The ADVISOR
TEACHERS, EMPLOYEES, and JUDICIAL
Vol. XLII—No. 6 SERVING OVER 345,000 MEMBERS December 2016

2016 Investment Performance

BY R. MARC GREEN, CIO

		Annualized		
	1 Year	Last 3 Years	Last 5 Years	Last 10 Years
Total Portfolio				
TRS	10.41%	7.75%	11.21%	5.56%
ERS	10.22%	7.65%	11.03%	5.34%
JRF	10.94%	7.46%	10.99%	6.28%

Fiscal Year ending September 30, 2016, was another year dominated by macro factors, most notably worries about the China economic slowdown, Brexit, continued energy price volatility, and finally the U.S. presidential election. The better performing asset classes were domestic stocks and emerging market stocks, as the U.S. dollar took a breather. Sentiment continues to remain fairly negative around risk assets, which has the effect of removing the marginal seller.

The RSA continues to hold an overweighting in equities and have used systematic hedging to help limit downside exposure. We also remain underweight in fixed income as it looks like there is a good chance that we may finally see some sustainable inflation pressures, which should cause a rise in interest rates.

Our peer group rankings (State Street Public Funds Universe greater than $1 billion) for the last year were in the top 28th percentile for the TRS and 36th percentile for the ERS. **The three- and five-year rankings remain in the top 12% for both the TRS and ERS.** The ten-year return numbers continue to struggle relative to our assumed rates of return, as the 2008-2009 "Great Recession" returns were pretty devastating for all investors.

Looking at a longer timeframe, returns for 30 years were 7.95% for the TRS and 7.8% for the ERS; returns for 35 years were 9.4% for the TRS and 8.98% for the ERS; which are all at or above our actuarially assumed rates of return.

Getting Ready for the Next Legislative Session

BY DAVID G. BRONNER

It's that time of year again. And I'm not talking about the holidays. The 2017 Regular Legislative Session that begins on February 7, 2017, is almost upon us.

Good news is that we have had great meetings with the Speaker of the House, Mac McCutcheon, and the President Pro Tem, Del Marsh, as well as other distinguished members of the Alabama Legislature. We discussed our common goal, which is to ensure that the RSA continues to pay the retirement benefits earned by its members – the education employees and state and local government employees who have dedicated their lives to public service. With this common goal in mind, all interested parties will work together to strengthen and protect the RSA for the benefit of its members and all Alabamians.

Most importantly, the financial news we will share with the Legislature during the next session is very positive. There are minimal increases in the employer contributions to the General Fund and Education Trust Fund for the ERS and TRS. The funded ratios for both the ERS and TRS increased for the second year in a row. Our investment returns for fiscal year 2016 are stellar. And the benefits paid out to RSA members continue to have a positive economic impact on our communities and the state as a whole.

But we still need your help. Talk to your Representatives and Senators. Remind them how important your benefit is to you, your family and the community. Let them know how much you appreciate their support on RSA issues. Thank them for their dedication in fully funding the employer contribution request set by RSA's actuaries EVERY YEAR – that is what helps keep your system financially sound!

PROJECTED STATE COSTS FOR 2017-18

Projected Retirement Employer Cost
Retirement Systems of Alabama
(Amounts in millions)

Retirement	Actual 2015-2016	Estimated 2016-2017	Requested 2017-2018
TRS (Teachers')	$749	$769	$782#
ERS (Employees' Regular-State)	199	195	197*
JRF (Judicial)	17	18	18
Total Retirement Cost	$965	$982	$997

FY2016 Increase in ERS primarily due to 2014 COLA funded in FY2016

Estimated $453.4M from Education Trust Fund
* Estimated $55.1M from General Fund

Projected Insurance Employer Cost
Retirement Systems of Alabama
(Amounts in millions)

Insurance	Actual 2015-2016	Estimated 2016-2017	Requested 2017-2018
PEEHIP (Teachers)	$981	$995	$1,027
SEHIP (State Employees)	318	325	356
Total Insurance Cost	$1,299	$1,320	$1,383

Note: PEEHIP numbers include amounts from Universities for retiree costs
Note: FY2018 estimated cost for PEEHIP totals $1.48 billion

Harvard Business Review

BY SIMON C.Y. WONG

The enormity of the challenges confronting pension funds — including substantial deficits, a tumultuous global economy, and a low-return environment — means that they need to be able to focus on maximizing investment returns without distraction. For those in the public sector, this includes being shielded from governmental politics.

Interference by elected officials — from imposition of local economic development obligations to excessive constraints on head count and compensation that impede recruitment of talented staff — has contributed to poor investment choices, higher total costs, diminished organizations, and disappointing performance at some institutions.

From my advisory work, research, and private discussions with executives and board members of pension funds, pension funds that succeed in keeping politics at bay combine strong governance with deft, often pre-emptive, management of issues that could spark a political backlash.

Strong governance. Autonomy for pension institutions starts with a strong governance framework. Some institutions, such as the Canada Pension Plan Investment Board, are stand-alone legal entities with an independent board and a requirement to operate at arm's length from government. In recent years, a number of jurisdictions, such as the state of Oregon, have explored introducing this model.

An independent board is considered by some to be so important that the drafter of a recent proposal to create a pooled public sector pension fund (one for the employees of several public sector entities) included a radical provision calling for the board to be granted the authority to appoint a majority of its own members. To ensure accountability, the government would be empowered to remove an individual director for cause or, in extreme cases, to dismiss the entire board. Its author reasoned that the government should be handed "a nuclear bomb but not a bunch of grenades."

A pension fund's structural independence needs to be reinforced by appointing experienced, well-respected, and non-partisan people to serve on the board. These individuals can provide valuable political capital that enables a fund to take and defend decisions that may be politically controversial. Due in part to the stature of its board, a North American pension fund was able to retain a market-competitive pay structure despite the clamor that erupted following its announcement that it had suffered substantial investment losses during the global financial crisis.

Another way to keep politics at bay is to ensure there is a counterweight to check elected officials. In Wisconsin, where beneficiaries of the public pension system share the burden if investments yield poor results, member associations have not only lobbied for greater resources for the State of Wisconsin Investment Board but have kept an eye on politicians to ensure they don't meddle inappropriately.

Deft, pre-emptive management. Pension institutions that enjoy a high degree of independence are fully aware that their freedom is never ironclad. Many have developed finely tuned political antennae so they can identify and defuse potential threats to their cherished autonomy early on.

In conjunction with its reallocation to higher-risk equities and alternative assets, one pension fund launched a communication campaign to inform the general public that greater year-to-year volatility of returns lay ahead. This move was designed to reduce the possibility of stakeholders pressuring politicians to intervene if market turbulence leads to substantial short-term losses for the fund.

Some pension funds proactively keep government overseers up to date so that they will not feel a need to be intrusive. The former executive director of one institution told me that he looked forward to his appearances before the state legislature's finance committee because "they were opportunities to keep politicians informed and keeping them informed is a way to keep them at bay."

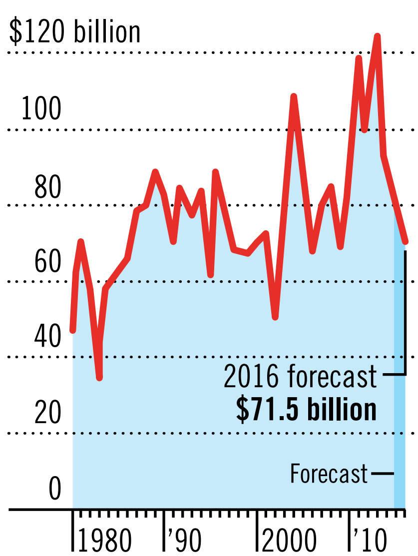
While transparency is essential to building confidence, there can also be too much of it. In a report for the Norwegian Government Pension Fund Global, London Business School professor Elroy Dimson cautioned that "transparency is not an unalloyed good" and the public's focus on the fund's quarterly returns may lead its investment manager, Norges Bank Investment Management, "to avoid certain investment strategies that would be naturally fitting — and likely profitable — for a large long-horizon investor, but that could occasionally result in adverse media and political reactions."

Aware that rising inequality has made politicians highly sensitive about pay at private and public sector organizations, including pension funds, some institutions have taken steps to avoid unflattering media headlines. The former chair of a large Canadian pension fund told me, "We pay a lot of attention to reputational risk — anything to avoid politicians looking, including moderating pay pre-emptively. We pay competitively but no hedge fund-size packages."

Amid debates in different countries on ways to improve the governance and performance of pension institutions, policymakers and pension-fund leaders and stakeholders should closely study these approaches for keeping politics at bay.

Pay Slump

Net farm income in the U.S. is expected to hit its lowest levels since 2009.



Note: In constant 2016 dollars
Source: Agriculture Department

Daniel Acker/Bloomberg News

New Jersey Tops Illinois as State with Worst-Off Pension System

BY MARTIN Z. BRAUN | BLOOMBERG

New Jersey became the state with the worst-funded public pension system in the U.S. in 2015, followed closely by Kentucky and Illinois.

The Garden State had $135.7 billion less than it needs to cover all the benefits that have been promised, a $22.6 billion increase over the prior year, according to data compiled by Bloomberg. Illinois' unfunded pension liabilities rose to $119.1 billion from $111.5 billion.

The two were among states whose retirement systems slipped further behind as rock-bottom bond yields and lackluster stock-market gains caused investment returns to fall short of targets. The median state pension had 74.5 percent of assets needed to meet promised benefits, down from 75.6 percent the prior year. The decline followed two years of gains. The shortfall for states overall was $1.1 trillion in 2015.

Pressure on governments to increase pension contributions has mounted because of investment losses during the recession that ended in 2009, benefit increases, rising retirements and flat or declining public payrolls that have cut the number of workers paying in. U.S. state and local government pensions logged median increases of 3.4 percent for the 12 months ended June 30, 2015, according to data from Wilshire Associates.

State and local pensions count on annual gains of 7 percent to 8 percent to pay retirement benefits for teachers, police officers and other civil employees. The funds are being forced to re-evaluate projected investment gains that determine how much money taxpayers need to put into them, given the recent run of lackluster returns.

Large pension shortfalls may lead to cuts in services as governments face pressure to pump more cash into the retirement systems, Cohen said. Illinois, whose effort to roll back benefits was struck down by a state court, owes vendors $9 billion and is behind on payments to schools and universities. In Connecticut, state spending on retired teachers' pensions is set to surge 28 percent, $282.7 million, next fiscal year, the Connecticut Mirror reported Tuesday.

"The crowding out is pretty obvious," Cohen said. States can't file bankruptcy, which gives them less leverage than municipalities to negotiate benefit cuts, she said.

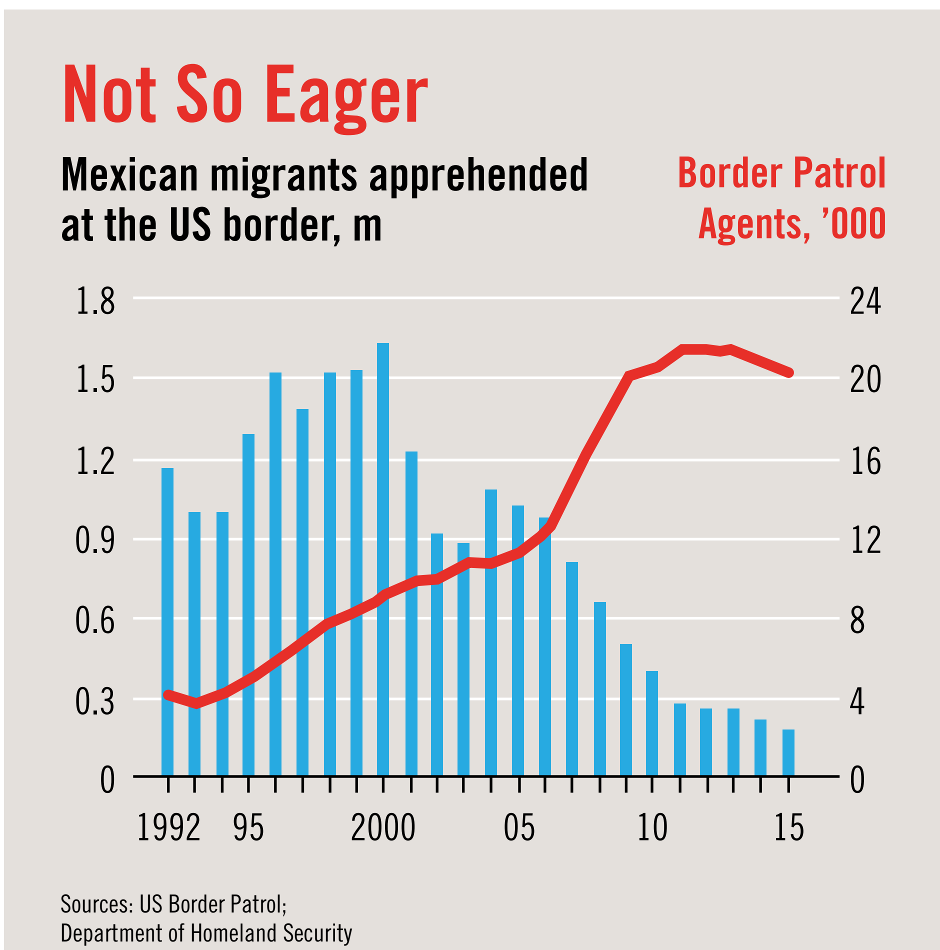
Broad numbers mask big difference in the health of public pensions between states. While New Jersey only has 37.5 cents available to pay each $1 of benefits, South Dakota, the state with the best-funded pension, had $1.04, according to data compiled by Bloomberg. Kentucky, the state with the second-worst funded retirement system, had a ratio of assets to liabilities of 37.8 percent, followed by Illinois at 40.2 percent.

New Jersey and Illinois' pension liabilities have led to credit-credit rating cuts and higher borrowing costs relative to other governments. The Garden State 10-year bonds yield about 2.5 percent, or 0.8 percentage point more than top-rated debt and the second highest among 20 states surveyed by Bloomberg. Illinois pays the highest, 3.7 percent.

In New Jersey, a proposed constitutional amendment supported by public-employee unions that would have mandated the state to make the full actuarially required contributions by 2022 failed to make it on the ballot this November.

In May 2015, the Illinois Supreme Court struck down a 2013 pension overhaul saying it violated the state constitution's ban on reducing worker retirement benefits. The ruling highlighted the lack of legal flexibility some states have in addressing their pension funding deficits.

Oregon's pension funding levels declined by 11.7 percentage points in fiscal 2015, the most among states that report liabilities under Government Accounting Standards Board rules that made it more difficult for some plans to minimize the scale of their unfunded liabilities. Oregon's pensions are 92 percent funded, lagging only North Carolina and South Dakota. Alaska was the only state whose pension funding increased among states that have adopted the new standards.



The RSA Staff wishes you a *Merry Christmas!*

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- January 1-2, 6-10, 15-18, 29-31
- February 7-9, 12-13, 20-22

The Renaissance Riverview Plaza—Mobile—$99
- December 1, 7-9, 11-18, 23-26
- January 1-2, 6-13 • February 1, 8-9, 16, 19-22

Marriott Grand—$109 plus a 15% resort fee
- December 1-5, 9, 11-22, 26-29
- January 1-5, 11-16, 26-31
- February 1-2, 5-7, 12-16, 19-23, 26-28

Marriott Grand—RSA Golf Package—$179 plus a 15% resort fee —Promotional code–R2A
Includes: Deluxe Room, One Round of Golf for Two People. Call for Tee Times after booking package
- December 1-5, 9, 11-22, 26-29
- January 1-5, 11-16, 26-31
- February 1-2, 5-7, 12-16, 19-23, 26-28

Marriott Shoals—Florence—$99; Breakfast Package $124
- December 4-12, 14-29
- January 1-8, 13-14, 20-22, 27-29
- February 2-6, 9, 12-13, 20, 23-27

Renaissance Ross Bridge—Hoover—$109
- December 1-8, 11-30 • January 1-31
- February 1-2, 4-5, 9, 12-20, 22-28

Opelika Marriott—$99
- December 4-8, 18-30
- January 1-7, 13-16, 22-26
- February 1-7, 12-13, 19-20, 26-27

Prattville Marriott—$89
- December 4-5, 11-12, 18-19, 25-26
- January 1-2, 8-9, 15-16, 22-23, 29-30
- February 5-6, 12-13, 19-20, 26-27

Renaissance Montgomery—$109
- December 18-30 • January 1-4, 15
- February 1, 5, 10-11, 24

RSA Spa Package—**$189—Promotional code–R2A**
- December 20-24, 27-30 • January 3-4
- February 1, 10-11, 24

Specific room requests may require additional charge. Rates available the 1st of the month and are not applicable to groups.
800-228-9290 Ask for RSA rate. **Promotional Code: R2A** on www.rsa-al.gov
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Annual raises:	1 percent
Annual return:	4 percent
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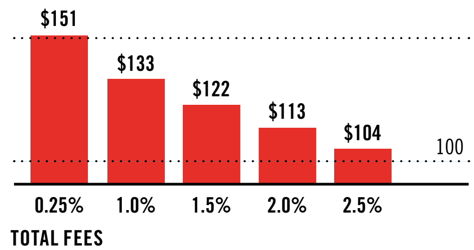
ESTIMATED BALANCE SAVED AFTER 30 YEARS

2016 dollars, in thousands



Note: Returns and salary growth rates are both adjusted for inflation, making the balances in 2016 dollars
Source: Vanguard

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