SERS Board Retreat
February 16, 2018

The annual Board Retreat was held at the School Employees Retirement System on February 16, 2018. The meeting convened in open session at 9:03 a.m. and continued with the Pledge of Allegiance. Following the Pledge of Allegiance the roll call was as follows: Chairman Daniel Wilson, Jeffrey DeLeone, Hugh Garside, James Haller, Christine Holland, Barbra Phillips, Beverly Woolridge and James Rossler. Mr. Wilson excused the absence of Catherine Moss. Also in attendance was John Danish, representative of the Attorney General, and various members of the SERS staff.

Welcome/Overview – Richard Stensrud, SERS Executive Director

Executive Director Richard Stensrud welcomed everyone to the retreat and provided an overview of the day's sessions which were built around the theme of sustainability. Mr. Stensrud then asked Chief Investment Officer Farouki Majeed to begin the Investments portion.

Investments Introduction/Update

Mr. Majeed provided an update on the Investment strategic plan that was adopted in 2012. Objectives at that time included adding value with improvements to the investment process and portfolio construction, focusing on risk management, reducing costs, and developing a strong investment culture. Mr. Majeed reported that progress has been made on all objectives resulting in total fund net of fee returns exceeding the policy benchmark over the three and five year periods. Mr. Majeed noted that the total fund performance has improved over the last ten years from 64th in the peer universe to 11th in 2017 with fees reduced by 16 bps since 2012.

Concluding his update, Mr. Majeed introduced Michael Hood, Managing Director and member of the Global Strategy team within Multi-Asset Solutions at JPMorgan Asset Management for a presentation on market outlook and expected returns.

Investment Outlook and Return Expectations

Mr. Hood discussed the recent 10% correction in the U.S. stock market, noting that a significant increase in bond yields was probably the biggest reason for the correction. In addition, Mr. Hood believes 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.

Mr. Hood noted that 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, Mr. Hood expects the strong market to continue, which should translate into good investment returns this year.

Mr. Hood stressed, however, the importance of being realistic about what capital markets will produce and to plan accordingly. Mr. Hood stated that while the near term economic outlook is favorable, the ten year return forecast for a 60/40 equity and bond portfolio is expected to produce 5.25%, which is below SERS' actuarial rate of return. A low return environment going forward is due to where we are late in the economic market cycle and asset valuations are high.

Following discussions on market outlook and return expectations, the Board thanked Mr. Hood for his presentation.

Concluding the presentation, the Board took a brief recess at 10:10a.m., and reconvened at 10:20 a.m. Upon returning to session, Mr. Stensrud introduced John Garrett of Cavanaugh Macdonald, LLC to for a discussion on actuarial assumptions and actuarial valuations.

Actuarial Assumptions

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.

Mr. Garrett stated that 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.

Mr. Garrett stated that 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 future investment income, demographic behavior, and economic factors must be assumed. He further stated that 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.

Mr. Garrett noted that 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 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.

Mr. Garrett stated that when assessing economic assumptions such as inflation, real rate of investment return, salary increases, payroll growth, and COLAs, they focus on long-term expectations, and not what might be expected in the next few years. They also factor in any changes to the pension plan's asset allocation since the last experience study.

Mr. Garrett stated that the information in the valuations and experience studies can be used to make projections about how future events will impact the retirement system. In that vein, Mr. Garrett discussed how the cost of future benefit payments, the effect of positive and negative investment returns on the system, and the effect of a possible decline in SERS' active membership could impact SERS. Mr. Garrett noted that information like this helps the Board as they make decisions intended to keep the pension system financially stable long into the future.

Concluding the discussion, the Board thanked Mr. Garrett for his presentation.

The Board recessed at 11:18a.m., and reconvened at 12:28p.m.

Mr. Stensrud introduced Consultant Keith Bozarth to discuss the attributes of successful boards.

Board Governance

Keith Bozarth discussed the fundamental functions of a pension board and the key attributes for performing those responsibilities successfully. His knowledge is based on experience serving and consulting with multiple boards in public sector pension plans.

Mr. Bozarth noted that the 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.

Mr. 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. Mr. Bozarth stated that 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.

Mr. Bozarth stated that 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, Mr. Bozarth stated that 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.

The Board thanked Mr. Bozarth for his presentation.

Following, Mr. Stensrud introduced Carol Nolan Drake of Carlow Consulting, who along with General Counsel Joseph Marotta and Senior Government Relations Officer Laurel Johnson, discussed national trends and issues for defined benefit plans.

Defined Benefit Plans: 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, discussed the following national trends and issues currently faced by defined benefit plans:

- **Repeal of the Employee Retirement Income Security Act's (ERISA) safe harbor regulations for state, local, and government-sponsored private sector retirement 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. The sponsor, 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, it is expected 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 in tax revenue over a five-year period.

- **Rothification**
  "Rothification" would fundamentally change the way retirement savings are taxed. Currently, most 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.

  The concern is that 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 various regulations. 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.

Concluding, the Board thanked Ms. Drake, Mr. Marotta and Ms. Johnson for the presentation.

Adjournment

Chairman Daniel Wilson moved to adjourn the meeting at 2:14 p.m.

____
Daniel Wilson, Board Chair

____
Richard Stensrud, Secretary