



# CYPEN & CYPEN NEWSLETTER for June 11, 2020

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Never Forget September 11, 2001  
and  
Always Remember May 2, 2011

## **1. SUPREME COURT RULES PENSIONERS IN FULLY FUNDED PLANS CAN'T SERVE ERISA SUITS:**

*Plaintiffs charging mismanagement of funds would have received the same fixed payment regardless of investment outcomes, the ruling said.*

Beneficiaries cannot sue fully funded pension plans for losing money on investments, the Supreme Court ruled. The decision settled a seven-year Employee Retirement Income Security Act (ERISA) case for defined benefit plans. Because plan participants James Thole and Sherry Smith would receive the same defined benefit payment from US Bancorp Pension Plan regardless of the fund's value or its investment outcomes, the plaintiffs lacked standing in their case, the ruling said.

In other words, the plan beneficiaries had no “concrete stake” in the *Thole v. US Bank* lawsuit, according to a 5-4 majority opinion led by Justice Brett Kavanaugh. Courts have ruled in the past that pension funds must cause harm to beneficiaries, meaning they can’t pay their obligations, in order to violate their fiduciary duties. But in a dissenting opinion, Justice Sonia Sotomayor wrote that the nation’s highest court had erroneously determined that pensioners cannot bring an ERISA suit against pension mismanagement unless the plans are on the brink of collapse.

She wrote, “the Constitution prevents millions of pensioners from enforcing their rights to prudent and loyal management of their retirement trusts.” And noted, “The court does not explain how the pension could satisfy its monthly obligation if, as petitioners allege, the plan fiduciaries drain the pool from which petitioners’ fixed income streams flow.”

When they first filed their complaint in 2013, Thole and Sherry argued that the US Bancorp Pension Plan violated its fiduciary duty when it invested all the fund’s assets in high-risk equities, which lost the fund \$748 million during the Great Recession and caused its funded ratio to drop to about 84%. Soon afterward, however, US Bancorp contributed \$339 million to fully fund the plan again at 115%, with \$86 billion in assets under management.

Prior to making its way to the Supreme Court, the lawsuit was picked over in a lower court and the 8th US Circuit Court of Appeals, which determined that the now-stable pension plan negated any losses. The Supreme Court didn’t accept this reasoning as sufficient to toss out the lawsuit until this ruling. “The decision, though a narrow one, seems likely to forestall any number of potential fiduciary breach suits, if only because it limits the circumstances under which workers and retirees can sue,” according to the American Society of Pension Professionals and Actuaries. Sarah Min, Chief Investment Officer, [www.ai-cio.com](http://www.ai-cio.com), June 1, 2020.

## **2. ARE PUBLIC PENSIONS DOOMED BECAUSE OF THE CORONAVIRUS PANDEMIC? STATE, LOCAL BUDGETS FEEL PAIN:**

Corey Shelton, an eighth grade science teacher in Jackson, Michigan, has earned a pension after more than 20 years on the job, but now he’s concerned that the economic devastation from the coronavirus pandemic will threaten the monthly checks he’s been counting on to fund his retirement. “We’re riding the first wave of a financial tsunami,” says Shelton, 43, who expects to retire in four years. “We don’t know the financial devastation that’s going to come out of this.”

Before this crisis even began, state pension plans across the country were already more

than \$1 trillion short of the funding needed to pay their future obligations to retirees, according to retirement experts at The Pew Charitable Trusts. Pensions typically receive funding from employer contributions that are invested in a wide range of assets, including stocks and bonds. Gains from those investments are designed to help reduce the amount the employer needs to add to the pension fund to make future payments to retirees. Now, with stocks well below recent highs and state and local government budgets crunched due to the coronavirus, public pensions are suddenly at risk of even greater shortfalls.

Facing an immediate gap in state revenue of \$650 billion over the next three years, according to the Center on Budget and Policy Priorities, officials may postpone pension contributions and slash future benefits for teachers, police officers, firefighters and state workers. At the same time, the risk of bankruptcy has suddenly jumped for cash-strapped cities and counties throughout the country, raising the prospect of pension cuts for current retirees, like what happened after [the City of Detroit filed for Chapter 9 bankruptcy in 2013](#).

After U.S. Senate Majority Leader Mitch McConnell [floated the possibility of allowing states to file for bankruptcy](#) instead of providing them money to plug their budget deficits, state government retirees voiced concerns that such a process could jeopardize their pensions, too (see Item No. 2 in our [April 30, 2020 Newsletter](#)).

When Arlene Buckley of New Jersey heard McConnell had proposed that option, she immediately feared the worst. “That’s going to be horrendous for us if that happens,” says Buckley, who has been collecting a state pension for 18 years since retiring from Rutgers University at 57. “It makes me very nervous.” While only 13% of private-sector workers have a pension, 77% of state-and-local government workers have one, [according to the Pension Rights Center](#).

State and local pension funds made up 19% of Americans' retirement assets as of the third quarter of 2017, according to the Urban Institute. More than 14 million Americans had a state or local government pension with a median annual pension of \$17,894 as of 2017, says the Pension Rights Center.

McConnell's comments came as lawmakers in Washington are debating whether to provide aid to state and local governments in their next coronavirus stimulus bill. House Speaker Nancy Pelosi, a Democrat, has proposed sending hundreds of billions to states to help cover their COVID-19 losses. While experts say that state bankruptcy is extremely unlikely due to constitutional law and political realities, the double-barreled crisis of market declines and budget deficits is expected to place additional pressure on states to make

difficult decisions in the months and years ahead.

The value of public pension funds fell by a median of 13.2% in the first quarter, compared with a year earlier, according to the Wilshire Trust Universe Comparison Service. That made for the worst quarter in the four decades since Wilshire TUCS began tracking the data. Although the market has recovered some of those losses since then, pension funds are still in crisis mode. Public pensions are at risk of their first full-year loss since 2009, says Greg Mennis, director of Pew Charitable Trusts' work on public sector retirement systems.

In addition to investment earnings, governments fund their pensions by making annual payments based on estimates of long-term investment performance and when pension recipients will likely die. State and local pension plans would fall from 71% funded in the 2019 fiscal year to 62.7% in 2025 with a faster market recovery or 55.5% with a slower recovery, the Center for Retirement Research at Boston College estimated in a May 2020 report. Experts say that the drop in revenue for state and local governments due to a decline in sources such as income taxes and sales taxes is likely to lead them to postpone contributions that could further hobble pension funds that were already shaky before this crisis began.

“We’re now in that phase of ‘what are we going to do to balance our budgets?’” says Teryn Zmuda, chief economist for the Washington, D.C.-based National Association of Counties, a group that represents the interest of counties. Governments will likely rely heavily on “gimmicks” to balance their budgets in the current situation, including short-term borrowing to cover deficits, drawing heavily on reserves, deferring certain costs until the next fiscal year or even extending the fiscal year, predicts Matt Fabian, partner at Municipal Market Analytics, which provides information on the health of municipalities and their debt. “It worsens the long-term situation” for pensions, Fabian says.

Budget gimmicks are already happening, he says. For example, the state of New Jersey has already extended the end of its fiscal year from June 30 to Sept. 30 after the federal government extended its tax filing deadline to July 15, which affects state income tax receipts, whose revenue helps fund pensions. One strategy governments could take to fix their pension problems is to switch future workers from pensions to 401(k)-style plans. But that won’t help them address current payment obligations tied to existing pension commitments, experts say.

Fabian says more governments may consider issuing pension bonds, which is the equivalent of borrowing to pay the bills by adding future liabilities to pay current debts. In

the early going of the pandemic, Riverside, California, issued about \$727 million in pension obligation bonds to reduce its pension liabilities. A form of pension bonds played a key role in tipping Detroit into bankruptcy, in part, because the city could not afford the interest payments on the debt when its finances collapsed.

Pension funds in states like Illinois, New Jersey and Kentucky are in particularly rough shape, while cities like Chicago and Dallas have faced steep pension shortfalls for years. For state and local governments, the current economic crisis is wide-reaching. They are swamped by a sudden spike in public health costs, uncertainty about property tax collection in a bad economy, an abrupt decline in sales and income taxes, a drop in fee collection and a decline in pension assets.

On average, state and local governments typically spent about 6% to 7% of their budget on pension contributions before the pandemic, though it varied up to about 20% in cash-strapped governments, Pew's Mennis says. Those obligations are poised to increase due to the pandemic, as revenue is expected to decline while pension obligations persist. "It is going to absolutely increase the amount of money that state and local governments are going to have to put in or contribute to their pension plans," says Tom Kozlik, head of municipal strategy and credit for Hilltop Securities. That could "take money away from other things" because governments are legally obligated to fund pensions at certain levels. That doesn't necessarily mean states and cities will fail to send pension checks on time and in full to retirees. At least for now, "pension insolvency risk is low," says Jim Van Horn, a bankruptcy attorney for Indianapolis-based Barnes & Thornburg. But "it stands to reason that states and cities will face difficult choices in terms of meeting their pension funding requirements without reducing resources for core government services."

The National Association of Counties and other municipal funding advocates are calling on Washington to step in to help plug budget shortfalls caused by the pandemic. "This is a critical need," Zmuda says. "It's a human need, it's serving residents, it's keeping people healthy, it's ensuring that people can keep their livelihoods and their jobs." Buckley, the Rutgers retiree and a resident of North Brunswick, New Jersey, says politicians need to keep the pension promises they made to retirees. "I feel like I earned this, and I shouldn't have to take a cut because I think you should be managing the money I paid in taxes in a proper way," she says. Shelton, the Michigan teacher, was appalled at the prospect of allowing states to file for bankruptcy to reduce their pension obligations. "It's insulting that the federal government can bail out banks and GM and airlines and cruise lines with a multi-trillion dollar bailout, but with a single news conference Mitch McConnell flippantly tells states that they can file bankruptcy and take it out on the middle class again," Shelton says. He is worried that bankruptcy would translate into pension cuts.

In Shelton's state, as in dozens of others, public pensions are legally protected from cuts. But those protections have crumbled in bankruptcy cases like Detroit, where a judge ruled that pensions are contracts that can be cut under the bankruptcy process. "All bets are off and my pension is now on a table" if bankruptcy becomes a reality for states, Shelton says. To be sure, experts say that the prospect of bankruptcy for the states is extremely unlikely because Democrats, who oppose such a plan, control the House of Representatives and because state bankruptcy likely violates the U.S. Constitution. "It's a scary thing that doesn't really exist," Fabian says.

But municipal bankruptcy is a different story. The federal government allows cities, counties and other local government entities to file for Chapter 9 bankruptcy if they obtain advance approval from state governments. If states don't get any or enough federal aid to plug their pandemic-caused shortfalls, they will likely cut back on revenue sharing with cities and counties, which need the cash to keep operating without massive deficits of their own, Fabian says.

"It is a fair expectation that we'll see more city bankruptcies and more payment defaults than we've seen before in the next few years," Fabian says. Yet filing for municipal bankruptcy won't necessarily solve the budget crisis for local governments given that their imminent challenge is a shortfall in revenue, Kozlik says. Bankruptcy is designed to slash debt, not boost income.

Shelton says Washington needs to take action to help state and local governments preserve pensions. "Nobody's downplaying the seriousness, but don't tell me you can give Carnival Cruise Line and JetBlue billions of dollars but we won't give you what we promised you for 30 years of service," Shelton said. Kozlik predicted that Congress would eventually provide hundreds of billions in aid. "State and local governments are on the front lines of this health crisis," he said. "I don't see how now could be the time to limit aid or relief for the entities that are on the front line. This is really a time where they're going to need more resources, not less." Nathan Bomey, USA TODAY, June 4, 2020.

### **3. LOW FUNDED PUBLIC PENSIONS MIGHT NOT SURVIVE THE DECADE:**

*Market downturn could be the final straw for struggling public pension plans.* This year's market downturn could end up being the death knell for struggling public pension plans which, after failing to replenish their funded levels in the decade since the financial crisis, might not survive to see the next decade. "Given that the aggregate funded status of public plans has remained virtually unchanged since the last financial crisis, this downturn is a serious step backwards in their funding progress," said a [report](#) from the Center for

Retirement Research at Boston College and the Center for State and Local Government Excellence.

The report said that if the markets maintain their current level, most public pension plans will close out fiscal 2020 with negative annual investment returns, reduced asset values, lower funded ratios, and higher actuarial costs. Although projections suggest that plan finances will continue to deteriorate in the aftermath of the downturn, the report says that plans “on the whole” should persevere and maintain sufficient assets from which to pay benefits. However, this does not include plans with extremely low funded ratios, some of which face an increased risk of depleting their assets and the high cost of “pay-go funding” if they do, the report said.

To determine how plans might manage in the wake of the downturn, the report used projections from 2020 to 2025 under two possible market scenarios. The first scenario assumes markets remain at current levels until June 2021 and then steadily climb to their previous peak by 2023. And, from that point on, plans would achieve their assumed rate of return of approximately 7.2%. The second scenario assumes a more pessimistic forecast with markets remaining at current levels until June 2021 but taking longer to recover, with markets not reaching their previous peak until 2025.

Under the first scenario, the aggregate funded status of public plans would decline to 62.7% in 2025, and the actuarially determined contribution would rise to 25.1% of pay. But under the more pessimistic scenario, the funded ratio would fall to 55.5% while required contributions would surge to 29.1% of pay. Additionally, the average ratio of assets to benefits, which is a rough gauge for the health of a trust fund, would decline to 9.4 or 7.9 in 2025 from 11.6 in 2020. This means that, in 2025, public pensions would have assets equal to an estimated eight or nine years of benefits.

The report said plans can maintain asset levels if annual investment returns exceed their cash flow, and that the projections show that cash flows fall to negative 3.8% or negative 4.5% in 2025 from negative 3% of assets. “Given these relatively attainable thresholds,” the report said, “no plans are projected to exhaust their trust fund within the next five years.” However, remaining solvent over the next five years isn’t exactly reassuring for pension plans and their decades-long time horizons.

Under a slower market recovery, as in the case of the second scenario, the average estimated funded ratio for the 20 worst-funded plans in the report’s sample would be 38.3% in 2020, falling to 32.2% in 2025, according to the report. And six of the plans-- Charleston (West Virginia) Fire, Dallas Police and Fire, Chicago Municipal, Chicago

Police, Chicago Teachers, and New Jersey Teachers--would see their funded ratios dwindle to 25% or less.

The average funded ratio for the 20 worst-funded plans is projected to decline to 4.5 in 2025 from 5.9 in 2020, which means that in 2025 they will have assets equal to less than five years of benefits. And Chicago Municipal, Dallas Police and Fire, and New Jersey Teachers would see their asset-to-benefit ratios erode even further to less than two years of benefit payments by 2025. "These sobering statistics highlight the precarious position of the worst-off plans," the report said. Michael Katz, Chief Investment Officer, [www.aicfo.com](http://www.aicfo.com), June 2, 2020.

#### **4. STATES FACING PUBLIC PENSION CRISIS NATIONWIDE:**

States nationwide are facing a pension crisis that existed well before the coronavirus economic shutdown ever hit, according to independent reviews of state budgets. "Politicians and fund administrators everywhere wasted the reform potential of an 11-year bull market," Steven Malaga wrote in an [analysis](#) of pensions published by the *Wall Street Journal*.

For the past [several months](#), politicians from blue states have been asking for more federal relief while legislators from red states argue taxpayers shouldn't have to bail them out. Economists note that deteriorating state economies existed even before the Great Recession of 2007 to 2009.

According to a December 2019 report published by [Pew Charitable Trusts](#), state and local public employee retirement systems manage over \$4.3 trillion in public pension fund investments, with returns on assets accounting for more than 60 cents on every dollar available to pay promised benefits. "About three-quarters of these assets are held in what are often called risky assets - stocks and alternative investments, including private equities, hedge funds, real estate, and commodities," according to the report.

Research by The Pew Charitable Trusts indicates that since the Great Recession, public pension plans lowered return targets in response to changes in the long-term outlook for financial markets. Pew's database includes the 73 largest state-sponsored pension funds that collectively manage 95 percent of all investments for state retirement systems. The average assumed return for these funds was 7.3 percent in 2017, down from over 7.5 percent in 2016 and 8 percent in 2007 just before the downturn began, Pew notes.

After the Great Recession, John Locke Foundation President John Hood argued that state leaders were entirely responsible for their own states' budget crises. If states "are to have

any hope of avoiding the twin nightmares of default and a federal bailout, governors and legislators must get serious about changing their ways,” Hood wrote.

The “fiscal calamity” state leaders found themselves in predated the previous economic slump before the Great Depression ever hit, Hood added.

“Their shaky financial foundations were in fact set long ago - through unsustainable obligations like retirement benefits for public employees, excessive borrowing, and deferred maintenance of public buildings and infrastructure,” he said. “The result has been a long-building budget imbalance now estimated in the trillions of dollars.”

Numerous economic reports point to similar state budget patterns prior to the coronavirus shutdown. In several analyses published by the nonprofit educational organization Truth in Accounting (TIA), most state budgets indicated that elected officials’ repeated financial decisions created significant debt burdens for their residents, and these states’ “financial problems stem mostly from unfunded retirement obligations that have accumulated over the years.”

“Looking across the 50 states, the tendency is, blue states tend to be in worse financial shape, mainly because of poorly funded, promised retirement benefits. It’s ironic but illuminating that this is the tendency, despite (or because of) the fact that blue states tend to have stronger unions, including in the government workforce,” Bill Bergman, director of research at TIA, told The Center Square. “There are exceptions at both ends of the scale,” Bergman adds. “States like Kentucky, Alabama and Louisiana are in worse shape than you might expect, given their ‘red’ state rankings, while states like Oregon, Minnesota and Iowa are in better shape despite where they rank on ‘blueishness.’

“But the general tendency is a strong one. Blue states tend to be in worse shape.” Chris Edwards, an economist at the Cato Institute, added that, “in addition to unfunded pension plans, state and local governments have trillions of dollars of bond debt and unfunded worker retirement health costs,” that add to their financial malaise. When the economy picks up again, Edwards says that state leaders should “start running consistent surpluses and use those funds to pay down debts and obligations and to build up state rainy day accounts.” In order to be ready for the next economic downturn, states should prioritize “paying down debts and putting aside money when times are good, just as responsible households do,” Edwards adds. Bethany Blankley, The Center Square, [www.thecentersquare.com](http://www.thecentersquare.com), June 3, 2020.

## **5. PLAINTIFFS’ ATTORNEYS; LEAVING PENSION POLICING SOLELY TO DOL WON’T WORK:**

In the hours that have elapsed since a divided U.S. Supreme Court published its opinion in the long-running case known as *Thole v. U.S. Bank*, two clear camps have emerged of attorneys providing early commentary about the outcome. As one might expect, given the fact that the Supreme Court ruling sides with the defendants in effectively declaring that pension plan participants cannot sue their employer under the Employee Retirement Income Security Act (ERISA) for fiduciary violations when their own benefit has not been cut or altered, those attorneys who work on fighting such claims hailed the ruling as a commonsense victory.

For example, Brian Netter, co-leader of Mayer Brown's ERISA litigation practice, says that in recent years, courts have been "swamped by lawsuits alleging that retirement plan fiduciaries breached their duties." "It's one thing when the plaintiffs filing the lawsuit have a stake in the outcome, but lawsuits by disinterested plaintiffs don't belong in federal court," he says. "The Supreme Court confirmed that the basic rules of Article III standing apply in the context of ERISA lawsuits, too."

Also on the pro-ruling side stands the American Benefits Council, which describes itself as a public policy organization whose members include more than 220 of the world's largest corporations that sponsor health and retirement benefit plans. "The American Benefits Council is delighted to learn that the U.S. Supreme Court's June 1 decision in *Thole v. U.S. Bank* followed the recommendations made in its November 2019 amicus brief filed with other employer groups," says Lynn Dudley, the council's senior vice president for global retirement and compensation policy. "A decision in favor of the plaintiffs could have opened the floodgates to lawsuits challenging particular investments in defined benefit [DB] plans-similar to lawsuits often filed against defined contribution [DC] plans-even though the benefits of the participants are not affected."

Netter and Dudley highlight the portion of the ruling that states that the employer, not plan participants, receives any surplus left over after all the benefits are paid. By the same token, they say, the employer, not plan participants, is on the hook for plan shortfalls. On the other side of the debate stand consumer advocates and the plaintiffs' attorneys who argue for employees in such cases.

Michael Joyce, Saul Ewing Arnstein & Lehr employee benefits and ERISA litigation partner, suggests the opinion "pushes the ability of participants in a defined benefit pension to file suit practically to extinction." "The Supreme Court technically left open an avenue for individual pension plan participants to file a claim on behalf of the plan even before their own benefit is cut, but their demand that any fiduciary breaches or mismanagement be outrageous and egregious makes the filing of suit nearly impossible in

practical terms,” Joyce says. “Even if a participant can show that there is such bad management going on that future insolvency is likely, which would put their benefits in jeopardy, the plaintiff would have to tackle the issue raised in footnote two in the ruling, which states that participants’ benefits are insured by the Pension Benefit Guaranty Corporation [PBGC]. It seems like the majority on the court feels that is sufficient to prevent standing, as well.”

Joyce says he is skeptical of the majority ruling’s statement that the Department of Labor (DOL) can adequately police fiduciary breaches among the nation’s many thousands of pension plans. “To me that is almost a comical position, because we all know that the plan participants and their counsel are really the watchdogs in this industry,” Joyce says. “They have the biggest stake and they care the most about what is happening to their plans. I think everyone would agree that, even if individual participants are still getting their monthly payments, they still a very direct interest in making sure their money is being handled appropriately.” To be clear, Joyce says, the Department of Labor can be a very effective and convincing litigator. The problem is more about scale and resources.

“I have dealt with the DOL in ERISA cases, and I can say confidently that when they bring a case, they really fight hard and do a good job,” Joyce says. “But there is just no way the DOL alone can police all the thousands of plans and the millions of participants.” John Manganaro, *Planadviser*, [www.planadviser.com](http://www.planadviser.com), June 2, 2020.

#### **6. “TRIAGE PLAN” AT INDIANA SYSTEM HELPED STEM LOSSES:**

After benchmark-topping net performance of 16.7% in 2019, Scott Davis, chief investment officer of Indiana Public Retirement System, Indianapolis, warned trustees during a Feb. 21, 2020 meeting "this might not last." His words proved prescient. "Coming into January, every asset class was up, and the portfolio was firing on all cylinders," Mr. Davis said in an interview. By the close of the quarter ended March 31, the impact on global markets of the COVID-19 pandemic resulted in a 9% asset decline in INPRS' defined benefit plan pooled portfolio to \$29 billion compared to Dec. 31. The net return of the plan was down 8.4% compared to the fund's benchmark return of -9.1%.

In fact, Mr. Davis said "performance was as expected" given the magnitude of the market draw-down. He said the "triage plan," which features low equity exposure as well as substantial asset class diversity and a high level of liquidity protected the fund from higher losses during the treacherous depths of the coronavirus-induced market decline. The asset allocation as of March 31 was 19.7% public equity, 19.2% fixed income (ex-inflation-linked), 13.7% private markets, 12.4% risk parity, 11.3% absolute return, 7.5% inflation-linked fixed income, 7.2% real estate, 5.9% commodities and 3.1% cash and overlay. "Our

three main imperatives are achieving our 6.75% long-term assumed rate of return, efficient management of the portfolio and always making sure we have enough cash on hand to pay the bills," Mr. Davis said. Mr. Davis and the investment team have been remotely managing the pension plan and \$112 million in non-retirement-related funds pool as well as overseeing investment options for the system's \$5.6 billion defined contribution plan without a hitch.

The DB portfolio benefited from continued employer contributions that are required by law until the plan reaches 105% funding. That inflow provided financial strength to the DB portfolio, Mr. Davis said. As of March 31, INPRS had sufficient liquidity to cover four months of retirement payments even if an employer was late in making the required contribution. INPRS implemented a cash overlay program a few years ago "specifically to help the investment staff manage through a liquidity crisis like this one. It really works for us," Mr. Davis said, noting the DB plan has close to \$16 billion in liquid assets.

INPRS staff tends to keep asset class weightings in the DB portfolio close to their targets and rebalanced halfway back to target levels after the equity sell-off in March by buying equities and commodities that month using futures, "which are much cheaper and faster for rebalancing than buying securities," Mr. Davis said. Given the fund's substantial liquidity, Mr. Davis said the system's investment team is "really focused on taking advantage of investment opportunities, primarily in private equity, private credit and private real estate. We're known as an investor that can act very quickly on opportunities and are getting a lot of incoming calls."

In just one week, the private markets team fielded 150 incoming phone solicitations from cash-hungry alternative investment firm marketers. Mr. Davis declined to name names, but INPRS has maintained its flow of commitments to new alternative investment strategies. Christine Williamson, *Pension & Investments*, [www.pionline.com](http://www.pionline.com), June 4, 2020.

## **7. RETHINKING PORTFOLIO STRATEGIES FOR DB PLANS:**

Providers that work with defined benefit (DB) plans are expecting a period of prolonged volatility caused by the COVID-19 pandemic. DB plan sponsors put a lot of effort into addressing two factors when investing: managing interest rate risk and generating returns to improve funded status. What strategies should plan sponsors consider for reaching their goals in the new market environment?

A [Willis Towers Watson Insights article](#) suggests that a well-designed interest rate hedging strategy "can protect against the plausible scenario under which interest rates fall

(and bonds become more expensive) into unprecedented territory, and remain there for a long time.” Jon Pliner, senior director, investments and U.S. head of delegated portfolio management, Willis Towers Watson in New York City, says there is still a lot of risk interest rates could fall and, with actions the Fed is taking in this economy, “we are not likely to see an increase in interest rates.”

Mike Moran, senior pension strategist at Goldman Sachs Asset Management in New York City, says that following the market volatility in March and April, clients are thinking about hedging their liabilities. He notes that long government bonds have worked well for DB plan sponsors as they move along their liability-driven investing (LDI) glide path, but with rates falling so much now, clients are wondering whether to shift to credit investments. “We would highlight intermediate credit as a place to look,” Moran says.

In commentary, Tom Meyers, executive director and head of Americas client solutions for Aviva Investors in Chicago, notes that in 2009, LDI investors were rewarded for tactically allocating away from Treasuries into corporate bonds and Aviva is seeing action in that direction right now. “Similar to the post financial crisis environment, an exposure to Treasuries successfully played its part in mitigating volatility. Now might be the appropriate time to, once again, increase long credit allocations for corporate DB plans,” he says.

Meyers notes that a review of the U.S. Long Credit Index over the past roughly 50 years has shown considerable reward for allocating to U.S. long credit following episodes of dramatic price declines. Kevin McLaughlin, head of liability risk management at Insight Investment in New York City, says his firm considers two ways to address low interest rates. He explains that DB plan sponsors can set a “floor” at which the portfolio is protected if rates drop lower. “Rather than hedging at current low levels, have a floor and be able to lift off hedges as rates rise,” McLaughlin says.

“Many plans have funded status triggers at which time they buy more fixed income,” he continues. “They may need to think beyond funded status triggers and use market-based triggers as well.” So, if Treasuries reach a certain level, plan sponsors can consider increasing their hedge. McLaughlin adds that it should not be an all-or-nothing decision when to hedge-consider what a plan sponsor would do if interest rates rise then subsequently fall back. “If plan sponsors review their triggers, they’ll find the likelihood of reaching them is lower. Also, interest rates used in funding calculations are range-bound right now, so they need to think about how to manage triggers in that context. Sell hedges when rates are high and buy them when they are low,” McLaughlin says.

Moran says clients are also thinking about generating returns to cover benefit accruals and make up for increased deficits following the market fall. But how can a DB plan portfolio generate returns when bond yields are so low? He says while DB plan sponsors have had a 10% nominal return target, they need to think about how to get to 6% or 7%. They should consider alternative asset classes again, the opportunity in private markets and, where there has been a move to passive strategies, now is a good time to think of active strategies again.

Pliner says diversification is important because it is unknown which way the market will move. "Don't just buy equities but a diverse range of assets with different return patterns in different economic environments," he says. DB plan sponsors should add protection strategies where they make sense, Pliner adds. "Options became sensitive as volatility spiked, so they may not be attractive. Plan sponsors should look for attractive opportunities to hedge out risks. Investments with low beta and convex return structures may do well when the rest of the portfolio is not," he explains.

If a DB plan portfolio moved more into fixed income based on a funded status trigger right before the market crash, Moran says sponsors should consider rebalancing. "We don't consider that re-risking, just getting back to strategic targets." However, he suggests plan sponsors don't just rebalance tactically, but move more into equity, which is re-risking. "Should [plan sponsors] re-risk as funded status falls? For the majority of our clients, the glide path is a one-way street, but they should consider what else is going on with the plan," Moran says. "For example, if the plan is closed or frozen and large, re-risking doesn't make sense. But for smaller plans or those with new benefits accruing, if they have the capacity to take on more volatility, they should consider re-risking."

Private market investments have been an increasingly popular place for DB plan sponsors to go to generate returns, and, Moran says, they still are for those plans that are open and accruing benefits. He cautions those plan sponsors with a goal of getting out of the DB business to not sign up for one with a 10- to 15-year life. He adds that he's also had more conversations lately about hedge funds than he has in the past few years. "It's a matter of working on the right playbook in this market. Look at some asset classes you haven't invested in recently or never have," Moran says.

Hedge funds are used for protection on the equity side. But, in the past couple of years, as plan sponsors developed their equity risk mitigation strategies, they have been trying to shrink the distribution of outcomes, Moran says. Plans may consider lower beta stocks, higher dividend paying stocks, more options-based strategies and interacting in a more systematic way with public equity holdings. McLaughlin says his advice is to consider tail

risk hedges. Tail risk is an extreme shock to financial markets that shows up as infrequent observations in the far left tail of a return distribution. It is technically defined as an investment that moves more than three standard deviations from the mean of a normal distribution of investment returns.

Tail risk hedging was a great concern following the 2008-2009 financial crisis. Institutional investors surveyed in 2012 noted the following as effective hedges against tail risk, ranked most to least effective: diversification across traditional asset classes, risk-budgeting techniques, managed volatility equity strategies, direct hedging-buying puts/straight guarantee, other alternative allocation (e.g. property, commodities), managed futures/commodity trading adviser (CTA) allocation, single strategy hedge fund allocation and fund of hedge fund allocation.

But, McLaughlin says, DB plan sponsors can still use fixed income, even though yields are lower, to generate returns. He says they should consider structured credit assets, which provide higher returns but not necessarily higher risk. "Think beyond corporate bonds and Treasuries to more securitized assets." "This is time when [plan sponsors] need to apply good judgment more than anything else," McLaughlin adds. "Long-term, we think the consequences of being in a bigger macro cycle are more profound. We expect to see more episodic volatility, and we don't have enough data now to react with sufficient confidence. At least in the short term, sponsors should rely on their best judgement. We are not advising wholesale changes. Plan sponsors should stay the course but give thought to what increased volatility means and pay attention to liquidity, and wait for data to come in. We need more clarity before we can be more aggressive." Rebecca Moore, *Plansponsor*, [www.plansponsor.com](http://www.plansponsor.com), May 28, 2020.

#### **8. RHODE ISLAND ATTORNEY JAILED FOR COLLECTING PENSION BENEFITS OF DECEASED CLIENT:**

*Attorney pleads guilty to taking \$234K over 12 years.* A Rhode Island attorney granted executive authority to sign off on checks of a former client has been sentenced for collecting nearly a quarter of a million dollars over 12 years following the client's death, the United States Attorney's Office announced.

The attorney, Oleg Nikolyszyn, was granted authority to sign and deposit checks meant for the client and to collect pension benefits. Nikolyszyn admitted to siphoning the funds to a jointly owned bank account between him and the client, and then allocating the money into the bank account belonging to him and his family. When the attorney was originally confronted on the issue, he lied, the court determined, and said that he was being responsible with the money and flying to Poland frequently to hand deliver it in bulk to the

deceased client's nephew. Following his purported falsehoods, and identification and condemnation of his behavior, he was suspended and disbarred from practicing law in Rhode Island.

Of the total \$234,000 taken from the client's arrangements, \$173,000 was sourced from the City of Providence Employee Retirement System, and \$60,000 was taken from the Laborers' International Union of North America Pension Fund. Nikolyszyn was sentenced to 12 months and one day in confinement, six months of subsequent house arrest, and one year of supervised release. Misconduct pertinent to the responsible distribution of pension trust assets happens somewhat frequently. Earlier this year, the founder of a New Jersey-based vending machine company was sentenced to two and a half years for embezzling over \$358,000 from the company's pension fund. Previously, a Louisiana accountant had been charged with stealing more than \$2 million from the New Orleans Firefighters Pension and Relief Fund, and separately, the former head of UK charity for the disabled was charged for stealing more than \$325,000 from the charity's pension. Steffan Navedo-Perez, Chief Investment Officer, [www.ai-cio.com](http://www.ai-cio.com), June 2, 2020.

#### **9. COVID-19 IS THE ENEMY, NOT PUBLIC PENSIONS:**

We have all witnessed the heroic efforts of healthcare workers and the courage of public safety officers, transit drivers and other essential public workers who show up for work every day in the face of a pandemic that has already taken more than 100,000 American lives. These workers are afflicted disproportionately with COVID-19 and have suffered high mortality rates.

Meanwhile, Senate leaders in Washington and Governor Scott, have already staked out a position that pension plans with high unfunded liabilities are a reason to withhold recovery funds, wrongly labeling them as underfunded plans. The 'failed public pension problem' is a red herring designed to accomplish the long sought-after goals of undermining public worker unions and eliminating a retirement system that has been in place for more than a century.

Coming into the pandemic, Florida's state pension plan was among the best funded plans in the country, and the state's municipal plans (aggregate) were funded to an average of 96 percent according the Florida Division of Retirement. They won't likely hold onto those numbers in the coming months, but 2008 showed us they are resilient.

The average state pension benefit is just \$22,422 (teachers, state and county employees) and average municipal retirement benefit is \$30,481 per year (public safety and local government workers) – and both fully taxable. We should reward public workers who put

themselves at risk daily for our benefit by securing their pensions. They are heroes. We should treat them as such. Kimberlie Prior, CEO, Florida Public Pension Trustees Association, [www.fppta.org](http://www.fppta.org), April 29, 2020.

#### **10. INTRODUCING THE PUBLIC RETIREMENT RESEARCH LAB; DEFINING THE FUTURE OF PUBLIC SECTOR RETIREMENT:**

Introductory webinar: EBRI President and CEO Lori Lucas and NAGDCA Executive Director Matt Petersen share the factors leading to the creation of the PRRL, and how each organization's singular strengths apply to effectively addressing current public retirement information shortcomings. Webinar attendees will also hear from EBRI Senior Research Associate Craig Copeland on the PRRL's first research study, and from PRRL Founding Partners and Steering Committee chairpersons about the anticipated benefits of the PRRL to better inform public sector retirement plan design, management, innovation, and legislation.

Date: June 18, 2020, 01:00 PM in Eastern Time (US and Canada). Click [here](#) to register.

**Public Retirement Research Lab**, [www.prrl.org](http://www.prrl.org).

#### **11. DOL GIVES GREEN LIGHT TO PRIVATE EQUITY IN DC PLANS:**

Defined contribution plan sponsors can include certain private equity strategies into diversified investment options, such as target date, target risk or balanced funds, while complying with ERISA, the Department of Labor said. The guidance comes by way of an [information letter](#) in response to a Groom Law Group request on behalf of its clients Pantheon Ventures and [Partners Group](#), who have developed private equity strategies that can accommodate DC plans.

While private equity investments have long been incorporated in defined benefit plans, defined contribution plan sponsors have mainly steered clear of incorporating alternative assets in their plans due to litigation concerns. In recent years, plan sponsors have been hit with class-action lawsuits centering on excessive fees. Notably, a lawsuit against Intel Corp. reached the Supreme Court, whose ruling in February gave DC plan participants more time to file ERISA claims unless they have "actual knowledge" of the sponsor's investment decisions and actions. The 2015 lawsuit alleged that plan managers violated their ERISA fiduciary obligations by offering too many alternative investments and inadequate disclosures of investments.

In a recent letter, the Labor Department said when evaluating whether to include a particular investment vehicle with an allocation of private equity as a designated

investment alternative, a plan must evaluate the risks and benefits associated with the investment alternative. To do so, the fiduciary should consider whether the allocation would offer plan participants the opportunity to invest their accounts among more diversified investment options within an appropriate range of expected returns net of fees; how the allocation fund is managed; and whether the allocation fund has limited the allocation of investments to private equity in a way that addresses potential cost, complexity, disclosures and liquidity issues.

The guidance will help quell some sponsors' litigation fears, said David Levine, principal at Groom Law Group. "It highlights that with a good, prudent process you can add these investments," he said. "Too often ... people are afraid to innovate and this helps support innovation." The Labor Department letter did not authorize making private equity investments available for direct investment on a standalone basis. Kevin Walsh, a fellow principal at Groom Law Group, said standalone investments are a different question and may be tackled in the future. "I don't view this as them saying, 'No way, no how,'" he said. "I read it more as, 'That's a different kettle of fish.'"

Robert Collins, managing director and head of Partners Group's New York office, said in a statement that the Labor Department has taken "a major step toward modernizing defined contribution plans and providing participants with a more secure retirement. At a time when working families are struggling to save, this guidance gives fiduciaries the certainty they need to finally provide main street Americans access to the same types of high-performing, diversifying investments as wealthy and large institutional investors, all within the safety of their 401(k) plans."

The information letter will help Americans saving for retirement gain access to alternative investments that often provide strong returns, Labor Secretary Eugene Scalia said in a news release. "The letter helps level the playing field for ordinary investors and is another step by the department to ensure that ordinary people investing for retirement have the opportunities they need for a secure retirement."

A group from the Defined Contribution Alternatives Association met with Labor Department officials in February to discuss what fiduciaries should consider if they intended to include private markets in their plans. In a proceeding letter to Preston Rutledge, former assistant secretary of labor for the Employee Benefits Security Administration, who took part in the meeting, in early March, DCALTA outlined issues such as fees, valuation and liquidity as things for fiduciaries to examine.

Jonathan Epstein, president of the DCALTA, said in an email that retirement savers

should be excited about the Labor Department guidance. “The DOL is helping plan fiduciaries give participants access to investment products that had previously been limited to institutional investors,” he said. “DCALTA was created five years ago to help drive this initiative and we are proud to have Pantheon as a founding member of DCALTA.”

Pantheon, in a statement, said it believes that private equity strategies have the potential to address the performance delta between defined benefit and defined contribution plans and merit consideration as a viable investment. “In our view, retirees really can’t afford to leave 40 basis points annually on the table over a 35-year investment horizon,” said Susan Long McAndrews, partner and member of Pantheon’s partnership board, in a statement. “We believe the department’s action today is an important step to address this and we look forward to working with plan sponsors to offer millions of ordinary working Americans the potential for a more secure retirement.” Brian Croce, *Pension & Investments*, [www.pionline.com](http://www.pionline.com), June 3, 2020.

#### **12. IRS REVENUE PROCEDURE 2020-34:**

Revenue Procedure 2020-34 grants temporary relief to arrangements that are treated as trusts under § 301.7701-4(c) which are, or have tenants who are, experiencing financial hardship as a result of COVID-19, to allow them to make certain modifications to their mortgages loans and their lease agreements, and to accept additional cash contributions without jeopardizing their tax status as grantor trusts. The revenue procedure indicates that a cash contribution from one or more new trust interest holders to acquire a trust interest or a non-pro rata cash contribution from one or more current trust interest holders must be treated as a purchase and sale under § 1001 of a portion of each non-contributing (or lesser contributing) trust interest holder’s proportionate interest in the trust’s assets. Revenue Procedure 2020-34 will be in IRB: 2020-26, dated 6/22/2020. IRS, [www.irs.gov](http://www.irs.gov), June 4, 2020.

#### **13. DID YOU KNOW ALBERT EINSTEIN SAID THIS?**

“Any fool can know. The point is to understand.”

#### **14. INSPIRATIONAL QUOTE:**

"Optimism is a strategy for making a better future. Because unless you believe that the future can be better, you are unlikely to step up and take responsibility for making it so." - Noam Chomsky

#### **15. TODAY IN HISTORY:**

On this day in 1776, Continental Congress creates committee (Thomas Jefferson, John

Adams, Benjamin Franklin, Roger Sherman and Robert R. Livingston) to draft a Declaration of Independence and in 1963, US President JFK says segregation is morally wrong and that it is "time to act".

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