Viewpoints

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Welcome to our latest Viewpoints, a publication presenting candid discussions with industry experts on vital topics. Should you seek additional information on this issue's subject, feel free to contact us. We welcome feedback as we shape content for future issues.

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Exploring the Unique Characteristics of Public Pension Plans

Callan and LGIM America both serve a wide array of institutional investors, each with their own unique set of objectives and challenges. In this issue, we will focus on public pension plans. All pension plan sponsors use financial management policies (including funding, investment and liability measurement) to manage liability-based challenges over time. They must decide how much money to contribute into the plan each year, how to invest the money and how to measure the liability growth and cost of the plan over time. There is often no "one-size-fits-all" answer to these interrelated policy decisions, as the right answers will be based on each plan's situation. Our conversation with Brianne Weymouth and Matt Sloan explores the unique characteristics of public pension plans and challenges they may face to meet their investment goals. Additionally, we discuss topical trends and investment areas that are emerging within the public plan space.

Before we begin, I would like to thank Brianne and Matt for providing their time and willingness to participate in our Viewpoints publication. Each has extensive expertise in the asset management industry and contributes a unique perspective to investment management, consulting or client strategy. We are looking forward to a stimulating discussion and a better understanding of the unique needs of public pension plans.

Brianne Weymouth, CAIA, is a Senior Vice President and Consultant in Callan's Chicago Consulting office. She works with a variety of clients, including corporate defined benefit and defined contribution plans, public plans, endowments and foundations. Her client responsibilities include strategic planning and implementation, investment manager reviews, performance evaluation, continuing education and the coordination of special projects. She is a member of Callan's Manager Search Committee and is a shareholder of the firm.

Matt Sloan is a Client Strategist at LGIM America. In his role, he is focused on client solutions and engagement, primarily with our Midwest and West coast based clients. Matt has expertise in both traditional and cash balance defined benefit plans and in defined contribution plans, enabling him to effectively support customized solutions for clients.

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To begin, I would like to ask you, Brianne, what are some of the defining characteristics of public pension plans that drive how they are managed?

Brianne: Public pension plans are typically open to new participants which means the plans have long investment horizons and can take a total return approach to investing. The use of an expected return assumption as the foundation for public plans' liability measurement is also one of the defining characteristics that sets these plans apart. A plan's contribution policy, benefit policy and funded status are characteristics that will determine the risk tolerance of the Board of Trustees, which informs the investment strategy.

How do these defining characteristics alter our thinking about an appropriate investment strategy for public pension plans?

Matt: Public pension plans, as Brianne mentioned, have greater flexibility in how liabilities are measured, and this measurement (determining the funding target) is linked to how assets are invested. As a result, public plans can use pension funding and investment as an enterprise financing mechanism. The enterprise financing mechanism enables them to defer pension funding by investing in riskier, higher-return assets, providing an alternative source of funding to municipal bond issuance. This connection between investments and funding, as well as the role it plays in financing objectives, emphasizes the importance of viewing funding and investment strategies in tandem.

We occasionally hear public plans and their actuaries discuss the Fundamental Cost Equation, which states that Benefits + Expenses = Contributions + Investment Earnings. In practice, do public pension plans make funding and investment decisions in a coordinated fashion, as the Fundamental Cost Equation suggests, or do governance structures exist that allow these decisions to be made more independently? Also, what are the implications of this?

Brianne: The Fundamental Cost Equation explains how the math works and can be a useful tool to educate trustees on how each component affects the fund. It also helps to differentiate the roles of service providers such as actuaries, investment consultants and investment managers. In addition to the Fundamental Cost Equation, we draw a Venn diagram illustrating the intersection between contribution policy, investment policy and benefit policy because these are the three main components of a pension plan.

Each public pension plan has their own unique contribution policy and benefit structure. For some plans, the funding policy is developed independently from the Board of Trustees overseeing the investments. In this case, the investment policy is reactionary to any changes to the benefits or contribution policy. In other cases, there are Boards who have the authority to adjust benefits, contribution policy (through changes to the actuarial assumed rate of return) and also make investment decisions. In the latter case, the Fundamental Cost Equation is a more meaningful description of their role.

In either case, an asset/liability study will help determine the investment risk tolerance of the Board.

We frequently hear or read headlines related to the relatively poor funding position of public pension plans. What are the drivers that have led plans to this point, and how would you characterize the current state of public pension plans?

Matt: Public pension plans have discretion to set their funding target (liability measurement) at various levels. There is no right or wrong answer to how this is done. The key is to understand how the liability grows over time. It grows with interest at the discount rate plus the rate of benefit accruals as a percentage of the liability. The overall system can remain in balance if asset growth, which includes expected investment returns plus plan contributions, is managed in a way to keep pace with liability growth. We call the required asset growth rate the pension hurdle rate. The pension hurdle rate is calculated by dividing the liability growth rate by the funded percentage. The key question is not what the plan's funded status is, but rather, whether the system is in balance. Additionally, it's important to know if asset growth is expected to meet or exceed liability growth. At LGIM America, we don't think public plans need to follow the same funded status norms as corporate plans.

Brianne: Callan believes that public defined benefit plans are the primary vehicle for ensuring retirement income security for public workers and that these plans are viable and necessary in this sector. Defined benefit plans are extremely cost effective and reliable in delivering basic retirement income security when the Fundamental Cost Equation is followed.

The biggest driver of pension underfunding is a lack of sufficient or consistent funding. This is not always intentional and can be attributed to several different actions. Well-funded defined benefit plans ensure that benefit increases are properly funded, that fund valuation and required contributions are determined using "reasonable" actuarial assumptions and that they receive their full annual required contributions from employers and employees. When funding is not received, the investment return on these assets are not compounded and the funding deficit grows by more than the missed contributions.

Since the investment returns are already factored into the contribution calculation, the fund's investments will not be able to fill the gap in funding. The investment return assumption is a long-term average or median of a wide range of investment outcomes, so the portfolio cannot be expected to consistently outperform this average or median in all capital market environments in order to compensate for funding gaps.

If a lack of sufficient or consistent funding is the main culprit for a plan's underfunding, what are the challenges these sponsors face in today's market environment from an investment perspective?

Matt: The low interest rate environment over the past decade has been a challenge because it can cause expected investment returns to grind lower over time. This can and has lead to periodic spikes in the liability/funding target that may not have been fully anticipated or planned for. This has led some plans to take on more investment risk in pursuit of greater returns, resulting in higher volatility of plan assets. Significant levels of investment risk can make the plan more vulnerable to significant drawdown risk during times of financial stress. This, in turn, may raise liquidity concerns about the ability to meet benefit payments without having to sell equities at depressed prices. As rates rise, as we have seen recently, the pressure to lower the expected return discount rate should ease and, in fact, some plans may have the opportunity to raise their assumption. This could help offset some of the losses in fixed income and equities that we have seen so far in 2022.

One recurring theme has been the idea of incorporating both contribution policy and investment policy into the decision-making process. In practice, do plans track expected asset growth (from both contributions and expected investment earnings) and compare it to expected liability growth to understand the implications for evolving funded status? Additionally, what suggestions do you have for plans and their advisors?

Brianne: Plans do track these measures. For instance, the annual actuarial report will project future expected asset growth, liability growth and funded status. This analysis may also include a plan to reach full funding by a certain date. As investment consultants, we then take that data and use it in our asset/liability studies to determine an appropriate asset allocation. We also look at expected asset growth projections when conducting private markets pacing studies so we can estimate annual commitments to closed-end funds.

It is important that investment consultants utilize input from the plans' actuaries when formulating investment recommendations. As I referenced in an earlier response, plan sponsors cannot depend on outsized investment returns to make up for a lack of contributions or to fund future benefit increases. For these reasons, it is important that plans are aware of the investment risks inherent in their investment strategy, and to be wary of straying too far into esoteric strategies with the goal of generating returns far in excess of their expected return assumption.

I understand that because of the way liabilities are measured for public pension plans, LDI strategies may be less effective. What are some of the other investment solutions that you've discovered that have resonated with this client base?

Matt: In the short term, public pension plan liability measurements are less sensitive to interest rates than corporate plans. Over long time periods of persistently low interest rates, however, plan liability measurements do respond to these lower rates. This suggests that longer duration fixed income may have a place in the asset portfolio of a public pension plan. As mentioned previously, we also see high liquidity needs among some public plans. This liquidity need, combined with high exposure to equities and other return-seeking assets (RSA), can lead plans to earmark certain assets for benefit payments (Treasuries, cash, cashflow-matched credit). RSA exposure can be maintained at the desired level through the use of derivatives. Plans are increasingly considering benchmarking credit and Treasury fixed income investments separately for a variety of reasons, including liquidity, transparency and flexibility.

Working at an asset manager, how could I not take advantage of the opportunity to ask the investment consultant how managers can better serve the public pension plan community?

Brianne: Our clients are always looking for lower fees and strong investment performance. I'm only half joking. The investment manager community is tremendously helpful in providing educational opportunities for trustees, staff and consultants. This can be achieved through participating in industry groups and conferences such as NASRA, NCPERS, NCTR, or through direct education sessions to clients and consultants.

New product development that evolves with investor needs and fits into the investment objectives of public pension plans is accretive. As preferences of public pensions plans shift, such as ESG-investing, climate aware investing and DEI, there is a need for new strategies and options for investors. As investor sophistication grows, so does the need for flexibility and customization for clients.

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>
> Brianne Weymouth, CAIA
> Callan

Lastly, do you anticipate any notable trends emerging across the public pension plan landscape in the next 3-5 years?

Brianne: The market environment has shifted considerably in the last few months, and these shifts have propelled changes to long-term capital market assumptions. For instance, with the rapid increase in interest rates, our expected returns for bonds have increased substantially as investors will be able to earn higher yields going forward. Our equity return expectations have also increased in response to the recent market drawdown. Six months ago, I would have mentioned increases to private investments as a means to reach for high expected returns, and while I still think that those investments will continue to grow and take advantage of the current market dislocations, I also believe that the changes to expected asset class returns will take some of the pressure off of public pension plans' need to increase risk.

With that in mind, I believe we will continue to see investments in private investments, such as private equity, private credit, real estate and infrastructure. Open-end versions of private funds are making some of these asset classes more accessible to plan sponsors.

I think trends such as ESG and DEI will continue to be part of the conversation. ESG preferences vary considerably from plan to plan, from encouraging to discouraging these factors as investment considerations. For those plans looking to implement ESG, the term is no longer specific enough to describe client initiatives. We are getting more requests for specific strategies such as climate aware, net zero carbon emissions, etc.

I also think diversity, equity and inclusion will continue to evolve as an objective for our industry. Callan, along with many of our peers, are compiling investment manager employee statistics and are building out investment manager databases to include this information. Clients developing a strategy to increase diversity in their portfolios are developing new criteria for measuring diversity and pushing this initiative further in our industry.

Matt: We believe that the return of higher interest rates, combined with public plans' recognition that interest rates do matter in the long run, may lead many plans to consider longer duration, higher earning fixed income strategies. Furthermore, managing fixed income invested in credit separately from the portion invested in Treasuries has advantages in terms of mitigating drawdown risk and addressing liquidity needs. This separation will also allow for increased investment in private credit and infrastructure. To Brianne's point, we have had an increasing number of discussions about ESG-investing and, in particular, interest in climate-focused solutions. We also anticipate that many public plans will increasingly recognize the interaction of investments and funding and will evolve governance structures to better accommodate this interaction. ■

About LGIM America

LGIM America (LGIMA) was founded in 2006 with the purpose of helping people achieve their long-term financial goals. We offer a range of strategies to help our institutional clients (corporations, healthcare agencies, non-profit, education, public plans and Taft-Hartley) manage their investment objectives, which can range from market-based alpha-oriented strategies to those that are designed to be more liability-centric, derivative overlays, or indexed solutions. Encouraging a diverse and inclusive environment coupled with a solutions-focused culture allows us to increase our breadth of knowledge and the likelihood of improved client outcomes and stronger financial performance. We have teams of experienced, innovative professionals committed to helping plan sponsors meet their pension promises, managing investment exposures efficiently to seek enhanced returns while mitigating risks, and working to generate returns while making a positive societal difference.

For further information about LGIM America, find us at www.lgima.com

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