SCHOOL EMPLOYEES RETIREMENT SYSTEM OF OHIO

BOARD MEETING HIGHLIGHTS

BOARD RETREAT FEBRUARY 2018

Multiple Roads, One Destination: SUSTAINABILITY

2018 Long-Term Capital Markets Outlook Educational Session

Michael Hood, managing director of the Global Strategy Team within Multi-Asset Solutions at JP Morgan Asset Management, provided an overview of the current U.S. economic conditions and discussed indicators that help predict what investment returns will be over the next 5-15 years.

Following the recent 10% correction in the U.S. stock market, Hood indicated that a significant increase in bond yields was probably the biggest reason for the correction. In addition, he thinks that stock prices look expensive after the big gains in 2017. With unemployment at historic lows and rising wages, there is concern about an uptick in inflation. All of these together create uncertainty, so it is likely that market volatility will continue.

Despite this volatility, there is a low probability that a recession will occur in 2018. He says that a recession is caused by a "shock to the economy" and currently there are no visible weaknesses or imbalances that could cause this. There are no signs that household wealth is deteriorating, corporate balance sheets are strong and profits are high, employment is low, and there are no indications of inflation. Therefore, he expects the bull market to continue, which should translate into good investment returns this year.

Probably the biggest worry beyond this year is a sudden burst of inflation. This scenario would lead the Federal Reserve to push up interest rates which would make stocks go down, and also cause bonds to fall. In this scenario, institutional investors would not be able to avoid investment losses. Hood did point out that inflation is usually slow moving and not a huge concern at this time.

Hood also addressed how the U.S. economy is linked to other global economies. During global expansion periods, individual economies are not roped together, meaning a shock to another economy generally does not affect the U.S. That is why the U.S. economy was able to brush off the Greek austerity period and Brexit. However, during global downturns, individual economies can be affected by shocks from other economies.

When making future economic predictions, Hood relies on the fact that markets and the economy are linked over the long term because corporate profits come from the economy and bond yields are determined by the economy. Population growth also is a reliable indicator of economic health. A growing population helps expand the economy. Because labor growth in the U.S. is only expected to grow about 0.4% per year, capital markets are currently expensive, and economic growth is slowing, he predicts that investment returns are likely to be lower in the next 5 years, averaging between 5% and 6%. He said it might be prudent to look at investments in other global regions where population growth and economies are expanding at greater rates.

Actuarial Valuation Basics

John Garrett, principal and consulting actuary with Cavanaugh Macdonald Consulting, SERS' independent actuary, provided an overview of how actuaries determine valuations, the importance of experience studies, and the value of projections.

At the heart of public pension funding is the simple equation that inflow (employee/employer contributions plus investment income) must equal outflow (benefit payments and expenses) to ensure long-term solvency of the plan. If inflows are greater, the plan's funding improves; if outflows are greater, the plan's funding declines.

To determine the funding status of a pension plan, actuaries perform valuations. While some of the valuation information is known such as benefit payments, employee contributions, and employer contributions, others like investment income, demographic behavior, and economic factors must be assumed.

To attain the best possible assumptions, actuaries perform regular experience studies. These studies compare actual plan experience with the actual assumptions used in the valuation over the most recent 3- to 5-year period.

When actuaries consider changes to demographic assumptions such as what age members leave active service, rates of disability, number of retirements, and death after retirement, they focus more on recent experience. They also take into account special events that happened during the investigation period (such as an early retirement window) and look for possible trends before recommending changes to demographic assumptions.

When assessing economic assumptions such as inflation, real rate of investment return, salary increases, payroll growth, and COLAs, they focus more on long-term expectations. They also factor in any changes to the pension plan's asset allocation since the last experience study.

Finally, actuaries use all of the information gained in experience studies to make projections about the cost of future benefit payments, the effect of positive and negative investment returns on the system, and the effect of possible declines in active membership on the system. All of these projections are used by the Board as they make decisions intended to keep the pension system financially stable long into the future.

Board Governance: Where Do Successful Boards Focus Their Efforts?

Keith Bozarth, a contract senior advisor with Funston Advisory Services, LLC, discussed fundamental functions of a pension Board. His knowledge is based on experience serving multiple boards in public sector pension plans.

According to Bozarth, basic functions of board members include policy oversight; assuring involvement of all board members; exercising board authority in a unified way; selecting, evaluating, and planning succession of leadership positions; and establishing and exercising systems of accountability.

Bozarth stressed that the Board must focus on its policy function, which includes implementing and monitoring governance policies; providing strategic direction for management; and avoiding involvement in day-to-day pension operations.

For a pension board to be successful, each member must participate in meetings and committees. This means that each board member has the personal responsibility of reading all relevant materials before a meeting to become reasonably informed before making decisions. As such, it is important that board members receive proper education in order to understand their obligations and fulfill their fiduciary duty to the pension system.

It is also imperative that the board speak with "one voice." Board members will not always unanimously agree on agenda items; however, once an issue has been voted on, all board members must work together to implement that decision.

Lastly, successful boards must establish effective methods of accountability. This is accomplished by setting clear expectations to direct reports and staff, maintaining regular communication and feedback through meaningful reporting processes, and using independent sources and external resources to confirm the accuracy of information reported to the board.

National Trends and Issues for Defined Benefit Plans

Carol Nolan Drake, SERS' federal government relations consultant, Joseph Marotta, general counsel for SERS, and Laurel Johnson, senior government relations officer for SERS, on behalf of Leigh Snell of the National Council on Teacher Retirement (NCTR), examined national trends and issues that defined benefit plans are currently facing:

- **Repeal of the Employee Retirement Income Security Act's (ERISA) safe harbor regulations for state, local, and government-sponsored private sector retirement plans**

  ERISA is a federal law that that sets minimum standards for most private pension and health plans. The Department of Labor, under President Obama, created a rule to exempt state-run IRA plans from the law. Last year, that rule was repealed and signed into law by President Trump. While the repeal does not prohibit such plans, it will make it more difficult for states to create their own retirement savings plans for private sector workers who do not have access to a retirement plan through their employer.

- **Public Employee Pension Transparency Act (PEPTA)**

  This legislation would require reporting pension system liabilities to the Treasury using a risk-free rate. This data would then be available through a public database. Failure to report would result in the imposition of new, yet-to-be-defined "comparability" standards. Rep. Devin Nunes has yet to reintroduce this legislation into Congress, but has indicated that he intends to do so.

- **Secure Annuities for Employee (SAFE) Retirement Act**

  Sen. Orrin Hatch introduced the SAFE Retirement Act, which would create a new pension plan called an Annuity Accumulation Retirement Plan. Sen. Hatch's plan would allow state and local governments to purchase fixed annuity contracts from insurance companies for each employee every year during their working career. The life insurance industry would pay the pensions and bear all of the investment risk. Hatch claims the bill would eliminate pension plan underfunding, while delivering lifetime retirement income.

  There are several concerns with the SAFE Retirement Act. First, existing defined benefit plans would remain as closed plans, so costs would continue to increase. There is uncertainty about the level of income replacement, and research suggests that the SAFE income replacement is significantly lower than current DB plans. Additionally, there is no requirement that the annual purchase of annuities must continue or be consistent, which will make it impossible for employees to plan for retirement, nor is there any mention of survivor or disability benefits.

- **Government Pension Offset (GPO) / Windfall Elimination Provision (WEP) Reform**

  Now that tax reform is over, we expect that Rep. Brady will re-introduce his legislation to modify the WEP. In the last Congress, the reform bill proposed a replacement of the WEP with a new "proportional" formula. While there has been discussion of a full repeal, there are concerns that it could lead to mandatory Social Security. In addition, a full repeal is estimated to cost at least $500 billion over a five-year period.

- **Rothification**

  "Rothification" would fundamentally change the way retirement savings are taxed. Currently, contributions to retirement accounts are made pre-tax, grow tax free, and are taxed at the time of withdrawal. Under "Rothification," retirement contributions would be made after tax and not be taxed at the time of withdrawal.

Using after-tax money to fund 401(k)s or IRAs will cause people to save less and therefore accumulate less for retirement. It is unclear if “Rothification” would apply to all contributions, or only a portion.

- **Repeal of Dodd-Frank**

  Last year, President Trump and Congress agreed to repeal certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, a bill passed under the Obama administration that aimed to reduce risk in the financial industry through regulation. Dodd-Frank was created as a safeguard against another global financial crisis. It is unclear what the impact of a partial repeal will be, but SERS will continue to remain informed on this issue.