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CYPEN & CYPEN
NEWSLETTER
for
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Never Forget September 11, 2001
and
Always Remember May 2, 2011

1. CalPERS LOWERS INVESTMENT RETURN, DRAWS FIRE

FROM GOVERNOR: California Public Employees' Retirement System has adopted a policy gradually to reduce the amount that the pension fund expects from its investments, a decision that came under fire from California's governor for not going far enough. (Hey, Guv, no problem; just put in more than recommended.) The move by the nation's largest public pension fund is, according to Reuter's, controversial because lower investment returns must be offset by higher contributions from the state's cities and public workers. CalPERS will reduce its expected rate of investment returns in years after the fund outperforms its 7.5% target by 4 percentage points. The goal is ultimately to reduce the rate to 6.5%, although that reduction could take decades under the new policy. CalPERS, whose total assets are now approximately \$300 billion, lost roughly 39% of its value during the 2008 financial crisis. CalPERS paid \$18 billion in pension benefits last year, compared to \$13 billion in contributions.

2. CHICAGO CLAIMS PENSION OVERHAUL DELIVERS

BENEFITS, DESPITE CUTS: Lawyers attempted to convince the Illinois Supreme Court that Chicago's plan to save its pension program from insolvency does not violate the state Constitution's protection against reduced benefits, because it ensures there will be, for decades to come, money to keep those checks moving. According to the Associated Press, in the second public pension overhaul case

before the high court in eight months, the city's lawyers tried to differentiate arguments from a separate, landmark pension plan involving state-employee retirement funds that the same justices rejected. ([See C & C Newsletter for November 26, 2014, Item 2](#)).

They said shoring up the city's pension accounts trumps the benefit reductions of 75,000 city workers and retirees. Lawyers for employees contesting the law tried to link it directly to the state case, which was argued in March. The Supreme Court dumped that plan just a few months later, saying the state cannot cut into its \$111 billion pension-account shortfall by unilaterally reducing benefits -- a violation of the 1970 Constitution's pension protection clause. The state of Illinois and its largest city are not alone in struggling with how to cover the decades-old promises made to hundreds of thousands of public-sector workers. Statewide, cities have only 55% of the money they need to cover their obligations. The state Constitution prohibits a promised pension from being diminished or impaired. The bailout in question was a Legislature-endorsed plan from the spring of 2014, which reduces automatic annual pension increases while requiring a \$750 million city property-tax hike over five years to cut down a \$19.5 billion deficit in the next four decades. The employees' lawyers argued that Chicago is simply trying to poor-mouth its way around the constitutional guarantee, because, like the state, the city has shortchanged pensions for years. These are defined benefits that are insulated from the political winds that may blow from time to time. The funding mechanism for employer contributions simply has not met known fund obligations. Now the result is that disconnect is

intolerable, they just do not want to pay for the benefits.

3. IS PBGC DRIVING SPONSORS TO EXIT DB PLANS?: Following the debate and approval of the Bipartisan Budget Act, sponsors of defined benefit plans are facing the unsavory prospect, yet again, of dramatic increases in Pension Benefit and Guaranty Corporation default insurance premiums ([See C & C Newsletter for October 29, 2015, Item 5](#)). This newly programmed series of increases comes on top of the significant premium hikes plan sponsors have already had to absorb in recent years. Under the terms of the bipartisan budget accord, PBGC premiums are expected to reach up to \$78 by 2019, far higher than they were just a few years ago, and the increased cost has many sponsors looking, more and more desperately, for an exit strategy. The budget agreement provides that the single-employer fixed PBGC premium will be raised to \$68 for 2017, \$73 for 2018, and \$78 for 2019, and then re-indexed for inflation after that. The variable rate premium would continue to be indexed for inflation, but would be increased by an additional \$2 in 2017, and additional \$3 in 2018, and an additional \$3 in 2019.

4. SOUTH KOREAN PENSION FUND RANKS 3RD BY ASSETS: Yonhapnews.co.kr reports that South Korea's state-run national pension service's total assets reached US\$429.8 billion last year, ranking third among state pension operators in the world. Japan's government pension investment fund topped the list with \$1.14 trillion in assets, followed by Norway's government pension fund with \$884

billion. The report comes from Nation Pension Research Institute, which cited a survey on the top 300 pension funds. The aggregated assets of the 300 funds reached \$15.4 trillion at the end of 2014, up 3.4% from a year earlier, accounting for 43% of the world's total pension funds. The top 20 firms have invested 42.2% of their money in stocks, 39.5% in bonds and the remaining 18.3% in other assets.

5. WHY PENSIONS AND HEDGE FUNDS DO NOT MIX: Year in and year out, public pension managers invest in hedge funds that promise market beating returns. The New York *Times* says the stated aim is to narrow the gap between what the pensions have promised future retirees and the money available to meet those obligations. What happens instead is that the pension gaps remain, while the hedge funds gorge on fees. In one study, the American Federation of Teachers looked at hedge fund holdings in 11 large public pensions between 2002 and 2015, finding that hedge funds lagged overall plan performance in most years, costing an estimated \$8 billion in lost investment revenues. The hedge funds, meanwhile, collected some \$7.1 billion in fees, which averages out to 57 cents for every dollar the pensions kept on their hedge fund investments. In effect, the pensions were looted. One obvious question is why pension managers keep investing in hedge funds. A common explanation is that pension trustees are naïve, desperate and easily outfoxed by Wall Street salespeople. There are also signs, however, of willful blindness. The new analyses are only the latest to cast doubt on the benefits of hedge funds for big, long-term investors. In addition, the California

Public Employees' Retirement System announced last year that it was winding down its hedge fund holdings, because of their complexity and high costs. Other pensions have not taken CalPERS' cue. There are several reasons why hedge funds do not live up to their hype. One is rapid growth -- to \$3 trillion recently -- which means that one bad year can outweigh the gains in years when funds were smaller.

Another is flattering performance that exclude poor performers and emphasize hot newcomers. The biggest hit to returns is layers of fees, typically 2% of assets under management, plus 20% of any gains -- for starters. Rosy promises about hedge fund returns can hurt pension plans in another important way, by giving politicians cover for not making full and timely contributions to troubled plans. Projections from pension plan managers that high-octane hedge funds can make up for any gaps relieves the pressure on delinquent politicians to make the required contributions. The end result is poorer pensions and richer hedge funds. The victims are the public employees who are counting on their pensions for a secure old age. Maybe.

6. FLORIDA REPUBLICANS AGAIN WANT TO CLOSE PUBLIC PENSION SYSTEM TO NEW MEMBERS!: Florida Republicans once again are taking aim at the Florida Retirement System, arguing taxpayers can save billions of dollars by closing the huge public employee pension program to new members, and offering them a 401(k)-style investment plan. The proposal, according to *Naples Daily News*, which is expected to be offered by House members in the coming legislative session, would preserve line-of-duty death benefits

for law enforcement officers and firefighters, a move designed to appease lawmakers from both sides of the political aisle, who have opposed the idea in the past. The state retirement system serves 621,000 Florida schoolteachers, firefighters, sheriff's office workers and employees across the state's 32 executive agencies. Another 346,000 are receiving benefits in retirement, according to a senate bill analysis performed in June of this year. Query: if the defined compensation model is so great, why not leave the existing investment plan portion as an option, as it has been for about 20 years? To ask the question, is to answer it. House Bill 87 has been filed by Representative Mike Hill, Republican from Pensacola. The Bill has Senate companion, SB 7012.

7. CalPERS' HIDDEN PRIVATE EQUITY FEES EQUAL \$3.4

BILLION: The largest U.S. pension fund said it has paid \$3.4 billion in performance fees to private equity managers since 1990, doling out about \$700 million in the past year alone. According to the *Wall Street Journal*, the California Public Employees Retirement System, disclosed its performance related expenses for the first time.

CalPERS said those performance fees were based on returns of \$24.2 billion since 1990 and \$4.1 billion for the year ending June 30, 2015. For years, pension funds have failed to either ask or disclose how much private equity firms kept in performance fees, which are the biggest source of profits for outside money managers. Scrutiny to provide such detail on private equity costs has escalated in recent months, as CalPERS and other public pension funds look to reduce

the number of outside managers they partner with and investment profits they have to share with them. CalPERS has asset of around \$295 billion, according to its most recent disclosure. Private equity firms by companies using money from pension funds and other investors, hoping to earn more in a sale of public offering later on. They typically charge clients a management fee of 1% to 2% of assets and performance fee of about 20% of the gains when they sell companies for a profit. CalPERS has about 10% of its portfolio, \$28.7 billion, invested with private equity firms. CalPERS has investments with more than 700 private equity funds, and works with some of the biggest names in the industry, including Blackstone Group, L.P. and Carlyle Group, L.P. Private equity is CalPERS' top performing asset, producing returns of 11.9% over the past decade.

8. EQUITIES MAKING A COMEBACK: Equities have found renewed favor with advisors, who are taking advantage of stocks perceived as undervalued, according to onwallstreet.com. Advisors reported that U.S. equity allocations reached a level not seen since January, 2015. Allocations to global equities also rose slightly. Advisors continued to shy away bonds, with many citing uncertainty over the Federal Reserve's intentions to raise rates. Several managers said they took advantage of great bargains, as some equities were mispriced. In explaining the move to U.S. equities, one financial planner cited increased consumer confidence, resulting from lower energy prices, better wages and employment opportunities. Another said the U.S. market seems to offer more stable investment opportunities. Several

advisors saw buying opportunities in international markets, with many pointing to lower valuations relative to U.S. equities. The global, non-U.S. market seems to be on sale right now. Several advisors reported that some clients were still reluctant to take advantage of perceived opportunities due to persistent fears of global turmoil, particularly Middle East unrest and China's economic slowdown. What to do? What to do?

9. SPECIAL IDENTITY THEFT TAX TIPS: Internal Revenue Service, state revenue departments and the tax industry have released the first in a series of special tax tips designed to provide people critical information to help protect their tax and financial data. The first of the Security Awareness Tax Tip series provides seven ways people can protect their computers, which takes on added importance as people prepare for the holidays, and the 2016 tax season approaches. A new tip will be available each Monday through the start of the tax season in January. (If we happen to catch them, we will print them here.) You can also subscribe directly at <https://www.irs.gov/uac/Subscribe-to-IRS-Tax-Tips-1>. In coming weeks, the tax tips will touch on key topics, such as ongoing phishing schemes and aggressive phone scammers posing as IRS officials. Other tips will discuss the importance of protecting sensitive paper and electronic tax records, as well as watching out for friends and family who do not keep their computer's software security updated. The first of the series is available at: <https://www.youtube.com/watch?v=aMH8TBeA4IE>. IR-2015-132 (November 23, 2015).

10. ISS RELEASES 2016 BENCHMARK POLICY UPDATES:

International Shareholders Services, a provider of corporate governance solutions to the global financial community, has released 2016 updates to its benchmark proxy voting policies. The updated policies will generally be applied for shareholder meetings on or after February 1, 2016. To ensure its voting policies take into consideration the views of its institutional clients, as well as the perspectives of the broader corporate governance community, ISS gathers input each year from institutional investors, issuers and other market constituents worldwide, through a variety of channels and mediums. Key US benchmark policy changes include that ISS is changing its director overboarding policy. For most directors except for standing CEOs, the maximum number of public company boards that a director can sit on before being considered “overboarded” is being reduced from six to five. There will be a one-year grace period until 2017, giving directors and companies sufficient time to make any changes in advance of the 2017 proxy season, should they wish to do so. During 2016, ISS research reports will highlight if a director is on more than five public company boards, but adverse voting recommendations will not be issued under this new overboarding policy unless the current maximum of six boards is exceeded. For CEOs, the current overboarding limit will remain at two outside directorships. With regard to board actions that significantly reduce shareholder rights without approval by shareholders (so-called unilateral board actions), ISS’s U.S. benchmark policy is being updated to distinguish between (1)

unilateral board adoptions of bylaw or charter provisions made prior to or in connection with a company's initial public offering and (2) unilateral board amendments to those documents made after a company's IPO. On executive pay and transparency, ISS's U.S. "Problematic Pay Practice" policy will be updated to add "Insufficient Executive Compensation Disclosure by Externally Managed Issuers" to the list of practices that may result in an adverse voting recommendation on executive compensation. The practice will apply when an EMI fails to provide sufficient disclosure to enable shareholders to make a reasonable assessment of compensation arrangements for the EMI's named executive officers.

11. TROOPS WILL HAVE TOUGH RETIREMENT CHOICES: In the coming days, President Obama will sign legislation putting into motion a massive military retirement overhaul that will affect the personal finances of hundreds of thousands of service members for decades to come. ([See C & C Newsletter for November 12, 2015, Item 3](#)). Just not right away, according to militarytimes.com. Defense officials still have dozens of details to work out with the new system, and the first individuals to feel the impact likely have not enlisted yet. The new retirement plan, included in the 2016 defense authorization bill expected to be signed into law by the president, represents not only a dramatic shift in the government's approach to recognizing troops' service, but also a shift toward bringing Defense Department benefits more in line with private-sector offerings. In contrast to the longstanding current system that reserves pension payouts for troops

who serve at least 20 years in uniform, the new blended plan would give troops who serve as little as two years some retirement benefits through vested 401(k)-style investments in their Thrift Savings Plan accounts. Today, about one in five service members sees any retirement pay. Under the new plan, officials estimate, about four in five will leave the military with some level of retirement savings.

12. ON SECOND THOUGHT...MAYBE THEY WERE WRONG?:

When the Paris Exhibition of 1878 closes, electric light will close with it and no more will be heard of it. – Oxford professor Erasmus Wilson.

13. TODAY IN HISTORY: In 1867, Alfred Nobel patents dynamite.

14. 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.

15. 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>.

**16. REMEMBER, YOU CAN NEVER OUTLIVE YOUR DEFINED
RETIREMENT BENEFIT.**

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