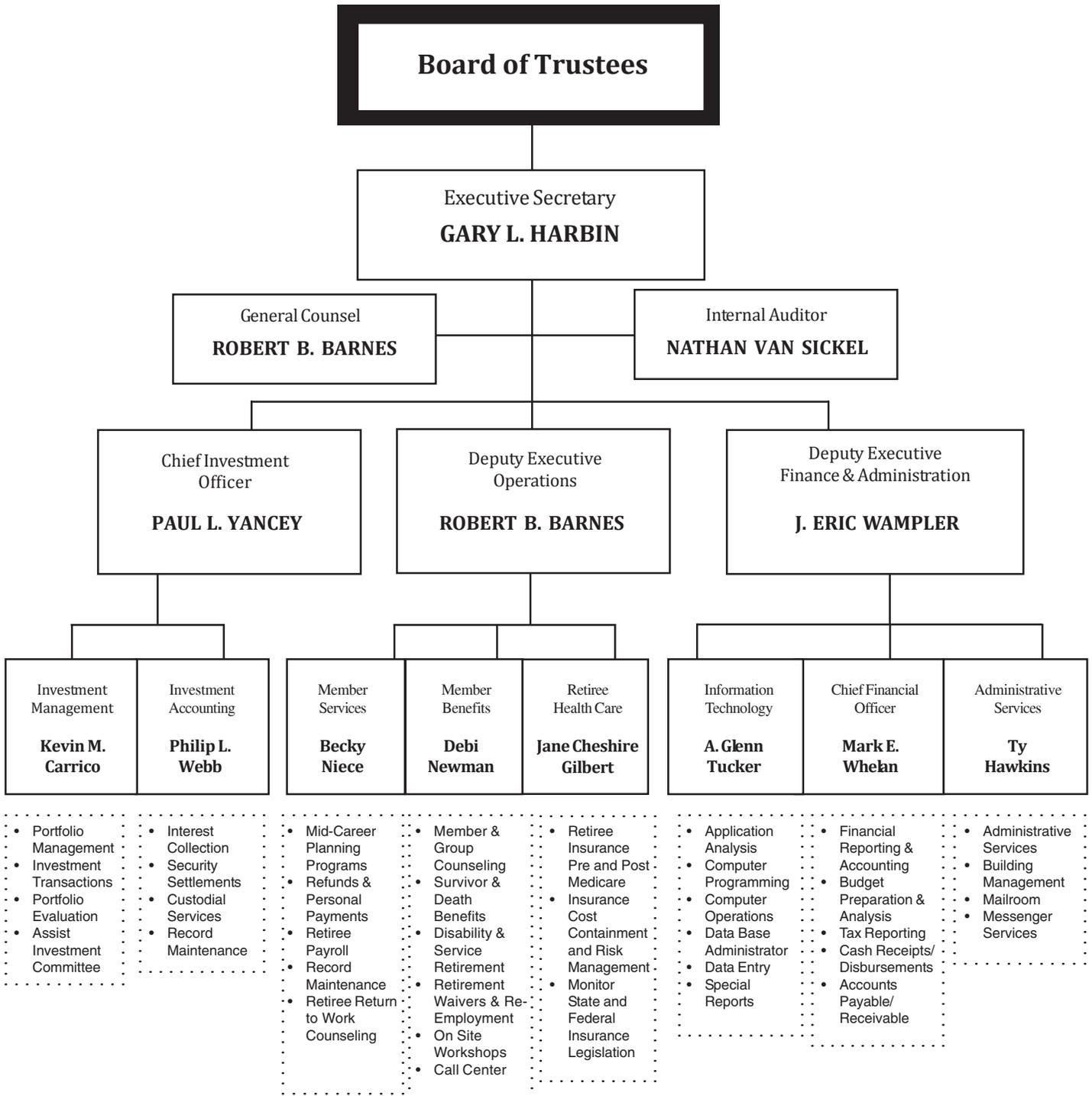
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Kennesaw, GA 30144

**AUDITOR**

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

*\* See pages 73 and 78 of the Investment  
Section for investment consultants.*

Kentucky Teachers' Retirement System  
Organizational Chart



Certificate of  
Achievement  
for Excellence  
in Financial  
Reporting

Presented to

Teachers' Retirement System  
of the State of Kentucky

For its Comprehensive Annual  
Financial Report  
for the Fiscal Year Ended  
June 30, 2011

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



*Linda C. Davison*

President

*Jeffrey R. Erner*

Executive Director

**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-four consecutive years (fiscal years ended 1988-2011).*



Public Pension Coordinating Council  
**Public Pension Standards**  
**2012 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

**PUBLIC PENSION COORDINATING COUNCIL**  
**PUBLIC PENSION STANDARDS**

*The Public Pension Coordinating Council awarded a Certificate of Achievement to the Teachers' Retirement System of the State of Kentucky for 2012 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.*