# SCHOOL EMPLOYEES RETIREMENT SYSTEM OF OHIO
# BOARD MEETING HIGHLIGHTS
# BOARD RETREAT FEBRUARY 2016

**Capital Markets Outlook and Expected Returns Educational Session**
Michael Hood, managing director for JP Morgan Asset Management, provided an overview of the current global economic outlook and delivered a baseline set of expectations for each asset class over the next 5-15 years.

Hood uses a range of 5-15 years because it is long enough to include two market cycles and a recession, which generally occurs at least once during that length of time.

Domestically, Hood predicts that the U.S. economy will not look like the economy of past decades. Economic conditions indicate that the U.S economy will grow at about 2.25% per year compared with the 3% average realized in recent decades.

For US equity, he forecasts returns to be in the 7% to 7.25% range for large and small cap stocks. The reasons for this lower than average forecast is that elevated valuations and narrowing corporate profit margins will put additional strain on capital market returns.

For bonds over the mid- to long-term, rates are expected to gradually rise from 2% today to around 4% over the long-term. Even with the gradual rise, returns in this asset class are not expected to be good. Furthermore, the bank deposit rate will hover around 2%, which is depressed by historical standards.

According to Hood, the atmosphere for alternative investments (i.e., private equity and hedge funds) is favorable. However, he cautioned that while returns above the 7% expected for equities are possible, manager selection and due diligence are critical. The spread between the best and worst returns is between 2% and 18% so the quality of the investments must be a priority.

Globally, Hood says that economic growth is moderating. However, he believes the outlook for non-US assets is better now than it was last year, mainly because the US dollar will likely deteriorate making foreign investments more valuable.

**Return Expectations for SERS' Portfolio**
John Lake and Christopher Moore, Principals of Summit Strategies Group, SERS' general investment consultant, provided an overview of return expectations for SERS' investment portfolio.

Moore, Summit's Chief Investment Office and leader of the Playbook/Risk/Modeling Group, focused on capital market assumptions. Due to slowing labor force growth and output growth that was below average, Moore said the growth potential of the US economy will continue to decline. Combined with headwinds from an aging population, high debt levels, and lackluster productivity growth, long-term growth potential will stay below historical averages.

Lake, who is a senior member of Summit's Manager Research group, discussed the return opportunities for SERS' portfolio in a low-growth environment. Summit predicted performance below 7% for the total fund over the next 10 years; however, Lake highlighted areas where the best return opportunities were possible.

Three strategies hold promise for significant returns: emerging market equity, emerging market debt (EMD), and master limited partnerships (MLPs).

Emerging market equity is positioned for higher returns because the value of those equities is currently at 2001 levels and has a lot of room for growth. EMD returns have significant upside because the value of the US dollar is expected to decline, which makes emerging currencies more valuable and fuel EMD returns. MLPs (publicly traded limited partnerships that derive 90% of their cash flows from real estate, natural resources, and commodities) are expected to increase profits through the growth of crude oil transport to storage and refining centers, natural gas transports out of the Northeast region, and growing exports of refined products, such as natural gas liquids and natural gas.

**Sustainable Investment Strategies Educational Session**

John McKinley, vice president of impact investing and strategic product management at BlackRock Impact, addressed strategies for sustainable investing, an investment approach that takes into consideration environmental, social, and governance (ESG) factors while generating strong financial returns.

McKinley identified three fundamental strategies of sustainable investing: screening, and ultimately excluding companies that are not aligned with the organization's mission or values; pursuing companies that promote the organization's social and financial objectives by investing in companies with strong ESG performance; and, targeting measurable impact outcomes and financial returns.

Impact investing consists of three core characteristics:

1. <u>Defining Impact Outcome</u> – Investors establish and communicate the intended social and environmental objectives
2. <u>Maintaining Targeted Financial Goals</u> – Investors set performance goals related to the desired outcome, with the intent of generating a measurable financial return
3. <u>Transparent Measurement and Reporting</u> – Investors monitor and measure performance by using a set of reporting standards established by the organization, then report on that performance to the organization and other interested parties

SERS incorporates sustainable investing by asking ESG-related questions in requests for proposals from qualified investment managers for investment management services. In addition, guidelines for support of ESG-related issues are included in SERS' proxy voting policy.

In a recent survey of SERS' existing investment managers, approximately 60% of those surveyed had existing sustainable investment policies.

**Consultant Provides Overview of Actuarial Basics**

In preparation for SERS' forthcoming five-year experience study, Tom Cavanaugh, co-founder and chief executive officer of Cavanaugh Macdonald Consulting, LLC, and Todd Green, principal and consulting actuary of Cavanaugh Macdonald Consulting, LLC, reviewed the basic retirement funding structure, the purpose of the actuarial valuation, and the types of actuarial assumptions used in the valuation.

The five-year experience study will examine SERS' demographic assumptions (rates of service and disability retirement, mortality rates, rates of withdrawal, etc.) and economic assumptions (inflation, salary increases, cost of living adjustments, etc.) over the last five years, and will compare those results with data over longer periods of time.

Based on the results of the study, the actuary may propose changes in actuarial assumptions, and determine the impact of those recommended changes on the pension fund.

Staff from Cavanaugh Macdonald will present the results of their 2015 five-year experience study to the Board in April.

## Healthcare Market Leader Presents Sustainable Health Care Strategies

Eric St. Pierre, a health care market lead with Gabriel, Roeder, Smith & Company (GRS), discussed the effects of the Affordable Healthcare Act, as well as short- and long-term strategies for SERS' health care program.

A number of pressures could impact future health care funding, including recent Board Funding Policy revisions, lower investment earnings, rising medical and prescription medication costs, and the impending high-value plan excise tax (slated to take effect in 2020).

In order for SERS to continue offering a high level of benefits to eligible participants, St. Pierre has two key recommendations:

- Identify and assist individuals who may be eligible for early Medicare and/or other government programs
- Consider a wraparound marketplace plan, which may allow retirees to receive coverage through the marketplace with an additional SERS benefit "wrapped around" it

St. Pierre commended Health Care staff who are already exploring the feasibility of these recommendations and looking for other ways to continue to preserve the health care fund.