

Consolidation of PSRS/PEERS Investments with Other Public Pension Plans

There is currently a discussion about consolidating the investments of Missouri's largest retirement systems, including The Public School and Education Employee Retirement Systems of Missouri (PSRS/PEERS), the Missouri State Employees' Retirement System (MOSERS), the Missouri Local Government Employees' Retirement Systems (LAGERS), and the Missouri Department of Transportation and Highway Patrol Employees' Retirement System (MPERS). Proponents of the state investment board concept have focused primarily on two issues: investment costs and boosting investment returns. Proponents have also suggested that the consolidation of investments would not result in some form of merging of the systems. This paper provides background information and facts on these issues.

Size of Missouri Retirement Funds

PSRS/PEERS is the largest public defined benefit plan in the state of Missouri and one of the 50 largest defined benefit plans in the United States. The total assets of PSRS/PEERS are greater than the total assets of all other defined benefit plans in the state. PSRS/PEERS had total assets of \$26.6 billion as of December 31, 2009 while MOSERS had \$6.9 billion, LAGERS had \$3.7 billion and MPERS had \$1.3 billion.

Loss of Control Over Investments

The proponents of an investment board have utilized a banking analogy: we do not need four banks when one would be more efficient. Additionally, under this structure, proponents have stated that "no other system will get the PSRS/PEERS money". While there could be one investment board (one bank) and all the money could be accounted for separately, history tells us that as banks consolidate and get bigger, problems can occur. One need only look back to last year when consolidation in the banking business (particularly Citigroup and Bank of America) caused significant problems and ripples through the economy. Because these banks became too big, there was a loss of oversight, a loss of control and a failure in terms of risk management, all because there was too great a consolidation of power.

PSRS was established in 1946 as a Trust Fund for the teachers of Missouri. Today, every PSRS/PEERS member is part of an election process to select four members of the PSRS/PEERS Board. Those Board members represent the concerns of the membership. As when parents establish a trust fund for their children, they choose a trustee who will manage their money for the benefit of their children's future well-being. A parent would not choose a trustee that would not have a vested interest in ensuring their children's future success.

If investment consolidation were to be implemented, **it is a fact that the PSRS/PEERS membership would lose representation over their retirement funds.** The initial discussion of an investment board would provide for one representative from each retirement system on the board. Thus, PSRS/PEERS would have one representative (25% of the board from the Missouri systems) even though the PSRS/PEERS assets would represent 70% of the investment board assets. This is a significant and potentially damaging loss in fiduciary oversight for our membership. While proponents of consolidation say it would not lead to a merging of systems, an almost complete loss over the investment function by the membership through its duly-elected representatives has essentially the same devastating outcome for members of PSRS/PEERS.

PSRS/PEERS is a Contributory System

There are substantial fundamental differences between the pension plans of Missouri. For example, the membership of PSRS/PEERS provides contributions through deferred wages (payroll deductions) to help fund future benefit payments, while most other retirement systems in the state do not require any contribution from its members. Of the \$26.6 billion in combined assets for PSRS/PEERS, over \$6 billion has been directly contributed by members of the Systems. While proponents of consolidation prefer to argue that all state retirement systems are paid for by taxpayers, PSRS/PEERS is funded by deferred wages of our membership, with members currently paying 13.5% of their salary for their retirement benefit.

Actuarial Soundness

The actuarial funded ratios for the three largest Missouri defined benefit systems (PSRS/PEERS, MOSERS and LAGERS) as of June 30, 2009 were between 79.9% and 83%, indicating that from an actuarial standpoint, all systems are sound. Proponents of the investment board have stated that because of greater returns with lower costs, contribution increases would stop and benefits would stay the same if an investment board were created. **This is not true.** Investment costs would be higher for PSRS/PEERS under the proposed structure. Contribution rates will continue to increase in the next year or two regardless of investment returns. And, most importantly, investment returns are not guaranteed so it is difficult to accurately predict future contributions or benefit structures based on moving the management of assets to a different entity.

Investment Returns

Investment performance is very time-period dependent. Performance has varied year-by-year over the last 20 years, with PSRS/PEERS outperforming in some years, and MOSERS/LAGERS/MPERS outperforming in others. Differences in investment returns between public funds can be expected because the investments of each fund are structured under a different risk tolerance. For example, PSRS/PEERS has historically utilized a lower risk portfolio than most of its peers primarily because PSRS members have a sizable contribution rate and because they do not receive social security.

The Board of PSRS/PEERS determines the amount of risk they are willing to take with their members' retirement accounts. Attempts to boost investment returns through greater risk-taking is most likely not in the best interest of the membership. Furthermore, if the assumption of greater risk in the pursuit of higher returns becomes appropriate, the current Board of PSRS/PEERS can elect to make that decision. It should not be made by those who are solely interested in minimizing the State's obligations to fund public pension plans.

Perhaps the most important factor to consider when projecting future returns is to heed the SEC-mandated disclaimer: *"Past performance is not indicative of future results."*

Investment Performance in a Down Market

As stated earlier in this document, investment performance is very time-period dependent. PSRS/PEERS has historically performed better than the average public fund in down markets and underperformed in up markets.

PSRS/PEERS has developed an investment portfolio that is designed to meet long-term return objectives with risk management at the forefront of the decision-making process. This has led to the preservation of capital in difficult markets. During the bursting of the tech bubble in 2001 and 2002, the S&P 500 Index (a measure of U.S. stock market performance) declined 16.4% on an annualized basis, but PSRS/PEERS declined only 2.4% during the same period. Other pension funds did not perform as well during that time period due to the underlying risk profile of their investment programs.

Most recently, during the severe market correction in the last six months of 2008, the S&P 500 declined 28% while over the same time period PSRS/PEERS declined 20% and most other large public funds declined more. Additionally, throughout the credit crisis, PSRS/PEERS had a large allocation to Treasury securities (the safest and most liquid asset in the world) to ensure the safety of member money. PSRS/PEERS has historically managed an investment portfolio with much less risk than the public fund universe. For example, for the 5-year period ending December 31, 2009, 81% of the public funds greater than \$1 billion took more risk than PSRS/PEERS.

The Proposed Consolidation Would Raise Investment Expenses for PSRS/PEERS

Investment expenses are hard dollar costs that will be paid whether a fund provides good investment returns or poor investment returns. Stated differently, investment expenses are guaranteed to be paid every year while investment performance is not guaranteed.

Proponents of an investment board have stated that, “by being able to cut overhead costs by not having to pay for duplicate investment staffs, there would be a reduction in contribution rates for teachers”. **This is not true.** Total internal investment staff expenses for PSRS/PEERS in fiscal year 2009 were less than 1¢ for every \$100 of total assets managed (\$1.7 million), which means that even if the investment staff at PSRS/PEERS were eliminated entirely, it would have virtually no impact on the contribution rate.

Proponents of the investment board have also stated that combining investment staffs will cut costs, similar to combining banks. This may be true as long as the larger bank (PSRS/PEERS) takes over the smaller bank. However, most discussions have centered on the PSRS/PEERS investments being managed under the MOSERS investment structure. This will directly increase costs to Missouri’s educators and impact contribution rates.

The MOSERS internal investment staff expenses were almost double that of PSRS/PEERS in fiscal year 2009 (\$3 million versus \$1.7 million) despite managing approximately one-fourth of the assets. MOSERS has 50% more internal investment staff than PSRS/PEERS and a substantially higher salary structure. While this is a significant difference, it is not material enough to create a contribution rate difference on a fund of \$26.6 billion. A more relevant consideration may be that an investment board would increase costs in terms of duplication of technology staff, accounting staff, legal teams and support staff. If a separate investment board were created it would require a significant operational staff to support the organization, as has been the model for investment boards in other states where the staffs are very large.

Most importantly, the real expense would occur in asset management fees. MOSERS total investment management expenses and fees were 0.81% (or 81¢ for every \$100 under

management) in fiscal year 2009 while the PSRS/PEERS total expenses and fees were 0.45% (45¢ for every \$100 under management). On a portfolio the size of PSRS/PEERS, this would increase management fees by tens of millions of dollars per year, which could **increase contribution rates**. In fact, if PSRS/PEERS incurred the level of investment management expenses and fees paid by MOSERS, nearly \$100 million per year of extra costs would be incurred by PSRS/PEERS.

The consolidation of Missouri's largest retirement systems into an investment board will not meet the goals as stated by the proponents. PSRS/PEERS is certain that an investment board will result in additional investment expenses and loss of control over investments for PSRS/PEERS members, all while offering no guarantee of investment returns.