PERFORMANCE AUDIT REPORT

Kansas Public Employees Retirement System: Reviewing Active and Passive Investment Management Approaches and the State's Pension Obligation Bonds

A Report to the Legislative Post Audit Committee
By Berberich Trahan & Co., an audit firm under contract with the
Legislative Division of Post Audit
State of Kansas
December 2006

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Legislative Post Audit Committee
Legislative Division of Post Audit

THE LEGISLATIVE POST Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about $11 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U.S. Government Accountability Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

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Legislature of Kansas

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December 11, 2006

To: Members, Legislative Post Audit Committee

Senator Les Donovan, Chair	Representative John Edmonds, Vice-Chair
Senator Anthony Hensley	Representative Tom Burroughs
Senator Nick Jordan	Representative Peggy Mast
Senator Derek Schmidt	Representative Bill McCreary
Senator Chris Steineger	Representative Tom Sawyer

This report contains the findings and conclusions from the completed performance audit, *Kansas Public Employees Retirement System: Reviewing Active and Passive Investment Management Approaches and the State's Pension Obligation Bonds*. The audit was performed by Berberich Trahan & Co., and audit firm under contract with Legislative Post Audit.

We would be happy to discuss the findings presented in this report with any legislative committees, individual legislators, or other State officials.

Barbara J. Hinton

Barbara J. Hinton
Legislative Post Auditor

Question 1: To What Extent Do the Retirement System and Its Investment Managers Use Active and Passive Investment Management Styles, How Have Those Styles Performed Historically, and How Would Those Styles Have Performed If Used in Different Proportions?

Once the Retirement System allocates its investment moneys to the various general types of investments–stocks, bonds, real estate, etc.–the System and its investment managers can use an active, passive, or semi-passive investment management style. *Rate of return on investments is influenced not only by choice of types of investment–stocks, bonds, real estate, etc.–but also by choice of investment management style. The investment management styles are defined as follows:*

.................page 3

- *A passive management style invests in specific individual stocks or bonds in the same proportion as those individual stocks or bonds are reflected in some benchmark index, such as the Standard & Poor's 500. This approach generally will earn about the index rate less management fees. This approach generally has lower management fees than an active approach.*
- *An active management style invests in specific individual stocks or bonds in different proportions with the intention of earning a higher rate of return than the index. This approach can earn more than the index, but can also earn less. Management fees are higher with this style.*
- *A semi-passive management style generally invests close to an index, but with selected deviations in an attempt to earn a higher rate of return.*

The Retirement System uses all three investment management styles. *At the end of fiscal year 2006, the fair value of the System's investments were allocated among the three styles as follows:*

.................page 4

Passive	*25%*
Semi-Passive	*42%*
Active	*33%*
Total	*100%*

These percentages are roughly the same as those at the ends of the four previous fiscal years.

For the period reviewed, the Retirement System earned more investment income using all three styles than it would have using only a passive style. *For each type of investment–stocks, bonds, etc.–a benchmark rate of return indicates what that type of investment earned in general. This benchmark rate of return, then, is what a passive investment*

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in that type of investment would have earned. Comparing the actual rate of return to the benchmark rate of return shows how well the actual investment management style did compared to a completely passive style. On a total investment portfolio basis, comparison to a "policy index"–which takes into account all the different types of investments and their relevant benchmarks–accomplishes the same purpose. The results of that comparison for the most recent one-, three-, and five-year periods are as follows:

PERIOD	***Actual Rate of Return Net of Fees (using all styles)***	***Policy Index (as if passive only)***
One Year	*12.3%*	*10.4%*
Three Years	*13.3%*	*12.0%*
Five Years	*7.6%*	*7.3%*

In each case, the actual rate of return net of management fees was higher than it would have been with a completely passive investment management style.

The Retirement System's proportional use of investment management styles has been similar to those of other states reviewed. *It appears that states with higher target investment rates of return tend to use an active management style more than states with lower target rates. Kansas has a target rate of 8%; the target rates of other states contacted ranged from 7.5% to 8.5%.* .... page 6

Question 2: What Has the State's Experience Been in Issuing Pension Obligation Bonds, Both in Terms of Earnings From Investing the Proceeds and Payments for Retiring the Related Debt?

To date, the State has earned 9.9% from investing the proceeds of the pension obligation bonds, somewhat higher than the actuarial target earnings rate of 8%. Over the life of the bonds, the debt cost will be about 5.4%, which compares favorably with an early working estimate of 6%. .... page 8

Agency Response .... page 13

NOTE: This executive summary was prepared by staff of the Legislative Division of Post Audit, based on the audit report prepared by Berberich Trahan & Co. under contract with the Division.

This audit was conducted by Berberich Trahan & Co., an audit firm under contract with the Legislative Division of Post Audit. If you need any additional information about the audit's findings, please contact Randy Tongier at the Division's offices. Our address is: Legislative Division of Post Audit, 800 SW Jackson Street, Suite 1200, Topeka, Kansas 66612. You also may call us at (785) 296-3792, or contact us via the Internet at LPA@lpa.state.ks.us.

Berberich Trahan & Co.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

PERFORMANCE AUDIT REPORT
DECEMBER 2006

Kansas Public Employees Retirement System: Reviewing Active and Passive Investment Management Approaches and the State's Pension Obligation Bonds

The Kansas Public Employees Retirement System (Retirement System or System) was established in 1962 to provide retirement and related benefits to public servants in Kansas. Today, the Retirement System manages approximately $12.7 billion in investments and serves more than 250,000 members and 1,450 participating employers.

By the early 2000's, the Retirement System faced a long term funding shortfall. As of the December 31, 2001 actuarial valuation, the Retirement System had an unfunded actuarial liability of $ 1.8 billion. Due to statutory employer contribution rates being less than calculated actuarial contribution rates, this unfunded actuarial liability was projected to grow in the future.

For the last several years, the Retirement System's highest priority has been developing a comprehensive plan to address the long-term funding shortfall. Funding improvements made during the last few years represent key steps toward improving the System's financial condition and securing funds for all future benefit payments. These steps included:

- A series of scheduled employer contribution rate increases.
- Issuing pension obligation bonds.
- Making actuarial changes.
- Reviewing possible plan design changes for *future* employees.

Additionally, maximizing the return generated by the Retirement System's investment portfolio is critical to improving the financial condition. One of the key components to management's investment strategy is meeting or exceeding the 8% assumed rate of return.

However, the current statutory cap for the increase of the employer contribution rates has kept the actual contribution rates from meeting the actuarial contribution rates. As of the December 31, 2005 actuarial valuation, the unfunded actuarial liability rose to $ 5.15 billion. The actuarial report does note the effect of these recent changes on the Retirement System's long-term financial health:

> "KPERS' long term funding outlook has improved due to legislation, Board action and strong investment performance in the last few years. The statutory contribution rate is projected to converge with the actuarial required contribution (ARC) rate before the end of the amortization period (2033). Therefore the System is in actuarial balance over the long term if all actuarial assumptions are met. However, the shortfall between the actuarial and statutory contribution rates will produce increases in the unfunded actuarial liability. As a result, the actuarial contribution rate is expected to increase until the ARC Date (defined as the date at which the actuarial and statutory contribution rates are equal) is reached."

It is important to note that this is a long-term funding situation rather than an immediate crisis. The Retirement System will continue to make all benefit payments to members and benefit payments are not in jeopardy at this time.

SCOPE OF PERFORMANCE AUDIT

Legislative concerns have been raised about the extent to which the Retirement System and its investment managers use active and passive management styles, how those different styles have performed historically and how they would have performed if used in different proportions. Legislative interest has also been expressed about the Retirement System's experience with pension obligation bonds approved by the Legislature, and the current status of that activity.

The Legislative Division of Post Audit has engaged Berberich Trahan & Co., P.A. to address the following questions:

> **1. To what extent do the Retirement System and its investment managers use active and passive investment management styles, how have those styles performed historically, and how would those styles have performed if used in different proportions?**
>
> **2. What has the State's experience been in issuing pension obligation bonds, both in terms of earnings from investing the proceeds and payments for retiring the related debt?**

To answer Question 1, we interviewed Retirement System personnel responsible for overseeing the investment managers and viewed historical investment returns for the past 5 years. We sent letters to ten selected Midwestern state retirement systems or investment councils to determine the extent to which different investment management styles are used. Annual audit reports and information obtained from the retirement systems' websites were used to clarify any questions arising from the responses. We reviewed relevant literature and information sources regarding the advantages and disadvantages of passive and active investment strategies. We also reviewed the Retirement System's investment policies and applicable State legislation regulating the use of these investment strategies.

To answer question 2, we obtained information regarding the pension obligation bond program and obtained the associated costs of issuing and repaying the debt from personnel at the Kansas Development Finance Authority (KDFA). We interviewed Retirement System investment personnel and viewed investment reports outlining how the proceeds of the bonds were invested and the associated returns. We also compared the actual experience to amounts projected during the consideration of the pension obligation bond program.

This work was performed in accordance with *Government Auditing Standards* for performance audits.

QUESTION 1 – ACTIVE AND PASSIVE MANAGEMENT

Alpha and Beta Returns

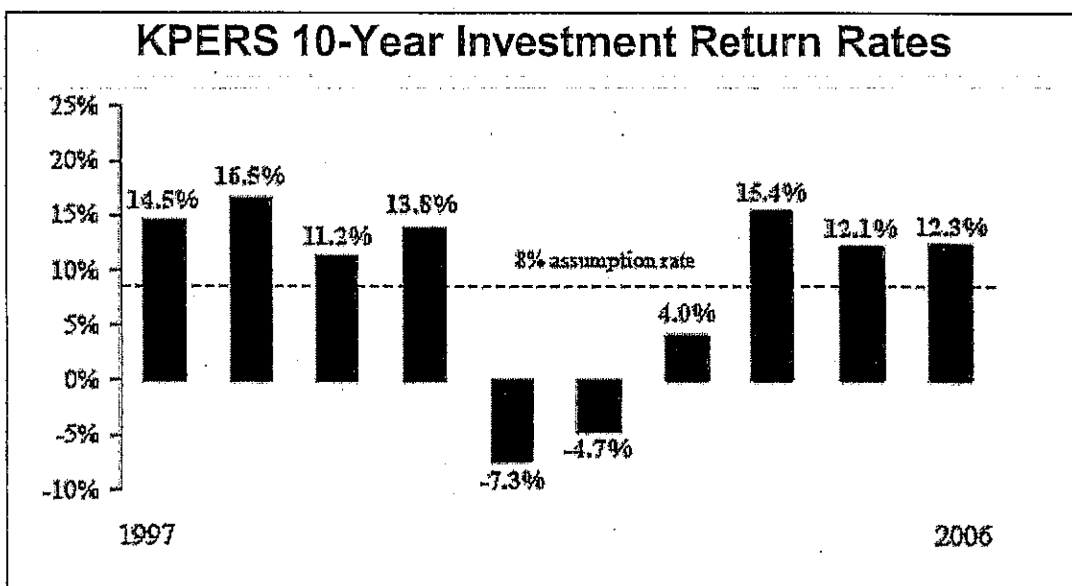
Every investment can be examined in the context of two distinct return components – alpha and beta.

- Alpha is the return generated through a manager's ability to select particular investments that perform better than the asset class as a whole.
- Beta is the return which is expected simply from having exposure to the asset class. It is the return that can be earned by investing passively within a specific asset class. Exposures to beta can be purchased very cheaply and, over long periods of time, it is expected that returns from beta should be positive and generally coincide with the risk associated with a given asset class.

Passively managed investments capture the return and risk inherent with the asset class (beta) with little or no risk or return associated with individual security selection, because the variance from the benchmark or tracking error is very small. The Retirement System measures additional risk and return by calculating rolling 36 month returns and analyzing the standard deviations of the return differentials from that of the benchmark.

Active vs. Passive Management

Passive management strategies utilize security allocations that mirror the allocation of an appropriate benchmark, such as a Russell Index. Thus, the investment portfolio will earn a return equal to the given index. Beta returns from passive strategies are entirely dependent upon the performance of the market as a whole. Favorable market conditions over the past three years have provided sufficient beta returns, particularly when compared to the market performance early in the 2000's. Market declines in that period largely contributed to the overall decline in the Retirement System's performance as shown below.



The primary benefit of passive management is generally lower management fees due to less decision making required by the manager. However, investment funds utilizing this management style are limited to the return of the market and offer no protection for market declines.

Through active management strategies, the Retirement System can earn additional return by allocating the portfolio away from the benchmark index, specifically targeting assets that may yield higher returns. This allocation provides the investment manager an opportunity to earn returns in excess of the benchmark index. However, these strategies have two disadvantages.

- Increased Fees – Investment managers earn additional fees for the time and effort expended in identifying those assets with increased return potential. Taking this into account, investment fund returns are generally stated as net of fees.
- Increased Risk – Variation from the benchmark allocation creates additional risk exposure, increasing the possibility of earning less than the benchmark return (or even experiencing losses).

The Retirement System's investment policy outlines that active/enhanced equity investment managers should strive to increase the return by one-half of the additional risk incurred. A portfolio taking on additional active risk would thus be expected to produce returns exceeding the benchmark return.

In addition to passive and active investment strategies, enhanced index strategies seek to slightly outperform a specific index while maintaining an overall risk profile comparable to the index. Enhanced index strategies (often referred to as semi-passive) are typically implemented through risk-controlled security or sector-selection strategies that exploit small inefficiencies occurring within capital markets.

With management fees that are typically lower than traditional active management, enhanced index strategies are an attractive investment alternative for many investors. The Retirement System utilizes these enhanced index funds within both its domestic and international equity portfolios.

The Retirement System's Statement of Investment Policy, Objectives and Guidelines recognizes legislative restrictions on both the type and percentage of assets that may make up the investment portfolio. The investment policy includes the statement of Fiduciary Responsibility. As such, "the Board shall exercise the judgment, care, skill, prudence and diligence under the circumstances then prevailing, which persons of prudence, discretion and intelligence, acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims by diversifying the investments of the fund so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." This statement applies not only to the Board, but all Retirement System investment personnel and external managers as well.

KPERS Utilization of Active and Passive Strategies

The Retirement System has only a few investment funds that are managed in a purely passive manner. These would include the Large Cap Index fund, Real Estate Investment Trusts (REIT) portfolios, Treasury Inflation-Protected Securities (TIPS), and Managed Cash. These portfolios' performance and holdings very closely mirror their respective benchmarks and overall market/industry performance and holdings.

These funds may not match the composition of the benchmark portfolio exactly as some small holdings included in the benchmark may not be included in the fund portfolio. The additional transaction costs that would be incurred by fully replicating the exact percentages of minor holdings would offset the benefit gained. Additionally, the Russell indices annually reconfigure, shuffling some of these smaller holdings between the 1000 and 2000 indices.

The remaining investments held by the Retirement System can be classified as active, as they incur some additional active risk in order to garner returns in excess of their respective benchmarks. The Retirement System has several management style classifications within the realm of actively managed portfolios. These are generally grouped according to the type of securities (fixed income or equity), market (global or domestic) and by the level of active risk the fund manager is expected to incur. This continuum is outlined below:

The first three classifications have very low tracking error. While the Retirement System considers each of the following to be actively managed, other states often refer to similarly managed investments as semi-active or semi-passive.

- Enhanced Index – Barclays Global Investors and Quantitative Management Associates manage enhanced index equity funds that closely follow their respective benchmarks. These funds begin by analyzing the respective benchmark and vary the allocations in an attempt to increase overall return. Payden & Rygel attempts to out perform by managing a portfolio of fixed income securities and equity futures.
- Active / Passive Core – Morgan Stanley Asset Management manages a fund that actively invests in specific foreign markets or industry sectors. Morgan Stanley, however, invests in 'baskets of securities' within that market or sector to passively implement their strategy.
- Core / Core-Plus – These funds are invested in fixed income securities. Loomis Sayles manages the most active fund with the highest alpha expectations. Pacific Investment Management Company and Western Asset Management Company have lower active risk. Payden & Rygel's Core fund is more limited by its benchmark in the types of investments allowed.

The following classifications all have higher degrees of risk exposure, as well as higher expected returns. These investment funds would be universally considered to be actively managed.

- Portable Alpha – Nomura Capital Management manages an international equity fund that is currently mandated to be 80% invested in the Japanese market and 20% invested in the Australian market. Payden & Rygel, in conjunction with Nomura's portfolio, uses futures and derivatives which are designed to limit the foreign market exposure (beta) from the Nomura investments.
- Quantitative – Acadian Asset Management manages an equity fund using quantitative tools which is managed similar to the enhanced index equity funds, but has a higher tracking error. Acadian is given the latitude to incur more active risk, but is expected to generate higher returns.
- Active – Funds managed by Alliance Capital Management, Wellington Management Company, and Capital Guardian Trust Company incur larger amounts of active risk in efforts to significantly outperform their respective benchmarks. These investment managers use a "bottom-up approach," identifying specific companies and investment opportunities rather than market sectors.

- Real Estate – The Retirement System has an externally managed group of real estate holdings overseen by AEW Capital Management and a Prime Property Fund managed by Morgan Stanley. By definition, these are classified as actively managed as a representative portfolio of real estate holdings and an investable benchmark are not present. Active management exposure is inherent in these investments.
- AIP / Direct Placements – These are externally managed investments that also qualify as actively managed.

Exhibit 1 shows the extent to which each management style is used and the relative weights of each investment type in the overall portfolio. Note that the Retirement System itself does not make the distinction of "Semi-Passive." This classification was made for the purposes of this report and making comparisons to other state systems. Over the last five years, the Retirement System has typically managed between 25% – 30% of the fair value of the total investment portfolio in a passive manner. The remaining 70% - 75% is actively managed to some degree. We will discuss how these percentages compare to other state systems surveyed in the next section.

Exhibit 2 provides the 1, 3 and 5 year annualized returns of the various fund classifications and the extent to which the funds exceeded or lagged their respective benchmarks. For most funds, this difference represents the additional return generated through active management. This data is summarized from data included in the Retirement System's Investment Performance Report for the year ended June 30, 2006.

The most important item to note is the overall performance of the portfolio compared to the composite policy index. This policy index is a representation of matching each of the benchmarks with a portfolio weighted as described in the footnote of Exhibit 2. The percentage by which the portfolio outperformed the policy index can be viewed as the overall additional return generated through active management.

Through the prudent use of active management strategies and investment diversification, the Retirement System has been able to generate additional returns above that which would have been achieved through an investment strategy consisting purely of passive investment in equity securities or index funds.

Comparisons to Other States

The Retirement System's investment mix and actuarial assumed rate of return are comparable to that of the other state systems surveyed. Furthermore, the extent to which active and passive investment strategies are utilized is similar to that utilized by other state systems.

Each of the state systems surveyed exhibited similar investment allocations. The largest allocations were to domestic equity, with lesser degrees of investment in international equities and fixed income securities. The degree to which each of these investment classes were actively managed seemed to strongly correlate with the required rate of return for each of the systems. Many of the state systems also had actively managed alternative investments in real estate and private equity ventures similar to the Retirement System.

The actuarial assumed rate of return for the Retirement System is 8.0%. This is the rate at which the investments must grow over time to cover the projected cost of benefits. Of the states surveyed the lowest assumed rates of return were Oklahoma and Iowa with 7.5%. Several states, including Colorado, Illinois, Missouri and Minnesota, had required rates of return as high as 8.5%.

The differences in required rates of return lead to differences in investment strategy. Not surprisingly, the Oklahoma Public Employee Retirement System (OPERS) investments are largely managed in passive and semi-passive styles (more than 72% of total market value as of June 30, 2006). The Minnesota State Board of Investment actively manages more than 33% of its Domestic Equity Pool, approximately 50% of its Bond Equity Pool, and more than 65% of its International Equity Pool. The Colorado Public Employee's Retirement Association (PERA) actively invests approximately 40% of its Domestic Equities and 70% of its International Equities.

As can be noted in Exhibit 1, the frequency with which active strategies are utilized by the Retirement System is more extensive than utilized by OPERS. One would expect strategy utilization similar to that of the Minnesota State Board of Investment, Colorado PERA and the Missouri State Employees' Retirement System (MOSERS), as these systems are required to generate greater rates of return.

MOSERS also greatly utilizes active management strategies, though this had not always been the case. Prior to 2002, MOSERS portfolio had been heavily weighted towards passive management strategies. The catalyst for the greater emphasis on active investment strategies was a 2002 study which concluded that beta returns would not generate the necessary returns to fund the liabilities of the system. MOSERS initiated the following changes:

- Adopt a more broadly diversified portfolio including alternative investments such as real estate, private equity, hedge funds, timber, and commodities.
- Increase the amount of active risk in the portfolio through efficient value added strategies.
- Allow staff to make limited strategic asset allocation shifts when market opportunities are present.

To measure the effectiveness of the strategic allocation shifts, MOSERS uses a two benchmark system. The Policy Benchmark measures the incremental return over a passively managed portfolio at the policy allocation. The Strategic Benchmark measures the incremental return over a passively managed portfolio at the actual allocations. The difference between these two benchmarks is used to evaluate the success of the decisions made to position the portfolio away from the initial policy allocation.

QUESTION 2 – PENSION OBLIGATION BONDS

HB 2014 authorized the issuance of up to $500 million in pension obligation bonds. This infusion, paired with increases in statutory contributions, was intended to help alleviate long term funding concerns associated with the unfunded actuarial liability. The Board of the Retirement System acknowledged in November 2003 that proceeds from the issuance of pension obligation bonds was a suitable means of partially addressing the long term funding concerns.

The Long Term Funding Study by the Joint Committee on Pensions, Investments, and Benefits issued in 2003 noted that "the projected impact of infusing $500 million in bond money into KPERS for investment could be improved by paying principal and interest from non-KPERS funds rather than paying principal and interest from KPERS funds."

In February of 2004, the State of Kansas issued $500 million in pension obligation bonds (KDFA Series 2004C). The Retirement System received net proceeds of approximately $440.2 million to be used to assist with the financing of the unfunded actuarial liability. The debt service on these bonds is to be paid by the State of Kansas in addition to the State's regular employer contributions. As of June 30, 2006, the State has paid interest in the amount of nearly $56 million toward the repayment of these bonds. The first principal payment is scheduled to be made in May 2009.

In addition, the State of Kansas issued $ 40,250,000 of pension obligation bonds (KDFA Series 2003H). The bond proceeds were used to finance the unfunded actuarial liability of the TIAA group of members and unfunded actuarial liability of members who retired prior to July 2, 1987 and are entitled to a Retirement Dividend payment pursuant to K.S.A. 74-49,109. These KDFA Series 2003H bonds will be repaid by the State of Kansas including an additional amount generated from increased State employer contribution rates. KPERS collects the contributions generated from this increase in rates and transfers the funds to the State of Kansas for making the debt service payments. For purposes of this performance audit, we have focused our attention on the $ 500 million KDFA Series 2004C bonds since the KDFA Series 2003H bonds were used for specific purposes.

Ultimately, judging the success of this strategy in helping alleviate a portion of the unfunded liability is whether the return from investing the proceeds of the bonds is greater than the costs associated with issuing and repaying the bonds. The Board of the Retirement System projected that "the ability to securitize future contributions at a cost approximating 6 percent through the issuance of bonds compared with the 8 percent actuarial assumption provides projected present value savings to the State of approximately $100 million in future contributions."

Upon receipt of the proceeds on March 10, 2004, the Retirement System immediately invested the proceeds. Investment of the bond proceeds is not tracked independently, as the funds were allocated throughout the investment portfolio. Initial investments were in a basket of futures contracts designed to replicate the returns of the Retirement System portfolio. As such, the return of the invested proceeds closely mirrors that of the Retirement System portfolio from March 10, 2004 to the present.

The Retirement System was able to generate the monthly returns (including the partial month when the proceeds were received) and prepare a schedule calculating the overall investment return of the portfolio from March 10, 2004 to June 30, 2006. The annualized return for that period is approximately 9.9%.

According to the debt service schedule prepared by the KDFA for the Series 2004C Bonds, the calculated all inclusive cost percentage over the life of the bonds is approximately 5.4%. This calculation includes issuance costs and interest payments. Simply stated, the scheduled principal and interest payments through the retirement of the bonds in the year 2034 represents a 5.4% rate of return for the bond investors and a 5.4% effective interest rate to the State of Kansas. Review of the current debt service schedule with KDFA personnel shows that no refunding or other changes to the Series 2004C Bonds have occurred to date.

Comparing the annualized return to the average annual cost rate, the issuance of the Series 2004C pension obligation bonds has to date been successful. The Joint Committee Report noted that the benefits would be realized in the latter part of the 30 year period and in the subsequent years after 2033. As long as the Retirement System is able to generate future returns in excess of the effective cost rate of issuing and repaying the bonds, the use of pension obligation bonds by the State of Kansas and the Retirement System will be beneficial.

Fair Value of Investment Funds Relative to Entire Portfolio
(Fair Value in Millions)

	June 30, 2006		June 30, 2005		June 30, 2004		June 30, 2003		June 30, 2002	
	Fair Value	Percent of Portfolio	Fair Value	Percent of Portfolio	Fair Value	Percent of Portfolio	Fair Value	Percent of Portfolio	Fair Value	Percent of Portfolio
Passive										
Domestic Equity										
Passive	$1,453.8	11.8%	$1,665.3	14.8%	$1,554.6	15.0%	$1,330.3	14.9%	$1,033.2	11.6%
Real Estate										
REITs	$380.7	3.1%	$339.2	3.0%	$274.5	2.7%	$292.4	3.3%	$307.2	3.5%
TIPS Portfolio	$1,047.2	8.5%	$1,056.5	9.4%	$971.0	9.4%	$893.2	10.0%	$835.3	9.4%
Cash & Equivalents	$264.7	2.2%	$496.7	4.4%	$197.7	1.9%	$69.6	0.8%	$222.1	2.5%
Total Passive	$3,146.4	25.6%	$3,557.7	31.6%	$2,997.8	28.9%	$2,585.5	29.0%	$2,397.8	27.0%
Semi - Passive										
Domestic Equity										
Enhanced Index	$2,149.4	17.5%	$1,253.9	11.1%	$1,130.8	10.9%	$876.3	9.8%	$1,047.8	11.8%
International Equity										
Enhanced Index	$826.4	6.7%	$459.9	4.1%	$310.3	3.0%	$0.0	0.0%	$0.0	0.0%
Fixed Income	$2,137.8	17.4%	$2,163.1	19.2%	$2,261.0	21.8%	$2,168.7	24.4%	$2,264.2	25.5%
Total Semi - Passive	$5,113.6	41.6%	$3,876.9	34.4%	$3,702.1	35.7%	$3,045.0	34.2%	$3,312.0	37.3%
Active										
Domestic Equity										
Active	N/A	N/A	$97.9	0.9%	$812.6	7.8%	$816.1	9.2%	$851.6	9.6%
Portable Alpha	$232.6	1.9%	$0.0	0.0%	$0.0	0.0%	$0.0	0.0%	$0.0	0.0%
International Equity	$1,690.1	13.7%	$1,841.7	16.3%	$1,873.0	18.1%	$1,644.3	18.5%	$1,455.6	16.4%
Global Equity	$1,037.8	8.4%	$877.4	7.8%	$0.0	0.0%	$0.0	0.0%	$0.0	0.0%
Real Estate										
Core	$409.9	3.3%	$398.0	3.5%	$318.9	3.1%	$211.6	2.4%	$290.1	3.3%
Non Core	$129.5	1.1%	$106.0	0.9%	$114.6	1.1%	$121.3	1.4%	$94.2	1.1%
Alternative Investments	$541.4	4.4%	$515.7	4.6%	$537.9	5.2%	$478.9	5.4%	$478.9	5.4%
Total Active	$4,041.3	32.9%	$3,836.7	34.0%	$3,657.0	35.3%	$3,272.2	36.8%	$3,170.4	35.7%
Total Portfolio	$12,301.3	100.0%	$11,271.3	100.0%	$10,356.9	100.0%	$8,902.7	100.0%	$8,880.2	100.0%

Annualized Returns and Comparisons to Associated Benchmarks
Fiscal Years Ending June 30

	1 year		3 year		5 year	
	Average Return	Return Above / (Below) Benchmark	Average Return	Return Above / (Below) Benchmark	Average Return	Return Above / (Below) Benchmark
Total Portfolio	12.3%	1.9%	13.3%	1.3%	7.6%	0.3%
Policy Index[1]	10.4%		12.0%		7.3%	
Domestic Equity						
Passive						
KPERS INDEX	9.3%	0.2%	12.1%	0.1%	3.1%	0.0%
Semi-Passive						
Barclays Alpha	11.9%	2.8%	13.6%	1.6%	4.6%	1.5%
QMA	10.1%	1.0%	N/A	N/A	N/A	N/A
Payden & Rygel	7.8%	-0.8%	N/A	N/A	N/A	N/A
Barclays Small Cap Value	12.7%	-1.9%	21.3%	0.3%	14.8%	1.7%
Barclays Small Cap Growth	N/A	N/A	N/A	N/A	N/A	N/A
Active						
Nomura / Payden & Rygel	N/A	N/A	N/A	N/A	N/A	N/A
International Equity						
Semi-Passive						
Barclays Int'l Alpha	28.8%	1.2%	N/A	N/A	N/A	N/A
Active						
Acadian	N/A	N/A	N/A	N/A	N/A	N/A
Morgan Stanley	29.0%	1.4%	24.1%	-0.5%	11.0%	0.5%
Alliance	N/A	N/A	N/A	N/A	N/A	N/A
Global Equity						
Active						
Wellington	16.8%	-1.8%	N/A	N/A	N/A	N/A
Capital Guardian	19.8%	1.2%	N/A	N/A	N/A	N/A

[1] The current Policy Index was implemented March 1, 2005. This asset allocation mix is 31% Domestic Equity; 18% International Equity; 8% Global Equity; 19% Fixed Income; 10% TIPS; 8% Real Estate; 5% Alternative Investments; and 1% Cash.

Note: Returns marked "N/A" indicate that the investment fund was initiated during the given time period.

Annualized Returns and Comparisons to Associated Benchmarks
Fiscal Years Ending June 30

	1 year		3 year		5 year	
	Average Return	Return Above / (Below) Benchmark	Average Return	Return Above / (Below) Benchmark	Average Return	Return Above / (Below) Benchmark
Real Estate						
Passive						
KPERS REITs	19.8%	0.2%	26.4%	0.2%	19.6%	0.2%
Active						
AEW Capital Management	29.9%	9.7%	15.1%	0.5%	9.8%	-1.1%
KPERS Regional Retail	-11.5%	-31.7%	16.9%	2.3%	N/A	N/A
Prime Property Fund	17.4%	-2.8%	N/A	N/A	N/A	N/A
KPERS Non Core Real Estate	39.8%	31.1%	23.6%	14.8%	17.0%	10.5%
Fixed Income						
Semi-Passive	0.3%	0.6%	4.1%	0.8%	6.2%	0.4%
Alternative Investments						
Active	27.0%	17.9%	19.4%	10.5%	6.0%	-0.7%
TIPS Portfolio						
Passive	-6.1%	0.1%	5.2%	0.0%	9.1%	0.1%
Cash & Equivalents						
Passive	4.0%	0.0%	2.4%	0.2%	2.5%	0.2%

Note: Returns marked "**N/A**" indicate that the investment fund was initiated during the given time period.

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KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM
KATHLEEN SEBELIUS, GOVERNOR

RECEIVED
DEC 11 2006
LEGISLATIVE DIVISION
OF POST AUDIT

December 8, 2006

Brad Koehn
Berberich Trahan & Co., P.A.
3630 SW Burlingame Road
Topeka, Kansas 66611

Dear Mr. Koehn:

Thank you for the opportunity to respond to the draft copy of the performance audit report on KPERS' investment management styles and the State's experience on the pension obligation bonds. The Retirement System appreciates the professional approach taken by your firm during this audit engagement.

The question of the merits of active versus passive investment styles is a very good one and is heavily debated in the investment industry. The KPERS Board of Trustees and staff systematically review the System's projected liabilities, asset allocation, and expected returns and risk levels from different asset classes and management styles. Based on this review and actual performance against benchmarks, we periodically make appropriate adjustments to our investment strategies and investment managers. As the audit report shows, this disciplined approach to investment management has enabled us to achieve our 8 percent long-term return objective and generate additional returns above a purely passive investment strategy.

The issuance of the $500 million in pension obligation bonds in 2004 along with the series of scheduled employer contribution rate increases approved by the Legislature were key steps in the long-term funding plan for KPERS. To date, the annualized return on the investment of the bond proceeds has significantly exceeded the annual cost rate on the bonds. Recently, we provided a projection to the Joint Committee on Pensions, Investments and Benefits showing that the receipt of the $440.2 million in bond proceeds improved the actuarially required contribution (ARC) rate and date projection from 16.36% in FY 2025 to 12.82% in FY 2019. As the audit notes, to date, the financial impact of the bond issue has been successful.

We look forward to discussing the audit with the Legislative Post Audit Committee.

Sincerely,

Glenn Deck
Executive Director

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