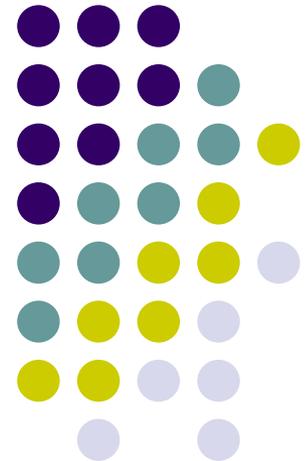


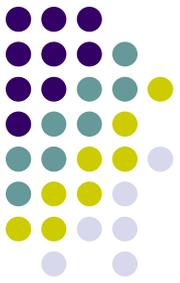
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# Public Sector Retirement Plans: The Key Issues In 2008

Girard Miller

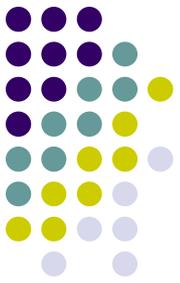


# Agenda



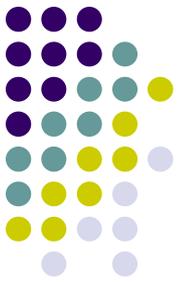
- Election year perspective
- Market perspective
- Public sector perspectives
- Baby Boomer perspectives
- Citizen & Taxpayer perspectives
- Fiduciary perspectives
- Strategies

# Election Year Perspectives



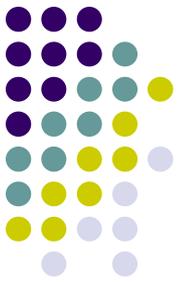
- Long odds for Republicans
  - War
  - Economy
  - Presently favor Dems gaining Congressional seats
    - Will Senate become veto-proof?
- But don't rule out the ticket-splitters
  - And Democrats' propensity to pull defeat from the jaws of victory

# Election year policy debate

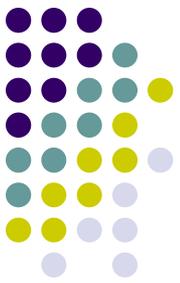


- Social Security
  - Higher taxes vs. semi-privatization
  - Latest trustee report on system solvency
    - Actuarial deficit = 1.7% of taxable payroll
  - Note: NOBODY is talking about retirement age !
- Medicare
  - “Won’t be solved without national health care”
  - Deeper structural deficits and escalating costs
    - Actuarial deficit = 3.5% of taxable payroll
    - Paygo costs rise to 11% of all US payroll if unabated !!
  - Unlikely to become a sharp focal point in 2008
  - Again, nobody talking about eligibility age or caps
- Tax policy
  - Restoration of Clinton-era tax rates
  - Capital gains and dividends tax issues

# Looking Ahead to 2009: The First 100 days

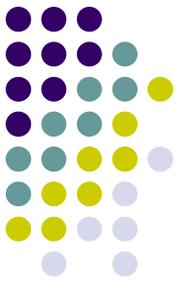


- Day of Reckoning?
  - Or just more partisan bickering and posturing?
  - Too soon to tell
- Best bet: Bipartisan commission on Soc Sec'y & Medicare
  - Politicians need air cover to take unpopular actions
- Best bet: Omnibus tax bill – a compromise
  - Higher income taxes for the rich, with a sop in estate tax reform
  - Top marginal rate will revert to 39.6% in 2011
  - Raise FICA tax caps on earned income
  - Dividends and cap gains: 20%?
    - Phased in? Public pensions need to weigh in !!!!!
  - Hedge fund tax treatment
  - AMT reform



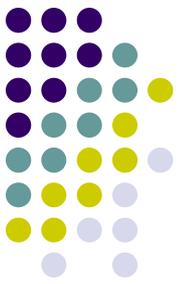
# Public retirement legislation

- 401x ?
- State legislative environment
  - Standoff in the DB-DC wars
    - Baby boomers can't afford DC as primary benefit
    - Now need to shift costs to their children
    - So much for moral authority !!
- OPEB legislation needed
  - Investment authority deficient in some states
  - Why not consolidated statewide systems?
  - Will these all look like Pennsylvania ???



# Markets: the Big Picture !!!

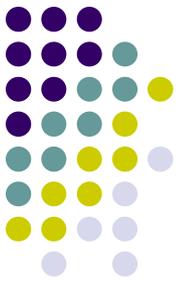
- Stagflation
- Domicile Deflation & Housing Hangover
- U.S. U-bottom
- Downbeat Dollar
- Global Growth
- Darwinian \$\$ Dynamics
- Unlisted Utopia



# Market perspective

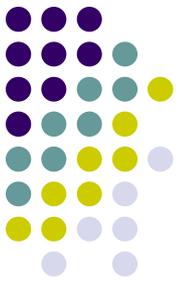
- Extended business cycles as background
- Financial meltdown akin to 1987 & 1998
- Risk of deeper US recession?
- Global economy offsets US weakness
- Investment returns < actuarial assumptions
  - Result: Declining funded ratios?
    - Smoothing will offset in some cases
    - Less noise about “overfunded” plans
- Hedge funds and “alternatives”
- Sovereign wealth funds

# Market perspective & strategy

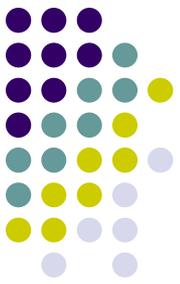


- Muni bond crossover
- Mortgage securities normalize in 2009
- Year of the active bond manager
- Risks of insidious inflation
- International equity exposure
- Private equity drain on stock index returns
- Multi-state consortia for venture capital and infrastructure?

# Public sector perspectives

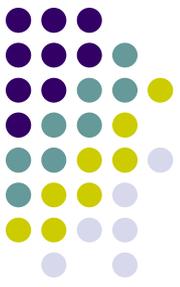


- Another perfect storm
  - Recession and eroding tax base + GASB's OPEB expense  
= Budget deficits and Funding shortfalls
  - Band-aid solution = ramping up contributions 1% per year
- Market correction
- Boomers beginning to retire
- Divestment legislation
- Possible “universal” Social Security effort?
- Financial economics
- GASB review of pension accounting



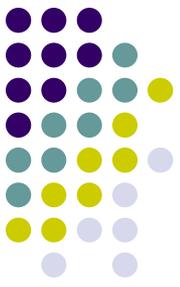
# Boomer perspectives

- “Forget DC!” Gimme steady income, baby !!
- Two market downturns have eradicated the allure of stocks as a source of wealth
  - Boomers now “get it” that money can run out
  - Most aren’t nearly ready to retire
  - Exception: public employees with strong pensions
    - Victims of our own success?
      - Pension envy
- Opportunity to “annuitize” or “pension-ize” 457 and other savings
  - Air-time provisions of PPA
- Boomers have NOT yet internalized the risk of inflation (*This is called magical thinking*)
  - “Forget Coke. Forget Pepsi. Gimme pension COLA !”



# Boomer Perspectives

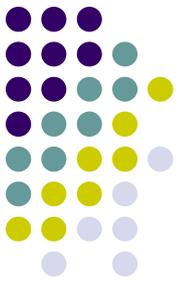
- Many would like to keep working – but less
  - They need to fill their income gap
  - Some would get bored eventually
  - In private sector, they need health benefits
  - Most Boomers need retirement education
    - E.g., what if there is no COLA fairy?
- Issue: pension rules standing in the way
  - Public/media obsession with “double-dipping”
    - Need cosmetically superior partial income strategies
    - Also need to clean up abusive DROP plans



# Citizen & Taxpayer Perspectives

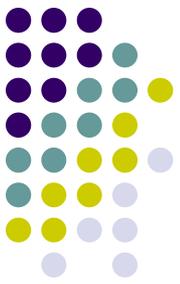
- Pension envy
  - Mostly reflective of conservative anti-government groups
  - Demise of private sector plans highlights the contrast
- Pension abuses
  - Spiking
    - OT, sick leave buyouts, extra pay, bonuses, etc
    - High visibility
  - Retroactive benefits as windfalls
- California taxpayer pension reform group
  - Pension Prop 13

# Fiduciary perspectives

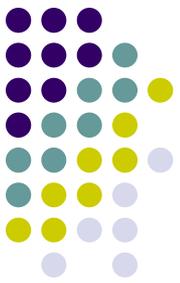


- Duty of Loyalty
- Duty of Care
- Divestment Dilemma
- Increasing fiduciary legal risk
  - Supreme Court decision in *La Rue*
- Inherent Conflicts of Public Employees as Self-interested Trustees
  - San Diego *Lexin* decision

# Issue #1: Divestment Dilemma



- Everybody's got an issue
- This won't stop any time soon
- Purely symbolic
  - Doesn't change # of shares in market
    - Only the ownership
    - So that people who actually give a darn must sell
    - Doesn't seem like a smart strategy to influence boards
      - Smarter strategy would be activist shareholder profile
      - Why aren't public funds joining forces on that strategy?
- Meanwhile, public funds sub-optimize their portfolios
  - Living below the efficient frontier
- Fiduciary plight: Slippery slope
  - Where's the Duty of Loyalty?



# A Smarter Strategy

- Down with Divestment!
  - No impact on corporate behavior
  - Dubious impact on stock price
  - Negative impact on portfolio
- Instead, consortia of responsible fiduciaries
  - Activist investor strategy
  - Require positive corporate actions
    - No more capital investments in target states,
    - Unless the firm materially and demonstrably advances social welfare and human conditions beyond simply providing employment

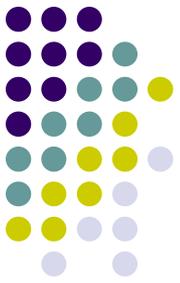
# Issue #2:

## Inherent trustee conflicts



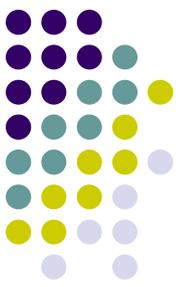
- Public employees voting themselves benefits increases
- What is their Duty of Loyalty to the plan and the trust?
  - Must supercede their interests as beneficiaries

# Cures for Trustee Conflicts



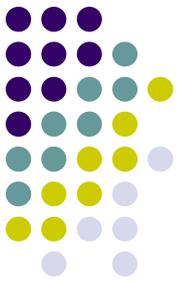
- Beneficiary trustees can disclaim all interests in benefit increases awarded during their terms
  - Some will consider this too high a price to pay for public service -- “Let Mikey do it”
- Interested trustees can recuse themselves from discussions and votes
  - Quorum problem in many plans
- Reconstitute the board with majority of independent trustees
  - Incomplete solution

# Alternative: A VEBA solution to trustee conflict?



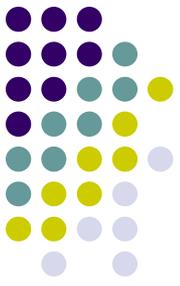
- Theory: If employees are running the show, perhaps they should bear the investment and actuarial risks (*Public sector Taft Hartley?*)
- Doesn't solve pure fiduciary issue, but rules are inherently different for VEBAs
- Employer cost could be capped
- Precedent: UAW
  
- Doubtful many employee groups would take the risk over the issue of governance

# The Mutual Fund ('40 Act) Independent Trustee Solution



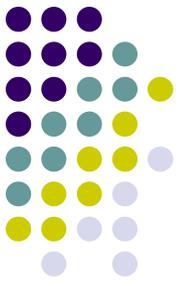
- Analogy: Investment advisor members of a mutual fund trust have a similar inherent conflict
- Solution per the 1940 Investment Company Act:
  - Independent trustees vote separately on key contracts where the interested trustee is conflicted

# Public retirement trust model for independent trustee actions on benefits increases



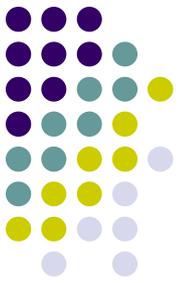
- Majority of board should be independent or “disinterested”
  - Not a beneficiary or elected by beneficiaries
  - By personal disclaimer
- Only independent (disinterested) trustees consider benefits increases
  - Must approve by supermajority
- Full board vote is thereafter conceivable
  - Upon positive recommendation by the independent trustees
  - Supermajority requirement

# Independent-controlled Governance for OPEB trusts



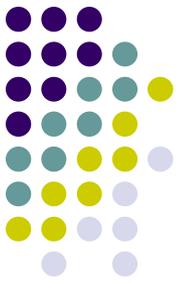
- Same issue applies
- Natural place to start this reform
  - Founding documents
  - Sets precedent for pension trusts

# OPEB: Reality is Settling In



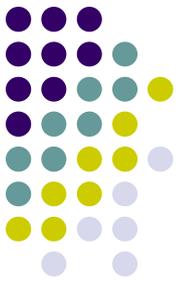
- \$1.5 trillion unfunded liability
- GASB statement 45 kicking in nationwide
- Using a hammer when an adjustable wrench is needed – the case for hybrid OPEB plans
  - OPEB = “Undefined benefit” plan
- Older workers and retirees require a DB solution
  - But higher hurdles & caps on benefits are inevitable
- Younger workers and new hires: DC solution

# OPEB action agenda 2008



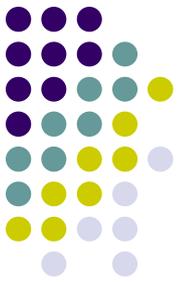
- Complete actuarial and accounting analysis
  - “Houston, we have a problem”
  - Pay close attention of amortization period vs. retiree lives
- OPEB plan consultant – need hybrid specialists
- Establish structure for OPEB trust
  - Investment authority, strategy and policy
  - Trustees and governance
- Establish structure for DC plan component
  - Economics will favor “sidecar” or “piggyback” DC plan administration (existing 457 vendor or rebid)

# OPEB investment strategy



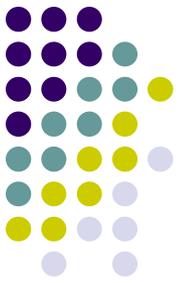
- All-equity DB plan portfolio (or 85%)
  - Market has undergone correction and is arguably at fair value notwithstanding risk
  - New plans are “zero balance” with long-term accumulation periods, hence higher risk strategy fits the plan characteristics
  - Enables full equity return to be considered in setting discount rate for initial period
    - Would subsequently shift to traditional pension asset allocations
- Index funds vs pension fund clones
  - Same issue of zero balance startup funds
  - Keep it simple with low fees
  - Do you really need private equity in a startup OPEB trust?

# States taking the lead in OPEB asset management



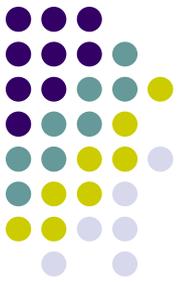
- CalPERS
  - Part of a broader strategy?
- Michigan MERS
  - Already offering a statewide option to municipalities in Michigan
  - Preparing for a multi-state offering

# DC component of OPEB plan: Investment strategy



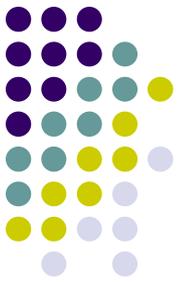
- KISS -- as simple as possible!
- Include target-date funds as default and preferred investment
- Mirror existing 457 menu to simplify admin.

# Deferred Compensation Plans (457)

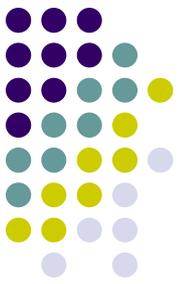


- Opportunity to redesign and reduce fees
  - Streamline fund lineup
  - Intense competition among plan administrators
  - Most rebids pay for themselves
- Revisit brokerage windows
  - However, provides defense against IRA rollouts
- Custom “pension date” funds vs. “target date funds”
- Piggyback OPEB DC plan

# Strategies



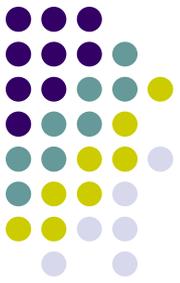
- Alternative investments
  - Needed: more inter-state, multi-plan collaboration
    - E.g., venture capital for economic development, infrastructure funds
  - Needed: lower cost hedge fund-of-funds for smaller municipal plans
- Inflation-hedge income portfolios
  - Real estate and oil trusts as examples



# Summary

- 2009 Post-election changes in federal retirement plan law
- DB-DC wars are over, for pensions
  - But OPEB hybrids are likely
- OPEB is Job #1 for 2008-9
- Inflation and recession risks
- Fiduciary reforms are needed
- Keep an eye on CA taxpayer group

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