The Office Of State Treasurer
Denise L. Nappier

News

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STATE'S LARGEST PENSION FUNDS RETURNS IN EXCESS OF 16% IN 2017

Pension Assets Grow by $4.2 Billion, Post Highest Calendar Year-End Value

2008 Pension Obligation Bonds Remain on Track – Earning Their Value

HARTFORD, CT – Connecticut's two largest pension funds, the State Employees' Retirement Fund (SERF) and the Teachers' Retirement Fund (TRF), generated robust investment returns, net of expenses, of 16.51 percent and 16.33 percent respectively, for calendar year 2017, State Treasurer Denise L. Nappier announced today.

These funds significantly outperformed their respective benchmarks by 74 and 63 basis points, respectively. In addition, each far exceeded their respective actuarial investment assumptions of 6.9 percent and 8.0 percent. Together, SERF and TRF represent 91 percent of the State's pension and trust fund portfolio.

The Connecticut Municipal Employees' Retirement Fund (CMERF), the State's third largest fund, earned 14.53 percent, net of expenses, exceeding its benchmark by 50 basis points. CMERF has a healthy funding ratio of 86 percent, and it likewise significantly outperformed its investment return assumption of 8.0 percent.

The strong returns helped propel the overall value of the Connecticut Retirement Plans and Trust Funds (CRPTF) -- which include six pension plans and nine trust funds -- to $34.4 billion, its highest level ever at the end of a calendar year. Overall, the CRPTF exceeded the investment performance of 70 percent of its peers, according to Wilshire Trust Universe Comparison Service (TUCS) data.

The increase of $4.2 billion over the calendar year was comprised of investment gains of $3.5 billion and net positive cash flows into the CRPTF of $700 million. The 2017 SEBAC agreement to restructure the State Employees' Retirement Fund and the lowering of the assumed rate of return from 8.0 percent to 6.9 percent contributed to the State's required contributions exceeding distributions for payment of benefits for the first time since 1999.

"This net positive cash flow will more than likely revert to a negative cash flow as a portion of the State's contribution and the contributions from new hires are directed under the SEBAC agreement to a new defined contribution plan, going forward," Treasurer Nappier cautioned.

"Our pension funds profited handsomely from the market's performance. The soundness of our strategic, diversified approach to portfolio design has enabled us to achieve returns that more than doubled the actuarially assumed rates of return for SERF and TRF, and that was 80 percent higher than the assumed return for CMERF," Treasurer Nappier said.

The solid performance of the CRPTF was led by the vigorous emerging, domestic and international developed equity markets, which returned 34.9 percent, 24.3 percent and 21.8 percent, respectively. The Emerging Market Debt portfolio of the CRPTF returned 14.2 percent. Additionally, the Real Estate and Private Equity portfolios had strong performances, posting returns of 7.3 percent and 12.9 percent, respectively.

Treasurer Nappier described the pension funds' performance as "a much needed boost for the asset side of the pension fund ledger." She continued, "This outperformance is especially needed at a time when the State is facing serious fiscal difficulties. When we perform above expectations, those gains can help trim the State's pension contributions going forward."

Treasurer Nappier Cautions Against Any Loss of Fiscal Discipline or Violation of Bond Covenants as Work Continues on Teachers' Retirement Fund Pension Funding Reform

However, Treasurer Nappier said, "Investment gains alone will not ensure the solvency of our pension funds. Passage of Governor Malloy's proposal to restructure payments into the Teachers' Retirement Fund would undercut a bond covenant that instilled the funding discipline we fought so hard to achieve."

Earlier this year, Governor Malloy suggested a restructuring of payments into the TRF. Treasurer Nappier challenged that plan because it would constitute a technical default under a bond covenant – something that the State has never before done. She said, "Once that line is crossed, the rating agencies may take a dim view of our promises, the consequences of which we will face for a generation. In fact, a recent report from Municipal Market Analytics confirms that any violation would be a 'clear credit negative'."

POBs

- ✓ **To date - $450 million in investment earnings over debt payments**
- ✓ **$1.2 billion - estimated COLA savings**
- ✓ **10 years - longest period of fully funding State's annual required contribution since 1979**

In 2008, the State issued pension obligation bonds (POBs), the proceeds of which were deposited into the Teachers' Retirement Fund. These bonds included a covenant that requires the State to annually pay the full amount of the actuarially required contribution for as long as the bonds remain outstanding, and prohibited changes to the calculation methods to reduce those annual payments.

The State has had the benefit of nearly a decade since the pension obligation bonds were issued. As of December 31, 2017, on a cash flow basis, investment earnings have exceeded debt service payments by approximately $450 million. In addition, the POB transaction was part of a larger pension reform initiative, which also included restructuring the financing of TRF COLAs at an estimated $1.2 billion savings over the 24 year life of the bonds.

Treasurer Nappier stated, "This bond covenant has stood the test of time. Since the redesign of the teachers' retirement plan in 1979 as an actuarially designed plan, the longest period of the State's consistent payment of 100 percent of the actuarially determined employer contribution has been during the existence of the 2008 bond covenant. Were it not for that covenant, there would have been temptation for the State to backslide on its commitment. In fact, the lack of such funding discipline

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prior to the establishment of the covenant is the single largest cause of today's chronically underfunded pension liability."

Since the proposal of the Governor, the Commission on Fiscal Stability and Economic Growth has suggested using lottery revenues or other assets to improve the funding status of the TRF. "While considerable work must be done to flesh out this idea, and while accounting standards may well interfere with certain options, this concept is intriguing and promising, Moreover, securitizing a portion of the lottery's historical revenue stream – resulting in an immediate infusion of cash for the pension funds – could be the most viable asset transfer option to bolster the pension funding status, lower the State's pension contribution and protect, if not improve, the State's credit rating," Treasurer Nappier said.[1]

"Any analysis of this asset transfer option must include input from my office. Given the State's system of pension fund governance, which includes a constitutional officer as principal fiduciary, the nature of the Treasurer's fiduciary duties, and the role of the independent Investment Advisory Council, it is critical that the Office of the Treasurer have representation at the table," Treasurer Nappier said.

She also said that her office has studied various pay-off options for the outstanding pension obligation bonds. After Fiscal Year 2025, the State can pay off the bonds for roughly $1.9 billion, using the estimated State contribution for that year. At that point, the bond covenant would disappear and the State then could restructure the amortization of the remaining liability. This option of a one-time diversion of the required contribution would not have a major impact on the fund's unfunded liability, according to the fund's actuaries. In addition, it would allow for future debt service savings, for FY 2026 of $260 million and overall of more than $2 billion.

"Along with any changes to the funding for the TRF, I encourage the General Assembly to adopt strong measures that ensure future funding discipline, including a requirement for supermajority votes, with public notice, for any decision to pay less than what is deemed actuarially required to meet the State's pension benefit obligation year in and year out," Treasurer Nappier said.

"It bears emphasis," she added, "that there is no urgency to taking action this session. Instead, there should be a comprehensive analysis of the options on the table, with information shared with all interested parties, followed by careful deliberation among all stakeholders."

In addition to SERF, TRF and CMERF, the CRPTF is comprised of assets held on behalf of the Probate Court Retirement Fund; State Judges' Retirement Fund; State's Attorneys' Retirement Fund; Soldiers' Sailors' & Marines' Fund; Arts Endowment Fund; Agricultural College Fund; Ida Eaton Cotton Fund; Andrew Clark Fund; School Fund; Hopemead Fund; Police & Fireman's Survivors' Benefit Fund; and State of Connecticut Other Post-Employment Benefits Trust Fund. All together, these additional funds make up roughly 3.5 percent of the CRPTF.

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[1] A recent Bloomberg article reported that Moody's does not consider future revenue a pension asset, saying "Future revenue streams aren't assets today. Instead we consider those contributions as they come in."

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