
Introductory Section

for Fiscal Year ending June 30, 2011

Chairperson's Letter

Teachers' Retirement System of the State of Kentucky

GARY L. HARBIN, CPA
Executive Secretary



December 30, 2011

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, 2011, the 71st 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 2010-2011 fiscal year with \$15.5 billion net assets. The active membership totaled 76,349 and the retired membership was 44,419 with an annual payroll of \$1.4 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,

Barbara G. Sterrett
Chairperson
Board of Trustees

BOARD OF TRUSTEES

BARBARA G. STERRETT
CHAIRPERSON
LEXINGTON

RONALD L. SANDERS
VICE CHAIRPERSON
HODGENVILLE

ROBERT M. CONLEY
PAINTSVILLE

CHARLES LUDWIG
LOUISVILLE

DR. TOM SHELTON
LEXINGTON

RUTH ANN SWEAZY
TAYLORSVILLE

LAURA ZIMMERMAN
LEXINGTON

EX OFFICIO
DR. TERRY HOLLIDAY
COMMISSIONER
DEPARTMENT
OF EDUCATION

EX OFFICIO
TODD HOLLENBACH
STATE TREASURER

Letter of Transmittal



Teachers' Retirement System of the State of Kentucky

December 30, 2011

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

Dear Governor Beshear:

It is my pleasure to submit the 71st 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, 2011. 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, 2011. 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. 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 94 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

The System 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

The Board of Trustees and Staff appreciate the extraordinary efforts of the many active and retired teachers and education community constituency groups who helped develop a "shared responsibility" solution for adequately funding retiree health care benefits. The Board and Staff are also grateful for the hard work of the General Assembly and Governor in enacting the plan. The shared responsibility solution for funding retiree health care was truly a historic accomplishment that will help insure the retirement security of the state's teachers.

The shared responsibility solution, which was introduced as House Bill 540 in 2010, passed through both chambers of the General Assembly without a single negative vote, and was signed into law by the Governor. The funding solution provides that active teachers, retired teachers, school districts,

and the state will all share in prefunding retiree health care benefits. This approach will help insure that both current retired teachers and active teachers will receive health care benefits during retirement. Moreover, prefunding retiree health care benefits with shared responsibility by all interested parties is the most cost effective and actuarially sound method for providing retiree health care benefits.

The shared responsibility solution also aids the actuarial stability of the retirement annuity fund by stopping the redirection of contributions from the retirement annuity fund to pay for the costs of current retiree health care. From fiscal year 2005 through fiscal year 2010, over \$560 million was redirected from the retirement annuity fund to the medical insurance fund with the agreement that the amount would be repaid by the state with interest over staggered 10 year terms. On August 26, 2010, this debt by the state to the KTRS retirement annuity fund was fully satisfied ahead of schedule when KTRS received the proceeds of a bond issued by the state. The Board is also very grateful to the Governor and General Assembly for this affirmative action to help insure the retirement security of the state's teachers.

The shared responsibility solution for funding retiree health care was effective on July 1, 2010, and the bond proceeds were received in the KTRS pension fund on August 26, 2010, both developments had positive effects on the actuarial valuations of the retiree medical and pension plans as of June 30, 2011. Furthermore, in the future, the shared responsibility solution for prefunding retiree health care and stopping the redirection of contributions from the retirement annuity fund to pay for the costs of current retiree health care will improve the funding status of both the KTRS medical insurance and retirement annuity plans.

KTRS Initiatives to Contain Health Plan Costs

The Board views the obligation to contain health plan costs where practical without shifting material costs to retired members or substantially decreasing retired members' benefits as part of its fiduciary responsibility. During the year, KTRS took action to implement several initiatives to contain costs in the health plan and improve the retirement security of the state's teachers.

On July 1, 2010, KTRS moved its Medicare drug plan to an insured Employer Group Waiver Prescription Drug Plan. KTRS took this action in order to receive deeper federal subsidies on an

annual basis, and to reduce the actuarial liability of the KTRS Medical Insurance Fund by \$900 million. Although the cost savings from this action was dramatic, there were no material changes to the existing drug plan design.

KTRS also took action during the year to add a "commercial wrap" to the existing KTRS Employer Group Waiver Prescription Drug Plan for plan year 2012. The commercial wrap, which is permitted under the federal health care reform, includes some infrastructure changes that will result in cost savings without significant changes to the drug plan for retired members.

During the year, KTRS took action to join the KY Rx Coalition spearheaded by the University of Kentucky. By joining the KY Rx Coalition effective January 1, 2012, KTRS will achieve annual savings through leveraging greater prescription purchasing power and deeper drug discounts. Another advantage will be the availability of the University of Kentucky resources with a dedicated University of Kentucky pharmacist available by phone and assigned to KTRS retirees to field prescription questions and to help find lower-cost generic equivalent drugs.

Implementation of the commercial wrap and joining the KY Rx Coalition during plan year 2012 will produce projected annual savings of \$11 million and reduces the actuarial liability of the KTRS Medical Insurance Fund by \$400 million.

Investment Program

KTRS's investment program had exceptional performance during the year with positive returns of 21.6%. 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. Moreover, during the year, KTRS 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 a bond in the KTRS pension fund. 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 and designing a new information technology system known as the "Pathway System." During the year, the Board took action and authorized hiring a vendor to begin building and installation of the new system. The objective of the Pathway System is to streamline retirement processes, and improve staff efficiency in providing services to retirees and active members. During this project, the current legacy KTRS Pension Management System will be replaced with a new system of database software and applications, which will accomplish these goals. The new system will allow KTRS to redesign and improve office processes and ultimately apply new 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 retirement 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 growth in value during the 2010-2011 fiscal year as the portfolio's market value increased from \$12,680,439,457 to \$15,547,900,381. The increase in value of the portfolio and of the overall market was due to improvements in the financial markets and realized capital gains. Employer and employee contributions also provided significant income to the portfolio.

Investment income, including appreciation of asset values, net of investment expenses, for the 2010-2011 fiscal year was \$2,772,410,985. The major contributing factor of the positive return from the System's investment portfolio was the net appreciation in fair value of investments in the amount of \$2,397,731,918. The largest earnings component, \$212,381,957 was the result of interest income. Other income, net of expenses, of

\$162,297,110 was generated from dividends, rent and securities lending.

According to the KRS 161.430 the KTRS 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 retirement system 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 21.6% in 2010-11, the portfolio's ten-year annualized rate of return is 4.8% and the twenty-year annualized rate of return is 7.7%.

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...etc.) paid this 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, 2011. This report reflects the System's assets, based on modified market value; totaled \$14.9 billion and the liabilities totaled \$26 billion. The funded ratio of actuarial assets to liabilities is 57.4%. The actuary reports: "...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 retirement fund 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 2011 employer contributions there remains a net pension obligation of \$229,548,428 (as detailed on page 88). Annual required employer contributions for the Medical Insurance Fund are provided in the schedule of employer contributions (on page 44). The 2011 employer shortfall of contributions created a net OPEB obligation of \$1,110,938,699 (as detailed on page 112).

The sustained decline in the funded ratio is a continuation of the cumulative effect of the transfer of contributions from the retirement fund to the medical insurance fund from 1998-2005. 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, 2011 indicated that the fund has an unfunded liability of \$3.1 billion. The funded ratio of actuarial assets to liabilities is 8.6%. The actuary reports: "...if the State contributions to the Medical Insurance Fund are

increased to the planned levels, the medical plans 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 successive actuarial valuations, the actuarial soundness of the Medical Insurance Fund to provide the benefits called for under the medical plans 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.

Effective January 1, 1999 KTRS eligible retirees and eligible dependents, who are not eligible for Medicare, have their health insurance through plans administered by the Kentucky Department for Employee Insurance. Under this arrangement, KTRS provides a monthly supplement to assist the eligible retiree in purchasing health insurance. Retirees eligible for Medicare have their health insurance through the Medicare Eligible Health Plan sponsored by KTRS. These retirees also receive a supplement for the cost of their coverage.

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. A certification from the Certified Public Accountant and Actuary are enclosed in this report. The System's consultants who are appointed by the Board are listed on pages 46, 47, and 74 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, 2010. 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-three consecutive years (fiscal years ended 1988-2010). 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 of the State of Kentucky for 2011 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.

The PPCC is a coalition of the four major public pension organizations in the nation. These include the National Association of State Retirement Administrators, The National Council on Teacher Retirement, the National Conference on Public Employees Retirement Systems, and the Government Finance Officers Association.

NCTR Executive Committee

Gary L. Harbin serves as the Past-President on the Executive Committee 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 69 state, territorial,

local and university pension systems with combined assets in excess of 2 trillion, serving more than 18 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 insure that the interests of the public sector are properly represented during the formulation, debate, and implementation of federal health care reform initiatives. Membership in the Roundtable is open to any statewide, regional or local governmental unit that provides health care coverage for public employees and retirees.

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, and is made available to all employer members of the System 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



Barbara G. Sterrett
Chairperson
Retired Teacher Trustee
Lexington



Ronald L. Sanders
Vice Chairperson
Lay Trustee
Hodgenville



Robert M. Conley
Lay Trustee
Paintsville



Charles Ludwig
Teacher Trustee
Louisville



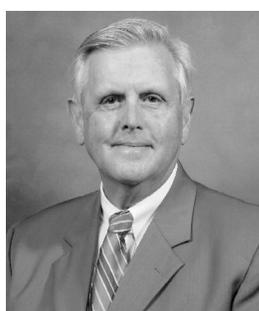
Dr. Tom Shelton
Teacher Trustee
Lexington



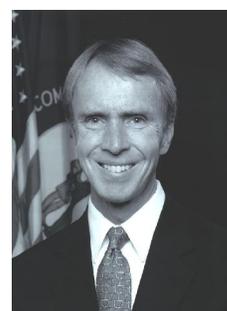
Ruth Ann Sweazy
Teacher Trustee
Taylorsville



Laura Zimmerman
Teacher Trustee
Lexington



Dr. Terry Holliday
Ex Officio Trustee
Commissioner,
Dept. of Education



Todd Hollenbach
Ex Officio Trustee
State Treasurer

Kentucky Teachers' Retirement System
479 Versailles Road
Frankfort, Kentucky 40601-3800

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

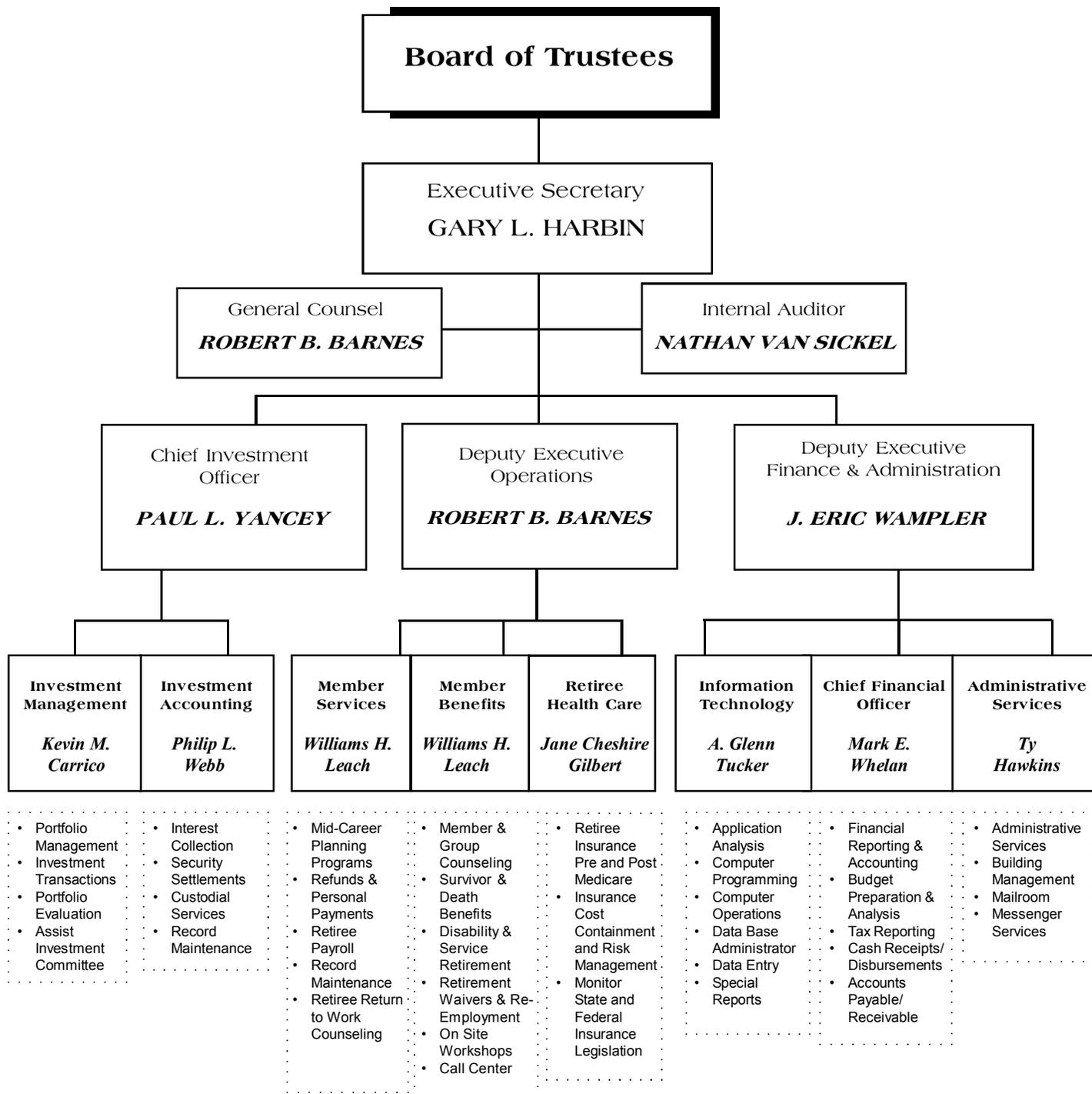
Cavanaugh Macdonald Consulting, LLC
3550 Busbee Parkway, Suite 250
Kennesaw, GA 30144

AUDITOR

Charles T. Mitchell, LLP
229 West Main Street, Suite 103
P.O. Box 698
Frankfort, Kentucky 40601

** See page 74 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, 2010

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. Emery

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-three consecutive years (fiscal years ended 1988-2010).



Public Pension Coordinating Council
Public Pension Standards
2011 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, reading '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 2011 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.