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2011 Plan Sponsor of the Year

Defined Benefit

The Public School and Education Employee Retirement Systems of Missouri
Steve Yoakum of PSRS/PEERS

Photography by Parker Eshelman

Of all the challenges facing public pension funds, none concerns Steve Yoakum more than growing public skepticism about whether these plans cost too much and give their participants unfairly generous benefits. “Some plans were very lucrative, and that reflects negatively on plans like ours,” says Yoakum, the Executive Director of The Pubic School and Education Employee Retirement Systems of Missouri (PSRS/PEERS), who has more than 30 years of experience. “The biggest challenge is trying to make sure that we are not all lumped in together, just because there are a few bad apples. We [public plans] are in a very difficult environment. People are questioning, Are we delivering good value for the taxpayers’ money? We have an obligation to demonstrate that.”

The question for public funds boils down to this, Yoakum says: How lucrative is your promise? Its retirees get 2.5% per year of their three-year final average salary, so a 30-year employee

receives 75%. PSRS' teacher participants and employers each contribute 14% of salary annually, while the non-teacher school employee PEERS members and their employers each contribute 6.63%; the plan has a "rule of 80" for benefits eligibility. The $29.3 billion plan, which has about 220,000 total participants, runs at an annual cost of approximately 50 basis points per participant, including investments, he says.

How, then, to respond to critics? "We have to talk about what is fair," Yoakum says. "Under our plan, we are asking teachers to dedicate to education probably the most productive 30 years of their lives. If a teacher walks out the door with 75% of his or her salary, it is 75% of a salary that is not exorbitant to begin with." On average, the plan's participants retire at age 58.6 with 23.4 years of service and a monthly benefit of $2,932; they do not receive Social Security.

To Yoakum, good governance is the biggest key to achieving the right balance in running a public plan. Created in 1946 as a not-for-profit trust fund and separate from state government, he says, "We have been insulated from politics, and we have had good trustees who are not conflicted in their judgments." Four of the seven trustees are active plan participants, one is a retiree, and two are governor-appointed citizen representatives, typically people with an investment or accounting background.

Although the plan had "just over" 100% funding in 2000, Yoakum says, by June 30, 2010, it had declined to 79.8%. He attributes that mostly to a very unusual stretch for investments: "It is what we call here in Missouri a '500-year flood'; it is not something we expected to see in our lifetime."

To boost funding, a contribution increase of ½% each for employers and employees starts on July 1. Required contributions may rise annually by 1% overall for several years, depending on the investment portfolio's results, Yoakum says. "We also asked the legislature five years ago not to pass any benefits increases, and they have complied," he says. "The first thing we have to do is not make it any more difficult to come out of this."

Major public pension reform legislation passed by Missouri legislators last summer will not apply to PSRS/PEERS, says Maria Walden, the plan's Director of Legislation and Policy. "We do not take any general-revenue funds. We take no money directly from state coffers," she says. The legislative steps taken include requiring new employees to make contributions, which PSRS/PEERS already does.

Separate legislation filed in February 2010 that would have mandated every new PSRS/PEERS member go into a defined contribution plan instead of the pension never left committee, Walden says. “I do not think that a defined contribution plan necessarily fits well to the educational model, particularly K-12,” Yoakum says. “The teachers generally do not have a lot of mobility. There is 50% turnover in the first five years, but generally speaking, if they stay five years, they will stay for a career. A defined benefit plan incents them to stay.” With its five-year vesting, the Missouri plan already acts much like a DC plan in the first five years, he says, and participants who leave during that time can only take their own contributions plus interest earned.

Investment performance has helped the plan recently: The portfolio rose 13% in fiscal 2010, beating its 11.3% policy benchmark. Plan officials worked with consultant Russell Investments on an asset-allocation policy focused tightly on risk, which they implemented in June 2009. “The board in the past very much thought of fixed income as their ‘safe asset,’” says Michael Hall, who worked with the plan on the policy as a Russell consultant and who recently joined Towers Watson as Seattle-based Practice Leader, Western United States. But, as a new asset/liability study progressed, the board came to realize that the Lehman Aggregate Bond Index it used as a benchmark contains bonds with substantially varying risk levels.

That kind of insight led PSRS/PEERS officials to decide that they wanted to think about asset-allocation categories differently. “We got into the vernacular of: What is safe? What is liquid? What is illiquid?” Chief Investment Officer Craig Husting says. “We looked at cash flow and liquidity and said, ‘How much cash do we need in a worst-case scenario, and how much can we afford to lock up?’”

The investment policy now takes a three-bucket approach to asset allocation. “It is very similar to the way that corporate plans think about it, but they use different language,” Hall says. Corporate plans “talk about liability-driven investing and building out a ‘hedge’ portfolio, and it is the same as the way that Missouri thinks about the ‘safe’ bucket,” he says.

PSRS/PEERS targets “safe assets” to make up 20% of the portfolio, and they include U.S. Treasurys and TIPS (Treasury Inflation-Protected Securities), completely liquid assets and essentially risk-free. The policy aims for “private risk assets” to comprise 20% of the portfolio, including illiquid investments locked up for several years, such as private equity, private real estate, infrastructure, and private credit, such as distressed debt. The “public risk assets” bucket, which makes up 60% of the target, includes U.S. equity, global equity, hedge funds, and credit bonds; Husting describes it as “anything that is primarily liquid but has risk associated with it.”

Each bucket has an allocation range that the fund can move within, as opportunities arise.

"The biggest change is to recognize how much we need to have in liquid and safe investments, and how much we can put out there to get higher returns," Husting says. "These buckets also help us communicate externally and internally about the investments." And the fund can move more quickly to shift investments, he says: If the staff previously thought equity was overvalued and wanted to allocate more to credit bonds or hedge funds, getting the necessary internal approval and executing the change could take months. Says Hall, "This gives the staff a lot more freedom to be responsive to market conditions." For instance, he says, with credit spreads currently tight and equities having had a good run, the staff has moved further into hedge funds. As he says, "The goal is to be able to be more nimble across a bucket of assets."

This approach forces plan officials to think constantly about risk, and focus on how much risk they take to get an increment of return, Yoakum says. He adds, "It goes back to, what are we here for? To earn the assumed rate of return, net of fees, with as little risk as we can."

—*Judy Ward*