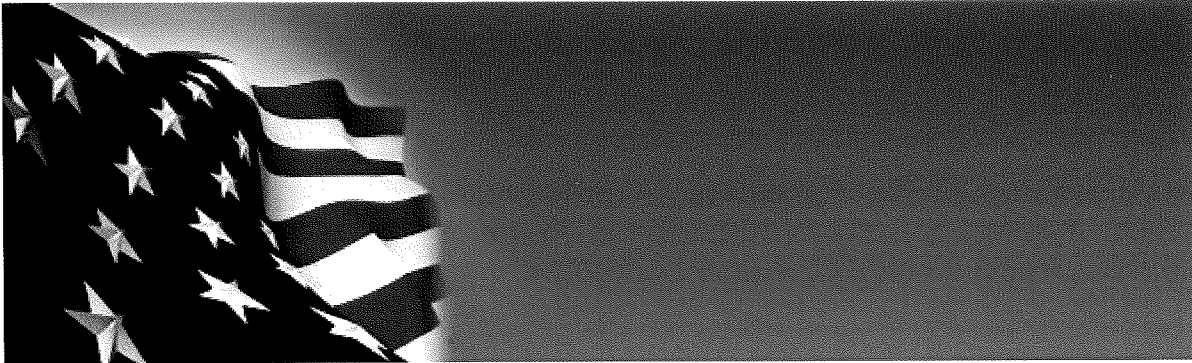


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CYPEN & CYPEN NEWSLETTER for NOVEMBER 20, 2014

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Stephen H. Cypen, Esq., Editor

Never Forget September 11, 2001

and

Always Remember May 2, 2011

1. NASRA ON TOTAL PENSION PLAN INVESTMENT RETURN ASSUMPTIONS: National Association of State Retirement Administrators has updated a prior issue brief on public pension plans investment return assumptions. Public pension investment return assumptions have been the focus of growing attention in recent years. Some critics of current public pension investment return assumption levels say that current low interest rates and volatile investment markets require public pension funds to take on too much investment risk to achieve their assumption. Because investment earnings account for a majority of revenue for a typical public pension fund, the accuracy of the assumption has a major effect on the plan's finances and actuarial funding level. An investment return assumption that is set too low will overstate liabilities and costs, causing current taxpayers to be overcharged and future taxpayers to be undercharged. A rate set too high will understate liabilities, undercharging current taxpayers, at the expense of future taxpayers. An assumption that is significantly wrong in either direction will cause a misallocation of

resources and unfairly distribute costs among generations of taxpayers. Although public pension funds, like other investors, experienced sub-par returns in the wake of the 2008-09 decline in global equity values, median public pension fund returns over longer periods meet or exceed assumed rates used by most plans. At 8.8%, the median annualized investment return for the 25-year period ended June 30, 2014, exceeds the median assumption of 7.75 percent, while the 10-year return is below this level. Public retirement systems typically follow guidelines set forth by the Actuarial Standards Board to set and review their actuarial assumptions, including expected rate of investment return. Most systems review their actuarial assumptions regularly, pursuant to state or local or system policy. Actuarial Standards of Practice No. 27 (Selection of Economic Assumptions for Measuring Pension Obligations) prescribes considerations actuaries should make in setting an investment return assumption. As described in ASOP 27, the process for establishing and reviewing the investment return assumption involves consideration of various financial, economic, and market factors, and is based on a very long term view, typically 30 to 50 years. A primary objective for using a long-term approach in setting public pensions' return assumption is to promote stability and predictability of cost to ensure intergenerational equity among taxpayers. Unlike public pension plans, corporate plans are required by federal regulations to make contributions on the basis of current interest rates. This method results in plan costs that are volatile and uncertain, often changing dramatically from one year to the next. This volatility is due in part to fluctuations in interest rates, and has been identified as a leading factor in the decision among corporations to abandon their pension plans. By focusing on the long-term and relying on a stable investment return assumption, public plans experience less volatility of costs. Since 1983, public pension funds have accrued an estimated \$5.3 trillion in revenue, of which \$3.2 trillion, or 60%, is estimated to have come from investment earnings. Employer contributions account for \$1.4 trillion, or 27% of the total, and employee contributions total \$662 billion, or 13%. Public retirement systems operate over long timeframes and manage assets for participants whose involvement with the plan can last more than half a century. Consider the case of a newly-hired public school teacher who is 25 years old. If this pension plan participant elects to make a career out of teaching school, he may work for 35 years, to age 60, and live another 25 years, to age 85. This teacher's pension plan will receive contributions for the first 35 years and then pay out benefits for another 25 years. During the entire 60-year period, the plan is investing assets on behalf of the

participant. To emphasize the long-term nature of the investment return assumption, for a typical career employee, more than one-half of the investment income earned on assets accumulated to pay benefits is received after the employee retires. The investment return assumption is established through a process that considers factors such as economic and financial criteria; the plan's liabilities; and the plan's asset allocation, which reflects the plan's capital market assumptions, risk tolerance, and projected cash flows. Investment return assumptions for most public plans are composed of two components: the real return, and the rate of inflation. The sum of these figures equals the plan's nominal investment return assumption, and most public pension plans regularly appraise each component of the nominal return pursuant to the above process. Standards for setting an investment return assumption, established and maintained by professional actuaries, recommend that actuaries consider a range of specified factors, including current and projected interest rates and rates of inflation; historic and projected returns for individual asset classes; and historic returns of the fund itself. The investment return assumption reflects a value within the projected range. Many public pension plans have reduced their return assumption in recent years. Among the 126 plans measured by the Public Fund Survey, more than one-half have reduced their investment return assumption since fiscal year 2008. The median return assumption is 7.75%. Over the last 25 years, a period that has included three economic recessions and four years when median public pension fund investment returns were negative, public pension funds have exceeded their assumed rates of investment return. Changes in economic and financial conditions are causing many public plans to reconsider their investment return assumption. Such a consideration must include a range of financial and economic factors while remaining consistent with the long timeframe under which plans operate.

2. IS OUTLIVING RETIREMENT SAVINGS A FATE WORSE THAN DEATH?: When faced with the prospect of outliving their money, *Financial Advisor* says most people might toss and turn at night or obsess about where to slash their budgets. Others have a more extreme reaction: wishing for early death. A new survey from Wells Fargo shows 22% of people say they would rather die early than not have enough cash to live comfortably in retirement. Other surveys bear those numbers out. One by Allianz of people in their late 40s found 77% worried more about outliving their money in retirement than death itself. Of the survey's respondents, those who are married with dependents are even more terrified, with 82% saying that

running out of cash is a more chilling prospect than death. Some do not believe that people have an actual death wish, they just do not know what they will do if they outlive their cash. In one respect, collective despair is simply an acknowledgement of how much -- or rather, how little -- we are saving. The Wells Fargo survey also discovered that 41% of those in their 50s are not putting anything aside for retirement, and 48% admit they will not have enough money to survive in their golden years. Instead of throwing up your hands, set a goal that is actually achievable. There are other ways to gain control of the situation. You may have to delay retirement by a couple of years, you have to find ways to supplement your income, and you may have to reduce your standard of living now and in retirement. All of these are ways are really focusing where you are at instead of just giving in to despair. But is this death wish that emerges in surveys really about us? Dig a little deeper into people's anxieties about outliving their money, and you often find out it is all about the kids. Parents feel like failures if they cannot leave an inheritance, and they certainly do not want to become financial burdens on their adult children. So instead of worrying yourself into paralysis, let go of all that parental stress and anxiety. You do not have to leave behind a huge estate; the kids will be fine. And if you have to lean on your family in old age, hey, human beings have done that for eons. Our retirement challenges may be formidable, but they are certainly no reason to hope that death arrives any sooner than it has to arrive. Easy for you to say.

3. IT'S TIME TO SAVE FOR RETIREMENT -- THE BENEFIT OF SAVING EARLY AND THE COST OF DELAY: As Albert Einstein once supposedly said, "Compound interest is the eighth wonder of the world. He who understands it, earns it; he who does not, pays it." This statement is particularly true with regard to accumulation of retirement savings, where starting early means saving a far more manageable percentage of income than starting later in life. A paper from Insured Retirement Institute paper uses real-world income and retirement plan contribution averages, as well as reasonable investment return and inflation assumptions, to demonstrate impact on potential lifetime income of starting to save for retirement in each year of working life, from age 30 to age 60, and conversely the percentage of income that would need to be saved in each working year, beginning at each of these ages, to achieve the same potential lifetime income as someone who began saving earlier. The paper will further show how critical this savings behavior is in terms of projected income need, based on 30 years of data on the spending habits of individuals in retirement. Here are

key findings and analysis:

- The retirement savings “window,” the period of time over which one can realistically expect to save for retirement, has shortened considerably, as young Americans enter the workforce later and thus begin contributing to retirement plans at older ages.
- The average age at which young workers reach the median wage has increased from 26 to 30 since 1980.
- A worker with annual income of \$42,000, approximately the median wage and a level of income associated with financial independence and saving 7% of income plus a 3% matching contribution, beginning at age 30 in a 401(k) or other defined contribution plan may be able to generate lifetime income of \$22,467 in today’s dollars from the plan account balance at age 65.
- The same worker waiting until age 70 would be able to generate \$38,829 in annual income in today’s dollars, due to the additional 5 years of contributions and investment earnings, 72.8% higher than if income began at age 65.
- At a 12% savings rate plus 3% match, potential income at age 65 in today’s dollars would be \$33,700; at age 70 it would be \$58,244.
- A worker putting off saving until age 35 would need to save more than 16% of income annually to produce the same potential retirement income at age 65 as someone who started saving at the 10% rate beginning at age 30; starting at age 40 would require saving more than 26% of income.

4. TO BUILD BETTER RETIREMENT OUTCOMES: Plansponsor.com says the rise of defined contribution plans as the primary retirement vehicle for many U.S. workers over the past few decades is here to stay. However, the data show that DC plan performance has persistently lagged that of institutional investment portfolios (endowments, state pensions and other defined benefit plans). For example, data from Towers Watson show that DB plans have outperformed DC plans in 12 of the last 17 years (from 1995 to 2011), and by an average of 76 basis points annually. This differential may seem insignificant, but over a 40-year working career, the impact amounts to a 35% reduction in the participant’s future account value

(that is, what could be the difference between meeting retirement goals and missing the mark). A potential explanation for the performance disparity is that large pools of institutional capital often utilize a wider variety of sophisticated strategies than in most DC plans. Above and beyond the difference in fees, the strategy selection plays a much larger role, particularly, when considering the broad universe of assets generally available within institutional investment portfolios, including alternative investments, high-yield bonds and global equity and fixed income, all of which can offer the opportunity to improve diversification, capture alpha, and smooth bouts of market volatility. If institutional portfolios have historically delivered better outcomes in part through exposure to a broader, more diverse asset mix, how can we justify restricting DC participant investments into an a narrower subset of the investable universe? Should not participants have access to the same investment opportunities as institutional investors? The authors argue that traditional DC investment menus need to add new courses that produce a taste of global diversification and an expanded palate of strategies. Diversified multi-asset mutual funds, as well as white label investment options that draw on the expertise of multiple underlying investment managers, are solutions for such diversification among strategies that may be able to take a bite out of the performance dichotomy.

5. COST-OF-LIVING ADJUSTMENT REDUCTION DECISION: The Colorado Supreme Court has determined whether Colorado Public Employees' Retirement Association members had contractual rights to the cost-of-living adjustment formulas in place at their respective retirements, for life without change. On summary judgment, the district court ruled that PERA retirees had no such contract right to an unchangeable COLA formula. The court of appeals disagreed. It determined that the retirees had such a contract right and remanded for further review to determine whether or not the legislation violated the Contract Clauses of the United States and Colorado Constitutions. The Supreme Court held that the 2010 legislation did not establish any contract between PERA and its members entitling them to perpetual receipt of the specific COLA formula in place on the date each became eligible for retirement or on the date each actually retired. The Supreme Court disagreed with the court of appeals, and agreed with the district court. It held that the PERA legislation providing for cost of living adjustments did not establish any contract between PERA and its members entitling them to perpetual receipt of the specific COLA formula in place on the date each became eligible for retirement or on the date each actually

retired. Accordingly, the Supreme Court reversed the judgment of the court of appeals and upheld the trial court's summary judgment order dismissing the case. Contract Clause analysis involves three inquiries: (1) does a contractual relationship exist; (2) does the change in the law impair that contractual relationship; and if so, (3) is the impairment substantial? If each of these three component questions is answered affirmatively, the court must then determine whether the impairment is nonetheless justified as reasonable and necessary to serve an important public purpose. Thus, while designed to protect vested contract rights from legislative invasion, the Contract Clauses are not to be interpreted as absolute. Applying the modern contract clause test, the court overruled any implication that pension legislation is not subject to the presumption that the legislature does not intend to bind itself contractually and does not intend to create a contractual right unless the legislature provides a clear indication of its intent to be bound. *Justus v. State of Colorado*, Case No. 12SC906 (Col. October 20, 2014) (*en banc*).

6. ANY (GREEN) BONDS TODAY?: According to *Governing*, green investments are the current darling of Wall Street. The market for them is expected to exceed \$40 billion this year, according to *Bloomberg*. But there is one huge institutional player that is being left out: state and local pension plans. Pension investment officials do not want tax exempt paper in their portfolios. Since pension plans are already tax exempt, they cannot claim the tax exemption. This situation leaves a mismatch between available pension capital and the public sector's infrastructure financing needs, especially for projects that lack a revenue source. But there may be a fix. These bonds are issued to finance environmentally friendly capital projects. In this article, the term green bonds is used very broadly to include essential environmental projects that might be funded by states and localities through bond financing. Pension plans are not the only investors that have eschewed tax exempt income: sovereign investment funds from abroad and endowment funds do not care about taxes either. So, what would attract these potential investors? What we need is a taxable option to be approved by Congress and limited to green bonds, not to every conceivable capital project, which is typically what happens when politics gets involved. A Taxable Bond Option is a concept that has been kicking around in public finance circles for four decades. Build America Bonds, authorized in 2009-2010 at the bottom of the Great Recession, were a taxable option. A TBO allows, but does not require, a municipal bond issuer to elect to pay taxable interest and receive a direct interest cost

reimbursement from the U.S. Treasury rather than the indirect subsidy of tax exemption. In most cases, the result is a lower borrowing cost, net-net, than issuing tax-exempt bonds. For pension plans, a TBO-yield will compare favorably with corporate credit and foreign sovereign bonds, plus the bonds would be a diversifier for bond portfolios. Foreign investors and endowment funds, as well as ordinary investors with incomes below \$200,000, would prefer taxable municipals. However, some leaders in the public finance community believe it is a slippery slope, that if the federal government starts down this path they will someday want to eliminate tax exemption for municipal bonds. Secondly, there has been a fear in some circles that the feds may run out of money and renege on their promise to pay the interest reimbursement. (In theory, it is harder to renege on tax exemption.) No one disputes Build America Bonds were successful. They were limited in term, and the bonds got scooped up and are sitting in portfolios now. Uncle Sam is paying his share and there is no sign of doing anything otherwise. It costs the Treasury less to pay a direct subsidy to the municipal bond issuer than to give a tax exemption to the typically wealthy investors whose effective marginal income tax rates are usually 28-40%. For state governments, a taxable option could help their revenues, as well. It works as long as the reimbursement rate of the direct subsidy is lower than the effective tax average rate on that issuer's municipal bonds. So what is the next step? The public finance community, public pension funds and their lobbyists on Capitol Hill have to step up and make this happen. Don't hold your breath.

7. PENSION SYSTEM FOR NEW YORK CITY PRIVATE EMPLOYEES:

From plansponsor.com we learn that New York City's public advocate is readying legislation that would create a board tasked with studying and establishing a centrally pooled pension fund for the city's private sector. The advocate said the percentage of New York City workers participating in a workplace based retirement plan dropped by 17% between 2001 and 2011. The data also found just 12% of New Yorkers in that same time frame had access to a defined benefit plan. The advocate will introduce a bill in City Council that would amend the city's administrative code and establish a Private Pension Advisory Board.

8. PUBLIC RECORDS ACT TRAINING VIDEOS AND MATERIALS: David Wolpin, Esq., writing a piece for the Florida Municipal Attorneys Association News, has prepared Public Records Act training videos and materials to meet the recent surge of public records challenges. Although these

materials were designed for a municipality, the Public Records Act applies to public pension boards, as well. To minimize potential Public Records Act problems, pension boards may want to consider giving every employee access to the basic understanding of the Act, provided by these materials. Materials consist of two online videos, a sample protocol concerning public records request, best practices and a list of frequently asked questions. The materials are available at: <https://www.dropbox.com/sh/8cdn6l7bwcu7206/AACol8BfeGTC5alAfnu7K-ya?dl=0>.

9. ERRATUM: Item 2 in our November 13, 2014 Newsletter made a reference to a working paper from The Wharton School. Unfortunately, we somehow quoted figures from a much earlier paper. Current numbers show that public employer defined benefit plans have assets of more than \$3 trillion and distributed benefits over \$229 billion.

10. STUFF YOU DID NOT KNOW: If you were to spell out numbers, how far would you have to go until you would find the letter A? One thousand.

11. TODAY IN HISTORY: In 1949, Jewish population of Israel reaches 1,000,000.

12. KEEP THOSE CARDS AND LETTERS COMING: Several readers regularly supply us with suggestions or tips for newsletter items. Please feel free to send us or point us to matters you think would be of interest to our readers. Subject to editorial discretion, we may print them. Rest assured that we will not publish any names as referring sources.

13. PLEASE SHARE OUR NEWSLETTER: Our newsletter readership is not limited to the number of people who choose to enter a free subscription. Many pension board administrators provide hard copies in their meeting agenda. Other administrators forward the newsletter electronically to trustees. In any event, please tell those you feel may be interested that they can subscribe to their own free copy of the newsletter at <http://www.cypen.com/subscribe.htm>.

14. REMEMBER, YOU CAN NEVER OUTLIVE YOUR DEFINED RETIREMENT BENEFIT: AS A REMINDER OF THE ABOVE PRECEPT, THIS CAPTION WILL APPEAR IN ALL NEWSLETTERS GOING FORWARD. THE CAPTION SAYS IT ALL; NO SUB-TEXT IS

NECESSARY.

* * * * *

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