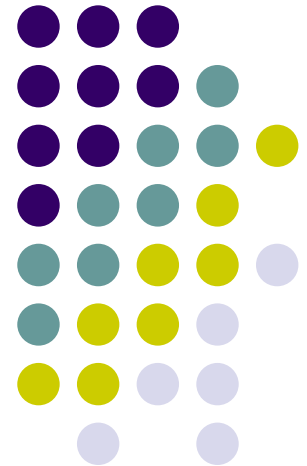


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Public Sector Retirement Plans: The Key Issues In 2008

Girard Miller



Agenda



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

Election Year Perspectives



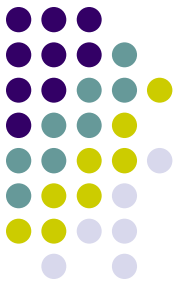
- Long odds for Republicans
 - War
 - Economy
 - Presently favor Dems gaining Congressional seats
 - Will Senate become veto-proof?
- But don't rule out the ticket-splitters
 - And Democrats' propensity to pull defeat from the jaws of victory

Election year policy debate

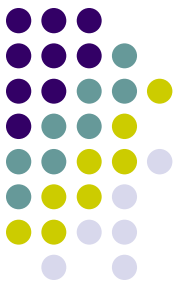


- Social Security
 - Higher taxes vs. semi-privatization
 - Latest trustee report on system solvency
 - Actuarial deficit = 1.7% of taxable payroll
 - Note: NOBODY is talking about retirement age !
- Medicare
 - “Won’t be solved without national health care”
 - Deeper structural deficits and escalating 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

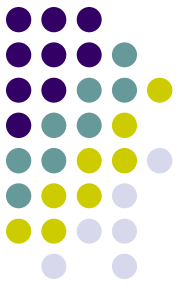


- Day of Reckoning?
 - Or just more partisan bickering and posturing?
 - Too soon to tell
- Best bet: Bipartisan commission on Soc Sec'y & Medicare
 - Politicians need air cover to take unpopular actions
- Best bet: Omnibus tax bill – a compromise
 - Higher income taxes for the rich, with a sop in estate 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



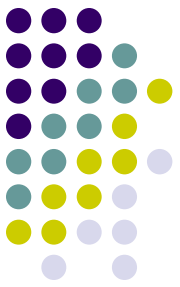
Public retirement legislation

- 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

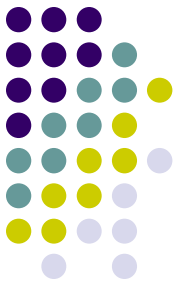
- Extended business cycles as background
- Financial meltdown akin to 1987 & 1998
- Risk of deeper US recession?
- Global economy offsets US weakness
- Investment returns < actuarial assumptions
 - Result: Declining funded ratios?
 - Smoothing will offset in some cases
 - Less noise about “overfunded”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

Market perspective & strategy

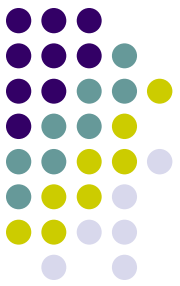


- Muni bond crossover
- Mortgage securities normalize in 2009
- Year of the active bond manager
- Risks of insidious inflation
- International equity exposure
- Private equity drain on stock index returns
- Multi-state consortia for venture capital and infrastructure?

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



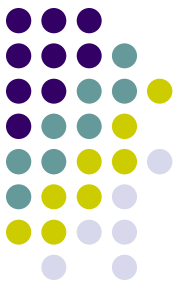
Boomer perspectives

- “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?

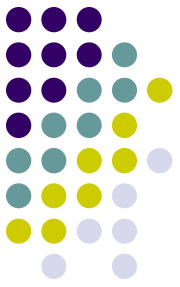
A Smarter Strategy



- 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



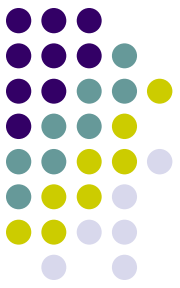
- Public employees voting themselves benefits increases
- What is their Duty of Loyalty to the plan and the trust?
 - Must supercede their interests as beneficiaries

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

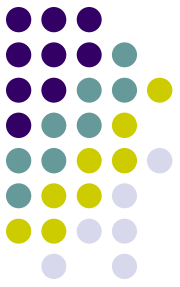
Alternative: A VEBA solution to trustee conflict?



- 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



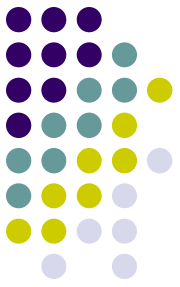
- Majority of board should be independent or “disinterested”
 - Not a beneficiary or elected by beneficiaries
 - By personal disclaimer
- Only independent (disinterested) trustees consider benefits increases
 - Must approve by supermajority
- Full board vote is thereafter conceivable
 - Upon positive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

Independent-controlled Governance for OPEB trusts



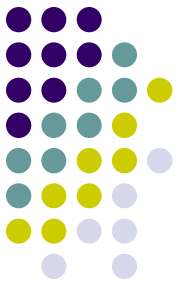
- Same issue applies
- Natural place to start this reform
 - Founding documents
 - Sets precedent for pension trusts

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)

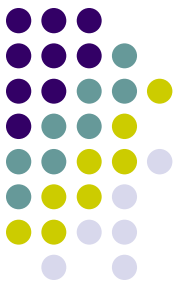


- Opportunity to redesign and reduce fees
 - Streamline fund lineup
 - Intense competition among plan administrators
 - Most rebids pay for themselves
- Revisit brokerage windows
 - However, provides defense against IRA rollouts
- Custom “pension date” funds vs. “target date funds”
- Piggyback OPEB DC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