SCHOOL EMPLOYEES RETIREMENT SYSTEM OF OHIO
BOARD RETREAT HIGHLIGHTS
FEBRUARY 2023

Educational Session on Current U.S. Economic Conditions

Dr. Anirban Basu, Chairman and CEO of Sage Policy Group, Inc., provided a Board Workshop on the current economic conditions in the U.S. and Ohio.

As an economist, Basu said that money supply is "at the heart of all things." When money supply is abundant, everything is good.

As the U.S. emerged from the pandemic, consumers had significant liquidity, and the economy heated up fast. Add to that the war in Ukraine, and lingering supply chain issues and there was more demand than supply. This brought on inflation as prices in consumer price index, such as food, energy, housing, clothing, and medical care, increased rapidly. To fight inflation, the Federal Reserve (Fed) began hiking interest rates to shrink the money supply.

Despite the Fed's rate increases, U.S. consumers spent right through the price increases. One reason was that retailers built up inventory in November and December, which led to sale prices in January.

However, inflation has negatively impacted poor households and older Americans on fixed incomes, affecting these groups the most, which are the main reasons there is government urgency to bring down inflation.

Even though U.S. consumers have shown great resilience as inflation is rising, there are signs that interest rate increases are slowing inflation. Data indicates that the savings rate is slowing and credit card balances are rising. One phenomenon surprising Basu is that the labor force continues to shrink, with more than 11 million jobs currently unfilled. One reason is that participation by men in the workforce is now 9.5% lower than it was in 1980. By contrast, the participation of women in the workforce is 5.3% higher than it was in 1980. In addition, younger women are outpacing younger men in earnings.

Basu said that the U.S. economy needs more workers. Substantial openings in skilled trades are slowing construction projects. He also said that fewer workers paying into Social Security is hurting its solvency because there are fewer workers per retiree.

Currently, large cities, especially in the South, are adding more jobs but finding workers is a major challenge. In Ohio, 105,000 jobs were lost between 2020 and 2022, but employers are still struggling to fill open positions. Looking forward, Basu sees indicators that the current economic cycle is beginning to change and a recession could be on the way. These include:

1. Expensive S&P 500 prices
2. Employers reducing staffed positions to control finances
3. Presence of an inverted yield curve, which is when the one-year U.S. Treasury yields go above 10-year U.S. Treasury yields
4. Rising interest rates, which decreased housing applications and reduced sale prices by 1%
5. A reduction in building permits on single-family and multi-family housing
6. Less capital being lent by banks to finance building projects

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Even if there is not a recession, he predicts economic weakness ahead. However, if consumer spending continues an the current pace and infrastructure projects continue to be funded, the economy could achieve the Fed's objective of a soft landing .

Risk Assessment Educational Session

In accordance with Actuarial Standard of Practice Number 51 (ASOP 51), Todd Green, president and consulting actuary, and John Garrett, principal and consulting actuary, with Cavanaugh Macdonald Consulting, provided a risk analysis of SERS' defined benefit plan.

As SERS' actuary, one of Cavanaugh Macdonald's roles is to identify risks that could impact the System's future financial condition. The primary types of risk that could affect funding are:

- **Investment risk:** Investment return is different than expected
- **Longevity risk:** Mortality experience is different than expected
- **Covered payroll risk:** Covered payroll will not increase as assumed
- **Active population risk:** Number of active members decline
- **Contribution rate risk:** Contribution rates are too high for the employer to pay

Actuaries assess these risks through a series of plan maturity measurements, such as comparing the number of actives to retirees; retired liability to total liability; net cash flow to market value of assets; and market value of assets to payroll.

Cavanaugh Macdonald began its qualitative risk assessment by examining SERS' funding and amortization policies; the size of active membership compared to growth in total covered payroll; and the effect of annual cost-of-living adjustments (COLAs).

Currently, employers and members are required to pay a contribution rate of 14% and 10%, respectfully Employer contributions exceeding those required to pay basic benefits may be allocated the Health Care Fund.

In keeping with SERS' objective of maintaining a closed amortization period, the Board approved a change to the System's funding policy in 2015. If the funded ratio of the pension fund is below 70%, all 14% of the employer contribution must be allocated to SERS' basic benefits; if the funded ratio is at least 70%, but less than 80%, the Board can allocate up to 0.50% of the 14% employer contribution toward health care; if the funded ratio is at least 80%, but less than 90%, the Board can allocate up to 0.75% to basic benefits; and if the funded ratio is 90% or greater, the Health Care Fund may receive any portion of the employer contribution that is not needed for basic benefits. Green noted that SERS' funding policy is a **positive factor** as it has accelerated the funding of the pension plan by $600 million.

The System's amortization policy is that SERS' unfunded actuarial accrued pension liability must be amortized, or paid off, within thirty years. Green remarked that this is also a **positive factor**.

When evaluating the size of SERS' active membership to the total covered payroll, the assessment found that this factor presents a **limited risk** due to decreased active membership.

Currently, there are two active members contributing to SERS for every retiree. While this is an adequate ratio to be able to fund basic benefits, membership has slightly decreased from pre-pandemic numbers.

In FY2019, 159,363 active contributing members paid into SERS. In FY2022, that number was 155,063. While FY2022 was lower than FY2019, it was an increase of 8,417 from FY2021.

Senate Bill 8 became effective in March 2018, allowing SERS' Board to decide how many anniversaries new benefit recipients must achieve before they are eligible for a COLA. Green indicated this authority is considered a

positive factor as it allows SERS to act proactively rather than pursuing legislation to address an issue and mitigate a portion of the risk.

As far as mortality risk is concerned, small, continuous improvements in mortality are anticipated. Green stated that recent experience represents approximately a 1% improvement per year. This presents a **slight risk** as retirees will be receiving a benefit for longer periods of time and there is the possibility in a sudden shift in life expectancy due to major medical advancements.

Finally, Green discussed investment risk. After performing a stress test, or an analysis used to determine the ability of a financial institution to manage an economic crisis, it was determined that SERS could sustain a single "shock" return like the one experienced in FY2009, but it would likely require more Board action to maintain pension sustainability. Therefore, this presents a **slight risk** to the System.

In conclusion, Green and Garrett stated SERS' risk profile has improved since the FY2018 assessment primarily due to investment performance and the Board's funding policy. However, the Board needs to continue to monitor risks and adjust as necessary.

Market Snapshot Educational Session

Candice Tse, global head of the Strategic Advisory Solutions team at Goldman Sachs Asset Management, provided an overview of the current U.S. economic conditions and inflection points.

Tse began by remarking that the Federal Reserve's attempt to bring down runaway inflation while preventing the economy from going into recession is still viable, but the path is narrowing. The Fed is making an effort to fight inflation by slowing economic growth enough to reduce labor demand and wage growth. The economy is not cooling off as rapidly as the Fed hoped, which helps with a "soft" landing, but this is a sign that the central bank will likely need to apply more tightening by continuing to raise interest rates.

The U.S. experienced extraordinary economic growth coming out of 2021 at 5.9%. Last year, the gross domestic product (GDP) increased by about 2.1% and economists expect it to increase by about 1.5% in 2023. Tse noted it is necessary for economic growth to remain low to prevent the economy from overheating.

While some believe a recession in the U.S. is imminent, Tse noted that Goldman Sachs believes there is a narrow path for a soft landing due to less impact from a tighter Financial Conditions Index (FCI), ongoing supply chain improvements, and well-anchored long-run inflation expectations. While it believes the intersection to inflation and policy is likely to remain volatile, there are clear points of entry, such as yield, idiosyncratic alpha, and pricing dislocation.

Some indicators that continue to be sources of volatility are:

- **Policy Rates**: The forecasted Fed terminal rate, or the long-term target rate is expected to reach 5.13% by May 2023.
- **Business Sentiment:** The index, which gauges the overall health of the business environment, is below 50, which indicates that the economy is contracting, rather than growing.
- **Debt Ceiling:** The current federal debt ceiling is $31.4 trillion; that amount is estimated to be breached later this year if not raised.
- **Recession Risk:** Economists believe there is a 65% chance of a U.S. recession.

Some indicators that are sources of stability include:

- **Banking:** Only 0.72% of total loans and leases are past due, compared with the long-term average of 1.9%.
- **Corporates**: Approximately 2.4% of U.S. high yield debt is maturing in 2023.

- **Housing**: Only 5% of households have an adjustable-rate mortgage, compared to 25% in 2006.
- **Labor**: The U.S. jobs-workers gap, or the difference between the number of job openings and the total labor force, is currently 5.3 million. The gap can provide a potential buffer to reduce labor demand.

As far as capital market forecasts, Tse noted that equities are likely to be resilient over the long-term, though volatility may persist near-term. While TINA (There Is No Alternative to equities) has been a key driver with real yields declining and stocks appearing more attractive, investors are now shifting to TARA (There Are Reasonable Alternatives to equities) with bonds appearing more attractive.

With real yields rising, investors are looking to potential wealth creators of the future. Approximately one-third of wealth creators are in the U.S., one-third are in Europe, and one-third are in Taiwan. Some examples include:

- **Innovators:** The Taiwan Semiconductor Manufacturing Company, the world's largest chipmaker, which expanded to the U.S.
- **Disruptors:** Electric vehicles, which changed the face of the automobile industry
- **Enablers:** Chipotle, which enabled the use of locally-grown, sustainable farm products
- **Adapters:** Tesco, a U.K. retailer, that responded to the pandemic by creating the Tesco Whoosh rapid delivery concept

Tse concluded her presentation by noting that more episodic volatility in the equity market presents opportunities for investors to consider other asset classes. This may mean renewed opportunities for income and tax-alpha.