NCPERS 1941

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The Voice for Public Pensions

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Message From the President

NCPERS: Global Expansion

In September 2011 NCPERS launched a membership campaign to grow globally. We have been working to expand our membership internationally through the development of relationships with Canadian organizations similar to U.S. funds. We've previously introduced you to the first Canadian organization to join NCPERS, Ontario Municipal Employee Retirement System. Our cover story for this issue comes from our newest global member Ontario Secondary School Teachers' Federation. Please take a moment to get to know them. ❖

Pat McElligott, NCPERS President

Ontario Secondary School Teachers' Federation Joins NCPERS

The **Ontario Secondary School Teachers' Federation (OSSTF)** is pleased to be the newest Canadian member of NCPERS, to join the community of interests represented by its membership, and to access the specialized resources it provides for public pension plans. OSSTF is a trade union representing 60 000 educational workers across Ontario including public high school teachers, occasional teachers, educational assistants, continuing education teachers and instructors, psychologists, secretaries, speech-language pathologists, social workers, plant support personnel, attendance counselors and many others in education, including university support staff. Most of our members participate in one of two large defined benefit pension plans, the Ontario Teachers' Pension Plan (OTPP) or the Ontario Municipal Employees Retirement System (OMERS), but our university members belong to smaller, private pension plans which vary in their provisions from defined benefit, to hybrid, to defined contribution.

Defending Retirement Security

On behalf of all of its members, OSSTF is committed to pursuing long term retirement income stability, anchored by the health of well-established, defined benefit pension plans,

continued on page 4

INSIDE THIS ISSUE (Click on Page Link)

The Enhanced Power of Dividends

By Chris Corapi, Chief Investment Officer, U.S. Equities at ING Investment Management U.S.

Last year was marked by extreme volatility in the equity markets; spikes in macro risk distracted from fundamentals, inspiring significant groupthink and resulting in large intra-day movements into and out of equities. This dynamic also inspired record-high stock correlations; S&P 500 constituents are trading in lockstep like never before, and similar trends are also evident among mid- and small-cap names.

While this is not the best environment for fundamental investors looking for an information advantage, it is a great one for dividend-oriented portfolios. The investment public — especially the large portion of the population in or near retirement — is starved for yield in the low-interest-rate environment. And after the flat equity market performance of the 2000s, professional investors are increasingly attuned to the important role yield plays in total return. Considering that interest rates are expected to remain low while equity markets deliver returns in the high single digits at best, demand for dividend-paying stocks should remain strong.

Meanwhile, there's an argument to be made that more companies will begin to pay dividends or increase existing dividends given the record levels of corporate cash. While corporate balance sheet repair in the aftermath of the financial crisis was prudent, these bloated cash balances are yielding next to nothing in short-term investments and are acting as a drag on earnings. To maximize shareholder value, companies need to deploy this capital; we believe dividends are an extremely beneficial way to return capital to shareholders over the long term. Although we saw a positive trend in dividend actions among S&P 500 companies in 2011, the payout ratio of the index (that is, dividends divided by earnings) remains at historically low levels, suggesting room for growth.

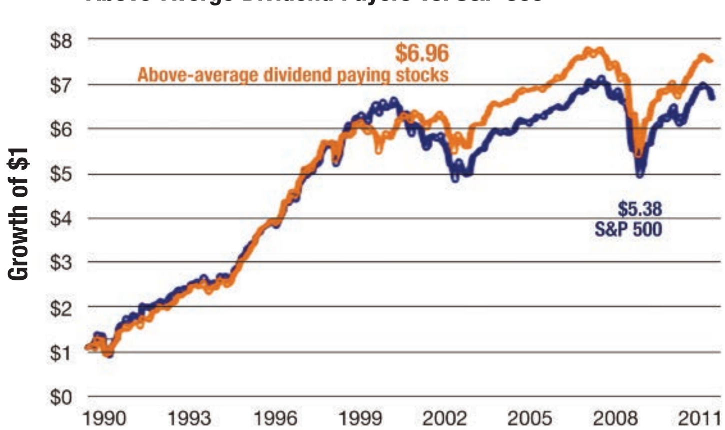
While the current environment may be particularly favorable for dividend-paying stocks, the appeal of these assets is somewhat timeless. Dividend-paying stocks have consistently outperformed over the long term, with lower volatility and in a variety of interest rate and tax environments. Going back to 1990, investors have experienced better risk-adjusted returns from stocks with above-average dividends versus the S&P 500 Index, with lower risk (see figures below). In addition, a company's ability to pay dividends can be taken as evidence of its health and thus may have some predictive value when it comes to stock price performance. Moreover, a well-managed dividend strategy should be able to beat its benchmark in most markets, including a down market, an up market and our current sideways/high-volatility market.

continued on page 6

- GASB governs accounting, not cash funding
- Because of more rigid GASB rules, accounting and funding won't match
- Be prepared for confusion, misinformation and misunderstandings
- PEPTA would have required an even more stringent "market value" of liabilities, which would have been more drastic
- NABL and GASB will also likely require new projections and historical disclosures

Above-Average Dividend Paying Stocks Have Delivered Better Returns…

Above-Averge Dividend Payers vs. S&P 500



…With Less Risk

	Standard Deviation	
	Above-Average Dividend-Paying Stocks	S&P 500 Index
1 year	11.20%	17.80%
5 years	18.30%	17.80%
10 yers	15.40%	15.50%
15 Years	15.40%	16.20%

Source: FactSet

Disclosure, Disclosure, Disclosure GASB, PEPTA & NABL

By William Fornia, President, Pension Trustee Advisors, Inc.

The year 2011 may be remembered as "the year of expanded disclosure rules." There were three major public pension disclosure initiatives which took place and three acronyms: GASB, PEPTA and NABL. Best known of the three is the Governmental Accounting Standards Board Exposure Draft standard revising pension accounting rules. The year kicked off with the introduction of the Public Employee Pension Transparency Act. Finally, the National Association of Bond Lawyers began an initiative to beef up public pension disclosure when issuing bonds.

What are the main components of "disclosure"?

When one considers public pensions from the perspective of the public, two questions are logical:

- How much is this plan going to ***cost*** this year?
- What's the ***liability*** so far for promises made to public workers?

These questions are not as simple as they may seem, and there is plenty of opportunity to use information in a misleading manner.

The ***cost*** is an annual amount, like the total year's mortgage payments or business expenses for the year. The ***liability*** is a measure of an amount at a specific point-in-time, like the year-end value of an investment portfolio or the balance owed on a mortgage. Virtually all pension disclosure and financial information falls into one of the two categories: an annual amount or a point-in-time measure.

GASB – Governmental Accounting Standards Board

Under current rules, each public pension plan follows GASB (for pension accounting) and state or local law or ordinance (for cash funding). Although most state and local laws and ordinances are written in a consistent manner with GASB, ***funding*** and ***accounting*** are quite different. The state and local rules pertain to *funding*, that is, what is budgeted and contributed to the plan (or recommended by the actuary to be contributed), and on what actuarial liability those funding contributions are based. But the GASB rules pertain to what is reported for *accounting* purposes. This distinction between accounting and funding is well known in the corporate sector, but less significant in the public sector—until now.

Under current policies, virtually all public plans calculate a contribution recommendation which is consistent with the GASB accounting rules. In fact, GASB even called their annual accounting expense the Actuarial Required Contribution (ARC), as if they had some authority over what is contributed. Because the concept of ARC has been used for many years as a prudent funding policy, a major impact of the new GASB rules will be the loss of the ARC. Despite my testimony to GASB in 2010, pleading to retain the ARC as a sound measure of what should be funded, they felt strongly (and consistently with their accounting mandate) that their role was strictly accounting, not funding.

Because the new GASB rules will produce more volatile pension expense numbers than the current rules, I do not expect pension funds to contribute the GASB amount, unlike presently where the best designed systems get the ARC contributed. Unfortunately, this will generate confusion—and great potential for misleading information.

GASB Implications

Much has been written about the GASB proposal, and I believe the following are the key implications:

- GASB accounting rules and funding (i.e., cash contribution) policies will be formally separated
- Increased volatility in GASB numbers will lead to GASB costs inconsistent with cash funding
- New GASB rules will include the unfunded liability (UL) on the balance sheet; previously, UL was shown only in a footnote
- New GASB values may be based on lower discount rate assumptions for plans which are projected to run out of plan assets
- New GASB values have more accelerated recognition of asset volatility
- New GASB rules will be much more complicated, necessitating additional resources for compiling required information and actuarial calculations for plans and governments
- Significantly increased confusion to the public regarding the interpretation of different numbers
- No more ARC, although I'm hopeful that actuaries and national organizations will fill the void caused by loss of ARC and issue recommended funding policies. The California Actuarial Advisory Panel has made a good start.

PEPTA – Public Employee Pension Transparency Act

In February 2011, PEPTA was introduced by California Republican

continued on page 6

continued from page 1

to enhance Canada's economy, preserve its collective social goals and ensure individual financial security for our members in retirement. North American demographics show that increases in the ratio of retired persons to working persons will increase significantly in the next number of years. It is imperative that our society consider how best to permit retirees to sustain themselves financially and continue to assist in the goal of fostering a dynamic and competitive economy. Defined benefit pension plans, in providing a guaranteed retirement income, indexed to inflation, mitigate the probability of a growing number of our citizens relying exclusively upon publicly funded income security programs in their retirement. The stability of a defined benefit plan creates the opportunity for retirees to both contribute to the economy and be less reliant upon other social programs.

Employers also find that a defined benefit pension plan is a useful tool for recruiting and retaining employees. For smaller employers, without the numbers of employees or funds to create their own defined benefit plans, OSSTF is actively encouraging legislative changes to permit employees and employers easier access to multi-employer pension plans (MEPPS). Pooling of resources and risks creates economies of scale and efficiencies not otherwise available to small employers. The establishment of these plans also encourages the shared pooling of contributions and facilitates individual accrual and entitlement to a single plan.

Governance

OSSTF pursues retirement security for our members through participation in governance structures which permit us to influence decisions about contribution rates, benefit provisions and investment opportunities. We have the greatest leverage in jointly sponsored plans like OTPP and OMERS. In these "partnership" arrangements, members and employers, or government, contribute equally to the provision of a defined benefit pension and share equally in risks and rewards; surpluses permit us to improve the pension benefits, but deficits require us to take joint responsibility for restoring pension plans to a fully funded position through increased contributions and/or benefits changes. Members have direct influence into how jointly sponsored plans are managed through their appointees to plan management boards; however, when a pension plan is employer-sponsored, like our university plans, employees may only occupy a seat on an Advisory Committee. Here they can provide input into management decisions, but benefit levels and contribution rates are really hammered out at the bargaining table, and susceptible to the give-and-take of negotiations.

The Government of Ontario and the Ontario Teachers' Federation, of which OSSTF is one of four teacher-member organizations, function as partners in the running of the Plan, setting contribution rates and determining benefit levels based on future projections of the Plan's long term health. Each Partner appoints four directors to the OTPP Board of Directors, who then select a chair. The Board of Directors is responsible for overseeing the administration of the plan, including member service, investments, valuations and executive compensation. Other joint committees such as the Partners' Committee meet regularly with OTPP staff to ensure the smooth implementation of plan changes, contained in legislation called *The Teachers' Pension Act*. OSSTF also participates directly in the jointly sponsored OMERS plans through its appointees to the Administration Corporation, responsible for pension services, plan administration, plan valuations, and investments, and to the Sponsors' Corporation, responsible for plan design, including contribution rates and benefits.

The Balancing Act

All pension plans continue to navigate the turmoil brought about by the financial crisis of 2008. The prolonged and uncertain nature of recovery has been hampered by aftershocks like political wrangling in the US about taxation and social spending and the European debt crisis. Add to this the persistence of low interest rates, and the failure of business to spend enough to reinvigorate the economy, and the resulting pressure on investment opportunity challenges the future sustainability of all pension plans so dependent upon investment returns. Even the good news story that our members are living longer in retirement than ever before, only increases the challenge of ensuring future pensions by adding longevity to the risk assumptions that determine projected cost.

Despite these economic constraints, our members in OSSTF continue to demand that the pension plans to which they contribute invest their money ethically, with due consideration to social and environmental goals. In response, OTPP has recently become a signatory to the United Nations Principles for Responsibly Social Investment (UNPRI) which obligates the Plan to provide an annual statement outlining the details of its adherence to these principles. Fiduciary responsibility in a partnership governance model is a balancing act. We must ensure plan sustainability and the income security of our retirees, while mitigating the financial burden upon current contributors; we must contain the inclinations of Plan management toward independence, engendered by their expertise and high salaries, while trying to satisfy the social/political agendas within our membership and the pressure they exert on investment choices.

For OSSTF, accustomed to balancing the needs of a diverse membership, the pension challenge is like walking a familiar tightrope. Our union has thrived since 1919. The key is to never look down. ❖

The Uncertainty Continues

By Robert D. Klausner, NCPERS General Counsel

California Supreme Court Finds Implied Contract for Retiree Health Care

In *Retired Employees Association of Orange County, Inc. v. County of Orange*, ___ P.3d ___, 2011 WL 5829598 (Cal. 2011), the issue was whether an implied contract can be created between a California county and its employees that confers vested rights to health benefits on retired county employees. For many years in the past, Orange County calculated health insurance premiums separately for active employees and retirees. However, in 1985, the county began grouping active employees and retirees together into a single unified pool for health insurance purposes. "The single unified pool thus had the effect of subsidizing health insurance for retirees, in that it lowered retiree premiums below their actual costs, while raising active employee premiums above their actual costs." The County paid a large portion of active employee premiums, but retirees were responsible for paying the majority of their own premiums. Therefore, the pooled arrangement worked to the substantial economic advantage of the retirees.

In 2007, the County passed a resolution that would effectively split active employees and retirees into two separate pools for purposes of health insurance premiums, resulting in an increase in retiree premiums. As a result, an association of retired county employees filed suit in federal court in California against the county challenging the resolution. The association took the position that the "County's action constituted an impairment of contract in violation of the federal and state Constitutions, in that [the] County's long-standing and consistent practice of pooling active and retired employees, along with [the] County's representations to employees regarding a unified pool, created an *implied* contractual right to a continuation of the single unified pool for employees who retired before January 1, 2008."

The U.S. District Court found that the county could not be liable for any obligation that it did not explicitly undertake pursuant to resolution. On appeal to the U.S. Court of Appeals for the 9th Circuit, the federal appeals court for California, which generally does not decide questions of state law, asked the California Supreme Court to decide the question of whether a contract for retiree health care could be implied even absent an express agreement under state law. The California Supreme Court ultimately held that in the absence of a legislative prohibition, "under California law, a vested right to health benefits for retired county employees can be implied under certain circumstances from a county ordinance or resolution." The U.S. Court appeals accepted the decision and sent the matter back to the federal trial court on December 19th to reconsider its prior ruling in favor of the County, with an admonition to expedite the final determination. The matter rests currently with federal trial court.

Oregon Courts Approve Recoupment of Overpayment of Pension Benefits

In a pair of decisions the Supreme Court of Oregon approved the recoupment of certain overpayments to retirees. The first case, ***Arken v. City of Portland***, 263 P.3d 975 (Or. 2011) involved the PERB's effort to recoup overpayment of benefits made based on a 20% earnings rate applied in 2000 which should have been slightly more than 11%. PERB offered to allow retirees to repay in a lump sum or have a small amount deducted monthly. COLA benefits were also recalculated based on the corrected number. The Board was legislatively authorized to withhold COLA payments until the overpayment was recovered. The retirees sued on a variety of grounds including detrimental reliance, lack of notice, and breach of contract. The Supreme Court of Oregon rejected the claims finding that retirees were not entitled to keep benefits not accurately reflected by the statute. Moreover, the Court applied general trust principles on the issue of recoupment. The Court did determine that the COLA freeze was not an authorized method of recovering overpayments. While the Fund could defer COLA increases until recoupment was completed, the law did not authorize a complete freeze in COLA benefits.

In a separate decision arising from the first case, ***Goodson v. PERS***, 264 P.3d 148 (Or. 2011) and decided the same day, the Supreme Court addressed the claim of a due process violation in that PERB did not give individual notice to affected retirees that a challenge to the 20% interest credit was pending that ultimately resulted in a downward adjustment in benefits. The Court rejected the due process argument on the basis that the affected retirees had no legal right to the challenged benefits based on the erroneous calculation andtherefore

continued on page 7

*This article is a regular feature of PERSIST. **Robert D. Klausner**, a well-known lawyer specializing in public pension law throughout the United States, is General Counsel of NCPERS as well as a lecturer and law professor. While all efforts have been made to insure the accuracy of this section, the materials presented here are for the education of NCPERS members and are not intended as specific legal advice. For more information go to www.robertdklausner.com*

Disclosure continued from page 3

Congressman Devin Nunes. There have been no hearings to date, although there is certainly a risk that similar requirements are slipped into a budget bill or tax reform. I co-authored a statement from the Conference of Consulting Actuaries' Public Plans Steering Committee that "PEPTA would produce a distorted picture of public pension funding and create substantial confusion about the proper actions needed to address current public pension funding issues."

This distortion is primarily because PEPTA would require pension reporting calculations based on a risk-free bond rate, and not the expected return on actual plan assets. This "Market Value of Liabilities (MVL)" methodology would result in costs that would be much higher than those calculated with valuation methods used currently and widely accepted.

When GASB and NABL began their deliberations, the public pension community was concerned that they, too, would adopt the MVL approach. So far, that has fortunately not happened.

NABL – National Association of Bond Lawyers

The National Association of Bond Lawyers is developing guidance regarding pension plan disclosure in bond issuance documents. The NABL has hosted a series of meetings of its municipal market's Task Force on Defined Benefit Public Pension Plan Disclosure. I am a member of that task force, and while the meetings are not public, it is likely that future guidance will retain the May 2011 exposure draft key elements:

- Don't reinvent GASB's financial accounting and reporting rules
- Use the actuarial reporting currently performed by the plan actuaries
- Heed the SEC advice that "mere" compliance with accounting and actuarial reporting standards may not be sufficient for federal securities law liability purposes
- Include an analysis of plan funding, which is integral to the securities law analysis

The mission of the Task Force is to provide useful guidance on issues to be

continued on page 7

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Dividends continued from page 2

Demand for Dividends Should Persist

It's hard for investors to find growth these days; even growth-focused portfolio managers can no longer completely ignore dividend-paying stocks. Looking ahead, we expect global economic growth that is slower, less leveraged and more risk averse than it had been in the past. Moreover, significant policy uncertainty — regulatory, tax, government spending, etc. — has paralyzed corporate managements to a certain extent and limited earnings visibility. In this environment, we believe markets will reward higher-yielding stocks with better returns and lower volatility, and we have positioned our clients' portfolios accordingly. Considering that interest rates are expected to remain low while equity markets deliver returns in the high single digits at best, demand for dividend-paying stocks should remain strong. ❖

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Disclosure continued from page 6

considered when assisting in pension disclosures. A catalyst for the project was the SEC's 2010 order which found that "the State misrepresented and failed to disclose material information regarding its under funding of New Jersey's two largest pension plans …"

What do disclosure changes mean for pension funds?

The overwhelming significance is the confusion which will result from GASB changes. New numbers will be reported which are inconsistent with the ARC. While this is problematic, it could have been much more drastic. If GASB (or even NABL) had adopted the MVL approach favored by PEPTA, or if PEPTA had become law, there would have been larger–and even more confusing–numbers which would be fodder for the anti-pension advocates. As I presented at a conference at Wharton in 2008, this would have opened Pandora's Box. Instead, we will have GASB numbers, which while different, will be conceptually similar to the current numbers and the funding numbers.

Disclosure, Disclosure, Disclosure – Key Concepts

The following table summarizes key concepts in current and new disclosure rules, highlighting how each standard treats plan costs per year and plan liabilities at a point in time. ❖

Standard	Purpose	Annual Cost	Liability
State or Local Law or Ordinance	Contribution Requirement or Contribution Recommendation	Based on Expected Return, and various Actuarial Methods – typically consistent with GASB 25/27	"Unfunded Actuarial Liability" Based on Expected Return, and various Actuarial Methods – typically on same basis as GASB 25/27
Current GASB 25 & 27	Financial Reporting of Government (25) and Pension Fund (27)	"ARC" – Based on Expected Return, and various Actuarial Methods	Net Pension Obligation – The shortfall of actual contributions versus ARC
Proposed GASB	Financial Reporting of Government and Pension Fund	"Pension Expense" – more volatile than GASB 25/27	Unfunded Actuarial Liability will be on balance sheet
NABL Proposal	Disclosure of pensions for bond issuance documents	Consistent with GASB and state/local; historical and projected	Consistent with GASB and state/local; historical and projected
PEPTA	Federally mandated disclosure of state and local government pensions	Based on treasury bond rates – Would generate much higher numbers than any current measure	Based on treasury bond rates and market values – Would likely generate much higher numbers in current environment

Uncertainty continued from page 5

had no protected property interest being taken without proper notice. In other words, an overpayment does not constitute a protected property right.

These three cases show the continuing confusion involving retiree benefits. The California case reflects the uncertainty of enforcing a contractual promise without proof of the employer's intent to create one. The next step will be to determine the reasonable expectations of the parties based on the manner in which the liability pool was structured and premium rates were set. The Oregon cases demonstrate a more critical judicial analysis of the essence of the pension contract. This seesaw battle between expectations and enforceable rights is likely to be repeated in numerous jurisdictions. ❖

The Voice for Public Pensions

PERSIST National Conference on Public Employee Retirement Systems

Calendar of Events 2012

Trustee Educational Seminar (TEDS)
May 5 -6
Hilton New York
New York, NY

Annual Conference and Exhibition
May 6 – 10
Hilton New York
New York, NY

Public Safety Conference
October 7-10, 2012
Omni Royal Orleans Hotel
New Orleans, LA

National Conference on Public Employee Retirement Systems
444 North Capitol St., NW Suite 630
Washington, D.C. 20001

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