Retirement Board of Allegheny County

2019 PENSION SUMMIT HIGHLIGHTS

Articles & Page Design by Mike Silvestre JUNE 2019 Pictures by Lisa Falgione & Ashley Stokes

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Current State of Public Pensions

Bill Flanagan moderated a panel of six experts on the situation: Vice President of Retirement Actuarial Services at Cowden Associates Brad Rigby, Managing Director at Wilshire Associates David Lindberg, Vice President of Wilshire Associates Craig Morton, Chief Investment Officer at Fragasso Financial Advisors Michael Godwin, Senior Managing Consultant at PFM Asset Management LLC Perry Giovannelli, and Pennsylvania State Treasurer The Honorable Joe Torsella.

Rigby opened the panel discussing the troubles in the private section pension system. Rigby explained troubles faced by multi-employer world which mainly deals with labor unions and the plans that they sponsor.

Rigby explained that the private sector pension system is backed by the Pension Benefit Guarantee Corporation (PBGC) and the PBGC projects to be bankrupt by 2025 because they are paying into so many pension plans that are projected to become insolvent that it will bankrupt all the reassurance that the PBGC provides.

David Lindberg and Craig Morton then discussed economic conditions and capital market expectations and how that impacts pensions. Lindberg noted that even with improving expected returns many pension plans struggle to remain properly funded and could cause problems with economic shifts in the future.

Michael Godwin followed by explaining the similarities and differences between active and passive management. "Even if you invest passively, it is still very important to make active decisions regarding that," Godwin said.

Perry Giovannelli added that through processes of change with management, an investment policy remains constant which is the strategic plan. It is the guideline to get the organization through the different market cycles.

State Treasurer Joe Torsella closed the panel by providing good news regarding the Pennsylvania State Pension System by saying that the legislation adopted a revised going forward plan that will be good news for future generations but does not solve immediate issues.

The Retirement Board of Allegheny County's Pension Summit, held at PNC Park's Hyundai Club on June 14, 2019, began with a panel examining the current state of public pensions.

The first two of the summit's breakout sessions focused on updates to pension plans and market cycles.

Updates to Your Pension Plan—Procedures You Should be Considering

In the first break-out session, Brian Gabriel from Campbell Durant Beatty Palombo & Miller led the seminar on the updates to pension plans on improvements that can be made on certain pension plans.

Municipal county plans are different than the Allegheny County Pension Plan in that the plans have a structure with requirements of a floor, ceiling and unknowns and the unknowns need to be figured out.

Obstacles that make it difficult to make pension plan improvements include unhelpful statutory language that makes amending a pension statute difficult and collective bargaining because it is mandatory and imposes things on to a pension plan that must be followed.

Brian Gabriel discusses updates to pension plans.

Excess or illegal benefits represent another improvement that must be made that mainly deal with definitions of salary, compensation, and service time to avoid confusion and battles over the pension plans.

Outdated pension plan language is another issue that needs to be reviewed to essentially create a useable pension plan for present day.

Gabriel then discussed that challenging illegal pension provisions through collective bargaining can be effective however, challenging through the courts will not result in change.

Gabriel examined the issues of the definitions of salary, compensation, and service time stated that the pension plans should be clear on these definitions to avoid problems and confusion within the pension systems.

Gabriel then discussed that because of Act 205, actuarial valuation reports must be submitted every two years for municipal pension plans.

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Market Cycles

Felicia Bennett, the Managing Director of Wilshire Consulting, and David Lindberg of Wilshire delivered the session on market cycles. Bennett began by explaining that markets go in cycles, each impacting portfolios differently and are difficult to predict.

Bennett broke down market cycles into four components. **Early Cycle**, which represents recovery from recession and slight market gains. **Mid Cycle** represents growing market and improved economic conditions. **Late Cycle** demonstrates moderating growth along with low unemployment. Late Cycle also represents a period of time with rising interest rates and rising inflation. The final component of market cycles is **recession** with declining interest rates and declining inflation.

David Lindberg began his portion of the presentation by stating that different asset portfolios behave differently in different cycles. Lindberg said consultants are looking for factors in the market that are predictable, unique, and not necessarily correlated to one another in order to accurately predict market cycles.

Lindberg explained that two measures are important: growth factor and inflation factor. Growth factor deals with interest rates and credit spreads. When growth factor is negative, bonds, lump bonds, and cash tend to do well. When growth factor is positive, stocks and private equity tend to do well. Inflation factor is primarily break-even inflation. Within a given market cycle there will be either rising or falling growth and rising or falling inflation. Different portfolios will perform differently due to rising or falling situations.

Factor Balance Portfolios are equally exposed to rising and falling growth as well as rising and falling inflation which demonstrates balanced risk. Expected returns are low but risk also remains low. Pension funds cannot afford to be allocated in a Factor Balance Portfolio.

(CONT. ON PAGE 3)

Updates to Your Pension Plan (Cont. from page 2)

Plan changes that will increase benefits are not permitted unless the plan is and will remain actuarially sound.

Actuarial cost studies must include the impact that proposed changes will have on the actuarial soundness of the plan, the impact on future financial requirements of the plan, and the impact on the future minimum financial obligation of the municipality.

The next issue discussed was interim military service time and the ability to purchase prior military service time. Gabriel stressed the importance of having a clear definition in how credit should be purchased to avoid confusion and problems.

Pension forfeiture was also examined as the PA Pension Forfeiture Act disqualifies a participant who is convicted or pleads guilty to certain crimes related to public office or employment from receiving a pension benefit from such plan. The act only applies to specific enumerated crimes and can be avoided through negotiations that result in guilty pleas to crimes other than the enumerated crimes.

Many plans include a detailed appeal procedure which culminates with decisions regarding disputes over eligibility and the value of pension benefits being decided by the municipality's governing body.

The final aspect Gabriel touched on was improperly drafted collective bargaining agreements may nullify the agency process and go straight to an arbitrator.

Market Cycles (Cont. from Page 2)

Typical Portfolios resemble most funds invested with a fair amount of exposure to growth assets. Typical Portfolios perform well with higher returns when high than expected growth occurs, but typical portfolios perform poorly when lower than expected growth occurs. Most pension plans operate in typical portfolios.

Lindberg then explained the uncertainty of the timing of the market and economic cycle that makes it difficult to predict how long a certain period will last. Recession periods are unknown and the average recession lasts just over twelve months. Historically, 14% of time is spent in recession. The Early and Mid Cycles average 25 months and 33 months and have the largest variations in time with equities performing well. The current mid cycle has been going on for 87 months. With uncertainty in cycles, it is difficult to allocate assets and one cannot guarantee which portfolio will do the best.

"There's a lot of talk today about where we are, you need to stick to the long-term assets allocation policy," Lindberg said. "Data shows you have low chance of successfully navigating through these different economic environments and having a portfolio do well in the environment you're in but then chance that to do well in the nest environment."

Felicia Bennett & David Lindberg of Wilshire Consulting break down market cycles into four components, explaining how each impacts portfolios.

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Managing Risk from an Actuarial Perspective

Brad Rigby, the actuary for the Allegheny County Pension Plan of Cowden Associates, gave a presentation on managing risk from an actuarial perspective. Rigby stressed the importance of understanding risk to properly manage certain plans and take the best course of action.

Rigby began by discussing the newly released Actuarial Standard of Practice, ASOP 51, which was released in November of 2018 and primarily governs how actuaries consult on the plans they serve by providing guidance of what actuaries should do to provide an understanding of risk.

Actuaries investigate where future results differ from where they are projecting them to be right now. The idea is to have those running pension plans to know where the variability will be in order to take advantage by increasing or decreasing risk during a certain time period.

The first aspect of risk Rigby discussed were investments. All projections are dependent on some assumption of what the invested assets are going to do in the future. Actuaries and managers look at the variability that returns may be greater or less than expected within a given time and analyze how the risks associated with return variability will affect the plan. Additionally, plan design may change with interest rates, investment return, and incoming contributions as time changes. Also, longevity or how long people live could create a change in plan design and these risks must be examined to make underlying assumptions on how plan liabilities are going to change.

Rigby then talked about contribution risk and said it is something we take for granted specifically in public plans, but it is something to look at based on the changing nature of the tax base and the funding picture.

Rigby discussed population changes and how the movement of people could create issues in funding the pension plan with certain areas growing in population while other areas are shrinking in population.

"If certain areas made large pension promises based on the assumption that the base of taxpayers providing incoming contributions into the pension would remain stable and it turns out that it is not, then they may have an issue providing funding for the pension plan in the future," Rigby said.

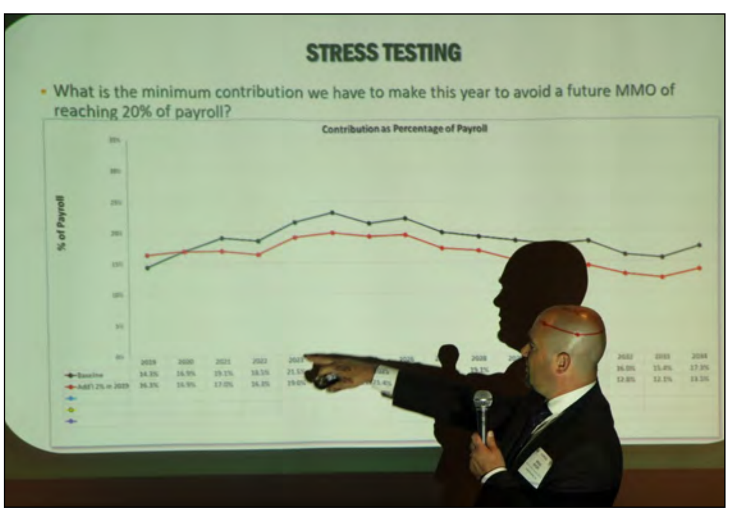
Rigby then noted three different ways actuaries communicate and test risk:

- **Deterministic Scenario Testing** includes presenting graphical illustrations of what will the picture be in the future is all current assumptions are met.
- **Stress Testing** shows sets of results where risk focuses on downsides only and figuring out what exactly cannot happen. Stress testing results will vary organization by organization as it depends on individual situations that could change year to year. Ultimately, stress testing helps managers determine what cannot happen and allows them to adjust accordingly to avoid taking harmful risks.
- **Stochastic Forecasting** brings variability of returns and outcomes into predictions which is not used in deterministic scenario testing or stress testing. Stochastic forecasting is not commonly used since it's an advanced technique and when it is used it is primarily used on investment return assumptions because it is difficult to get metrics of variability.

The three different ways of testing and analyzing risk makes the comparisons of portfolios possible and provides the best guidance for dealing with risk within a certain organization.

"Risk generally only deals with downsides, but risk is really just the variability of results,"

—Brad Rigby



Brady Rigby of Cowden demonstrates an example of stress testing; exemplifying how tests are used to show risk.

General Trustee Education

Craig Morton of Wilshire Associates opened his presentation on general trustee education by speaking about trustee responsibilities. Morton discussed that responsibilities can vary, and an important step is identifying who the decision makers are and knowing the elements involved in building an investment program.

Morton discussed the importance of the Investment Policy Statement which is a living document tailored to the unique considerations of each institution. The policy statement will be adjusted over time to help maintain course towards stated goals.

Morton talked about understanding how risk drives the investment process and that Wilshire has been a pioneer in objectively identifying and quantifying investment risks and experience has shown that effectively managing risks and costs are critical factors in achieving long-term investment objectives.

Morton then discussed asset allocation as it drives 90% of the variation of a portfolio's return. Asset allocation is the most important decision to build a portfolio to achieve the fund's objectives and for pension plans, this step also includes an analysis of liabilities.

Morton then spoke about capital market assumptions explaining that current and former market environments can provide context but it is important to keep the focus on forward looking expectations. There are three main factors to consider:

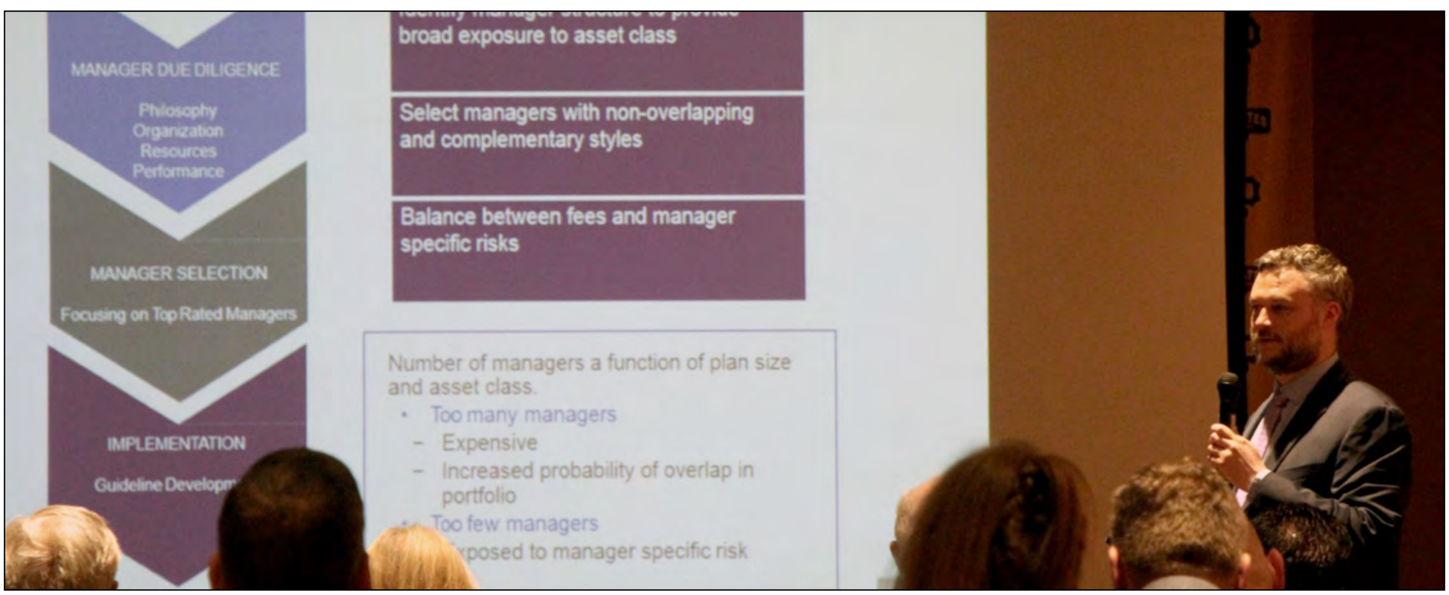
- **Expected return**: median return with a 50% probability that the asset class return will be greater than the expected return, and a 50% probability that it will be less than the expected return.
- **Standard deviation**: measures the dispersion of asset class returns around the expected return.
- **Correlation**: measures the movement of asset class returns in relation to one another.

Morton said after asset allocation, investment structure decisions are the second most important decisions a fund will make as the decisions account for 5-7% of return variation. Investment structure addresses active versus passive investment management issues and establishes structure targets for controlling risk and capturing market opportunity.

Active management attempts to exploit market inefficiencies, has higher fees and expenses, and requires more administrative oversight. Active management is used in less efficient markets.

Passive management creates broad diversification, has lower fees and expenses, and requires less administrative oversight. Passive management is used in more efficient markets.

Morton concluded his presentation discussing manager and benchmark selection which will vary with each manager. The investment policy cycle is ongoing and continuous, and it is important to revisit the basics regularly.



Craig Morton of Wilshire Associates gave a presentation on general trustee education. The discussion focused on the key elements involved in building an investment program: investment policy statement, risk, asset allocation, investment structure, and manager selection and monitoring.

Fiduciary Governance

Gregg Daily of Fragasso Financial Advisors gave a general overview of the best practices in fiduciary governance.

Daily began by defining the importance of understanding the definitions of ethics, ethical, and fiduciary. Daily stressed that the definitions are important because fiduciaries often adhere to their own standards and may be unaware of the existence of standards that apply to them.

Daily defined ethics as a system of code of conduct and moral judgement. Ethical is defined as conforming to moral standards, including those of a given profession. Fiduciary is a person who holds something in trust for another or others and involves public confidence and support.

Daily then explained that a fiduciary is anyone with control over a plan's management or assets, including anyone who provides investment advice to the plan. All duties of a fiduciary trace back to the Prudent Man Rule where an individual is required to act with the care, skill, prudence, and diligence that a prudent man would act in a legally satisfactory manner.

Daily then spoke about the best practices for investment policy. The policy should match the established, textbook principles of portfolio management. Proper management would indicate that the policy should consider the Investment Policy Statement, Investment Guidelines, and monitor the portfolio against market environments.

Daily moved to discussing socially responsible investing and how socially responsible investing is achieved. Socially responsible investing is categorized in three categories: environmental, social, and governance. Each represents a different area of impact in current investments.

Gregg Daily of Fragasso Financial Advisors concluded the summit with a presentation on fiduciary governance and responsibility. Daily highlighted ethics, roles of a fiduciary, and best practices for investment policies.

Daily concluded by explaining the mindset of a trustee. Daily states that most trustees want to do the right thing for their employees and for themselves. Most trustees wish to reward loyal employees and to create their own financial stability. Trustees desire to see everyone retire with security and dignity after their career's work is completed.

Special Thanks to our Emcee, Bill Flanagan

Bill Flanagan serves as Chief Corporate Relations Officer for the Allegheny Conference on Community Development. Bill guides the development of regional and organizational messaging strategy and supervises Investor Relations activities.

Bill came to work in southwestern PA in 1982 as a reporter for KDKA-TV. He served as the station's Money Editor for 13 years and has written about personal finance for The Pittsburgh Post-Gazette and KDKA-AM.

Bill serves on the boards of Leadership Pittsburgh, Inc. and Rivers of Steel National Heritage Area.

We would like to thank the following firms for their generous sponsorship of the 2019 Pension Summit:

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