2011 NCPERS Public Fund Study

June 2011

Study conducted by
National Conference on Public Employee Retirement Systems
and Cobalt Community Research

2011 NCPERS Public Fund Study

Compiled by Cobalt Community Research

This study reviews funds' current fiscal condition and steps they are taking to ensure fiscal and operational integrity

About Cobalt Community Research

Cobalt Community Research is a nonprofit research coalition created to help governments, local schools and other nonprofit organizations measure, benchmark, and manage their efforts through high-quality affordable surveys, focus groups and facilitated meetings. Cobalt is headquartered in Lansing, Michigan.

Executive Summary

In March and April 2011, the National Conference on Public Employee Retirement Systems (NCPERS) undertook the most comprehensive study to date addressing retirement issues for this segment of the public sector. In partnership with Cobalt Community Research, NCPERS has collected and analyzed the most current data available on member funds' fiscal condition and steps they are taking to ensure fiscal and operational integrity.

The 2011 NCPERS Public Fund Study includes responses from 215 state and local government pension funds with a total number of active and retired memberships surpassing 7,590,000 and assets exceeding $900 billion. The vast majority – 83 percent – were local pension funds, while 17 percent were state pension funds. The study's primary findings are strongly positive. Public pension funds are experiencing a robust recovery from the historic market downturn of 2008-2009 – reporting strong investment returns, growing assets and funding levels on track to meet obligations. In addition, funds have responded to changes in the economic, political and social landscape by adopting substantial organizational and operational changes to ensure their long-term sustainability.

NCPERS is the largest trade association for public sector pension funds, representing more than 500 funds throughout the United States and Canada. It is a unique nonprofit network of public trustees, administrators, public officials and investment professionals who collectively manage nearly $3 trillion in pension assets. Founded in 1941, NCPERS has been the principal trade association working to promote and protect pensions by focusing on advocacy, research and education for the benefit of public sector pension stakeholders.

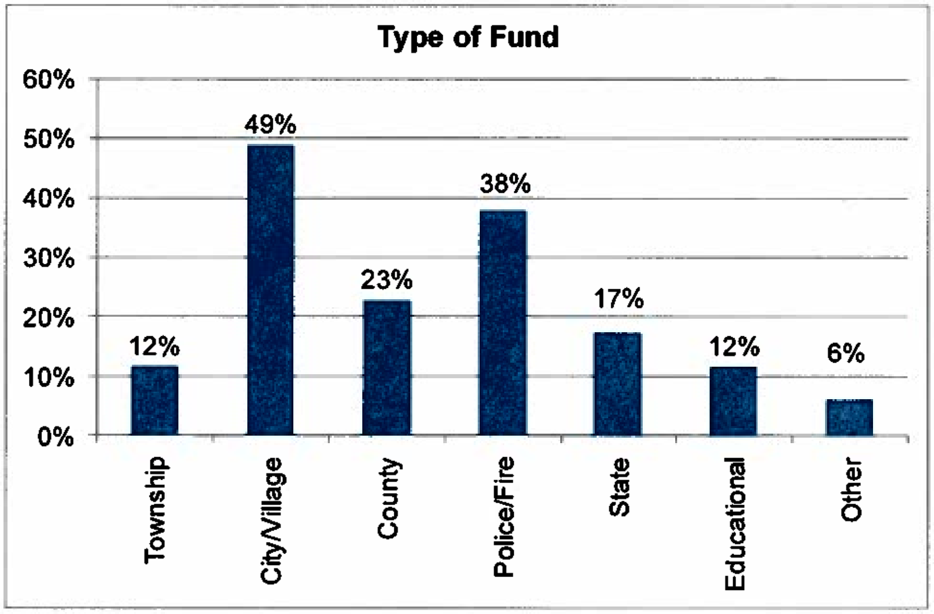
Key Findings

1. Despite weak short-term investment experience in 2008 and 2009, the long-term investment discipline of fund managers has produced an average 1-year return of 13.5 percent based on most recently reported data. Funds participating in the study reported a 20-year average of 8.2 percent. The average return that respondents use to calculate assets is 7.7 percent with an assumed rate of inflation of 3.5 percent.
2. Investment returns are the single most significant source of plan funding, comprising approximately 66 percent of fund revenue. Members are a significant source of plan funding and contributed 10 percent of plan revenue. Employer contributions comprise only 24 percent of plan revenue.
3. Although media coverage has focused on a handful of troubled funds, most funds are managed responsibly and maintain strong funding levels. On average, funds are 76.1 percent funded and continue to work toward full funding. According to its February 2011 report *Enhancing the Analysis of U.S. State and Local Government Pension Obligations*, Fitch Ratings considers a funded ratio of 70 percent or above to be adequate. As with a home mortgage, funding levels are designed to slowly be funded over many years. The average amortization period for respondents is 25.8 years.
4. Funds have been very active in responding to changes in the economic, political and social landscape; however, there are many practices identified in this study that funds may consider for further action. Three changes with significant activity are lowering the actuarial assumed rate of return, raising benefit age and service requirements and increasing employee contributions.

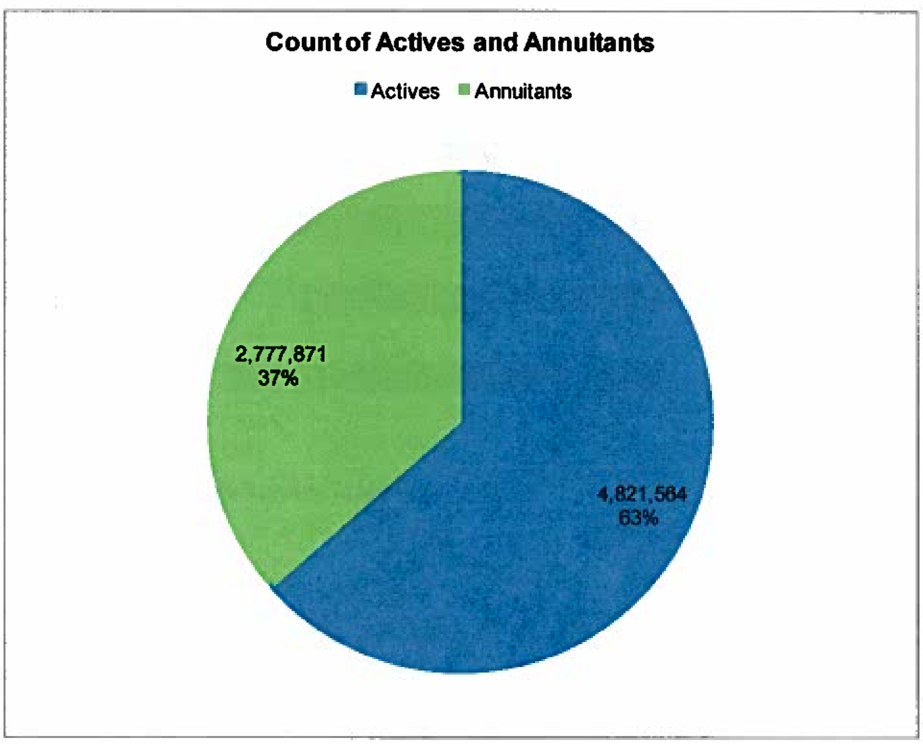
2011 NCPERS Public Fund Study Findings

Who Responded

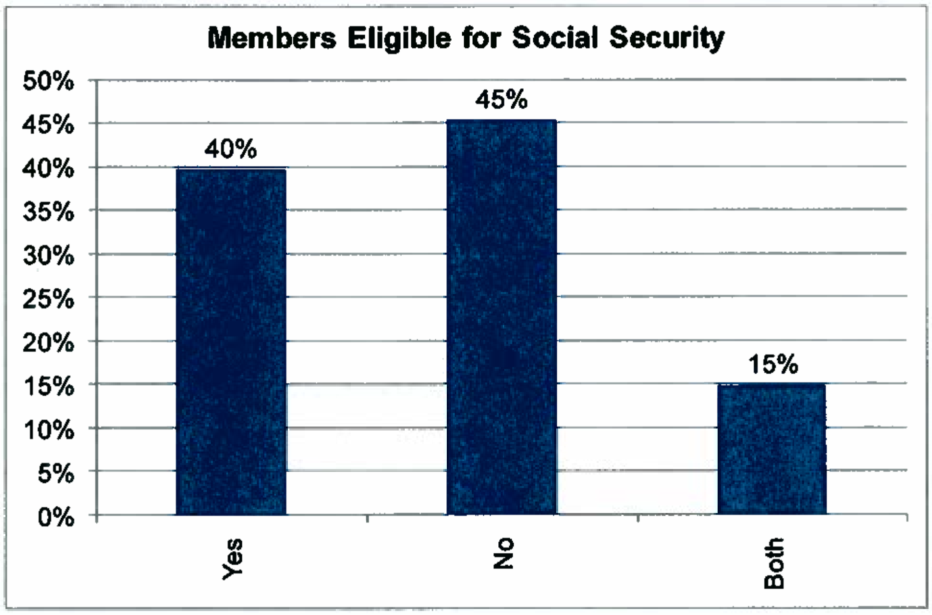
For the 2011 study, 215 respondents provided feedback to NCPERS using the most recent data they have available. Responding funds are members of NCPERS, and 49 percent served city and village jurisdictions. About 38 percent of the responding funds serve police and fire employees. The graph below shows the distribution of jurisdictions that the funds serve (totals may exceed 100 percent because of multiple response).



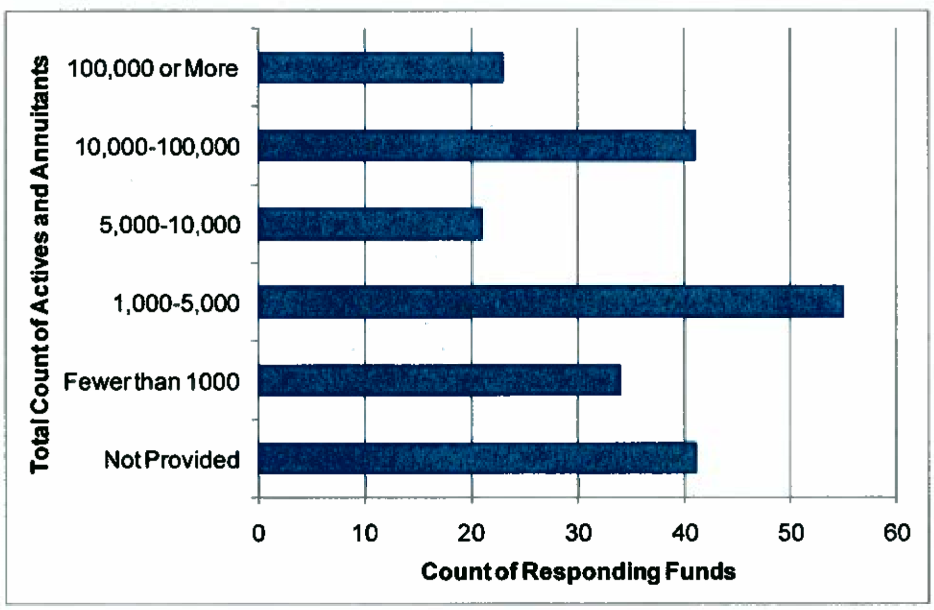
The graph below shows the number of active members and retiree/beneficiaries represented by these funds. This totals more than 7,599,000 covered lives.



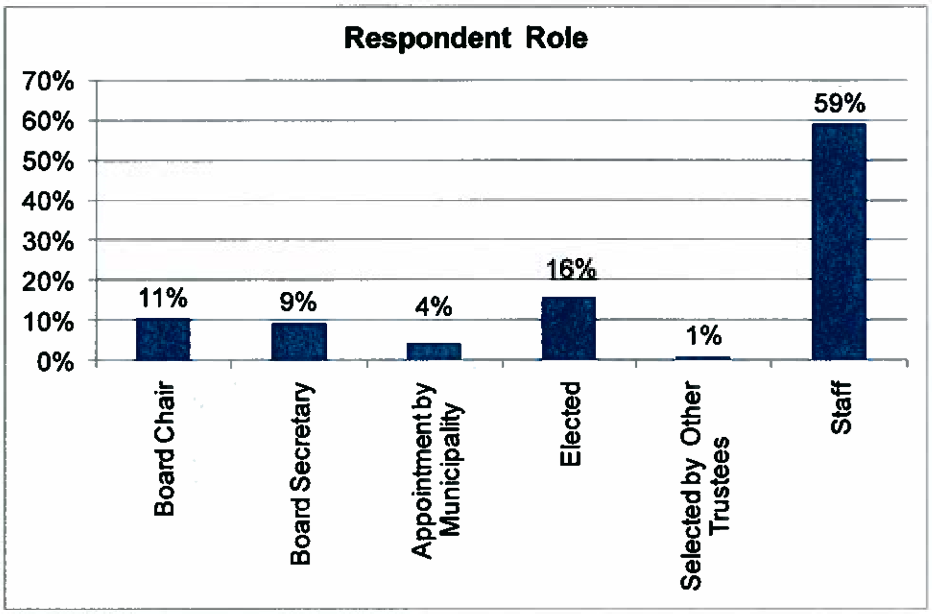
Approximately 40 percent of responding funds have members who are eligible for Social Security, 45 percent are not eligible, and 15 percent have a blend of members who are and are not eligible. In this report, breakdowns are presented for "Eligible for Social Security" and for "Not Eligible for Social Security." The grouping "Not Eligible for Social Security" includes those funds who indicate they have both types of members.



The graph below shows the number of responding funds divided by the size of the fund, determined by the number of active members and annuitants. The largest number of funds represent a population between 1,000 and 5,000.

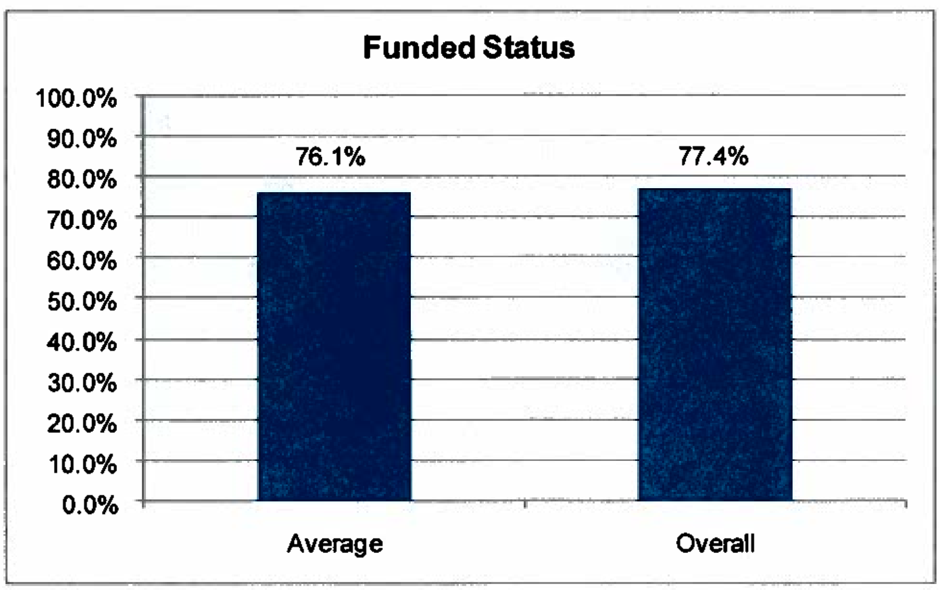


Finally, the majority of respondents serve as staff for the fund. These individuals comprise 59 percent of respondents.

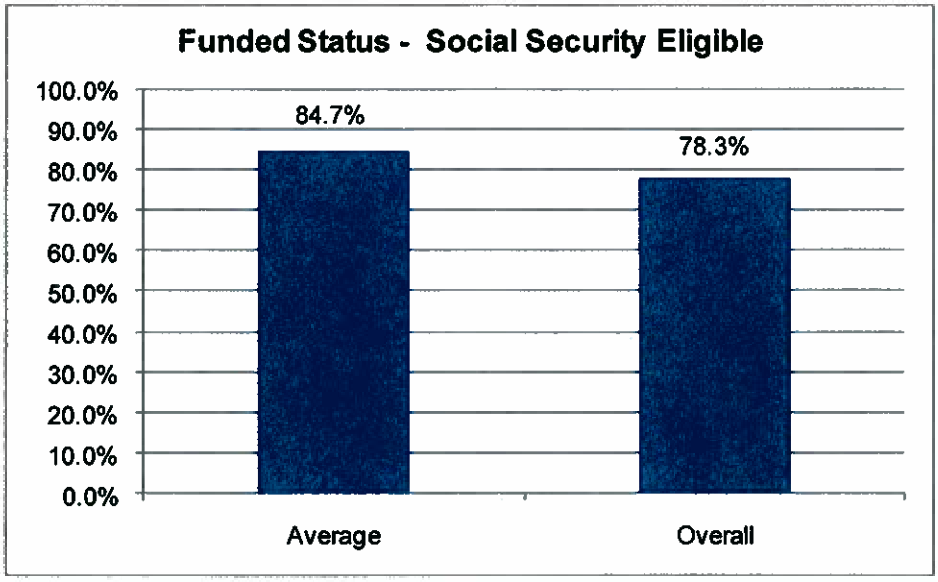


Funding Levels

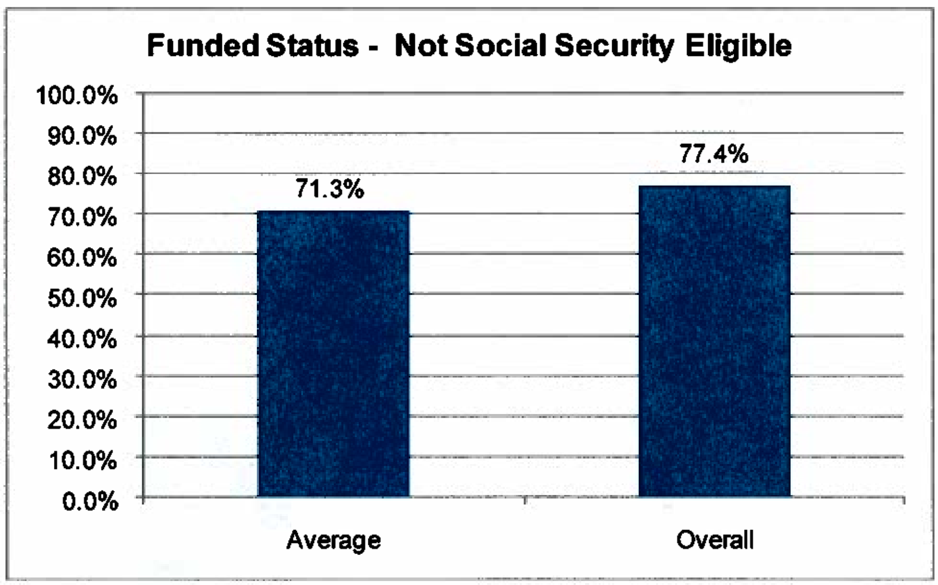
On average, the funded level is a solid 76.1 percent. When comparing the total actuarial assets of all respondents to the total liabilities, there is an overall funded status of 77.4 percent. Pension funds are designed to pay off liabilities over a period of time to ensure long-term stability and to make annual budgeting easier through more predictable contribution levels. For responding funds, that period of time averages to 25.8 years. The graph below shows funded status for all responding funds.



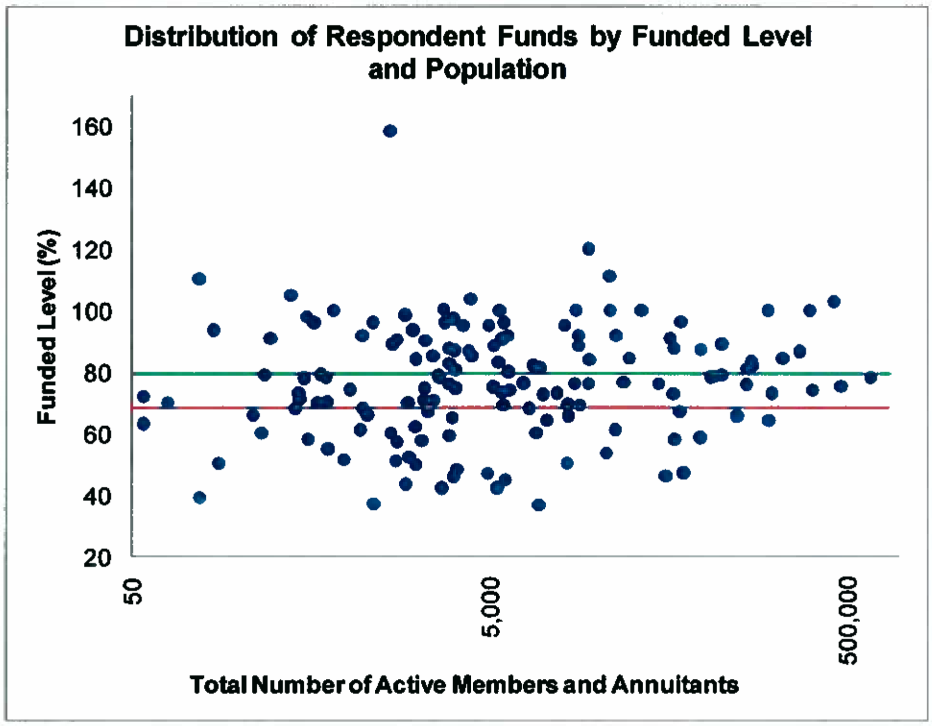
The graph below shows the funded status of funds in which members are eligible for Social Security.



The graph below shows the funded status of funds that include members who are not eligible for Social Security.

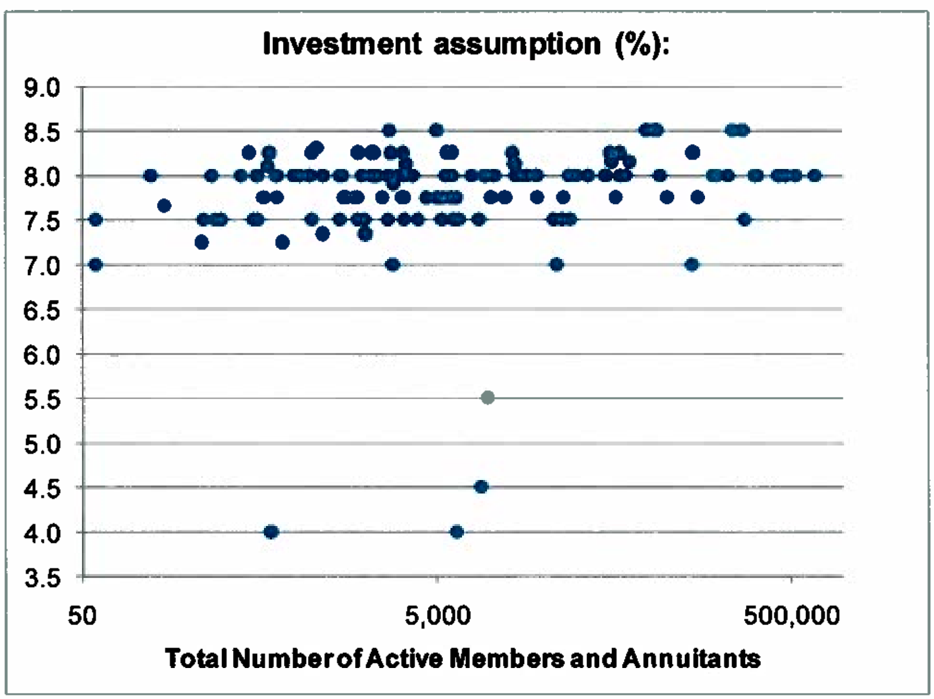


The graph below shows the overall distribution of funds. Approximately 68 percent of funds are above the red horizontal line, which shows the 70 percent "adequate" level of funding as defined by Fitch Ratings. The green horizontal line shows the 80 percent level of funding. Over time, funds are designed to slowly move toward 100 percent funded. This graph shows that the majority of funds are currently at sound funding levels.

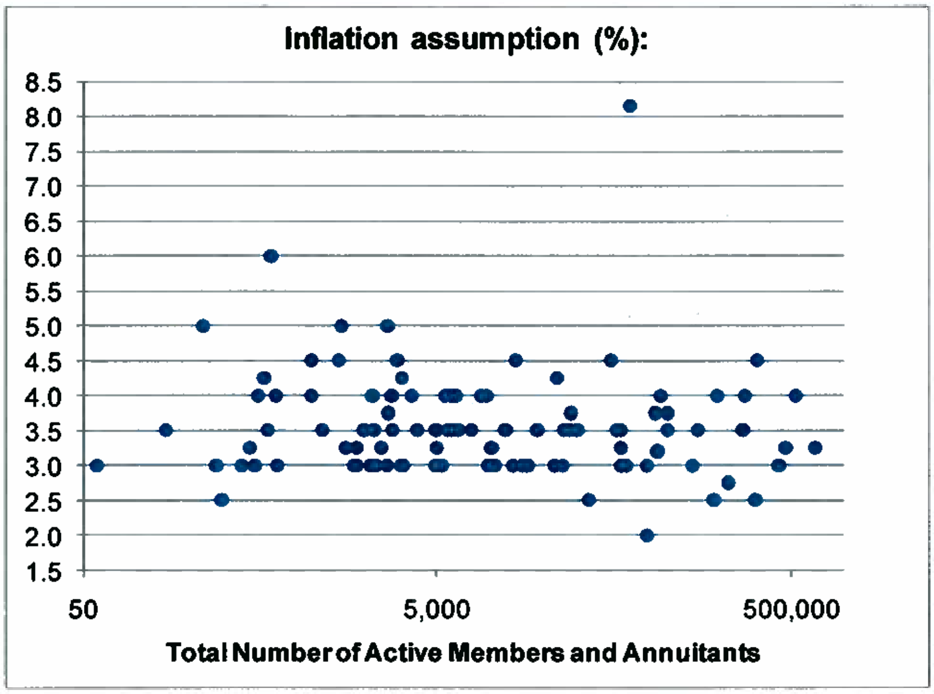


Assumptions

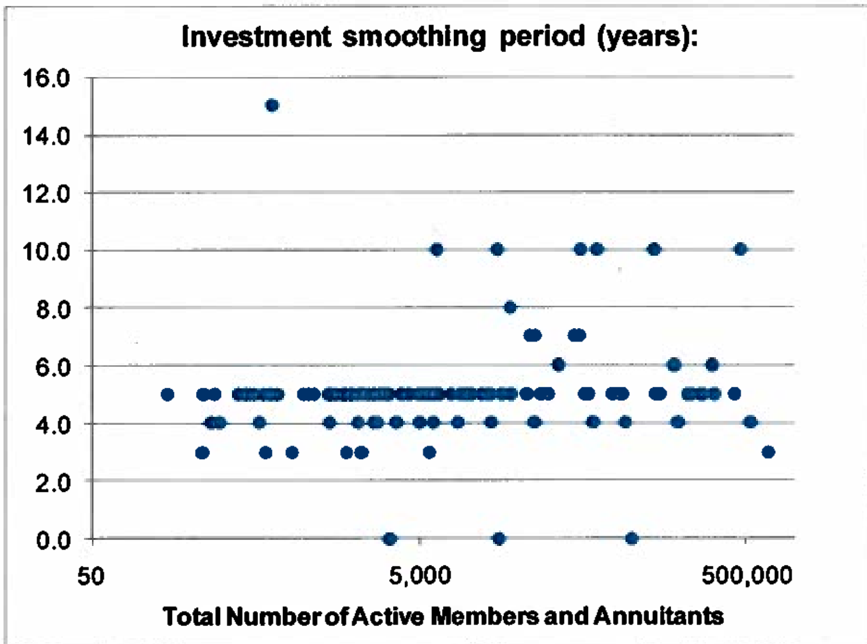
The average investment assumption for responding funds is 7.7 percent. Approximately 23 percent of responding funds have reduced this assumption in the past two years, and an additional 15 percent plan to do so in two years.



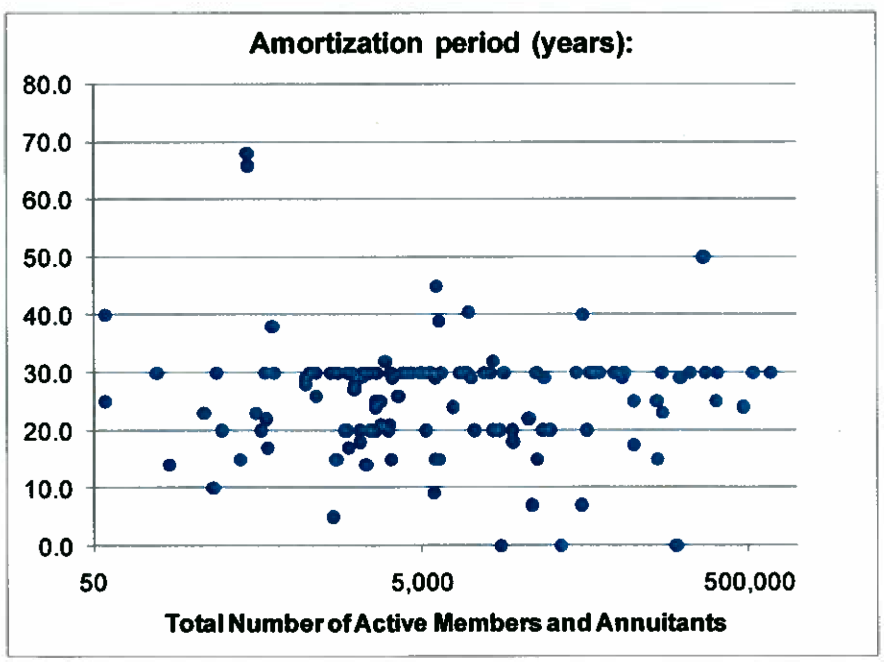
The assumed rate of inflation is an important factor in calculating a respondents' funded ratio. The average assumed rate of inflation is 3.5 percent. This average is consistent between both Social Security eligible and non Social Security eligible funds.



The investment smoothing period is a key factor in calculating the assets currently held by the fund and the contribution levels required to continue moving toward full funding over the amortization period. By smoothing investments, funds are able to dampen sharp changes in asset levels and thus contribution levels. This helps keep contribution levels more stable over time without undermining the long-term integrity of the funding mechanism. The average investment smoothing period for respondents is 5.0 years. For Social Security eligible funds, the smoothing period is somewhat lower with an average of 4.8 years.

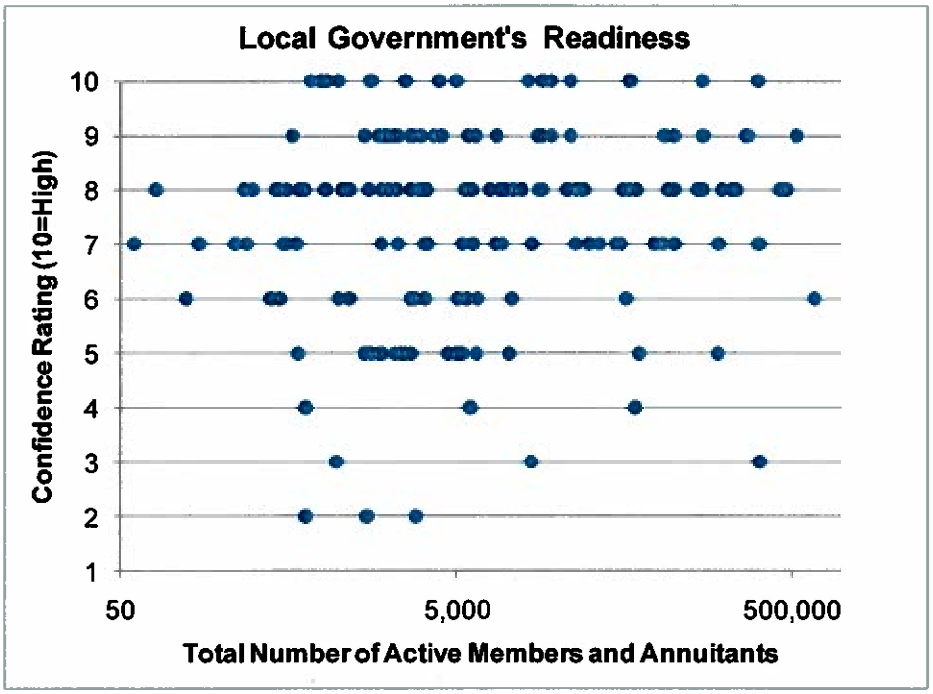


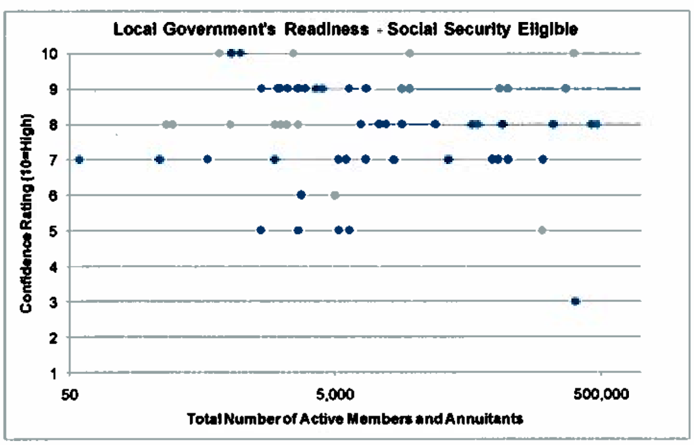
Similarly, the amortization period specifies the number of years used to project the value of assets, liabilities and other factors. This helps set contribution rates to meet long-term funding targets. The average for respondents is 25.8 years. Social Security eligible funds have an average of 25.2 years. About 30 percent of respondents have changed amortization periods in the last 2 years, and about 11 percent plan to do so in the next 2 years.

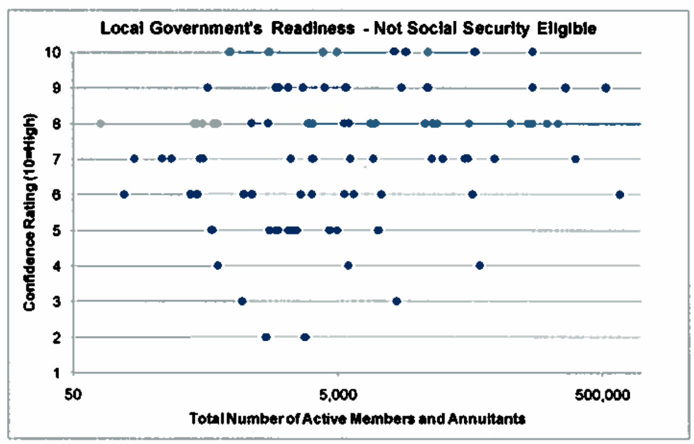


Fund Confidence

The survey asked respondents "How satisfied are you with your readiness to address retirement trends and issues over the next two years." Overall, respondents provided an overall "confidence" rating of 7.4 on a 10-point scale (very satisfied =10). Social Security eligible funds rated this question higher, with an overall rating of 7.8.

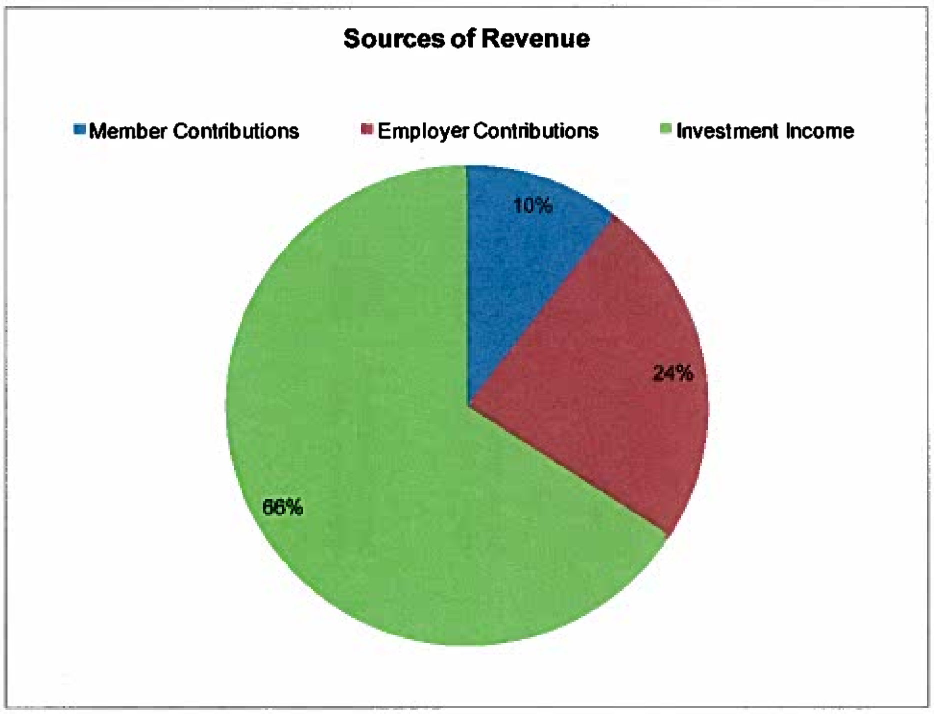


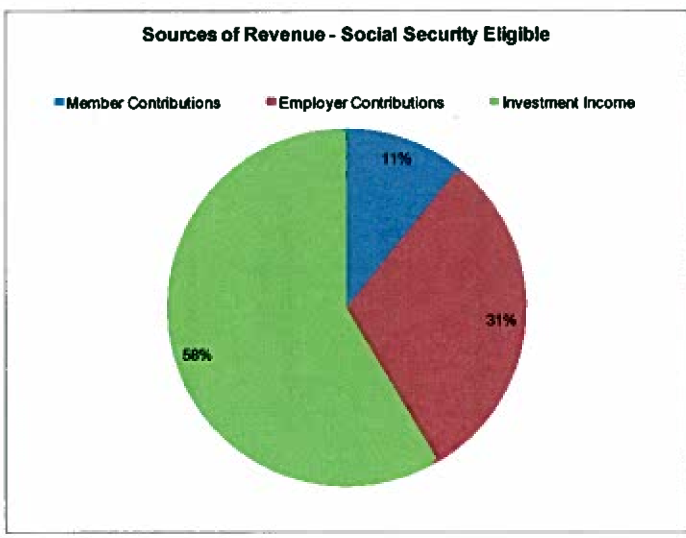


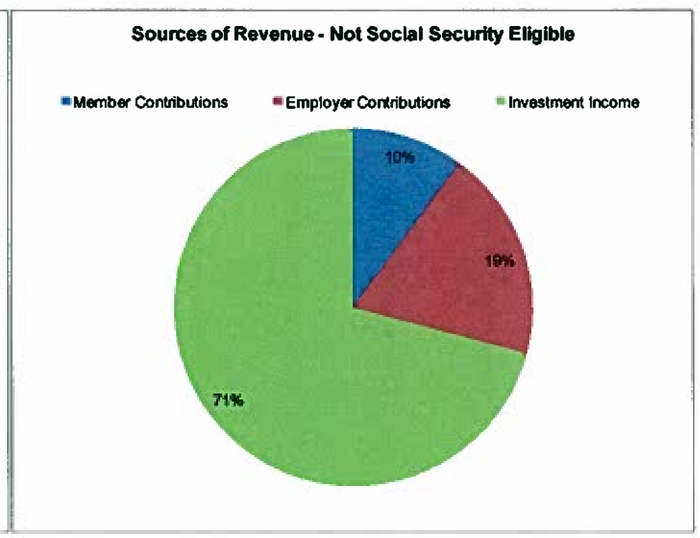


Sources of Funding

Income used to fund pension programs generally comes from three sources: member contributions, employer contributions and investment returns. The chart below shows the proportion of funding provided through each of these sources based on reported data. By far, investment returns are the most significant source (66 percent). Member contributions make up 10 percent of fund income. Employer contributions equal about 24 percent. These findings are consistent with other credible industry studies. Both this study and other industry studies show that annual fund expenditures and economic impact significantly exceed the annual contributions made by the employers. The pie charts below show the overall sources of funding for responding funds. Funds with members who are not eligible for Social Security reported a higher proportion of investment income in the study.

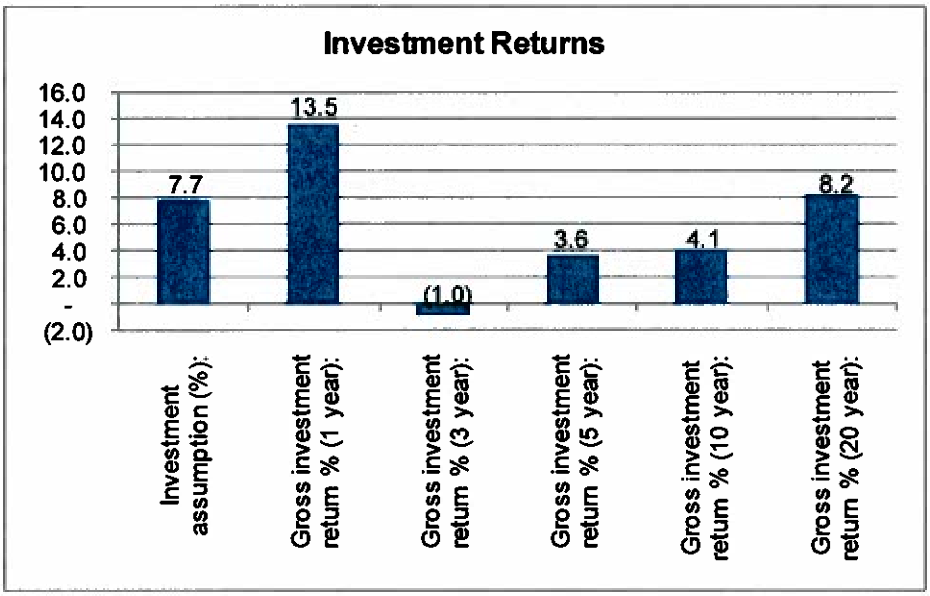


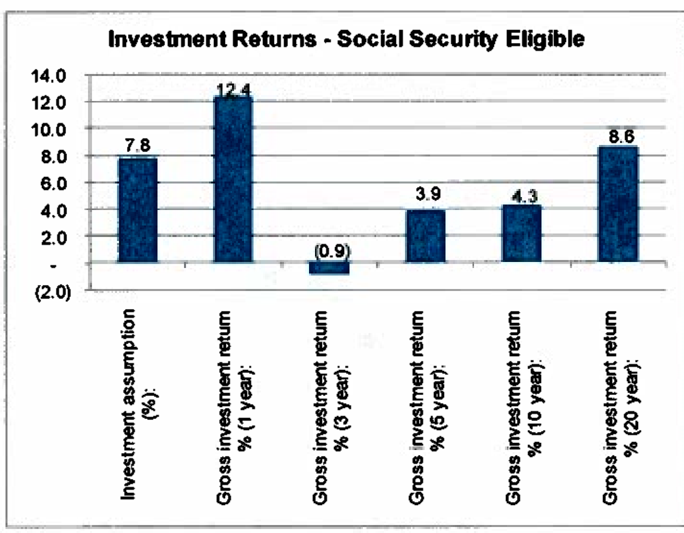


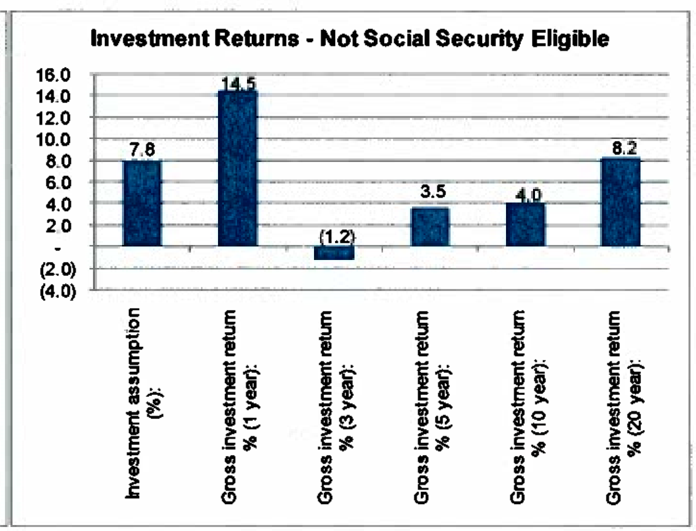


Investment Returns

Funding level is affected by the average investment returns a fund experiences over a set number of years. For respondents, the average number of years used in the calculation is 5 years. This is done to keep employer contribution rates more stable, as annual market return fluctuations would create significant volatility in the budgeting process. With the market declines in 2008 and 2009, the market and actuarial value of fund assets has declined; however, both 1-year and 20-year returns reported by participating funds points to continuing long-term improvement in funded status. The graphs below show average reported returns. Funds with members who are not eligible for Social Security reported higher returns in the past year, but they also had 20-year returns that trailed Social Security eligible funds by 40 basis points.

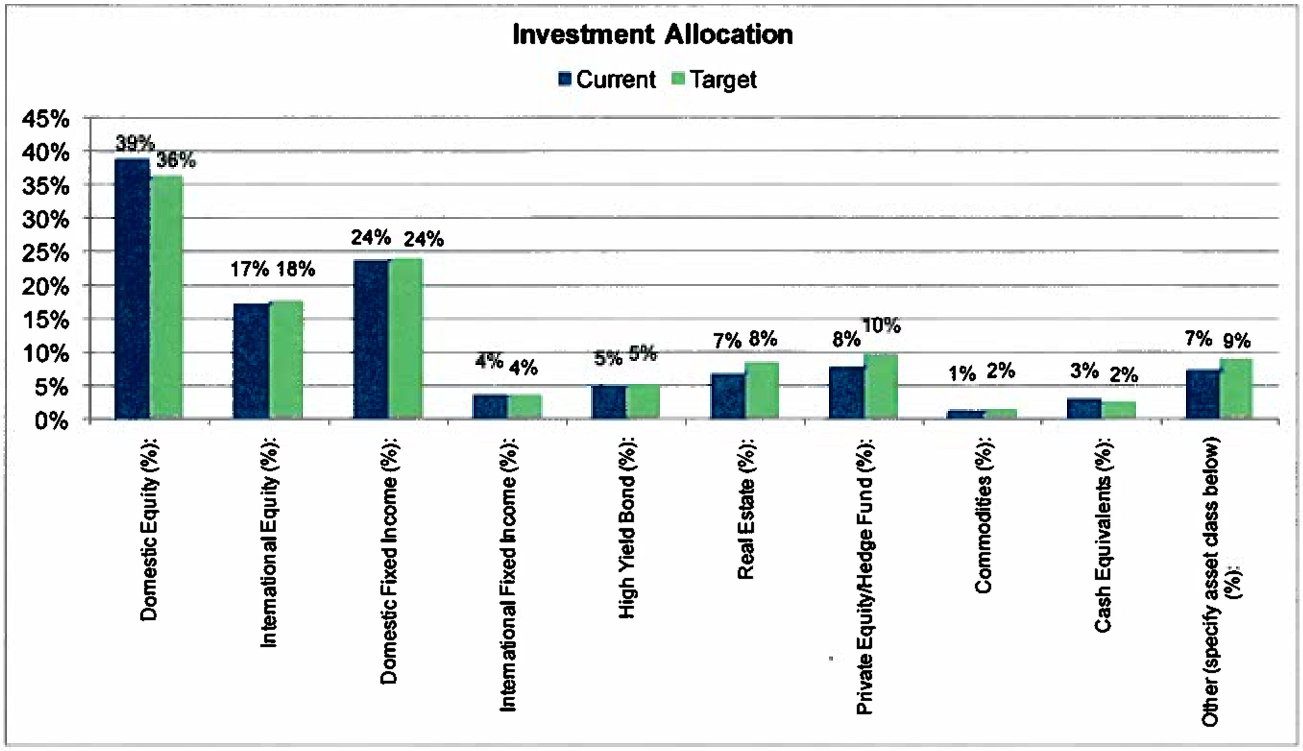


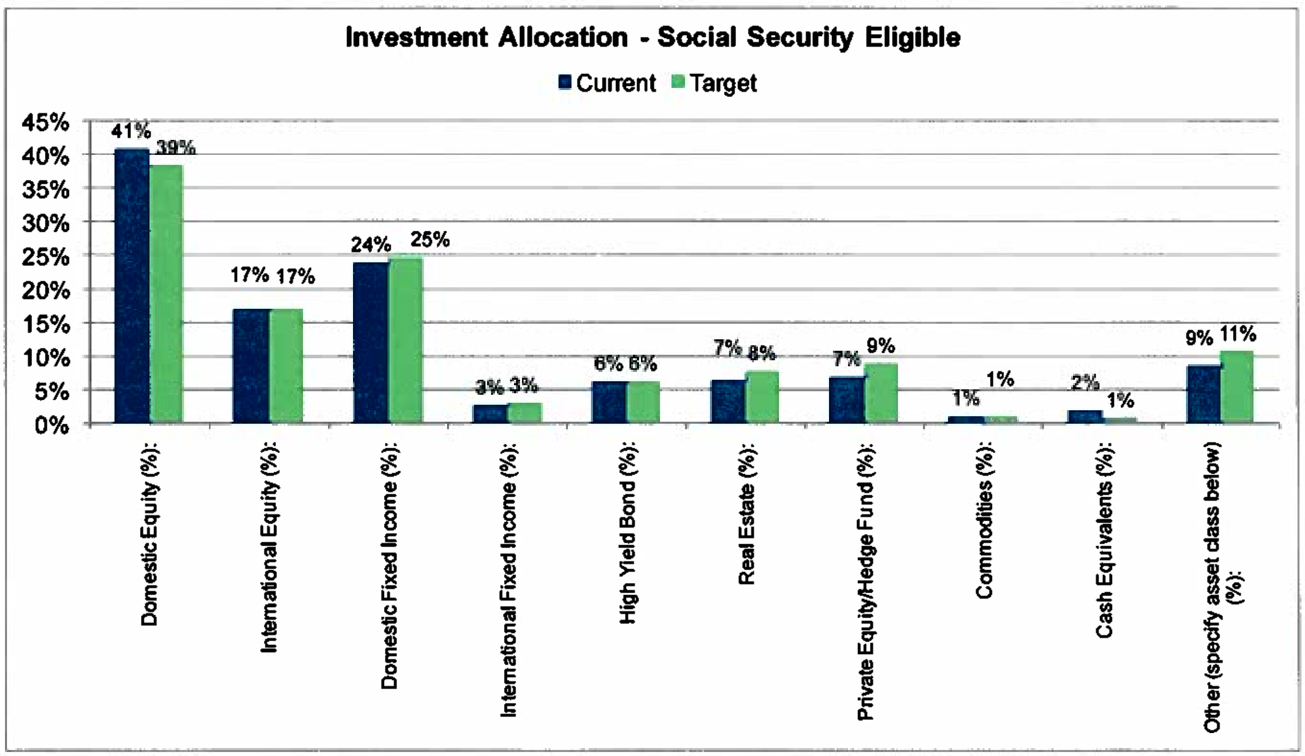


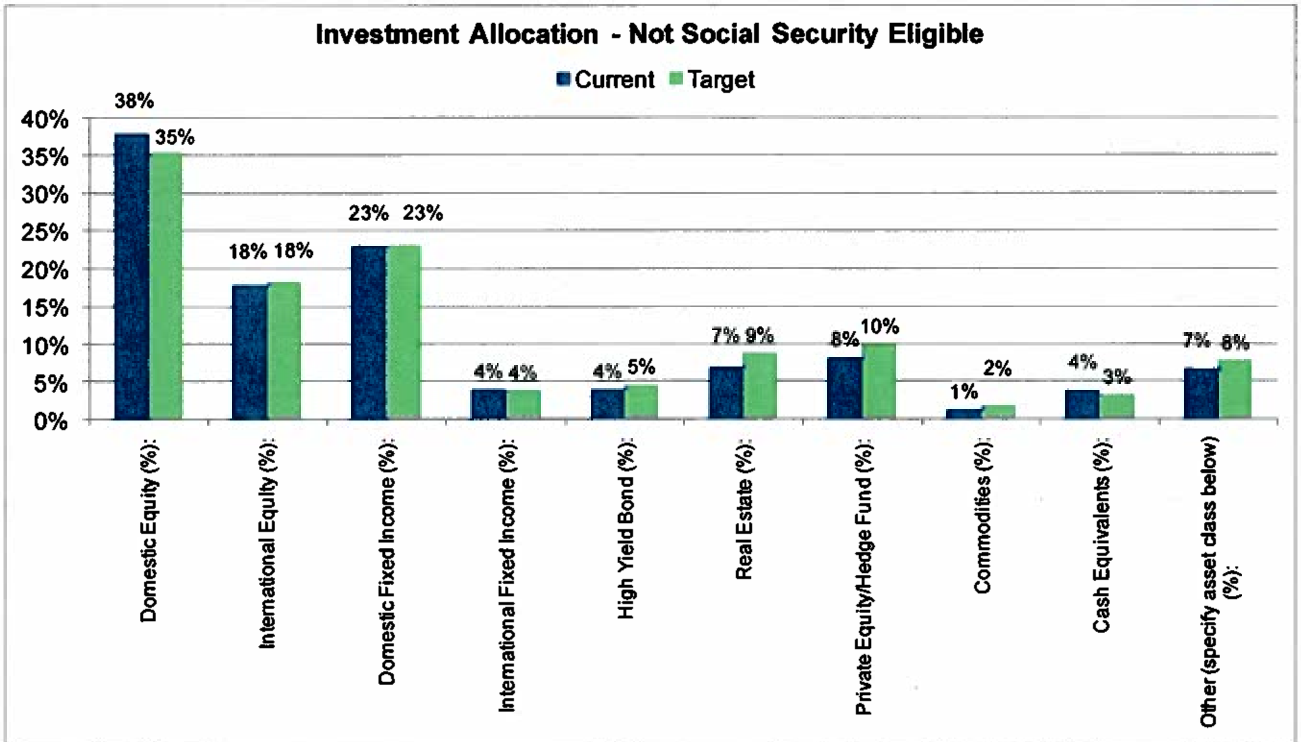


Investment Allocation

Overall, funds reported equity exposure (both domestic and international) at 56 percent, and overall international exposure at 21 percent. In the next two years, funds plan to reduce domestic equity slightly and increase allocations to private equity/hedge funds, real estate, and other investments.



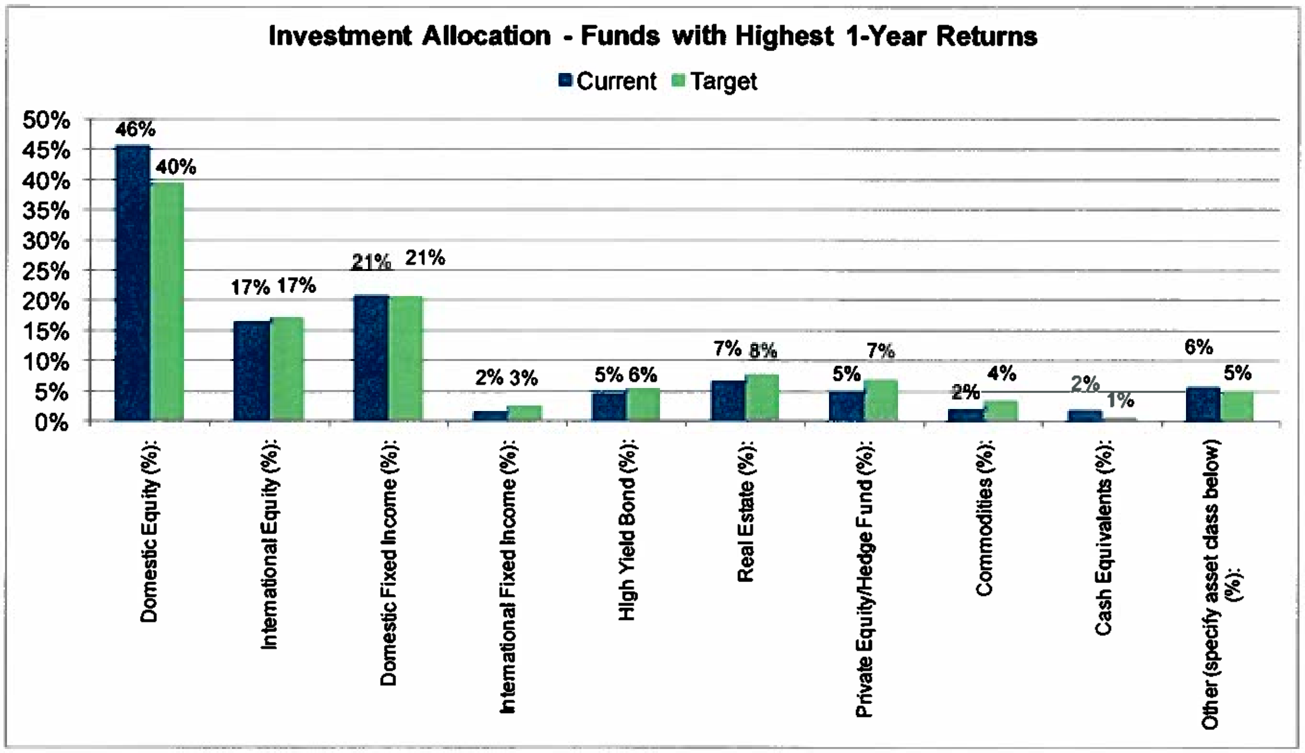


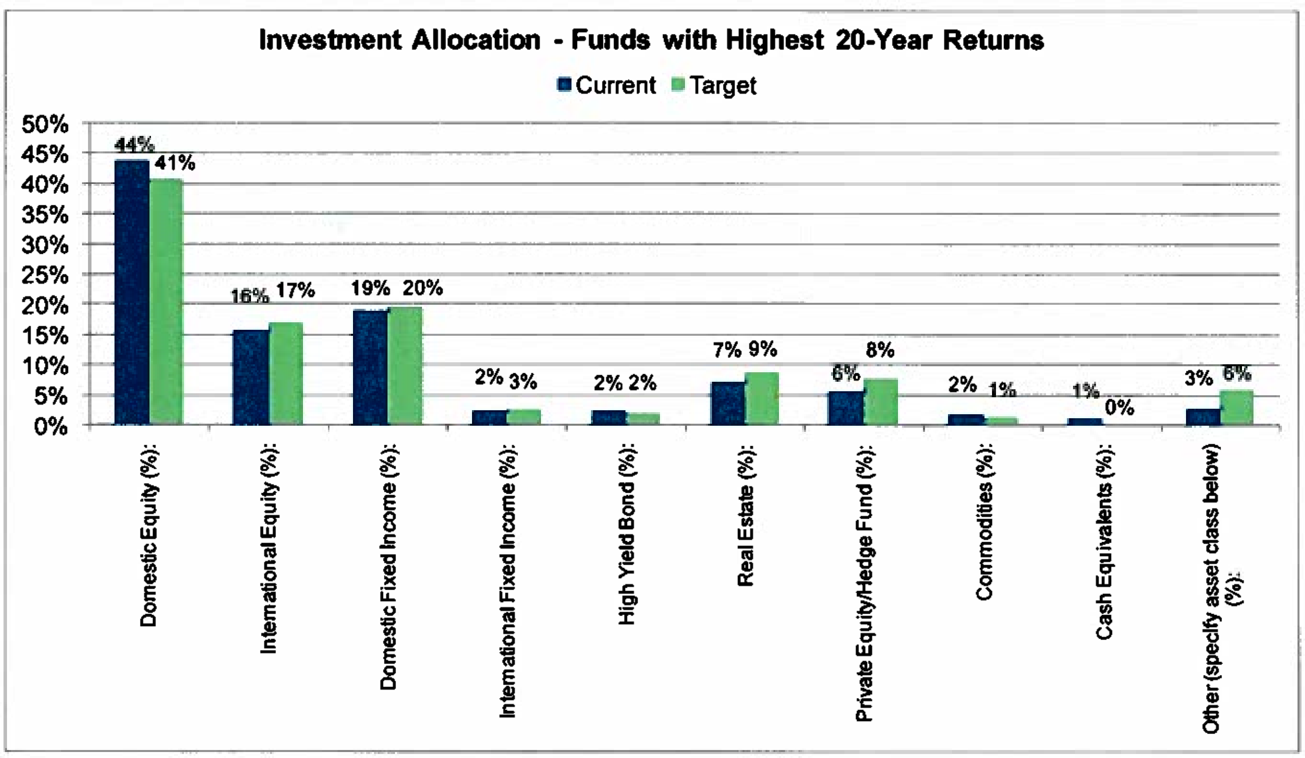


Respondents described other investments to include the following:

Absolute Return
Absolute Return + Alpha
All weather and Energy MLPs
Alternative Assets - includes real estate, private Equity
Arbitrage
Convertibles
Distressed Debt
Emerging Markets
ETI
Global Asset Allocation
Global equity
GTAA
GTAA 6.5; Alt 8.5
GTAA. Absolute Return and Real Assets
Hedge funds
Inflation Linked (ILAC)
Infrastructure
Long/Short
Market Neutral
MLP's
Mortgages
Natural Resources
Opportunistic and Absolute Return
Opportunistic and real assets
Private Equity
Real assets
Real return
REITs
State fund
Tangible Asset Innovation
Timber
TIPS

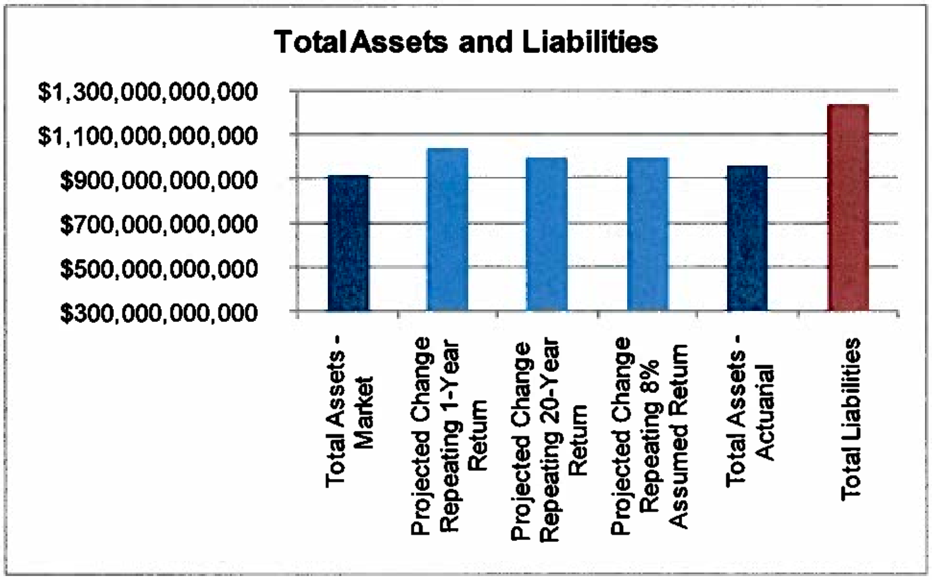
Below are two graphs that show the asset allocations for those 10 funds who reported the highest 1-year and the highest 20-year returns.

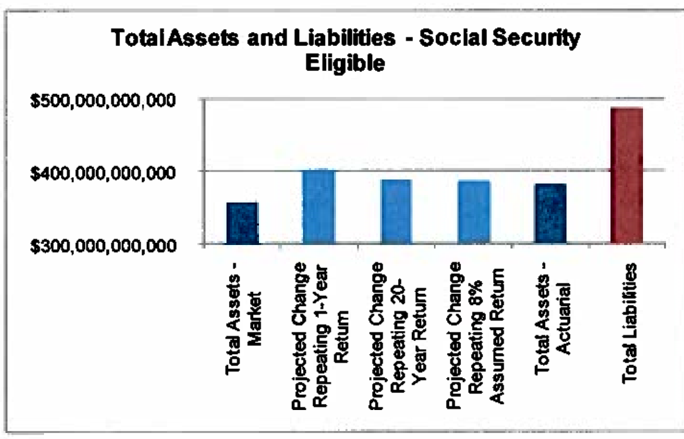


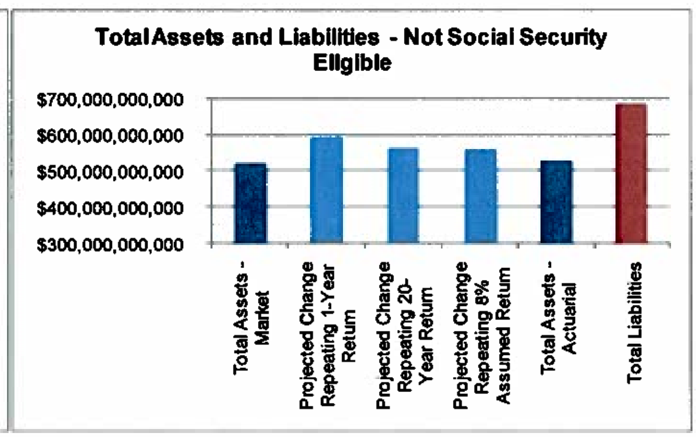


Investment Performance

The following graph shows the market value and actuarial value of assets (dark blue columns). The red column shows actuarial liability that pension plans are designed to meet over time. The light blue columns project the improvement in market assets in one year using three scenarios: repeat of the 1-year return (13.5 percent), returns that equal the reported 20-year return (8.2 percent), and returns that equal the average reported actuarially assumed rate of return (7.7 percent). Essentially, this graph shows despite short-term market declines, funds will continue to make progress toward funding liabilities.



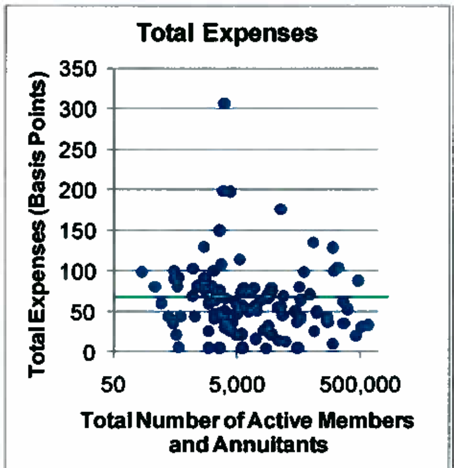


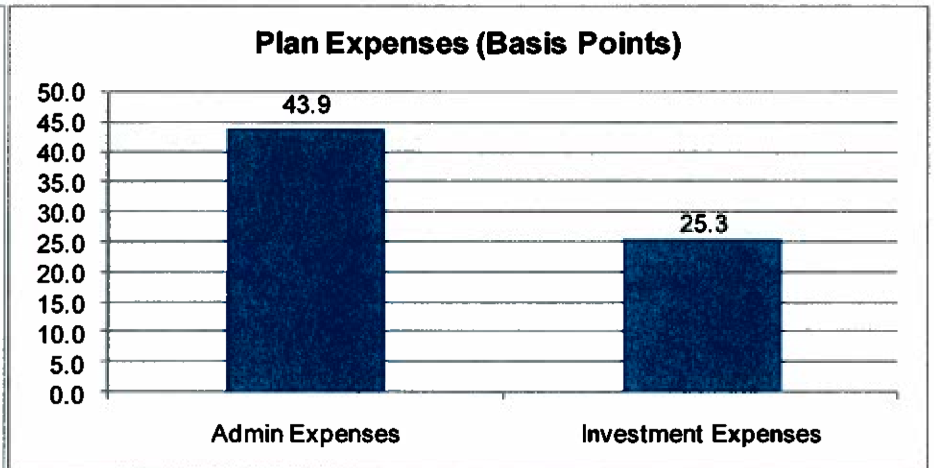


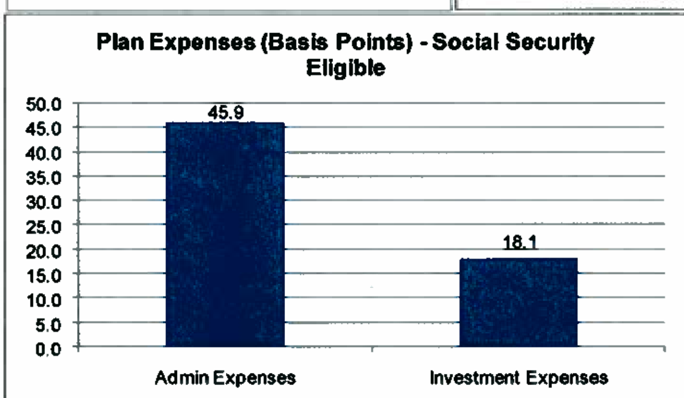
Expenses

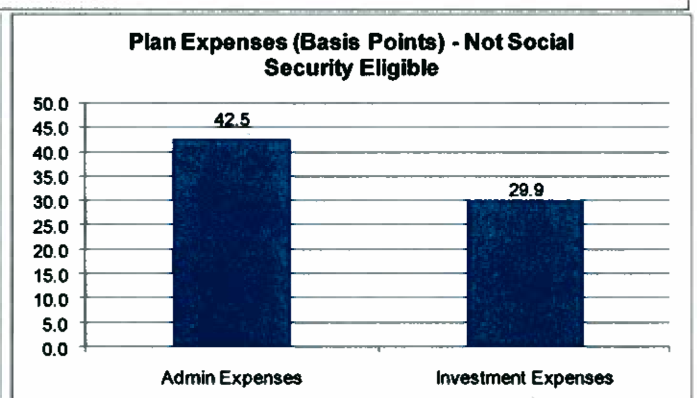
The overall average expense for respondents to administer the funds and to pay investment manager fees is 69.2 basis points (100 basis points equals 1 percentage point). According to the *2010 Investment Company Fact Book*, the expenses and fees of most mutual funds were well above 100 basis points. This means that funds with lower expenses provide a higher level of benefit to members (and produce a higher economic impact for the communities those members live in) than most mutual funds.

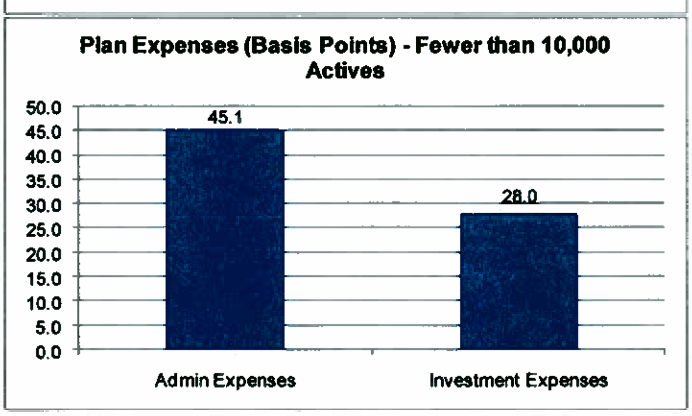
Social Security eligible funds have total expenses of 64.0 basis points, non Social Security funds pay 72.4, smaller funds pay 73.1, and larger funds pay 62.9 basis points.

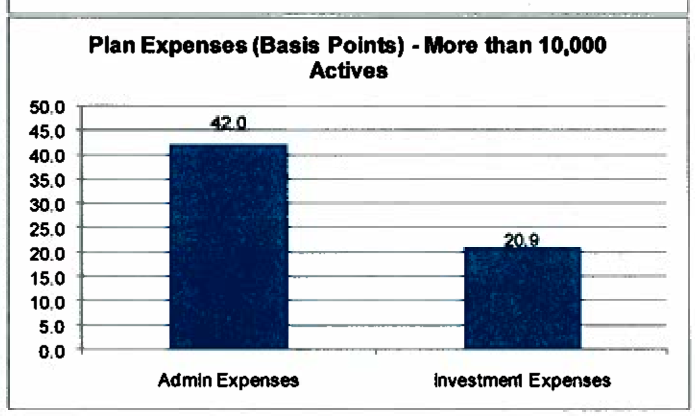






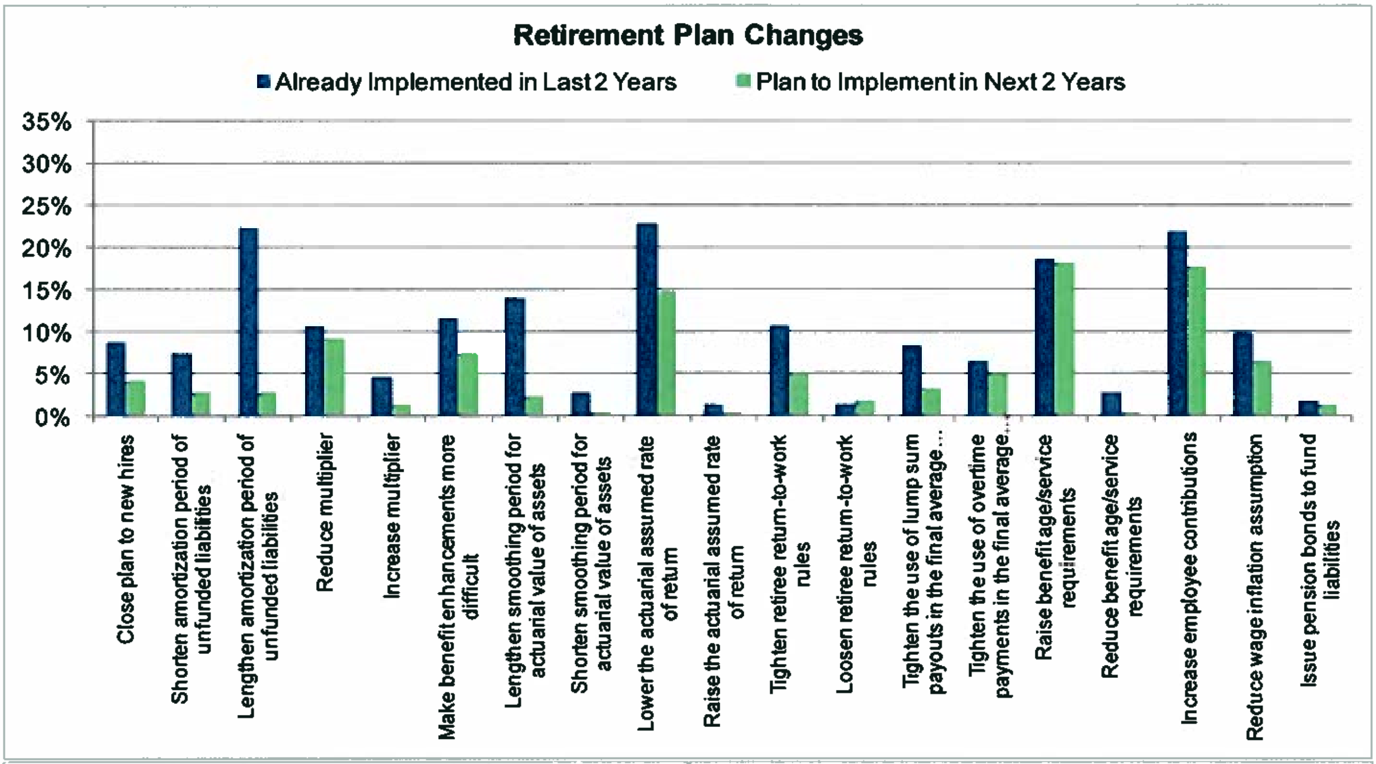


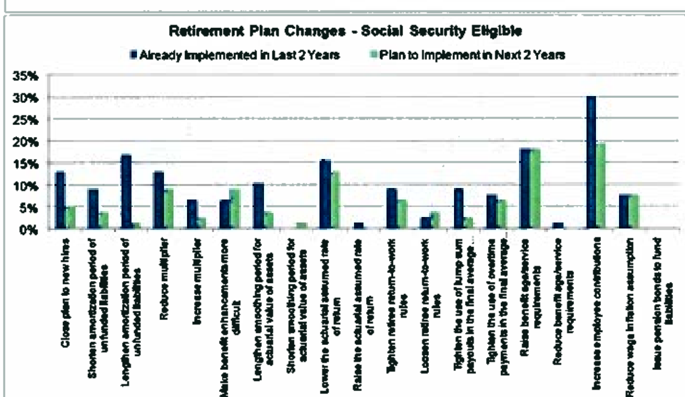


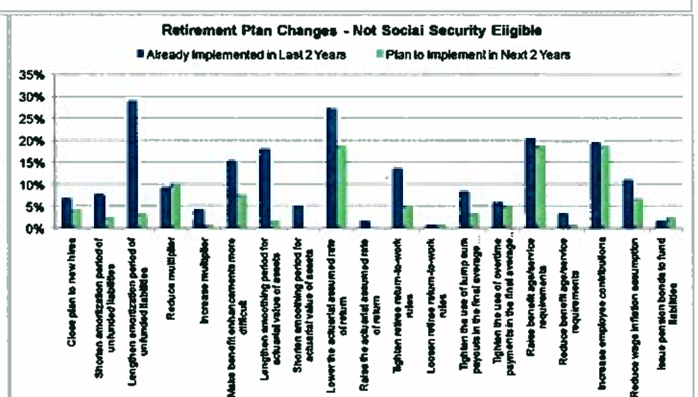


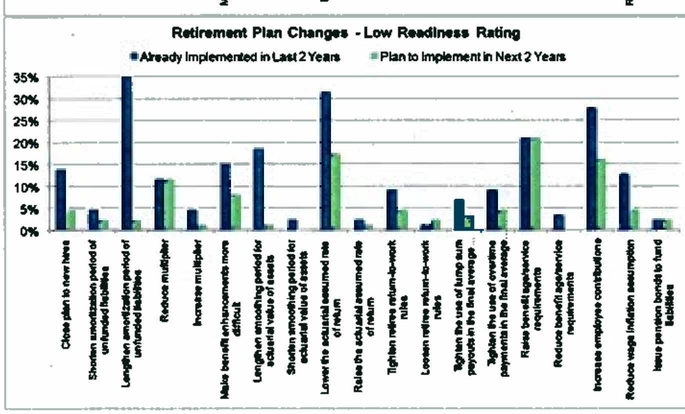
Trends in Retirement Plan Changes

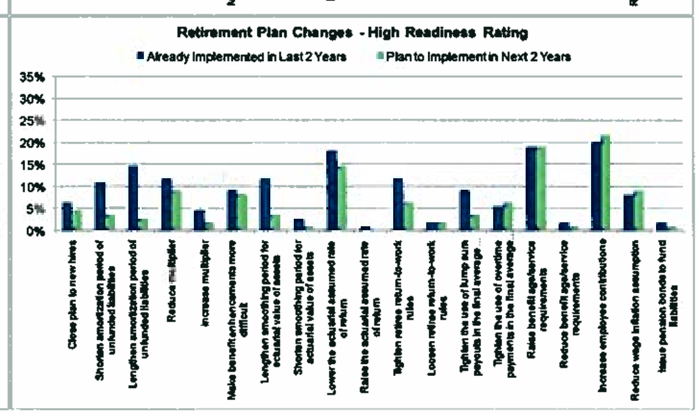
As changes emerge in the political, economic and demographic landscape, funds are adapting their design and assumptions to respond and to maintain the sustainability of the plans. Overall, funds have moved to lower assumed rates of return, lengthen amortization periods, increase employee contributions and raise benefit age/service requirements.





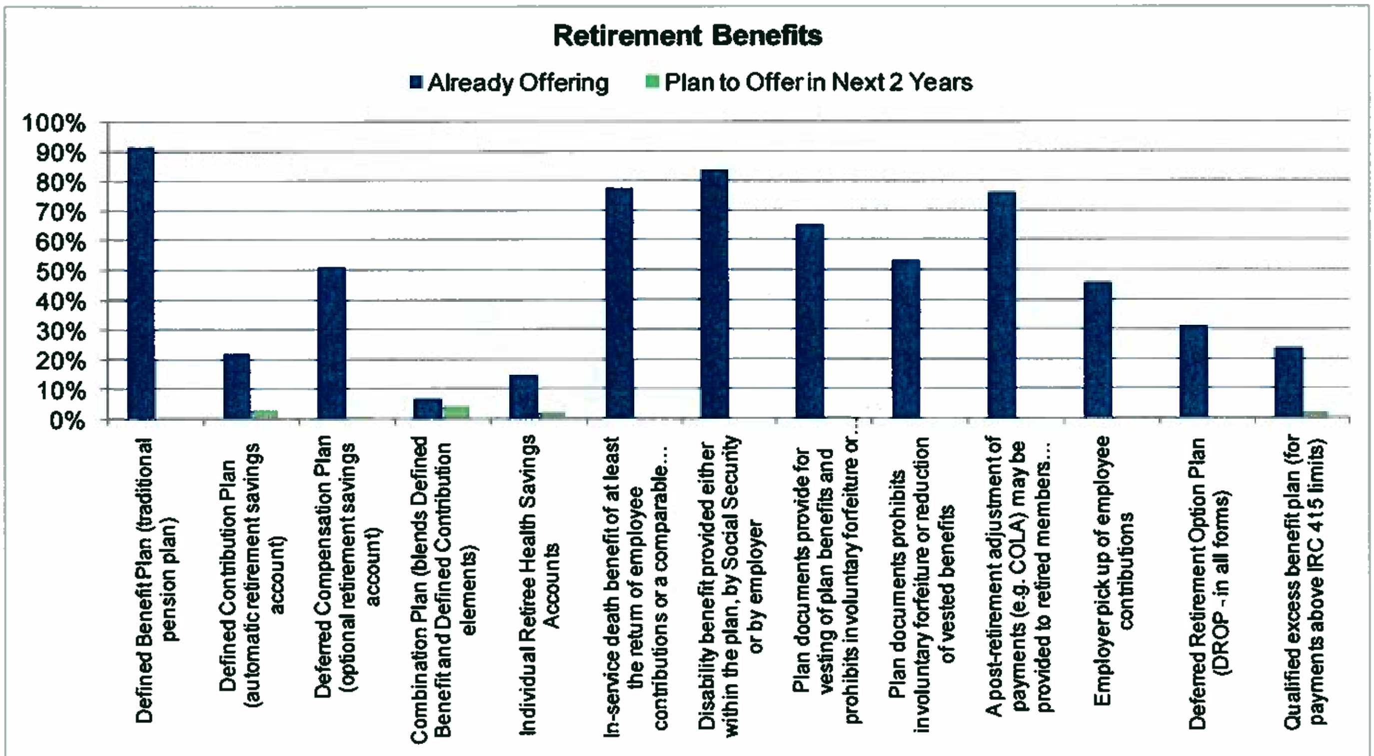


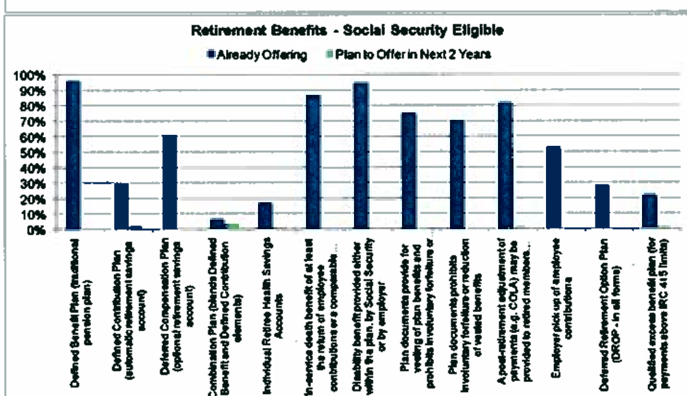


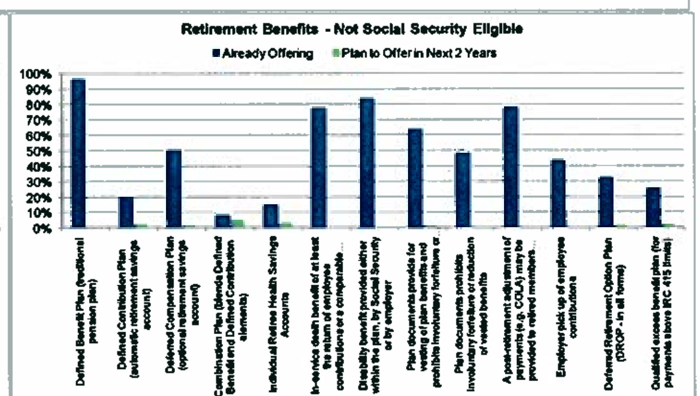


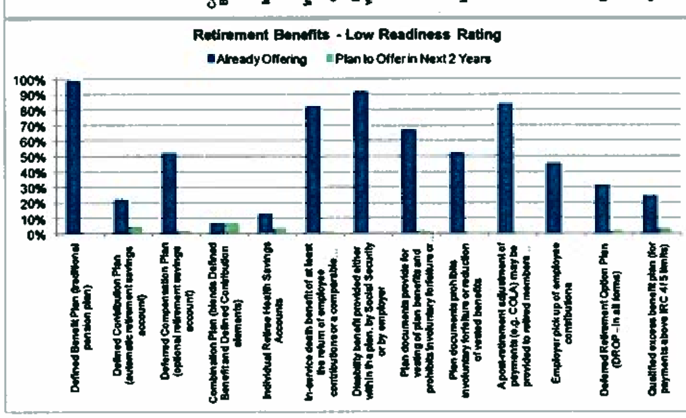
Trends in Retirement Benefits

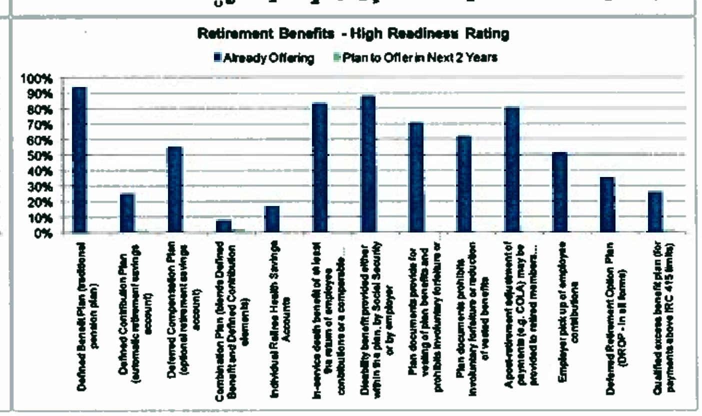
While the design and assumptions of benefit plans is changing, the mix of benefits will be stable in the next two years, with only modest growth in combination (hybrid) plans that blend defined benefit and defined contribution elements. Traditional defined contribution plans and individual health savings accounts will see a slight increase.





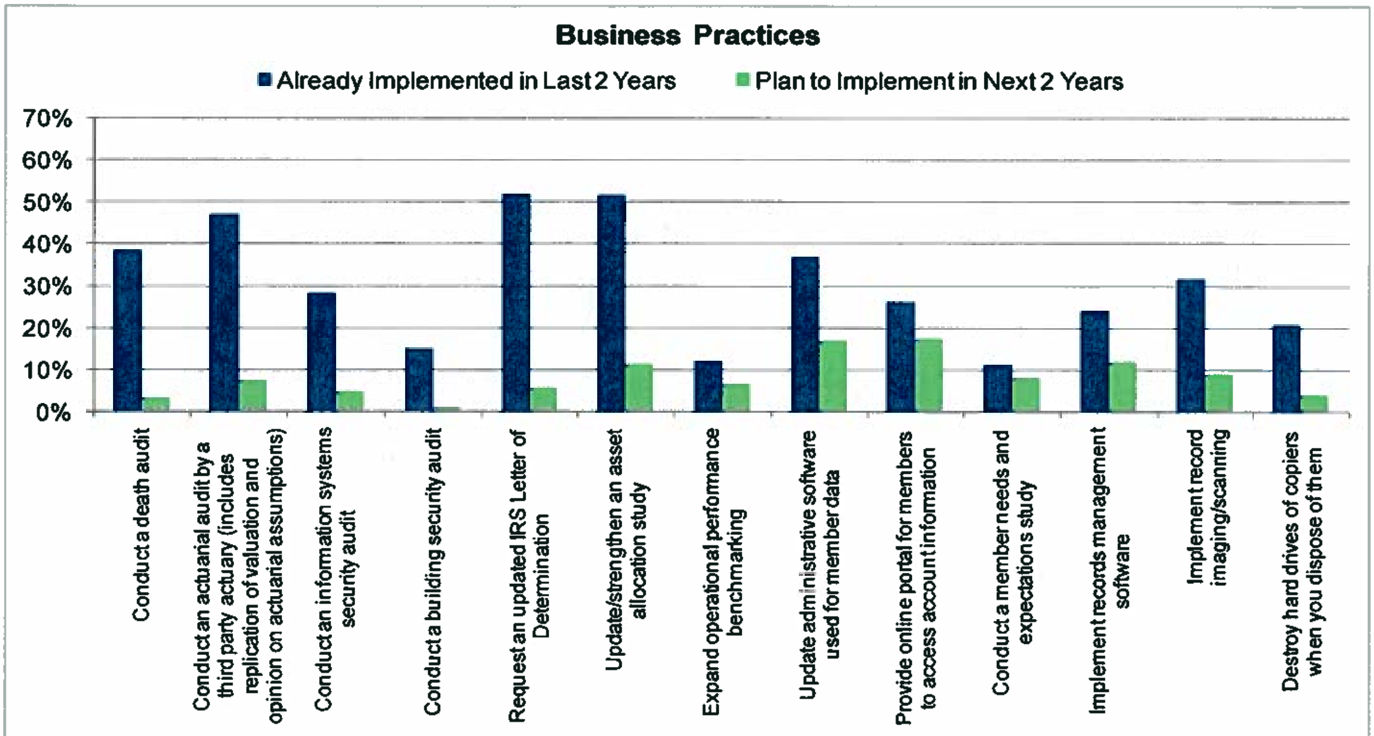


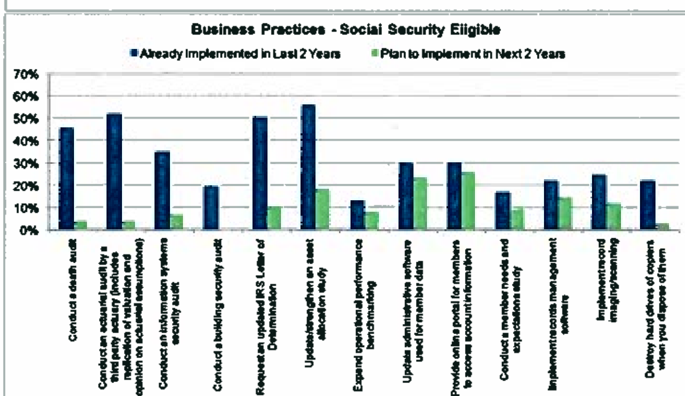


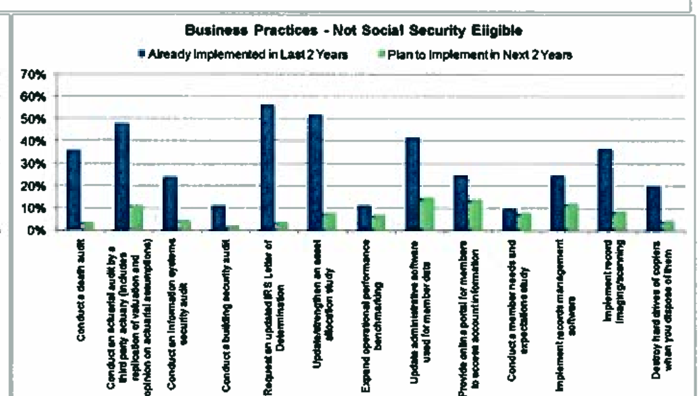


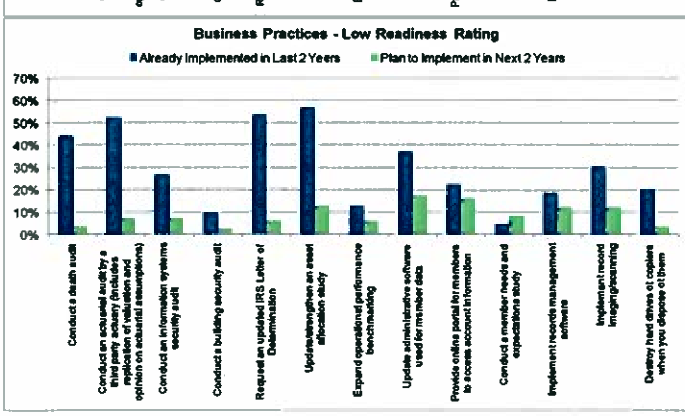
Trends in Business Practices

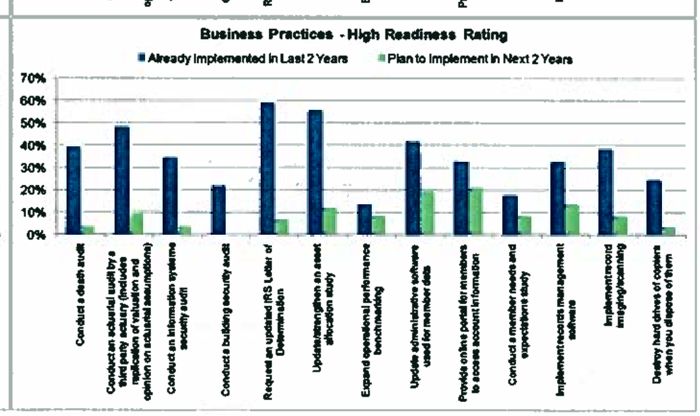
Business practices are those activities that are designed to improve the integrity, efficiency and effectiveness of fund administration. While many funds are already updating IRS letters, asset allocation studies and actuarial audits, there is significant opportunity for more funds to step up the practices noted on the graphs below.





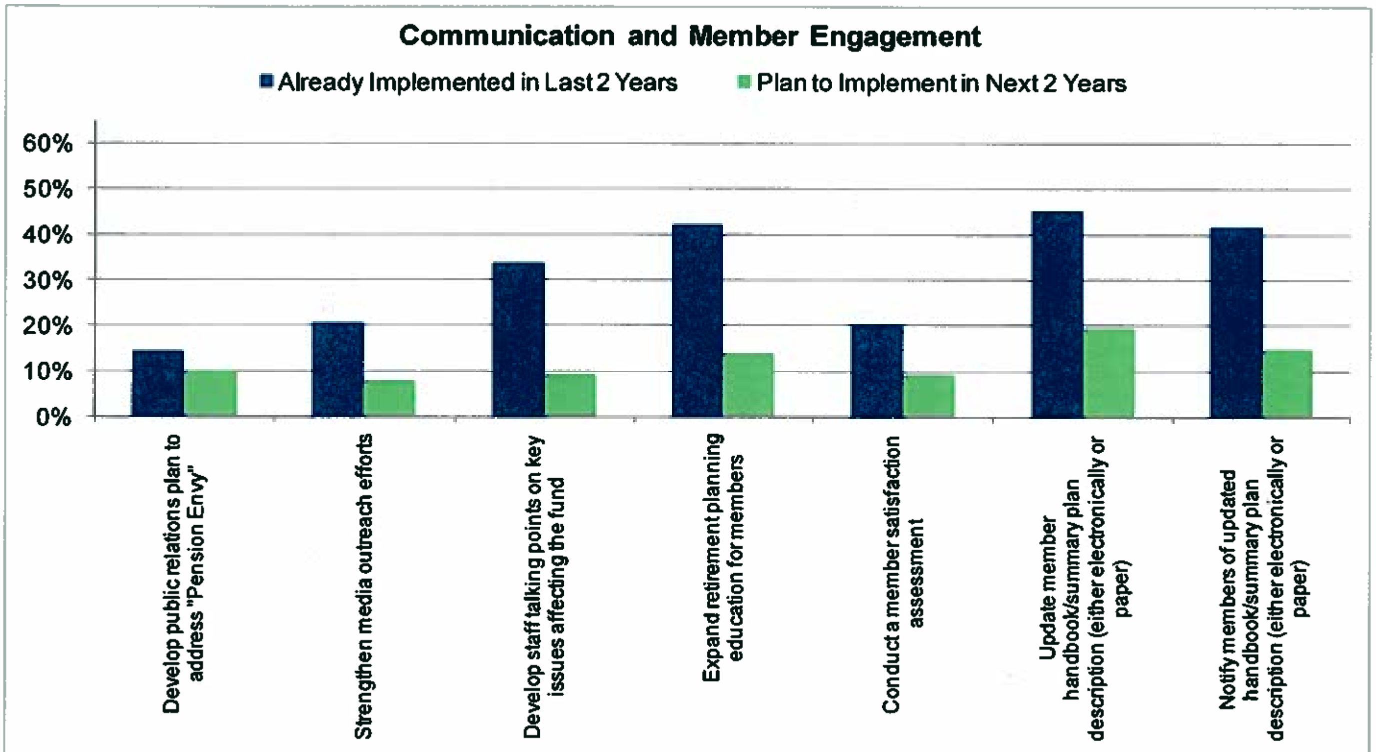


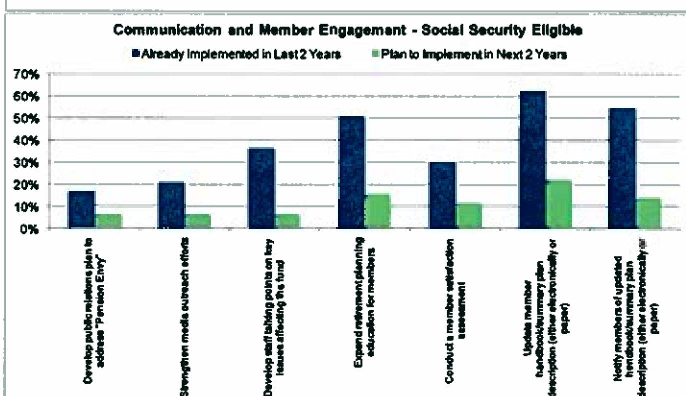


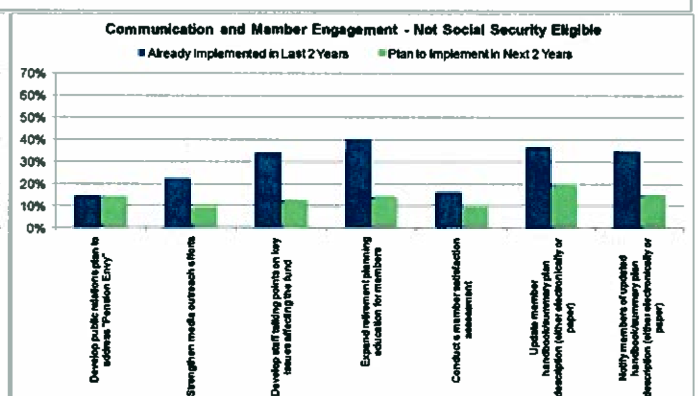


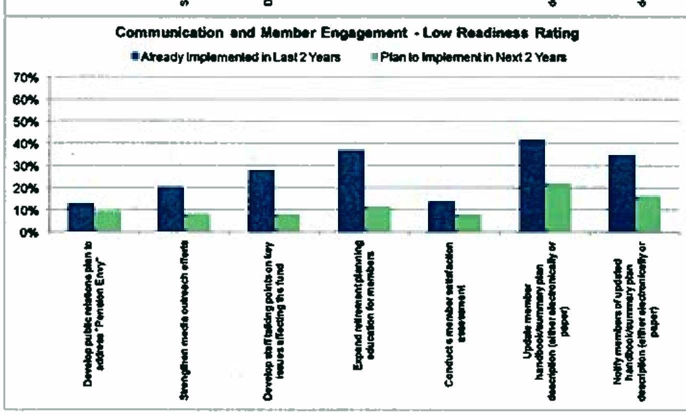
Trends in Communication and Engagement

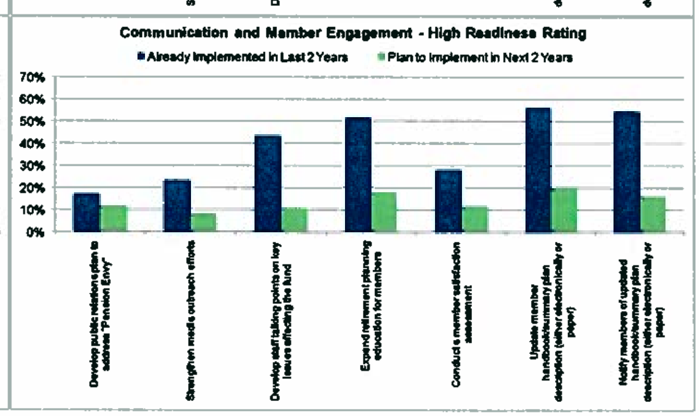
As with business practices, communication and engagement activities that are designed to improve the fund administration and maximize the value it provides to stakeholders. Handbook and retirement planning activities are the most common; however, media and member engagement is providing benefits for many funds as well.





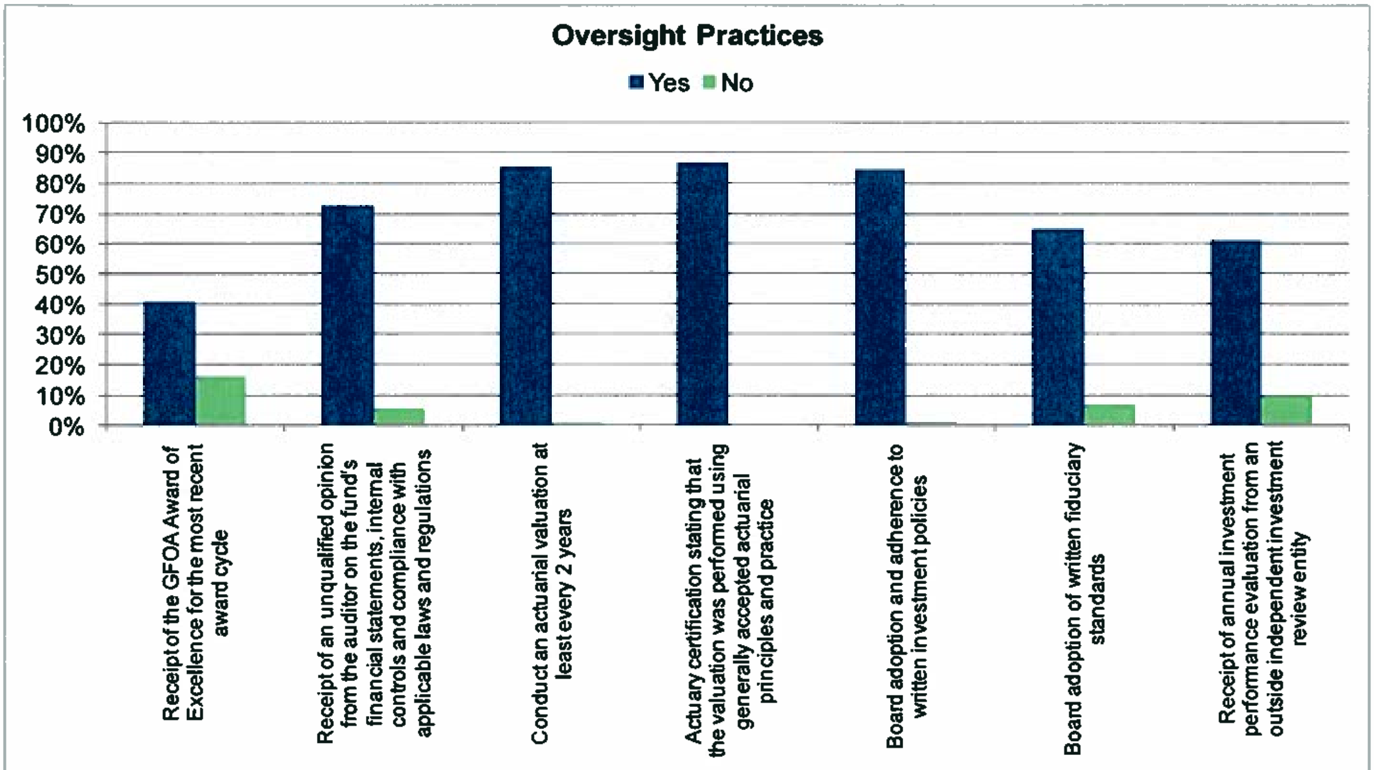


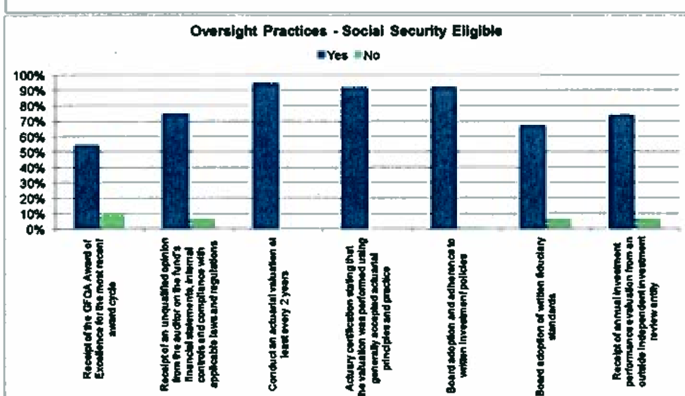


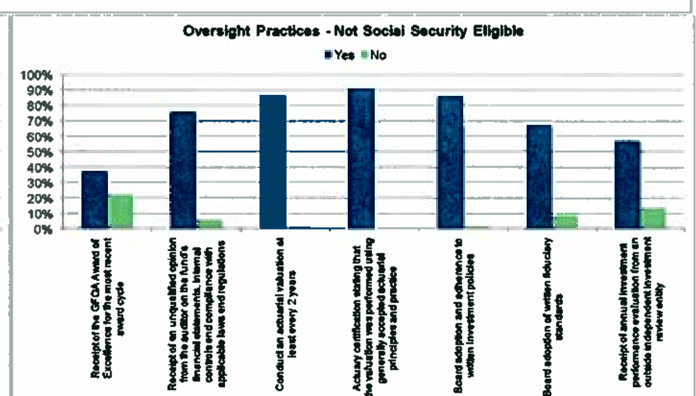


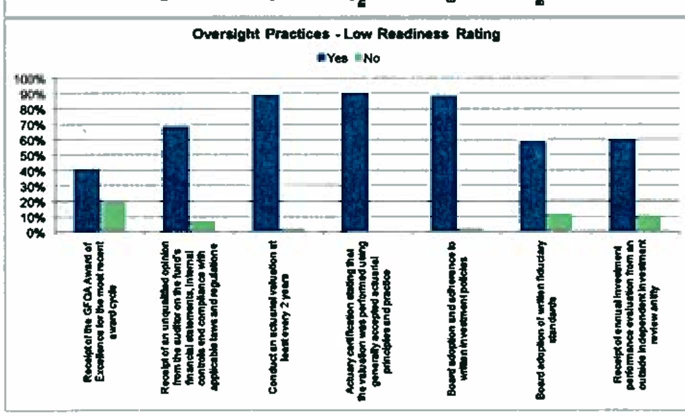
Oversight Practices

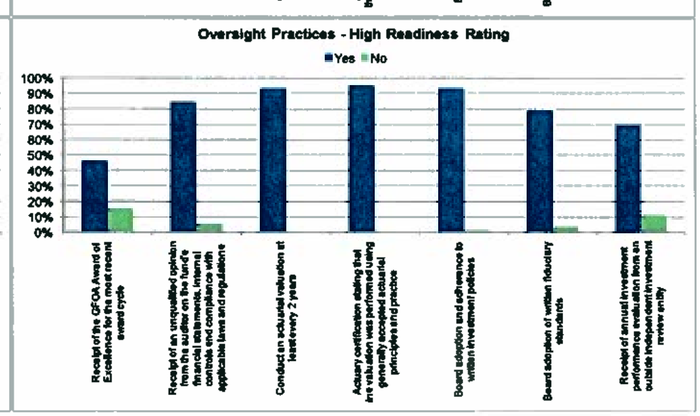
Oversight practices are those activities that help demonstrate a fund is following industry practices that enhance the transparency, credibility and effectiveness of fund administrators. Many practices below are widely followed; however, there is opportunity for funds to take additional action.











Conclusion

The market downturn had wide impact across all sectors of the economy. The market crash and subsequent recession illuminated many opportunities for strengthening public retirement. As this study shows, many reforms and structural changes have been made or are being made, and these changes along with market recovery have rapidly improved the outlook of the nation's public retirement funds. In addition, public funds are continuing to review and improve oversight, communication, and business practices.

Although media coverage has focused on examples of troubled funds, the data show that retirement funds overall are acting in a thoughtful, responsible and long-term manner. Improved funding, closer management of benefit levels and stronger oversight are important components of the health of public retirement – and of the nation's overall economic health. Affordable, sustainable retirement benefits help provide modest, consistent income for millions of Americans. And these benefits also provide consistent, stainable economic benefits for the communities in which they live and do business.

For more information:

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