



## MEMORANDUM

To: PCA Clients

Date: 3/16/2010

From: Neil Rue, CFA, Managing Director

**RE: Recent Press Articles Critical of Public Fund Investment Activities**

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Over the last recent days, the press has released at least two articles that raise questions about the investment activities of public pension funds.<sup>1</sup> Both articles hypothesize that public pension funds as a collective group are ratcheting up the risk of their investment portfolios to recoup recent investment losses and to improve their funded status.


PCA's view is that these articles are misreading the activities of many large plan sponsors and these opinions are disingenuous to the public fund investment community.

Both articles (and others) highlight many corporate plans' moves to fixed income beginning in 2006/2007. In retrospect, this shift proved highly beneficial in light of the financial crisis, so give them credit. Keep in mind, however, that the regulatory framework under which corporate plans operate (Pension Protection Act of 2006) virtually forced them to make this move. Also, many plans were likely overfunded in 2006 and 2007, so immunization strategies made much more sense. In Corporate America, one of the key strategies taking place is to (i) immunize their overfunded DB plans and then (ii) close them down to new employees. America's public pensions are a much more central part of overall public-employee compensation, so the DB model is still considered extremely important. That being said, many public retirement systems are beginning to modify their plan structures.

Among our clients, public plans are seeking to stabilize returns rather than moving toward a stricter immunization-type of approach. In fact, several plans have moved to reduce their policy exposure to public equity by 25%-30%. Offsetting this reduction are typically allocations to one or more new classes, such Absolute Return, Inflation-Linked, and/or Opportunistic. Clearly, these new classes have to be justified. By design these classes are typically not high risk classes. While certain classes may be modeled utilizing Hedge Fund of Funds, Infrastructure, or other segments as key components, the goal is to utilize lower volatility components that exhibit no relationship to the other major classes. In addition, a significant part of either an Absolute Return or Inflation-Linked class could initially contain inflation-protected Treasuries, meaning that any reduction to standard fixed income assets (which, more often than not, exhibited a significant amount of credit risk and volatility) is actually being allocated to lower-risk default-free Treasuries that are structurally designed to protect against inflation. The remaining components of these new, broader strategic classes are often included to provide a

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<sup>1</sup> See, for example, "Public Pension Funds are Adding Risk to Raise Returns," The New York Times, March 9, 2009 and "2 approaches to 1 problem," Pensions & Investment, March 8, 2010.



*form of insurance* against major *tail risk events*, not pile on additional risk. Increased policy allocations to Private Equity (over time) and Real Estate (over time), do lead to the notion of taking on more risk. We would be the first to admit that Private Equity is a return-driven/higher-risk class. Real Estate, on the other hand, can be whatever a pension fund desires it to be and this issue is an important point of discussion at several of our clients right now. Over recent history many of our clients' real estate portfolios have become too risky. One could argue, however, that reconfiguring the Real Estate class to a more stable income generator over time is prudent and better classifying the more return-driven real estate into a more appropriate risk class is a better and more explicit reflection of the risks being taken by the trustees/decision makers.

It is very important to recognize that immunization is not necessarily a viable solution for underfunded plans.<sup>2</sup> Fully immunizing an underfunded plan right now (in a historically low interest rate environment) would likely double the funding costs to the plan sponsor. Even for fully-funded plans that offer some form of COLA-adjusted payments to retirees, immunization becomes less attractive. Only in the case where (i) future payments are fixed and certain (i.e., no COLAs and closed plans), (ii) interest rates are at least at their normal historic levels, and (iii) a plan is more than fully-funded, does immunization become attractive. That being said, if the plan sponsor is actually willing to take on the additional contribution burden long-term, then it may be worthwhile to consider such strategies.

There is a very important lesson here for public plans, however: it's what to do with the surplus in the case a plan finds itself over-funded. In the past, for the most part, when a public plan produced a surplus it used that surplus to grant more benefits. Very likely a more prudent approach would be to establish some form of reserves with the surplus (which are then invested conservatively) to protect existing benefits in times of crisis. This is a very important policy decision and goes directly to plan sustainability over the long term.

Finally, we have included three P&I articles from Gary Findlay, the Exec Director at Missouri. In my view, any proposals of LDL/immunization-type concepts should be counterbalanced with Findlay's (or similar) viewpoints.

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<sup>2</sup> See, for example, Litterman, Robert and the QRS at Goldman Sachs Asset Management, Modern Investment Management, Chapter 10, Wiley Finance, ©2003.



# Pensions & Investments

## LDI misses the philosophical mark

Source: Pensions & Investments  
Date: January 26, 2009

In a Dec. 22, page 6 article headlined “[Plan losses may spur shift to LDI strategy](#),” the subhead stated that “Those that made switch couple of years ago reaping benefits during current market drop.” Further along in the article a consultant was quoted as saying, “Folks who chose to go LDI two or three years ago are looking real smart.”

The issue not addressed in the article was whether or not the LDI strategy performed as advertised. LDI proponents have argued that it will result in assets and liabilities moving in lock step, up or down, depending on economic conditions and thus lower relative volatility between the two. A quick look at the recent outcome would suggest that LDI completely missed the philosophical mark and, in the process, generated extreme volatility that exacerbated rather than mitigated the relationship between assets and liabilities — it coincidentally did so in a way that favored those that adopted the strategy. In implementing the strategy, a common approach would have been for the plan sponsor to use a combination of Treasury securities and interest-rate swaps with the combined duration being approximately equal to the computed duration of the plan’s liabilities. Given the big rally in the bond market during the fourth quarter of 2008, that combination produced big, real money gains for the plan. On the mythical market value of liabilities side of the equation, an AA corporate bond index was probably used to determine the discount rate. A reasonable expectation might have been for that index to have a spread over Treasuries of 50 to 100 basis points — not the 400 or so that materialized that resulted in a dramatic drop in computed liabilities. (That’s an accounting number and not real money, but it does result in real money in terms of the determination of the required contribution to the plan.)

Those who adopted the strategy are faced with an interesting dilemma. Will they let it ride or take their real money asset winnings off the table, unwind the strategy, and put their gains into relatively low-priced equities? Given that the strategy clearly did not work as had been suggested, I’d make a serious bet on them not letting it ride.

This is all just further evidence of the truth of the statement that if you have a choice between being lucky and being good, go with lucky every time.

Gary Findlay

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of market value"&gt;



# Pensions & Investments

## An "ASOP" fable: The illusion of market value

By Gary Findlay  
Source: Pensions & Investments  
Date: November 10, 2008

With apologies to Aesop, a fable seems to be unfolding on a fast track in the actuarial community with a moral that is still up for grabs. U.S. actuarial organizations have universally adopted a code of professional conduct. A quick read of Precepts 3 and 8 of the code together would lead one to conclude that actuarial services must satisfy applicable standards of practice and that actuaries must take reasonable steps to assure that their services are not being used to mislead other parties — both admirable objectives. Even though the code currently includes just 14 precepts, an argument can be made that they should add one more to be called Precept 22 (as in Catch-22). Specifically, what should an actuary do when firmly convinced that following an Actuarial Standard of Practice, or ASOP, will, in fact, mislead other parties? As you will see from what follows, this may not be an academic question.

Recently, the board of directors of the American Academy of Actuaries asked the Actuarial Standards Board to develop standards for consistently measuring the “economic value” of pension plan assets and liabilities. While the terminology they have used is remarkably vague, sorting through the related academic appearing documents prepared by the proponents of so-called consistency in economic value leads to one reasonable conclusion, at least as it relates to public sector pension plans. Specifically, by proposing a “consistent economic value,” they are essentially advocating a one-dimension approach to a multidimensional issue. They would treat the misleadingly labeled “market value of liabilities” as an end in itself, as a substitute for the historically used obligation that is a means to an end derived from several components. The actual end that should be targeted is intergenerational equity achieved through contribution rates that remain relatively level as a percent of payroll over decades of time together with reports that allow assessments of the extent to which that objective is being achieved through adherence to a responsible funding program.

Whether or not what is being advocated is proper for the private sector is arguable, but trying to apply it to the public sector “for consistency” is ridiculous. Once you strip away the trappings of rigorous analysis obfuscating what is being proposed, you end up with what is, essentially; (i) a plan termination-like obligation for a plan that cannot be terminated; (ii) information which is presumably needed by a plan sponsor that cannot go out of business so they can report what will happen if they go out of business; and (iii) amounts computed based on capital market expectations for markets that differ dramatically from the way in which plan assets are being prudently invested for the long term to offset obligations. (It may be worth reading the last sentence again — not that it will become any clearer, but it does point out the inconsistencies in what is allegedly being proposed for the purpose of achieving consistency.)

To their credit, the proponents of this inconsistent consistency have come up with interesting tactics for attempting to neutralize the opposing voices of the key staff spokesmen for the plans involved, and the actuaries who are retained to do work for those plans. They maintain that staff members are not really stakeholders but are rather “pass-through agents” for the plans and further maintain that the actuaries are simply shilling for their clients in hopes of continuing to be retained. I think the most interesting thing about this approach is their naivete in concluding that totalitarian tactics might actually work. However, their loyal opposition will not be bullied into silence. Facts that they would probably prefer not come into evidence include at least the following:

- Plan spokesmen are more than just pass-through agents. In addition to probably having the best grasp of the big picture, they are also taxpayers and plan participants who are very concerned about the sustainability of reasonable benefits at affordable levels. They recognize that public plan terminations would result in post-employment income security being provided by pay-as-you-go entitlement programs at a considerable multiple of the cost of responsibly funded retirement programs. (This is not to mention the negatives associated with such a shift in terms of being hamstrung in pursuing desirable and admirable personnel management objectives.)

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- The actuaries who are being discounted by the proponents of market value of liabilities are simply demonstrating integrity. They actually read their Code of Professional Conduct and have clearly identified the potential conflict that would stem from being required to compute and report the MVL for public plans.

In an earlier op-ed piece on this subject, I borrowed from Ralph Waldo Emerson in calling the extension of MVL to public plans a "foolish consistency." In its entirety, Mr. Emerson said, "A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines." I don't think there is any way I could improve on the clarity of that with such brevity.

It is almost a certainty that the Governmental Accounting Standards Board will be approached by the proponents of using the so-called market value of liabilities for financial reporting (and possibly funding) purposes, arguing that the opponents are resisting transparency. Not to put too fine a point on it, but that's nonsense. Plain and simple, we are opposed to reporting misleading information. On the other hand, we are more than willing to address ways in which *relevant economic values* might be more meaningfully displayed.

*Gary Findlay is the executive director of the Missouri State Employees' Retirement System, Jefferson City.*

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# Pensions & Investments

## Market valuation non sequiturs

### Pressure to change how public plans measure liabilities

By Gary W. Findlay  
Source: Pensions & Investments  
Date: June 23, 2008

Should public employee retirement systems be reporting the “market value” of their liabilities determined using a “risk-free” interest rate? According to a small but very vocal group of actuaries and so-called financial economists, they should.

In considering what is being proposed, I first asked myself if it is possible that proponents of reporting market value of liabilities, or MVL, do not understand the meaning of the terms market value and risk-free. I questioned this because what they are advocating does not appear to meet any reasonable description of market value, and the interest rate being proposed for determining that value is not free of risks. Given their training and experience, I had to conclude that they must have at least a fundamental understanding of these concepts and was surprised to learn how much traction they appear to be gaining with their non sequiturs.

Before pursuing this further, just a word of caution for anyone who might consider challenging MVL armed only with the position that what its proponents are proposing does not make sense for public plans — be prepared to hear that you simply don't have sufficient training in finance to understand their position or that you simply have not thought about it enough. The fact is that a number of very bright people who are well schooled in finance, who are not conflicted and who have thought about this a great deal have concluded that what is being proposed does not make any sense either.

In a rather cavalier manner, MVL proponents summarily dismiss distinctions between public plan sponsors and corporations that are critical in assessing the magnitude and duration of debt and how debt service should be addressed. I'd be astounded if they don't understand the public/private differences, and that line of reasoning led me down a different path. Specifically, when non sequiturs appear in the financial community, an explanation will often emerge by “following the money.” In this case, honest answers to the following may provide some insight:

- Are the individuals who are volunteering substantial amounts of time to support and promote the MVL effort connected with investment banking?
- Does the proponent group include those who would benefit financially from plans shifting from stocks to bonds or a specific “market liability driven” investment model for public pension plans?
- Would the proposed change result in public plans appearing to be substantially less well funded than they are on the basis of reasonable going concern assumptions and methods? If so, would this increase the pressure for DB to DC conversions and put more money in the pockets of those in the financial services industry who service DC plans?

It does not require much investigating to come up with “yes” answers to these questions. However, one might also then say, “So what? They don't have real clout so what's the problem?” In my experience, when people have a product they can't sell on its own merit, sometimes they will attempt to persuade a standard-setting body (like the Governmental Accounting Standards Board) to embrace it, thus creating an artificial market (but a market all the same). Is that what's happening here? I don't know, but it seems plausible. (As an aside, it's also worth noting that an addition to disclosures, recommended by the pension practice council of the American Academy of Actuaries, would, if embraced by the GASB, produce a nifty little justification for a spike in fees for actuarial services regardless of whether it produces any information of value — how convenient!)

Public retirement system managers should discuss the MVL issue with their consulting actuary and position themselves to respond to proposed changes in public plan accounting literature distributed by the GASB. (Notably, on April 24, the GASB announced the addition of a project to its agenda to assess the effectiveness of existing standards for accounting and financial reporting for post-employment benefits, focusing on a review of existing pension standards in GASB Statements No. 25 and No. 27.)

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As fiduciaries, those of us who represent the public retirement fund universe are obligated to administer our plans in the exclusive interest of plan participants. Contrary to the likely end result of what is being supported by the proponents of change, I find nothing in trust law to suggest that we should be administering our plans in the interest of Wall Street.

When I first learned about all of the activity in this space, I initially concluded that maybe the proponents of MVL just don't "get it" with regard to public plans. For example:

- they don't get infinite time horizons;
- they don't get contractual obligations for future benefit accruals;
- they don't get intergenerational equity; and
- they don't get the societal implications of terminating DB plans.

Upton Sinclair explained it succinctly in 1935 when he said, "It is difficult to get a man to understand something when his salary depends upon his not understanding it." It is possible that the MVL proponents would say the same of those of us who are resisting their well-orchestrated initiative, but I can say with great confidence that my personal pocket will not be impacted by the outcome of this debate. I am skeptical about their ability to say the same. With the exception of a few people who have drunk the financial economics Kool-Aid who have no personal monetary interest in the end result, I suspect the things most of them do "get" include at least the following:

- private-sector DB business is drying up quickly;
- there is a lot of public-sector DB money on the table; and
- there has to be a way for them to get a share.

Shazam! With a little rationalization you can be on the yellow brick road. Remember, just follow the money.

### **A final thought**

There are actuaries who acknowledge that contribution-rate volatility can also be mitigated by simply lengthening the smoothing period used in establishing the actuarial value of assets, such as has been done at the \$245.4 billion California Public Employees' Retirement System. So, why has this not gained any traction? Some suggest it is because you don't need to host a seminar to explain it and you can't build a product around it — just follow the money.

*Gary W. Findlay is executive director of Missouri State Employees' Retirement System, Jefferson City.*

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