Truth, Transparency & Integrity II

In the last issue of The Spotlight, we began a three part series entitled “Truth, Transparency & Integrity.” Our goal was to address the issue of the “funding crisis” involving public pension plans. The first truth we acknowledged was that Pennsylvanians are facing a huge liability as a result of the unfunded status of our largest public pension plans in the state – The Public School Employees’ Retirement System, the State Employees’ Retirement System, and the public retirement systems established by the cities of Philadelphia and Pittsburgh. The second truth we noted is that the Pennsylvania Municipal Retirement System is NOT like those other public plans and we are NOT facing the magnitude of unfunded liabilities that these other plans are experiencing. As to transparency, we observed that the numbers being published are probably all true but what they represented was not readily transparent. It was our observation that the numbers being advanced were not for purposes of understanding. Rather, they were manipulated to advance the users’ arguments (both pro- and anti-public pension plan). Finally, we challenged our members and the general public to examine the truth, transparency and integrity of the PMRS board and staff as we continue to address the ongoing debate concerning the status of public pension plans. In this article, we address one particular aspect of the debate that is not only a key determinant of the funded status of a pension plan; it is important to PMRS because it has become a source of some notoriety. To begin, one must understand that an actuarial assumption is “an estimate of an uncertain variable input into a financial model, normally for the purpose of calculating premiums or benefits.” (Investopedia.com).

PMRS Adds Two New Properties

PMRS is pleased to announce the acquisition of two additional properties to their real estate portfolio. In September, PMRS completed purchase of 4,696 acres of timberland in northern Oregon. This property, named Coquille and managed by Forest Investments, is valued at $15.9 million and is comprised primarily of Douglas Firs. Douglas Firs are used extensively as structural timber, railroad ties, flooring and furniture. They are also a popular Christmas tree.

Forest Investments, based in Atlanta, is the sole manager of all PMRS-owned timberland. PMRS currently owns properties in seven states along the east coast and in the south that total over 48,000 acres.

The second purchase was the Republic Distribution Center in Houston, Texas. This 312,000 square foot property was purchased for $15.2 million and is 100% occupied by Nestlé Waters North America. Nestlé offers over 65 brands of sparkling and still waters, and this is a key strategic location in Nestlé’s $7.7 billion international water sales market. This property will be managed by TIAA-CREF, which manages commercial and retail property for PMRS in five different states.
It is a prediction of an outcome. One of the most significant assumptions used in funding pension plans is the assumed rate of return, which is the expected investment performance of the pension fund’s assets. Why is it so key to a plan's funding? The answer relates to what Benjamin Franklin called the Eighth Wonder of the World – Compound Interest.

Author’s Warning – Get ready for some intense math!

While it might be a little laborious, we would like to share why PMRS believes it is better to have a conservative assumed rate of return versus a more generous one. We start with the simple idea of Franklin's compound interest. If we have $1,000 to invest for a 30-year time period and could get a bond that pays 5.5% interest, that $1,000 would grow to $5,187, providing $4,187 in investment earnings.

But what if we could get a bond at 6.0% interest? The value of our investment after 30 years? $6,023 or $1,836 more in investment income. Now, what if we could get interest of 7.5%? The value of our investment would be a whopping $9,422 after 30 years.

In the world of pensions, it works a little bit differently, though. Let’s go back to our first example and say we need $5,187 to pay someone a pension 30 years from now. We know that if we can assume that we will earn 5.5% a year in interest, we need to have a deposit of $1,000. But if we need $5,187 and we could assume that our investment return was going to be 6.0% instead of 5.5%, we would only need to deposit $861 now. We could save ourselves $136 dollars!

If we really want to save ourselves some money, we could assume an investment rate of return of 7.5%. Then we only need to deposit $551 - a 45% reduction in up-front money. Who wouldn't want to assume better investment returns?

The problem only surfaces in 30 years when we need that $5,187 to pay that promised retirement benefit. What happens if we assumed a 7.5% return and deposited $551 BUT only made a 6.0% return? Well, after 30 years, our $551 would have grown to just $3,318. We would have to come up with an additional $1,869 to be able to pay our pension. The end result – to have the money we need it will cost us our original $551 plus $1,869 more for a total cost of $2,420. Ignoring the impact of possible inflation, wouldn't it have been better to pay the $1,000 up front? Imagine how happy we would be if we did make that 6.0% return. Instead of having to come up with $1,869 more in cash in year 30, we would have had $1,836 more than needed, or an actuarial surplus!

These examples are to serve two purposes. First, we wanted to share why we believe that if we are going to make mistakes in assumptions, it is better to err on the conservative side. Then we can be happily surprised if we are wrong. Secondly, we wanted to share why some of the other public pension plans in the state are experiencing (in part) large unfunded liabilities. Aim high and if you are wrong, you will have to pay more in the long run.

Perhaps this is why Stanford University Finance Professor Joshua Rauh recently said using past investment performance to plan for future investment returns was so dangerously optimistic. We came across Rauh’s comments made at a Manhattan Institute for Policy Research event at which pension reforms were being discussed. Pointing to the oft-used 7.75% rate of return that many pension plans project, Rauh said that means governments are planning that every dollar invested will double roughly every 10 years. “In the private sector, with that kind of accounting...you'd be hauled off to jail,” he said. “But in government accounting, that's the way it works.”

We just want to note – that’s not the way it works at PMRS.

Accounting Division

Ever wonder how PMRS decides the order in which to generate the municipal financial statements (GASB-25 information) and the members’ Annual Benefit Statement for its 960+ pension plans?

PMRS uses a “first come, first served” policy. This means that preparation of the financial and member statements will be processed in the order that municipalities provide complete and accurate information to PMRS. Our starting point is the receipt of a plan’s completed Fourth Quarter 2013 Quarterly Report of Contributions (PMRB-21). Once our staff verifies that all information is complete for the 1st, 2nd, 3rd and 4th quarters, the municipality’s pension plan will be ranked. This process takes about three weeks from receipt of the completed PMRB-21 until the plan is put into the queue. The placement of a plan can be seen on the PMRS website (www.pmrs.state.pa.us) beginning in late January. The queue will be updated daily once our staff begins generating financial statements around February 1st.

If a problem is discovered, the municipality will be contacted and the plan’s processing will be delayed until the problem is resolved. It is extremely important that our membership understand that a plan’s statement will not be prepared until the municipality has provided us with all of the information we need to properly administer the pension plan. A plan will not go into the queue until all issues are resolved.

Our goal is to allow our enrolled plans more control over the timely preparation of their financial statements and to make the statements as complete and accurate as possible. We have been extremely pleased with the success of this approach during the last several years and believe it...

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PMRS Reinstitutes Pre-Retirement Seminars

On November 16th, PMRS held its first in a series of seminars aimed at helping members better understand their pensions as part of their overall retirement plan. The inaugural seminar, held in Wilkes-Barre, addressed an array of retirement planning topics such as how a pension works, annuity options available through PMRS, financial planning concerns beyond your pension, and an update on the status of PMRS. The presenters included Retirement Counselor Heather Seilhamer, Membership Services Chief Sean Christine, and PMRS Secretary Jim Allen.

What attendees took away from the three hour gathering was as unique as the people themselves. Some benefited from learning the differences between a Single Life Annuity and options that include a survivor annuity benefit. Some people remarked that they were grateful we covered the differences between taxable and non-taxable annuity benefits. Other people enjoyed our presentation of some considerations outside of the pension. No matter the reason why they were there or what they got from the seminar, 100% of the responding attendees said they would recommend the seminar to other members.

To honor our commitment to serve our members we will be hosting more seminars throughout Pennsylvania in 2014. Our goal is to better prepare PMRS members for their financial future once they leave municipal service. Our next seminar will be:

Saturday March 8, 2014 at 9:00 A.M.
Radisson Hotel Valley Forge
1160 First Avenue
King of Prussia, PA 19406

Topics covered will include an update on PMRS, how your pension works, what choices you have to make at retirement, some financial planning considerations outside of your pension, and the PMRS retirement process. Although it’s ideal for anyone planning to retire in the next five years, it’s truly an opportunity for any member to learn more about their retirement.

The seminar is free of charge but space is limited. If you would like to attend the event in March, please let us know. If this is outside your travel area and would like to attend a future event closer to home, we would like to know that too. Registration forms are available at www.pmrs.state.pa.us. For more information, please contact Heather Seilhamer at (800) 622-7968.

(Accounting, cont.)

is the fairest way to provide our 960+ pension plans with their 2013 financial and member statements. No exceptions will be made.

One final observation regarding the 2013 Financial Statements, please note that all member forms associated with 2013 transactions including Enrollment (PMRB-1 & 2), Retirement/ Vesting (PMRB-8) and Termination (PMRB-4) must be received by PMRS prior to February 1, 2014, in order for the event to be reflected on the 2013 Financial Statements. Forms received after February 1, 2014, will be recorded as a 2014 fiscal year financial transaction.

If you have any questions, please contact the PMRS Accounting Division at (800) 622-7968.

Board Chairman Stepping Down

At the September Board meeting, PMRS Board Chairman John Haiko announced he would not be seeking reappointment for another term as Board Chairman.

Looking back, he reflects that “It truly was an honor and special privilege to have served over the past eleven years on the Pennsylvania Municipal Retirement Board and as its Chairman for the last six years. I had the distinct opportunity over those challenging years to serve with many dedicated board members who represented the Commonwealth’s various municipal associations and agencies in forging successful PMRS pension investment policies and guidance. In particular, it has been most enjoyable working with and witnessing the dedicated efforts of the PMRS Secretary, James Allen, and his knowledgeable staff over those years. They consistently have implemented the Board’s policies and directives while flawlessly conducting operations of the Pennsylvania Municipal Retirement System to make it the most respected and financially sound statewide pension system.”

The new chairman will be selected at the February 27, 2014 PMRS Board meeting.
According to the PMRS Investment Relationship Manager, Nat Raney, “Both of these properties fit very well into the PMRS portfolio. The timberland in Oregon is well positioned to take advantage of increased demand for lumber in China and Southeast Asia. In addition, this bottling and storage facility in Houston will provide long-term and stable income from a multinational corporation that is the largest food company in the world.”

This increase in real estate allocation reflects the recent Board action that increased real estate and timberland to 20% of the portfolio and decreased fixed income from 20% down to 15%.

The graph on the right side of this page shows the proposed changes in the asset allocation.
Even 2,000 years ago, we knew that if we have no idea where we want to go, it doesn’t really matter how we get there. Every day at PMRS, we work with more and more people entering retirement; and, we find that although it is an exciting time for our members entering a new stage in their lives, it is also one of the most stressful times. With pension plans having four to eight annuity options on average, it can be difficult to decide which one is right for you. It’s even more frustrating to figure out where to start if you are employed by a municipality that is considering a change in benefits, offering retirement incentives, or possibly spinning off a group of employees to an authority.

As pension administrators, it’s easy for us to put the cart before the horse. There’s no problem for us to tell you that you have X number of options, what your monthly annuity payment will be, or what happens to your pension when you die. We can also prepare estimate upon estimate to throw different scenarios at you: “Well Mr. Smith, if you retire at age A, you will receive $B every month; but, if you wait to age X, you will have $Y.” Unfortunately, this can be a disservice that is no better than what you get at a bank. Did you ever look at a rate board in a bank? You can see that a savings account is only paying .02% and a five year CD is paying 1.21%, but which one is right for you?

Therein lays the problem. When we choose a path to get somewhere without first considering our final destination, we have no idea if we are choosing the right way. In the case of retirement planning, not having a retirement goal makes choosing a pension option little more than flipping a coin. “Should I retire this year or wait until next year?”; “Is Option II or Option III better for me?”; or “Would I be better off to take an Option IV withdrawal, or leave my money in the pension?” These are all great questions (and ones the membership services staff at PMRS is eager to help you answer). However, these are examples of questions to determine which path to take toward your retirement goal. To answer these questions, you should really know what your retirement goals are first. Here are some questions to help you figure out where you want to go, so that we can help you figure out how to get there:

1. **Why is money important to me?**
   This sounds like a silly question, doesn’t it? The first thing most people will say is that money is important because they have to pay their bills. Here, we’re asking you to dive a little deeper into that question, though. A 2004 study cited by the World Bank found that about one in five people in the developing world (over one billion people) lived off of less than $1.00 per day. As Americans, we clearly live off of much more than that, and our “bills” represent much more than what it takes just to stay alive. So ask yourself,
   
   “What do I value?”
   “Where does my money go every month, and are those things important?”
   “How do I picture my life years from now?”

By answering “why” your money is important, you start to see what you want to accomplish in life. Maybe you have a dream of someday traveling around the world. Maybe you have a special needs child to provide for after your death. Maybe putting a child through college is important. Or, maybe you just want to have the same lifestyle in retirement that you enjoy now. No matter what, the first step to retirement planning (or any financial planning for that matter) is to start with a vision.

2. **What are my highest priorities?**
   Hopefully you’ve enjoyed considering all of the possibilities for your financial future. Unfortunately, now reality sets in, and we have to consider that yacht in Miami may be more like a pontoon boat at the lake; and, the summer home in Naples, Italy may turn into a time share in Naples, Florida. The point is, after you develop some goals for your future, you should consider which of those goals come first.

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3. **How much will it cost to fund my goals?**

At this point, you know roughly what you want to accomplish in life and what is most important to you. Now, you have to figure out how much that will cost. To do this, you may have to do some research.

One of the biggest dream killers is inflation. For example, if you are 40 years old now and want to retire when you’re 65, it’s guaranteed that most of what you buy at retirement will cost more than it does now. For example, let’s say that your number one financial goal in life is just to maintain the standard of living you have now when you retire. Using an expense method of financial planning, imagine that your current bills, vacations, and general living expenses are $2,000 per month. Now let’s assume that inflation continues at a steady 3% per year. At age 65, your $2,000 per month in expenses will now cost you $4,187 per month. Also consider that inflation doesn’t stop just because you are retired. The goods and services you purchase at age 85 will cost even more than they did at 65.

With that being said, you do have to consider some expenses you might not have any more at retirement. Will your house be paid off? Will you be driving a lot less? Can you get rid of one of your cars? What about family expenses? Will your children be grown and out of the house? Also, consider other sources of income. What do you expect social security to provide each month? Do you have any other sources of funds, like an IRA or 401k from an old job? These are some other things that may take the pressure off relying solely on your pension when you retire.

The point is that you may need to take a deeper look at what you’re spending now, what you hope to be spending in the future, and additional sources of retirement assets to see how much your retirement is going to cost. This leads to the next step – identifying your starting point.

4. **Where am I starting from, today?**

Hopefully by now in the process, you’ve got an idea of what retirement might look like and how much it might cost. Now it’s time to take a look at where you are right now. One place to start is by getting an estimate from PMRS. When you call our offices for an estimate, we will calculate what you can possibly expect to receive when you retire based on current assumptions, like the actuaria credited interest rate, your salary, and contributions to your plan by you and your employer.

This is also a time to do some homework and identify all of the other assets and revenue sources you have for retirement. These may include savings, IRA’s, investments, and Social Security to name a few.

5. **How do I get from where I am, to where I want to be?**

We’d like to tell you that at this point, the hardest part is behind you. However, this is where the rubber meets the road in your financial plan. Let’s take a look at how far we’ve come:

a. You know what you want to do in retirement.

b. You know what is most important to you and what you can live without.

c. You have an idea what retirement will cost.

d. You have a grasp of your current financial status.

Now, it’s up to you to determine how to get from where you are to where you want to be. Of course, this is no small task. As far as your pension goes, we have a staff that is more than eager to help. You have at your disposal Retirement Technicians who can estimate your pension at a future date of your choosing, and you also have a Retirement Counselor at PMRS who can help you make sense of the different annuity options in your pension. Together we can work with you to show you how your pension fits into your overall retirement plan. Outside of PMRS, you can also pull together resources like friends and family, your employer’s pension representative, your tax preparer and your financial advisor.

By knowing where you want to go and working with the right people to develop a plan to get there, you are sure to make your golden years a time to cherish.