School Employees Retirement System of Ohio
Board Workshop Highlights
February 2025

Educational Session on Current U.S. Economic Conditions

Dr. Anirban Basu, Chairman and CEO of Sage Policy Group, Inc., provided an overview of the current economic conditions in the U.S. and Ohio.

Inflation remains the primary economic topic of interest. While the Consumer Price Index (CPI) has declined to 3.3% from 9.1% in June of 2022, inflation remains “sticky” which means it isn’t moving closer to the Federal Reserve’s target of 2%. Since May of 2020, CPI has increased the cost of goods nearly 25%. One of the repercussions of high inflation is the increase of the Federal Funds Rate, which currently sits at 4.50%.

Looking forward, there are some economic policy proposals from the current administration that could increase inflation:

- Extending the 2017 Tax Cuts and Jobs Act
- Reducing the corporate tax rate to 15%
- Eliminating taxes on Social Security benefits
- Eliminating taxes on tips
- Implementing tariffs
- Mass deportation of all undocumented immigrants

Despite the higher inflation environment, the U.S. consumer has kept the economy healthy. Retail sales have continued to climb, and the gross domestic product has remained positive since the second quarter of 2022. While job openings are down from highs registered in 2021-2022, there are still more openings than there are unemployed workers. Businesses are still challenged to find qualified workers.

Some other warning signs for the economy include:

- The personal savings rate for Americans is declining
- Credit card debt rising
- Auto loan delinquencies are rising
- Rent payment delinquencies are rising
- Commercial real estate vacancy is high and banks may be getting close to foreclosing on properties to get the debt off their books
- Mortgage applications are down
- Home sale prices are 35% higher than they were in 2012
- Building permits for multi-family structures are down

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Some good signs for the economy include:

- Building permits for single-family homes are up
- Small business optimism about the economy is higher, which could lead to more hiring
- Economic indicators do not forecast a recession in the next 12-18 months
- Forecasts predict that the U.S. economy will grow between 2.3% and 2.7% in 2025

Since February of 2020, Ohio's, non-farm employment growth lagged behind the 4.4% U.S. average by 2.9%. Private education and health care services; construction, trade, transportation, and utilities; professional services; and financial activities all registered job gains in Ohio, while mining and logging, government, information, leisure and hospitality, and manufacturing all registered job losses. Regionally, Cincinnati, Columbus, and Cleveland registered the most job gains. No Ohio cities ranked in the top 25 largest metropolitan areas in the categories of employment growth or unemployment rates.

Market Snapshot: Tales, Tells, and Tails

Elizabeth Burton, managing director and client investment strategist in the Client Solutions Group within Goldman Sachs Asset Management, provided the Board with an economic overview from the perspective of an asset manager.

Goldman believes that economic data continues to be solid without any system financial imbalances. The final stretch of inflation reduction is progressing slowly and might be delayed by uncertainty over tariffs. The labor market is tightening, more from a reduction in job openings rather than layoffs. They also expect the Federal Reserve to reduce the lending rate to 3.50-3.75% by June of 2026, but the decline could be delayed by tariff implementation.

Burton said that Goldman expects the U.S., China, and emerging markets to lead the world in GDP growth in the next 1-2 years.

Next, Burton discussed Goldman's forecast for asset class returns over the next year.

For U.S. equity, return expectations are somewhat muted by the fact that current valuations of U.S. assets are high. When equity assets are high, returns are generally lower. They believe that the Magnificent 7, the seven top stocks in the S&P 500, still have the potential to outperform the rest of the market. However, over the 10-year period, they predict U.S. equity returns could trail bond returns and only average a 3% return.

In developed markets, international equity may offer attractive opportunities especially since valuations are lower than those in the U.S. Emerging market equities that are shielded from U.S. tariffs may also offer opportunities for outperformance.

Even though private equity returns have declined recently, Goldman projects that a more normalized dealmaking environment will return this year leading to better returns.

In fixed income, attractive current yields and decelerating inflation could produce good investment opportunities, especially in core bonds.

Burton also said that private credit continues to be a good space to be invested. The biggest opportunity seems to be in hybrid capital, flexible financing solutions that can serve a range of situations, including real asset credit, directly-originated investment-grade credit, and asset finance.

In real estate, Goldman predicts that a rebound in the market will take place if interest rates moderate. Lower rates would stimulate transaction activity, especially in core and core plus assets. US multifamily and industrial markets may see a better supply/demand balance due to a decrease in new construction projects.

Risk Assessment Educational Session

Todd Green, president and consulting actuary with CavMac Consulting, provided a risk analysis of SERS' defined benefit plan. This session was scheduled as part of the Board's ongoing commitment to review the System's sustainability metrics at least once per year.

As SERS' actuary, one of CavMac'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.

CavMac performed 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.

The System's amortization policy is that SERS' unfunded actuarial accrued pension liability must be amortized, or paid off, within 30 years. As an alternative for the Board to consider, Green explained that some other pension systems are using a layered amortization policy, where, with each additional

actuarial valuation, the incremental change in the unfunded actuarial accrued liability is amortized over a new closed period. This results in a series of “layered” amortization bases. The total amortization payment is equal to the sum of the amortization payments for each of the “layered” amortization bases.

Green commented that while this design offers some benefits, such as reducing volatility in required amortization payments and easier tracking of funding progress, it is not suitable for SERS at this time. CavMac believes the current amortization policy provides the necessary flexibility to calculated stable actuarial determined contributions and meets the requirements established by the Ohio Retirement Study Council.

SERS has steadily improved its funding ratio since the Great Recession. Currently, the System is 78.99% funded over a 20-year period.

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

Currently, there are approximately two active members contributing to SERS for every retiree. While this is an adequate ratio to be able to fund basic benefits and active membership has actually increased since last fiscal year, covered payroll may not increase as assumed if active membership decreases or salary increases are less than expected.

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 allowed 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. 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.

In conclusion, Green stated SERS’ risk profile had improved since the FY2023 assessment primarily due to investment performance, the Board’s funding policy, and the fact that payroll grew by 5.8% compared to the assumed rate of 1.75%.

However, the Board needs to continue to monitor risks and adjust as necessary.

Asset Allocation Update

Farouki Majeed, SERS’ chief investment officer, and Joanna Bewick and Chris Tessman, both of Wilshire Associates, provided an update on SERS’ asset allocation changes and a comparison of SERS’ Total Fund portfolio to a 60/40 equity and bond index portfolio.

Since 2010, SERS has made several asset allocation changes that have added value to the portfolio. These changes included:

- Reducing hedge funds from 15% in 2012 to 0% in 2020
- Increasing real assets from 10% in 2012 to 20% in 2023
- Including infrastructure in the real assets portfolio in 2024, with a target of 7%
- Increasing private credit from 0% to 5% in 2020

- Changing the global equities portfolio from having specific targets to U.S. and Non-US markets to managing it relative to the MSCI ACWI global benchmark

Majeed noted that if hedge funds had not been removed from the portfolio, SERS' returns would have been much lower. Because of the asset allocation changes, private credit and infrastructure realized greater returns over the long term. In addition, he estimated that SERS' total fund balance would have been approximately $500 million less without the above asset allocation changes.

Majeed and Bewick remarked that SERS' diversified portfolio has several advantages over a 60% stocks/40% bonds index portfolio:

- SERS has lower risk and higher returns over a 10-year period
- SERS' portfolio has a much smaller drawdown during economic downturns
- SERS' portfolio has better diversification across inflation, interest rates, and growth factors

While U.S equities and bonds are negatively correlated to inflation, meaning that as inflation increases, the returns of the 60/40 portfolio decrease, a diversified portfolio such as SERS' can blunt the harmful effect of inflation shocks.

Similarly, SERS' diversified portfolio resulted in a drawdown that was nearly half of what it would have experienced in a 60/40 portfolio over the last 10 years.

Tessman concluded the presentation by commenting that while past performance is not a guarantee of future results, a diversified portfolio is expected to outperform a 60/40 portfolio by 87 basis points over the next 10 years. While the last few decades have been an extraordinary time for investors with low inflation and declining interest rates, circumstances are likely to change going forward and SERS' diversified portfolio is expected to provide protection against future long-term risks and implications.

Health Care Legislation Presentation

Fred Dombo partner, and Chris Carney, senior policy advisor, with Nossaman LLP, addressed the Board on the state of the health care environment under the new presidential administration and Congress. Nossaman is a national law firm with attorneys and policy advisors, which SERS contracts with for assistance with federal policy.

Because it is early in the new Congressional term, it's difficult to predict what health care changes might be in the works. Dombo and Carney predicted that, in the search for savings currently being pursued throughout the government structure, changes to Medicaid are possible. They also suggested that changes to pharmacy benefit manager (PBM) operations could also be made. Changes to Medicaid and PBMs could negatively affect SERS and its retirees.

Dombo and Carney suggested that SERS representatives interact with the state's federal legislators, especially those on financial committees, to make sure they understand the impact that changes to Medicaid and health care would have on SERS' retiree population.