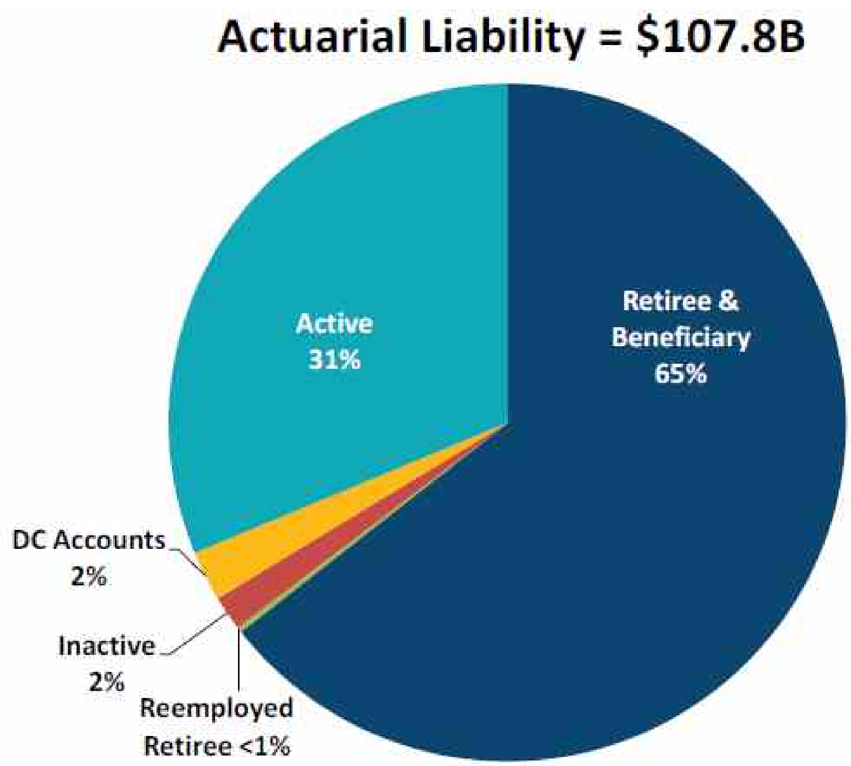
STRS report for OCHER, November 2023. Jerry Newsom

The major recent news story about STRS is the suspension of Bill Neville as Executive Director, based on an anonymous letter claiming to be from staff members. I can think of two reasons such a letter would be sent: 1) Neville really has been a horrible manager, and 2) someone doesn't like him and wants him out. There are, unfortunately, many people who fit the second possibility. As Executive Director, he's a lightning rod for critics of the system. The STRS critics on the Board tried to get a majority vote last February to say they had no confidence in his leadership, which failed (it was a 5-5 tie). Neville is the head of the staff that did not go along with putting STRS assets into QED, as some wanted them to do. More recently, those who want to keep the STRS daycare center operating have been furious that Neville decided to close it (although that's what the STRS critics had been calling for). Apparently the Attorney General has appointed an investigator to determine the validity of the accusations; we are well served if the investigation is thorough and prompt. I would not be at all surprised is the charges are found to lack merit.

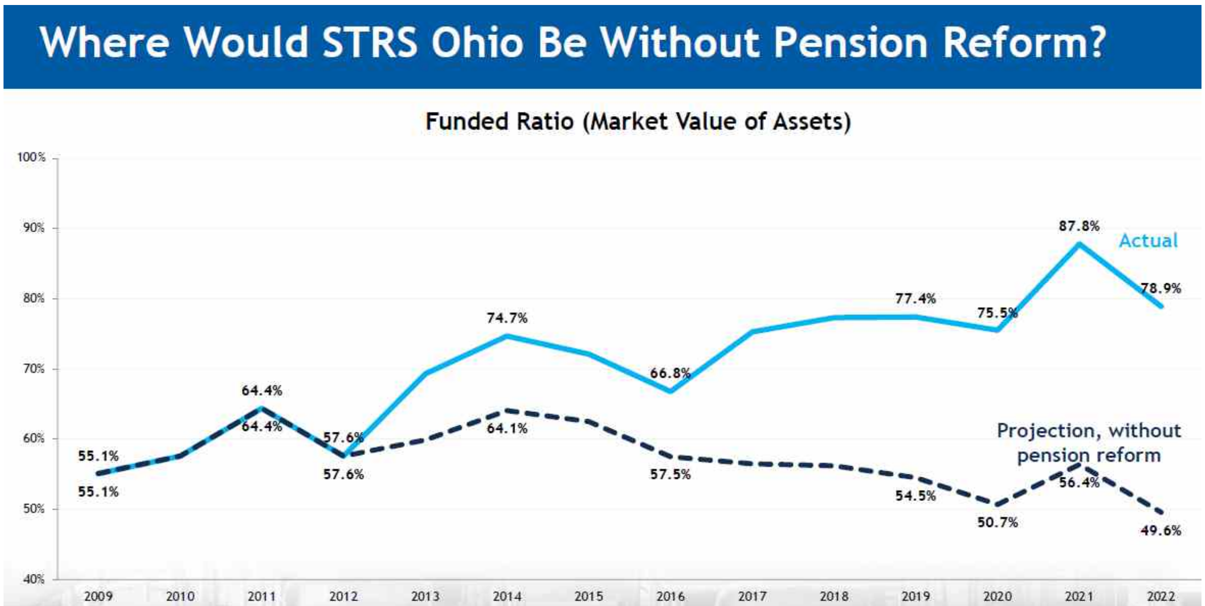
Cheiron, the actuary for pension and health care valuations, noted at the October Board meeting that 4.6% of assets are needed each year to pay pensions and other expenses. Since investment returns (assumed to be 7%) are also quoted as a percentage of assets, one can think of the returns as paying 4.6% of assets to cover costs and the rest to pay down the deficit. When the unfunded liability goes to zero, then much more would be available to pay for such things as COLAs and reduced contributions from active teachers. More than most public pension funds, STRS relies more on investment returns to make payments; this results from Ohio having lower combined contribution rates from employers and employees than in most states, sometimes dramatically lower (discussed further on page 3). Cheiron reported that at the end of FY 2023, the funding period (how long it takes for assets to equal liabilities if all assumptions are met) dropped from 11.5 to 11.2 years. Had all assumptions been met in FY 2023, it would have dropped by one year, to 10.5 years, so adding in the 1% one-time COLA for FY 2024 helped delay the time when we will get a permanent COLA. A breakdown of the liabilities is shown in the graph at right. Actives have a smaller part of the pie because, on average, actives are roughly halfway through accumulating their pension obligations.



The graph below shows how needed pension reform was, in spite of the pain it has caused. Without pension reform, the funded ratio (ratio of assets to liabilities) would have been 49.6% instead of 78.9% at the end of FY 2022. The changes in pension reform include

- beginning in 2012: increasing employee contributions, COLAs reduced from 3% to 2%, and no COLA for the first 5 years of retirement

- beginning in 2015: smaller initial pensions for those with more than 30 years of service plus more years of teaching for full pension if retiring at age 55



- beginning in 2017: suspension of COLAs.

September saw a net loss in STRS investments of 2.29% (-1.72% return for the fiscal year), so the first quarter of FY 2024 has not been good for investments. STRS invests more in publicly traded companies than in private companies, and it was noted that there are less than 7000 companies listed on the New York Stock Exchange or NASDAQ and over 6,000,000 private companies in the U.S. Managers of private equity firms have a lot of potential companies to check out.

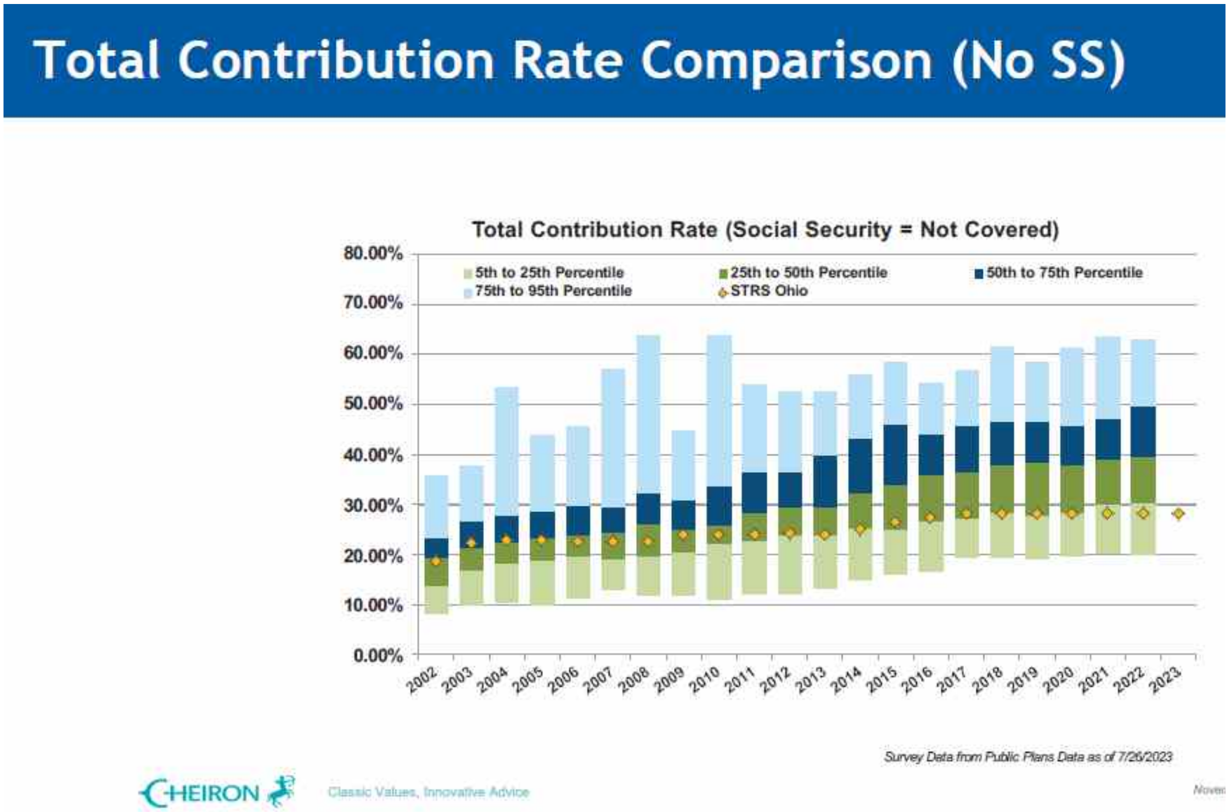
Questions on accounting generally don't have easy answers. How do administrative costs for STRS compare with other large pension systems? Each system publishes its financial report, from which one can readily find what fraction of annual expenses are charged to administration. But as CEM Benchmarking noted at the September STRS Board meeting, one has to look carefully. For example, STRS lists maintenance on its headquarters as an administrative expense, but some pension plans list their building in their investment portfolio, in which case maintenance is charged against net investment earnings. Another example: Some pension plans include health insurance and some do not, so a valid comparison requires the health-care administrative costs be backed out. There's no substitute for having consultants who dig into the data. Also, CEM said that Franklin County has 12% higher costs than elsewhere in central Ohio, so maybe one should expect somewhat higher administrative costs. CEM's conclusion was that STRS, with a total pension administration cost of $98 per member, was $11 below the peer average.

CEM also evaluated STRS' service to members in 2022. STRS had a score of 93% (the second highest of the 42 plans in their database) vs a peer average of 81%. For instance, the average wait time when someone calls STRS was 16 seconds, vs. a peer average of 307 seconds. At that point, new member Pat Davidson said he thought members would be happy with a longer time on hold if it helped free up resources to reinstate a COLA (to cheers from the backbenchers). The comparison was not well founded; a savings of hundreds of thousands of dollars per year won't do much to help reinstate a policy that costs tens of billions, but it served to keep the focus on COLAs.

To argue how badly STRS retirees fare without a COLA, one speaker at the public comment session compared someone with Social Security vs someone in STRS, assuming both started out with a $40 k pension. Right away one can see a problem. Social Security invests in government bonds, generally returning less than 3%, vs. the 7% or 8% that state pension plans average. Even with annual COLAs, there is no way Social Security will compete with state public pension plans in providing funds for retirees; the initial pension would be considerably smaller in Social Security.

Speakers continued protesting the closing of the day-care center, but apparently many participants in the program have already moved to other providers. Pat Davidson's motion to keep the center open until June was soundly defeated.

The push in the legislature to increase employer contributions to 18% of salary for OPERS and STRS is gaining momentum, and Marla Bump reported to the Board that a bill is expected to be introduced in the legislature. No one expects quick action, however. The graph below I think provides strong support for increasing employer contributions. It shows the range of employer plus employee contributions to pension plans for states that do not participate in Social Security. For the first few years of this century,



the STRS contribution rate was at the median. But that rate stagnated while most other plans increased theirs, until STRS was about in the 25th percentile from the bottom by 2012. STRS ramped up the employee contribution rate from 2013 through 2016, keeping us near the 25th percentile, but starting in 2021 we fell below even that value. I don't know if the legislature will be at all impressed with how out of step Ohio is with an employer rate that hasn't budged since 1984.

Notices are being sent out in November to employers to inform active teachers of the election next spring for someone to take Dale Price's seat. There's been no announcement whether Price will run for reelection again, but if he leaves the Board, I will greatly miss his institutional memory. Should he retire from teaching, he would have to resign his active teacher's seat on the Board. The challenger for the seat is reported to be Michelle Flanigan, a member of OEA and ORTA (most challengers have been in OFT, not OEA).

When Funston Advisory Services did a fiduciary audit of STRS for the Ohio Retirement Study Council (ORSC) in 2022, they recommended some changes to the Defined Contribution (DC) plan, and STRS reported in September on responses to Funston's report. Note the STRS DC plan does not include the Alternative Retirement Plan (ARP), which is independent of STRS. Nearly 28,000 are currently enrolled in the DC plan, with an average balance of $92,523. Of all members in STRS, 92.4% are in the defined benefits (DB) plan, 4.7% in the DC plan, and 2.9% in the combined plan, with money in both DB and DC plans. STRS expects significant changes to the DC plan next year, but there was no indication what these changes might be. The mitigating rate, the part of employer contributions that go to STRS for participants in a DC plan, has been reduced to 2.91% of salary. Participants in the ARP and DC plan often complain about the mitigating rate, but it's now considerably lower than it used to be.

Those arguing that pension funds should assume an investment return equal to what Treasury notes pay (called Low-Default-Risk Obligation Measure, or LDROM, which would be an absurd way to invest) got the accounting rules changed so reports to pension funds have to include liabilities under an LDROM assumption. This would increase STRS' lability from $105 billion to $149 billion. (The American Legislative Exchange Council (ALEC), which supports right-wing causes in state legislatures, assumed a return of 1.13% (a "risk-free discount rate"), resulting in a huge unfunded liability for public pension plans (nearly $7 trillion across the country)).

Cheiron apologized for including it but explained they have no choice. If you want to paint a bright side of this, say that the reduction of $44 billion in liabilities shows the value of having a diversified portfolio. Cheiron also provided "stress tests" for the financial future of STRS, starting with projections where all assumptions are met (with assets equaling liabilities in 2035). This was repeated except with a -6% return on investment in FY 2024 (unfunded liability goes away about 2044), with a -6% return in FY 2024 and +20% return in FY 2025 (assets equal liabilities in FY 2036), and with actual returns from the last 20 years used for the next 20 years (assets equal liabilities in 2027 but only for two years; things are bad for the next four years and then unfunded liabilities go away in 2033). So how soon do we get annual COLAs back? With good investment returns, it could be in a few years; with a sluggish market it could be a decade or two.

Cheiron also provided a "dashboard" report at the October meeting, where several inputs (e.g., funded ratio, funding period, chance of either of these taking a big hit, 10-year returns on federal debt) are summarized in a single number. A dashboard number around +5 or above indicates STRS should increase benefits and/or cut contributions; below about -5 means STRS needs to take steps to improve its finances. Last year it was -1 and now it's -2, not a danger signal but a warning that finances are tight. The dashboard for the health-care plan, +9 last year, dropped all the way down to 0 now, with the biggest drop triggered by a stress test on the effect of a drop in government subsidies and lower investment returns. Cheiron reported that the actuarial funded ratio (an average of several years, as opposed to the market funded ratio, which uses actual values at the end of the fiscal year) went up from 80.9% at the end of FY 2022 to 81.3% at the end of FY 2023.

Current rules for the STRS Board say the meetings should be "guided" by Roberts Rules of Order (RRoO), and Rudy Fichtenbaum asked in June just what that meant. When nobody was quite sure, he moved to have Board meetings be conducted in accordance with RRoO, which implied that STRS would then need a parliamentarian to make sure things were done right. The STRS General Council, Stacy Wideman, worked on wording of the motion to make sure it would comply with Ohio law. May Remson, who presumably knows RRoO forwards and backwards, explained to the Board subtleties that are often misunderstood. To wit:

- the purpose of seconding a motion is to show that more than one person wanted to discuss it, but if discussion starts without a second, a second would be superfluous so is not needed;

- there should not be a motion to accept the minutes of a previous meeting; the chair asks if there are any corrections and, if so, the group agrees to the corrections, following which the chair announces the minutes are adopted;

- if a member calls the question, that means that member is ready to vote; it does not require that debate be cut off. It takes a majority vote to cut off debate.

Every year STRS earns several million dollars by renting out securities they own to companies that may need to cover a short trade, vote a proxy, settle trades, show they have high quality collateral, etc. The Bank of New York handles the details, keeps 10% of the rent, and guarantees STRS will get its securities back. The program has raised $345 million for STRS since it started in FY 1992.

For years a chief complaint about STRS by the insurgents has been the claim that, compared to what an active teacher contributes to the system, the payback in pensions is among the lowest in the country. That is not a valid criterion, as I described in the following, my public comments at the October Board meeting:

> My name is Gerald Newsom. I retired in 2004 after 35 years on the faculty of The Ohio State University. I'm here representing only myself. We've all heard the familiar accusation, that STRS is the worst public pension system in the nation, based on the belief that what a teacher receives in a pension compared to what they paid into the system is the lowest in the country; sometimes it's claimed that the teacher gets back only 74 cents for each dollar paid in. While the accuracy of this belief is highly dubious, its relevance is even less appropriate. Suppose the law was changed, so instead of having employees and employers each pay STRS 14% of a teacher's salary, the salary was reduced by 14% and the employer covered the entire amount that employee and employer current pay together. Teachers get the same take-home pay; the lost salary is made up for by not contributing to STRS. School boards have identical costs to what they have now. STRS receives the same total contribution and pays out the same pension. Nothing is changed, except now what a teacher receives in a pension compared to what they paid into the system becomes infinite. If you believe that ratio of what you paid in to what you receive is how you measure the value of a pension, you'd be absolutely ecstatic; this would be the best you could ever hope for. Imagine, getting all that pension money after having contributed nothing. But financially, it's exactly the same system we have now, that critics call the worst in the country. The conclusion is that, appealing as the idea sounds, you cannot measure the value of a pension system by what a teacher receives in a pension compared to what the teacher paid into the system.

The November Board meeting was non-traditional, devoted to education about fiduciaries and governance (the latter topic is in response to the recommendations of the Funston Fiduciary Audit conducted for ORSC). Aon consultants discussed Funston's recommendations for Board governance at the Board's November discussion. Funston had recommended changing the STRS committee structure, with the Board meeting less often and relying more on committees. Aon agreed with most but not all of

Funston's governance recommendations. For example, Aon recommended that the Board's Disability Review Panel and Final Average Salary Committee be dissolved, with staff taking on those functions.

Considering how often the STRS critics talk about fiduciary duty in their public comment sessions, I was sorry they didn't show up to learn more what the term means. (With no public comment session in November, they apparently saw no reason to attend.) ORTA keeps arguing that STRS would be much better off if they just put all their investments in a stock index fund, but when Aon explained fiduciary duty, they noted that "diversification is explicitly required as a duty" of fiduciaries. The Attorney General is authorized, under Ohio law, to bring suit should STRS not follow fiduciary duty. Each fiduciary in the system is bonded or insured for at least one million dollars. Fiduciaries in STRS must be independent of constituents who elected them, taxpayers, the public, etc., so when retirees make speeches demanding reinstatement of their COLAs, it would be illegal for STRS to defer to these demands.

Cheiron illustrated the concept of Present Value used in computing pension liabilities. If you owe $100 today, you need $100 to pay it. If you owe $100 payable a year from now and you assume a 7% return on investments, you need $100/1.07 now. For a debt is due in two years, you need $\$100/1.07^2$ now. What you need now is called the Present Value of the liability. In calculating the Present Value of STRS' liability for future pensions, they also have to include the probability that each retiree remains alive during the time being considered. Cheiron uses mortality tables to calculate the probability each retiree will be alive for each year in the future and multiplies that by the Present Value of the pension payment for that year, then adds them up for every person receiving a pension. Adding that up for every year in the future until all current retirees have died gives you the liability STRS has for pensions owed to current retirees. The Present Value of this liability is much less than the amount that will actually be paid. An example was given for an annual pension of $1000 for a recent retiree; if one assumes 0% return on investments, the Present Value is $25,341. With a 6% return, it drops to $13,034; a 7% return has a Present Value of $11,964, while an 8% return needs $11,045. It was a good illustration of how important it is that the assumed rate of return is realistic.

Under current policies, Cheiron calculates at the end of FY 2024 the Funded Ratio and Funding Period as 80.3% and 9.7 years respectively. Cheiron presented a table showing the effects of policy changes (e.g., increasing employer contributions by 1% of salary, one-time and annual COLAs of 1%, 2% and 3%, and changes in years of service needed for unreduced benefits). Board members started asking about implementing COLA options and Cheiron reminded the Board that this was for the March meeting, when Cheiron will announce how much they will approve for the Board to spend on benefit enhancements. Board discussion was illuminating, with the more traditional members and those recently elected seeming to talk past each other. The recent members of the Board portrayed a failed system, which is not giving expected COLAs and retirees seeing their income steadily eroded by inflation. The older Board members described a system that is saddled with overly generous pensions offered to those who retired from 1999 to 2014 and the huge losses in the Great Recession, problems which the Boards before 2012 did not address; starting with pension reform in 2012, STRS Boards have been doing a responsible job in getting us out of the hole they inherited. Part of the message to me was that paying benefits they can't afford leads to problems down the road, and the newer members of the Board want STRS to pay increased benefits that Cheiron says they can't afford; the legislative requirement that the funding period must stay less than 30 years is designed to make sure pension boards don't make the same mistake again.

News from around the country

Since 1975, participation in private sector DB plans dropped from 27.2 million to 12 million, while participation in DC plans went up from 11.2 million to 85.3 million, according to the Bureau of Labor Statistics data.

STRS was among a group of pension funds (including OPERS and SERS) that pushed the Securities and Exchange Commission (SEC) to establish rules to make fees for Alternative Investments more transparent. The SEC announced the standardized reporting rules on 23 August 2023 and it is expected that it will be another year to year and a half before we see the new rules being enforced, according to the ORSC.

Nearly all the state pension systems across the country are paying off liabilities. Two public health-care programs in North Carolina got an item inserted in the budget bill allowing them to leave the state pension system, which means they no longer would be responsible for helping to pay down the past debt. That increases the share that the remaining state employers and employees would have to pay; the state treasurer blasted the bill.

The Indiana legislature is involved in decisions on whether the Indiana Public Retirement System will pay COLAs. In its budget negotiations, at one point a proposed COLA of 0.4% was put forward, but when everyone agreed that was not enough, the issue was put on hold. A new legislative ban required the fund to divest some of their holdings in China, and most of that has been done.

Various government entities in Michigan have their own pension plan and some of these are way underfunded. The Flint Municipal Employee Pension Fund was 29% funded at the end of FY 2022, for instance. Governor Whitmer released $533 million to shore up local pensions.

A Department of Labor ESG (environmental, social and governance) rule appeared to limit investments in oil and gas companies, and 26 states sued to block the rule. A U.S. District Court in Texas ruled against the states, noting that the rule requires fiduciaries to not subordinate financial interests when considering ESG. This had an interesting result in Oklahoma, where an anti-ESG law requires pensions to divest investments in firms perceived as being hostile to the oil and gas industry. Pension boards are exempt from the requirement if the board members feel it would force them to violate their fiduciary duties. When the Oklahoma Public Employees Retirement System exercised that exemption, the Speaker of the House removed his two appointees from the board. Amid concerns over ESG investing, Nebraska is moving half of its "passive" investments away from Blackrock, but Blackrock will continue to manage the state's "active" investments. [Since passive investing (as in index funds) doesn't involve much deciding how to invest, it's hard to see how ESG would be much of a factor.]

The U.S. District Court did say that, while federal law prohibits fiduciaries from subordinating financial factors to non-financial ones, ESG criteria can still be used, for example, as a tiebreaker. The ruling will be appealed.

Morningstar's analysis of proxy voting by public pension funds concluded that the funds supported ESG resolutions 88% of the time, much higher than general stockholders, with 56% support.

The Texas legislature approved payments of COLAs for most retired teachers in the system and voters supported the measure with 84% of the vote. Bills in the Pennsylvania legislature would provide COLAs for retired teachers for the first time in more than 20 years.

Some Alaskans participate in a managed accounts program, where the employee can actively direct their investments, with the help of a specialist. A study showed the plan charged higher fees and retirees received lower-than-expected returns, so the plan may be closed.

Auto makers subject to the strike by UAW workers claimed that reinstating defined benefit pension plans as the UAW wants would bankrupt the companies. The agreement between the UAW and auto companies failed to win back DB pensions for post-2007 hires.