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ATTORNEYS AT LAW

To: All Florida Pension Plans

From: Klausner Kaufman Jensen & Levinson

Re: LeRoy Collins Institute September 2012 Report

Date: October 5, 2012

On September 25, the LeRoy Collins Institute released a new white paper entitled *Years in the Making: Florida's Municipal Pension Plans* (hereinafter the 2012 "Study"), a continuation of their earlier 2011 report regarding municipal pension plans in Florida. The purpose of this memo is to share our thoughts with clients about the important role of defined benefit ("DB") plans in the public sector. We will use the 2012 Study as a foil to discuss retirement security and the advantages provided by DB plans. We also encourage clients to discuss the "trends" described by the 2012 Study with their actuary, so as to compare whether and how the new Study's conclusions have any bearing on their plan.

This memo begins with an overview of the 2012 Study. The second half of the memo addresses the underappreciated lifetime security and retirement income provided by DB plans and what some have described as the failure of the 401(k) experiment. In summary, the underlying purpose of this memo is to provide a broader and longer term perspective than the Collins Study, that is less hostile to public employee benefits.

<u>2012 Collins Study</u>

By way of background, the 2012 Study uses Annual Reports from the Department of Management Services ("DMS") from 2005 to 2011 to answer the following question posed by the Study's authors:

> whether Florida's municipal pension plans are fundamentally healthy and just need time to weather the current financial storm or have structural problems that require significant repair.

The Study doesn't justify, explain or define what would constitute a structural problem. Nor does the Study hint at any constructive "structural repairs" to the self identified problematic trends. With that said, as set forth below, the Study's findings are generally unremarkable for trustees who are

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familiar with DB plan funding and the undeniable poor investment experience over the past decade. More remarkable, however, and potentially suggestive of the Study's agenda, is the concluding sentence that plan costs are "adding insult to injury for many cities struggling to make ends meet." Yet, no mention is made of the hundreds of thousands of Floridians who earned their DB pensions during a lifetime of public service, or the advantages of DB plans compared to their inferior alternatives.[1]

According to the Study's introductory notes, the LeRoy Collins Institute attempts to report on the "typical" pension plan. It uses median values to do so, excluding variations which are deemed to be outliers. The number of outliers excluded from the universe of 492 plans is not identified.

Interestingly, in comparing plan data from 2001 to 2010, the 2012 Study fails to mention that a not insignificant number of plans were closed during this time period. We understand from the Division of Retirement that at least 67 of the municipal plans in Florida are currently closed to new participants. This fact may skew the Study's results, particularly with regard to the ratio of retirees to active participants. A closed plan, by definition, does not add any new members. Similarly, future payroll growth assumptions are irrelevant for a closed plan with no remaining active members. The distinction between open and closed plans is not addressed in the 2012 study. Moreover, the growth of pension contributions, as a percentage of covered payroll, becomes increasingly meaningless in the context of a closed plan.

The Study concludes with the following summary of its findings: (i) concerns about underfunded municipal pension plans were not caused by the downturn in the stock market, but rather under funding that began before the market fell; (ii) pension contributions have substantially increased from 2005 - 2011; (iii) local governments are picking up more of the pension cost; (iv) the number of retirees is growing and is "outstripping" the growth of active participants; (v) plans tend to overestimate assumed salary growth and investment earnings; (vi) payments for unfunded liabilities represent a growing proportion of annual pension contributions.

The Study's first finding announces that funding levels have declined nearly every year since 2001. According to the Study, "the problems facing many municipal pension plans are long-standing", yet the Study acknowledges that in 2001 the typical municipal plan was nearly 100% funded. In other words, the Study effectively minimizes the downturn in the stock market over the past decade, when the past ten years were book-marked by some of the most severe market dislocations in modern history. It is therefore puzzling why the Study concludes on page 12 by stating that the "underfunding began before the stock market fell." Moreover, the underlying resiliency of the plans' investment portfolios is too easily dismissed by the Study. Favorable market returns for the fiscal year that just ended on September 30 are of course omitted.

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[1] Readers are referred to the NCPERS website, www.ncpers.org for materials and fact sheets regarding defined benefit pensions and the retirement security they provide.

Figure 1 on page 2 of the Study compares funding ratios from 2001 to 2010. We remind readers of two bear markets in equities, the bursting of the tech and dot.com bubble, Enron, WorldCom, the 9/11 tragedy, two wars, the housing bubble, the subprime mess, the Lehman bankruptcy, the government takeover of Fannie Mae and Freddie Mac, AIG, and the new vocabulary of the Great Recession, the worst recession in seven decades. Indeed, as measured by the S&P 500, the calendar decade studied by the Collins Institute ended with a negative total return. Had an unlucky individual investor bought the S&P 500 on the last day of 1999 @ 1469, on a pure price basis they would have lost 24% as the index closed 2009 at 1115. Including dividends, the S&P lost 10% from January 1, 2000 to December 31, 2009. As a consequence, even well diversified portfolios were not immune from losses.

During this period, many individual investors in defined contribution ("DC") plans have had to postpone retirement as their DC and 401(k) balances were decimated. By not acting in accordance with a long-term investment policy, too many individual investors reacted emotionally and sold equities during market lows, prior to the current rebound.

By contrast, investment decisions in DB plans are made by professional money managers overseen by fiduciaries. As a result, DB plans were regularly investing and rebalancing their portfolios during market downturns. This is one of the reasons why over the long term DB plans consistently outperform their assumed investment rate of return.[2] This also illustrates the wisdom of Florida statutory requirements which mandate payment of actuarially determined contributions on an annual basis. By preventing plan sponsors from taking "funding holidays", DB plans are empowered to stick with their long term investment strategies.[3]

As for its second and third findings, the Study observes that over the past seven years "local governments are picking up more of the pension costs, especially for public safety plans." "While employee and state contributions are fairly stable," the Study expresses concern that the costs for municipalities are growing. This should not be a surprise, however, in light of the underlying investment and actuarial experience. Trustees understand that increasing employer funding obligations, by design, is what happens in a DB plan when investment risk rests with the plan sponsor.[4] This fact illustrates why the 401(k) experiment is considered by many to be a failure, as investment risk lies entirely with the individual investor. Increasing employer contributions

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[2] www.nasra.org/resources/issuebrief120626.pdf

[3] It is unfortunate that for the past several years, the Florida Legislature has only contributed the normal cost into the Florida Retirement System ("FRS"). By not making contributions to fund the growing FRS unfunded actuarial liability, the FRS funded ratio is projected to continually decline over the next two decades. Municipal plans in Florida annually fund both their normal cost and UAL, and accordingly are improving their funded ratios.

[4] At the same time, however, anecdotal evidence already suggests a meaningful trend of increased employee contributions and lower benefit packages for newly hired workers.

following adverse experience is the appropriate and necessary result to gradually restore DB plan funding, about which the Study otherwise seemingly complains.

No surprise for trustees, the Study illustrates the consistency by which Florida municipal DB plans have invested by employing long-term investment strategies. Unlike individual investors, the 2012 Study necessarily concedes that Florida municipal DB plans maintained "a consistent asset allocation strategy" during this challenging market environment and were not "chasing" returns or market timing. The Study describes an unattributed but "widely held concern that pension investors will seek to recover 'losses' by shifting to riskier stocks," but the Study's analysis actually provides proof to the contrary for Florida municipal DB plans.

Unlike DB plans, DC plan participants are generally required to reduce their exposure to market risk and thereby lower their expected returns as they age. By contrast, DB plans, through pooling market and longevity risk, are able to invest more cost effectively and obtain better long term investment returns. For any given level of retirement benefits, DB plans are less expensive than DC plans.[5]

The Study's fourth finding discovers that the number of retirees is growing and is "outstripping" the growth of active participants. In dramatic fashion, the Study is troubled by the fact that payouts may have exceeded contributions in 2010. Yet, actuaries and trustees are generally not concerned, as this merely reflects the maturation of the average DB plan. After all, the purpose for accumulating pension assets is not to store them up for perpetuity, but to pay them out. One should not be surprised or necessarily concerned when a pension plan distributes pension benefits.

Additionally, the Study's analysis is potentially flawed as it does not adjust for the fact that approximately 13% of the plans in the Study are closed and have no new active members. On page 5, the Study attributes the increase in the number of retirees to "several factors, including demographic shifts and concerns that retirement incentives were going to become less generous". Left entirely unmentioned is the downsizing, hiring freezes, and layoffs that have been implemented in recent years. Again, thankfully, many of these retirees have secure income from their DB pensions.

Ironically, to the extent that the Collins Institute or some of its supporters may be seeking to replace DB plans with DC plans, the net result would be to accelerate the replacement of participants with retirees. Actuarial studies have shown that closing a plan is likely to cost *more* over the short term. Any long-term cost savings of switching to a DC plan are uncertain.[6] We would argue that closing

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[5] Beth Almeida and William B. Fornia, "*A Better Bang for the Buck*" (Washington, National Institute on Retirement Security, 2008). www.nirsonline.org/index.php?option=com_content&task=view&id=121&Itemid=48

[6] *The Top 10 Advantages of Maintaining Defined Benefit Pension Plans* (NCPERS, January 2011) at page 6. www.ncpers.org/Files/2011_ncpers_research_series_top_ten.pdf

or terminating a DB plan after adverse actuarial experience is analogous to selling out of the market after a major correction. In hindsight, this often turns out to be a regrettable decision.

The Study's final findings express concern about plans overestimating assumed salary growth and investment earnings. Here too, one might question the Study's analysis. On page 7 the Study stresses the "consistent underestimation" of salary growth during 2004-2007. Less attention is paid to the more pronounced reverse trend in salary data starting in 2008. We understand that the deceleration of wage growth has generally continued into 2012, which will contribute to future actuarial gains.[7] In fact, some actuaries are recommending reductions in the salary assumption as an offset to the impact of lowering the investment assumption. Accordingly, the setting of assumptions is a dynamic process which should self correct over time with actuarial experience.

As described by the Study, it was "unexpected" that plans did not meet their investment assumptions in 2004 or 2005. We invite the Study's authors to revisit the data. The Study fails to explicitly recognize that plan data is generally reported on a fiscal year basis. Notwithstanding the introductory notes, to a casual reader figure 7 appears to treat the investment assumptions and investment returns on a calendar year basis. Moreover, not all plans submit annual actuarial valuations.

Accordingly, greater transparency would result if the Study disclosed how many plans are measured by each statistic. For example, the Study, which relies on the Division of Retirement's Annual Reports, does not disclose that valuations for the plan year ending 2010 were only available for *at most* 344 plans, not the full universe of 492 plans. Therefore, if the Study exclusively relies on the Division of Retirement's annual reports, *at best* 70% of the universe was analyzed in 2010 (before removing outliers, which are also not quantified). Making a larger point, we invite the Collins Institute to objectively examine longer term data and trends, without seizing on market turmoil to undermine a fundamentally sound and resilient retirement structure.

<u>In Defense of DB Plans</u>:

Disclaimer: In the opinion of Klausner, Kaufman, Jensen and Levinson, there is no better tool to attract, retain, and provide employees with a secure retirement than a DB plan. Since the severe market dislocation of 2008, it has become increasingly clear to many that relying solely on a DC plan will result in inadequate retirement benefits for the vast majority of participants. This is our perspective, which we openly admit.

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[7] Recent national data indicates that public sector wages have been below 1.5% for more than two years, and below two percent since the middle of 2009. http://wikipension.com/index.php?title=Compenation

As counsel for the National Conference on Public Employee Retirement Systems ("NCPERS"), we share NCPERS' philosophy that in a perfect world retirement income should be based on a three legged stool of Social Security, an employer sponsored DB plan, and personal savings (including supplemental DC accounts). The following discussion will summarize the critical role of DB plans for public employees.

In a political environment when Washington can agree on very little, it is noteworthy that this summer, Congress adopted and President Obama signed into law H.R. 4348. The Moving Ahead for Progress in the 21st Century Act ("MAP-21") was included in a two-year omnibus highway transportation bill. We mention the legislation, which provides funding relief for private sector DB plans, not because it has any direct application for public plans. Rather, MAP-21 illustrates that Congress understands the importance of defined benefit pension plans.
As critics of DB plans cannot deny, one of the major differences between a DB and DC plan is investment risk. When a DB plan is closed, investment risk is off-loaded to future hires. Increasingly, retirement professionals and academics are acknowledging that 401(k) plans were never intended or designed to replace DB plans. They cannot. DC plans at best provide a complement to DB benefits, particularly for public sector employees.

Serious observers are increasingly recognizing that all too often, employees who are permitted access to their DC or 457 balances withdraw from their plans to pay for college education, medical expenses, home improvement, home ownership, and other non-retirement related expenses. When "leakage" of DC assets is coupled with the fact that DC plans place all of the investment risk on employees, it is not hard to understand how DB plans are far superior options, especially for long-term employees. We leave for the investment professionals to explain the common mistakes that are made by individual investors, who are asked by DC plans to shoulder the responsibility for their own retirement. Another disadvantage of DC plans is that they force participants to serve in the role of professional money manager.

The story continues after a retiree separates from service. A DC plan retiree must budget their withdrawals over time and gradually reduce their exposure to riskier asset classes. DB retirees, by contrast, know in advance of the decision to retire that they will enjoy monthly retirement income, invested and overseen by fiduciaries. Thus, a DB plans allows retirees to maintain a stable portion of their pre-retirement standard of living.

In summary, the benefits of DB plans include:
- predictable, secure retirement income that retirees cannot outlive;
- pooling of longevity and investment risk;
- superior investment returns compared to DC plans;
- balanced and professional portfolio diversification by professional money managers and consultants to maximize returns over a long time horizon;
- more efficient with lower investment management fees and administrative costs than DC plans;
- reduced employee turnover, employee training and recruitment costs;
- disability and survivor benefits, which are critical for public safety employees;
- flexibility and the ability to facilitate orderly retirement succession by providing employees with the ability to retiree even in difficult market environments;
- higher standard of living with less likelihood of retirees living in poverty;
- economic benefits for local economies if retirees remain in their local communities[8].

Klausner Kaufman Jensen and Levinson welcomes questions and invites you to visit our website, along with the following resources: www.robertdklausner.com; ncpers.org; nasra.org; nirsonline.org.

[8] According to the *Pensionomics 2012* study by the National Institute on Retirement Security, 360,065 residents of Florida received a total of $7.2 billion in pension benefits from state and local pension plans in 2009. http://www.nirsonline.org/index.php?option=com_content&task=view&id=684&Itemid=48