North Carolina Total Retirement Plans

Dale R. Folwell, CPA
STATE TREASURER OF NORTH CAROLINA
DALE R. FOLWELL, CPA

MINUTES

BOARD OF TRUSTEES OF THE TEACHERS' AND STATE EMPLOYEES' RETIREMENT SYSTEM

The special session meeting of the Board of Trustees was called to order at 9:36 a.m., December 9, 2020, by the Chair, State Treasurer Dale R. Folwell, CPA. The meeting was held in the Dogwood Conference Room of the Longleaf Building at 3200 Atlantic Avenue, Raleigh, NC 27604. The Chair thanked the members of the Board for their service. The Chair indicated there would be a public comment period for organizations and individuals to address the Board later in the agenda.

Members Present
Treasurer Dale R. Folwell.

Members in Attendance via Telephone
Lentz Brewer, John Ebbighausen, Vernon Gammon, Dirk German, Barbara Gibson, Oliver Holley, Margaret Reader, Joshua Smith, Greg Patterson, and Jeffrey Winstead.

Members Absent
Linda Gunter and Kathryn Johnston (designee for Mark Johnson).

Guests in Attendance via Telephone
Jonathan Craven and Larry Langer of Cavanaugh Macdonald Consulting LLC (CMC), Katherine Murphy from the North Carolina Attorney General's Office, and Anne DarConte of HillStaffer.

Department of State Treasurer Staff Present
Thomas Causey, Patti Hall, Patrick Kinlaw, and Sam Watts.

Department of State Treasurer Staff Present via Telephone
Chris Farr, Elizabeth Hawley, Lisa Norris, and Christina Strickland.

Ethics Awareness and Identification of Conflicts or Potential Conflicts of Interest
The Acting Chair asked, pursuant to the ethics rules, about conflicts of interest of board members. No conflicts of interest were identified by the board members.

Presentation of the Public Pension Coordinating Council's Public Pension Standards Awards for Funding and Administration 2020
The Chair recognized Sam Watts, Legislative Liaison for the Department of State Treasurer. Mr. Watts announced that the Registers of Deeds' Supplemental Pension Fund (RODSPF), the North Carolina

National Guard Pension Fund (NCNGPF), the Consolidated Judicial Retirement System (CJRS), the Local Governmental Employees' Retirement System (LGERS), the Firefighters' and Rescue Squad Workers' Pension Fund (FRSWPF), the Teachers' and State Employees' Retirement System (TSERS), and the Legislative Retirement System (LRS) were all individually awarded the Public Pension Standards Awards for both Funding and Administration for the year 2020 by the Public Pension Coordinating Council. Mr. Watts stated that there are two awards available for each plan, funding and administration, each with specific criteria to meet. Mr. Watts noted that the criteria for achieving the awards included topics addressed by today's Board meeting, namely, establishing appropriate actuarial assumptions and methods, regularly reviewing those assumptions and methods, and following a sound funding policy. Upon request by Mr. Watts with leave of the Chair, Thomas Causey, as Secretary to the Boards, read aloud the following text of a letter dated December 8, 2020, addressed to the Chair and the Boards:

> "Dear Mr. Treasurer and Retirement System Trustees:
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> "We wish to congratulate the trustees of the state and local government retirement systems for the recent recognition of North Carolina's pension plans by the Public Pensions Coordinating Council (PPCC)'s 2020 Standards Awards for Funding and Administration. All seven of the state's eligible pension plans providing retirement services to over 900,000 current and former public employees received recognition.
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> "We are pleased to acknowledge the awards for [each of the seven systems].
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> "The funding and administration of the retirement systems is a 79-year long success story through bipartisan cooperation among state and local government leaders, and these awards recognize that collaboration and effort. We congratulate the retirement trustees for showing outstanding leadership to support the systems and to meet the high standards of these awards."

Mr. Causey stated that the letter was signed by Governor Roy Cooper; Rep. Tim Moore, Speaker of the House; and Sen. Phil Berger, President *Pro Tempore*.

The Chair expressed appreciation for the letter on behalf of the Board. The Chair agreed that the awards are possible because of the commitment of many state and local governmental leaders over the generations.

Analysis and Impacts of the Actuarial Experience Review

The Chair recognized Larry Langer and Jonathan Craven from CMC to provide a better understanding of the analysis and impacts of the actuarial experience review discussed at the October board meeting. Mr. Craven noted that he would be focusing primarily on CMC's recommendation that the assumed rate of investment return for TSERS, CJRS, LRS, NCNGPF, LGERS, and FRSWPF be reduced from 7.0% to 6.5% per year. He noted that under a "building block method," the current assumption of 7.0% return is based on price inflation of 3.0% and a real rate of return (i.e., return exceeding inflation) of 4.0% per year. Mr. Craven pointed to several data points indicating that the long-term price inflation assumption of 3.0% should be reduced, reporting that CMC's recommendation is that it be reduced to 2.5% per year. Mr. Craven reported that there is no new information to suggest adjusting the assumed real rate of return from its current level of 4.0% per year; and therefore, CMC recommends that the total investment return assumption be set at 2.5% plus 4.0%, or 6.5% per year, with the impact of the changes on employer contribution rates gradually recognized through direct rate smoothing over a five-year period. Mr. Craven then discussed contribution projections for both TSERS and LGERS under the current and recommended assumptions.

Staff Comments on Assumed Rate of Return

The Chair recognized Patrick Kinlaw, Director of Policy, Planning, and Compliance, and Staff Actuary for the Retirement Systems. Mr. Kinlaw noted that he was speaking on behalf of RSD staff to provide more information on the long-term assumed rate of return. He noted the consequential nature of the decision the Boards expect to make in January on this assumption. He reminded the Board that CMC has recommended changing the assumed rate of return for certain retirement systems from 7.0% to 6.5% per year. He stated that CMC has recommended that the full change be recognized immediately for financial reporting, and when calculating the funded percentage level; but for the purpose of determining employer contribution rates, the effect would be phased-in over a period of five years. If the Board were to adopt CMC's recommendation, employer contributions would first be affected July 1, 2022, for the fiscal year ending in 2023. By the fiscal year ending 2027, the five-year phase-in would be complete. The fiscal year ending 2027 would be the first year of a 12-year period for paying off the unfunded liabilities resulting from the final year of the phase-in of the assumption change. Therefore, the contribution schedule resulting from CMC's recommended change would last through the fiscal year ending 2038.

Mr. Kinlaw stated that he believes the recommendation of 6.5% is reasonable. He noted the importance of setting an assumption the Board is comfortable with for five years. He stated that if an assumption significantly higher than the recommendation were chosen, it would increase the likelihood that the Board would need to revisit the assumption in two or three years. Mr. Kinlaw stated the Board could always do that if necessary, but that type of situation would be undesirable for several reasons. For example, it would disrupt the stable contribution policies (ECRSPs); the five-year phase-in would have put employers even farther behind where they would need to be to adapt to such a change; and it would call into question whether the five-year phase-in should continue to be used in the future. In choosing an assumption that the Board is comfortable will last for five years, the Board reduces the chance of those negative consequences.

Mr. Kinlaw then began referring to the staff presentation, beginning with background information about pension funding and the relevant Actuarial Standards of Practice (ASOPs) that provide guidance for setting assumptions. Mr. Kinlaw emphasized that the rate of return is a forward-looking assumption which should be based on long-term expectations for the NC Retirement Systems' investments. He noted that historical returns can be informative, and assumptions made by other states can be informative, but ultimately the assumption is about future returns for our systems.

Mr. Kinlaw moved on to discuss the history of the Retirement Systems' rate of return assumptions. He stated that historically, the State and Local Boards have used a single assumption, which is important due to the similarity in how the assets are invested and for smooth administration of benefits. Mr. Kinlaw reviewed the high-level results of the asset allocation study conducted in 2016 for the Investment Management Division (IMD) of the Department of State Treasurer, which looked at the return expectations over the 10-year, 20-year, and 30-year time horizons. Mr. Kinlaw noted the 2016 study was based on market conditions and assumptions as of year-end 2015 and that the current assumption of 7.0% is slightly greater than the 20-year median expectation from that study but slightly less than the 30-year median expectation. This was the primary rationale for the assumption at the current level of 7.0%. While discussing the 2016 study, in addition to noting the long-term median returns, Mr. Kinlaw recommended that the Boards consider the potentiality of unfavorable outcomes, such as the 5th-percentile and 25th-percentile returns. If actual returns over a sustained period of time turn out to be less than the assumed rate, then unfunded actuarial accrued liabilities will develop, and that gap will have to be funded. Therefore, by lowering the assumption the Board reduces the chance that unfunded liabilities will develop, and reduces somewhat the size of unfunded liabilities in case they do develop.

Mr. Kinlaw noted that although there has been no forward-looking asset allocation study specific to our Retirement Systems since the 2016 IMD study, it is reasonable to consider the 2016 study in conjunction with how economic conditions have changed since the 2016 study. He noted that staff looked to a well-regarded survey conducted every year by Horizon Actuarial Services which gathers information on a range of institutional investment advisors and what they expect about the future performance of different types of investments. Mr. Kinlaw discussed that since the 2016 edition of this survey, there has been a significant drop in expected returns for stocks and a very significant drop in expected returns for bonds. The 2020 edition of the survey has the lowest expectations yet in these categories. By matching up the changes in expected returns, by asset class, with North Carolina's target allocation, the implication is that the Boards should expect return outlooks to be less than they were in 2016 (when the IMD study was published), by approximately 0.45% per year over a 10-year period, and by approximately 0.56% per year for a 20-year period. Mr. Kinlaw reported that a similar analysis using North Carolina's actual (not target) allocations yielded a similar result; further, an analysis using the target allocations of other major U.S. public retirement systems yielded significant implied reductions as well.

Mr. Kinlaw moved on to discuss a survey conducted by NASRA on the rate of return assumptions used by 130 state-sponsored retirement systems as of October 2020. He observed that in 2001, the median assumption was 8% return, while today it is 7.25% and clearly declining. During that time, the Boards have reduced their assumption by 0.25% per year, from 7.25% down to the current level of 7.00%. Adopting CMC's recommendation would move North Carolina's position to among the lower assumptions in the survey, which is closer to where North Carolina has stood historically relative to peers. Mr. Kinlaw noted that this outcome would be consistent with the concept of taking less investment risk than many other systems. Mr. Kinlaw reiterated that the Board should not be overly influenced by what other states are doing, but that the data can be informative.

Mr. Kinlaw elaborated on the observation that North Carolina takes less investment risk than many other systems. First, the target allocation is less risky than most other systems, for example with a greater allocation to fixed income. Second, the current allocation is more toward fixed income and cash than its target allocation. Third, empirical measurements by BNY Mellon have shown North Carolina to be in the 94th percentile (among public funds valued greater than $20 billion) over a 20-year historical period, among the very least volatile.

Mr. Kinlaw reviewed historical returns for the systems during the period 2000 through 2019. Mr. Kinlaw stated that during this time the Boards assumption was 7.25% for most of the period until it changed to 7.2% and then 7%. The average return on the actuarial value of assets during this period was 6.83%. Mr. Kinlaw stated that the return average return on the market value of assets during the 10-year period ending with 2019, coinciding largely with the longest continuous bull market in history, was 7.6%. For the 15-year and 20-year periods ending 2019, the average returns were 6.3% and 5.8% per year respectively, which were less than the current assumption of 7.00%, and also less than CMC's recommended future assumption of 6.5%. The State and Local systems have seen unfunded liabilities develop over that time, in large part because the assumed returns have not been met.

Mr. Kinlaw concluded by reiterating that staff recommends that the assumption be lowered to 6.5% as suggested by CMC, with these changes gradually recognized for employer contribution purposes over a five-year period beginning in the fiscal year ending 2023.

The Chair opened the floor for comments or questions from members of the board. Allen Buansi, of the Local Board, asked for an explanation on why the average return expectations have declined for public equities. Mr. Kinlaw stated that different experts might have different opinions. However, one common thread would be that after the 2008-2009 financial crisis and quantitative easing measures, many believed low inflation rates would revert to historical norms that were higher, but since that time, more experts have migrated to the view that low inflation rates are a longer-term phenomenon; and inflation is a building block for the total return one sees for any kind of investment. Barbara Gibson, of the State Board, requested real life examples to be shown in January on how the decision would impact administration of retirement benefits. Mr. Kinlaw stated staff would work up some examples to circulate to the board for the January meeting, if not prior to the January meeting.

Public Comment Period

The Chair recognized Anne DarConte of HillStaffer, representing North Carolina Retired School Personnel, to provide public comments.

Board of Trustees Comments

The Treasurer provided a brief comment about a retiree's situation that underscored the interconnectedness of the issues handled by the Department. The Treasurer further requested that the meeting be closed in memory of sheriff's deputy Ryan Hendrix of Henderson County, and sheriff's deputy Jared Allison of Nash County.

Adjournment

There being no further business before the Board, Oliver Holley moved to adjourn, which was seconded by Margaret Reader, and the meeting was unanimously adjourned at 10:54 a.m.

Dale R. Folwell, CPA

CHAIR

Thomas G. Causey

SECRETARY

2/3/21

DATE