

# **Report on CalSTRS Meetings, February 6, 7, 8, 2008**

**By Pat Geyer, CRTA Liaison**

## **Executive Summary**

- 1. The Richman Initiative did not receive enough signatures to be on the ballot**
- 2. Governor's budget proposal is to guarantee the 80% purchasing power protection in return for making restrictions to the SBMA**
- 3. Staff expects the next draft of the health benefits task force report to be completed by the end of February. The Task Force will be scheduling a new meeting to discuss the new draft.. Correction: The Health Benefits Proposal is a health account of \$400 a month for pre-1999 retirees; a health account of \$300 a month for 1999 and after retirees; a health account of \$100 for actives when they retire. The \$100 account will be funded from increased contributions with the goal of reaching a \$300 account**
- 4. The Investment Committee voted an asset allocation of 41% US Equity, 20% Non-US Equity, 8% Alternative, 10% Real Estate, and 20% Fixed Income for January 1, 2008.**
- 5. Selected Active, Inactive, Retired, and Recipients of Survivor Benefits will receive a survey. STRS goal is to better understand educators' needs in order to improve benefits and provide financial education.**
- 6. Congress will not move forward with a restructuring of Social Security, and that will hamper efforts to repeal or reduce the WEP and GPO. The main problem is cost. Repeal of the WEP and GPO will cost a total of \$80 billion over ten years.**
- 7. There is growing Congressional scrutiny of the funding levels of State and local pension plans as well as scrutiny of all forms of "alternative investments"**
- 8. The final Elk Hills payment to the SBMA fund is tied up in litigation. STRS must wait until the court case is resolved before it can seek Congressional appropriation.**
- 9. STRS fund is \$165 billion, down 4% for this fiscal year.**
- 10. March 6 will be a teleconference at the STRS office from 10-11 a.m. The following STRS meeting will be April 1,2,3.**

## **Audits and Risk Management Committee**

A charter schools survey has been sent out and a return is requested by February 28. The survey results will enable STRS to more accurately identify charter schools that pose risks to the system.

A risk assessment will be made of the new headquarters building so that there are no hidden risks. The STRS audit plan is proceeding as expected. Audit vacancies have dropped from 40% to 18%

## **Board Governance Committee**

The Committee approved policies for information requests and for policy debate and resolution. They also approved a framework for the long-range strategic plan. Finally, the Committee approved the revisions to Board Manual Section 600H, stating that any party doing business with STRS is restricted in making gifts or campaign contributions to any STRS Board member or employee.

## **Client Advisory Committee**

Jennifer Baker, STRS staff, reported on State legislation. AB 36 (Niello) and AB 1844 (Hernandez) make it a crime to make false material statements in applying for CalSTRS benefits. AB 1480 (Mendoza) authorizes CalSTRS to offer a Roth IRA as part of its Pension Program. AB 789 (Mullin) a CRTA bill, allows the state to make yearly interest payments to SBMA. (AB 36, AB 1480, and AB 789 are two-year bills, introduced in 2007.)

The deadline for introduction of new legislation is the end of February. CalSTRS plans to introduce a housekeeping bill and a bill to remove restrictions on post-retirement earnings. The Richman Initiative did not receive enough signatures to be on the ballot. (The Richman Initiative if passed would increase the retirement age to 67, lower the retirement factor from 2% to 1.5%, require final compensation to be the highest 5 years of pay, among other restrictions)

Ed Derman, Deputy CEO, reported on the Governor's proposal to guarantee the 80% purchasing power protection in return for making restrictions to the SBMA. CAG members responded that the Governor's proposal would make it nearly impossible to increase purchasing power in the future and would restrict other uses of the SBMA monies.

Joe DeLuca, STRS Investment Officer, reported that STRS had 18 reverse mortgages in its home loan program. The majority of STRS home loans are now being made to members in their 20's. STRS does not invest in sub-prime mortgages, and STRS is reevaluating its relationship with Countrywide.

Selected Active, Inactive, Retired, and Recipients of Survivor Benefits will receive a survey asking about employment, plans for retirement, retirement savings, income, health insurance coverage, other types of insurance, residence, and expenses. STRS goal is to better understand educators' needs in order to improve benefits and provide financial education.

Virginia Johnson, Health Benefits, reported that the health benefits survey and draft of the new report by the end of February. The Health Benefits report is due in June. The Committee will be scheduling a new meeting. **Correction:** The Health Benefits Proposal is a health account of \$400 a month for pre-1999 retirees; a health account of \$300 a month for 1999 and after retirees; a health account of \$100 for actives when they retire. The \$100 account will be funded from increased contributions with the goal of reaching a \$300 account.

## **Investment Committee**

The Credit Enhancement Program which underwrites or guarantees municipal bonds, made commitments of \$2.6 billion and earned \$5.1 million in fees, an increase of 30% and 8% over prior years.

The Subcommittee on Corporate Governance asked the Investment Committee to help them evaluate their focus for 2008. Present focus is on Executive Compensation and Disclosure of Carbon Emissions – Climate Change. Board diversity and proxy voting were other suggested topics.

The Committee evaluated the asset allocation targets. The Investment Committee voted an asset allocation of 41% US Equity, 20% Non-US Equity, 8% Alternative, 10% Real Estate, and 20% Fixed Income for January 1, 2008. The Committee will revisit the targets at June 30 with the goal to being at the long-term rates of 40% US Equity, 20% Non-US Equity, 9% Alternative, 11% Real Estate and 20% Fixed Income.

The Committee reviewed the Investment Policy for Geopolitical, Environmental, and Social Risks. There is a statement of principles, policy, and the 20 risk factors. Ian Lanoff, Fiduciary Counsel, spoke against requiring STRS investment managers to divest based on the risk factors especially the last 7 (human rights, civil liberties, political rights, discrimination, workers rights, environment and acts of terrorism). He suggested that these might not be financially defensible. The Board should leave investment decisions to the financial managers.

Christopher Ailman, CIO, gave the investment overview. STRS fund is \$165 billion, down 4% for this fiscal year. However, for the fiscal year US stocks –14%, UK stocks – 9%, German stocks –14%, Japan stocks –24%, Hong Kong (China) + 8.9% and emerging markets +3%. STRS has been helped by unbelievable returns in the capital markets during the last 30 years. Over the last 100 years stocks have returned an average of 10%, but have a volatility of 20%.

## **Subcommittee on Corporate Governance**

The Subcommittee reviewed the Proxy Voting Guidelines and the Corporate Governance Report. Janice Hester Amey, provided a summary of STRS correspondence regarding corporate governance..

## **Teachers' Retirement Board**

Ed Derman, Deputy CEO, reported on the Public Employees Post Employment Benefits Report. California state and local government pensions are 89% funded. However, there is a liability for health benefits, which tend to be funded on a pay-as-you-go basis. STRS only health benefit is the Medicare Part A Premium Payment Program, which is funded by employer contributions. Any program recommended by the Health Benefits Task Force will need to be designed to be prefunded.

The Board adopted the 2008-09 meeting calendar. March 6 will be a teleconference at the STRS office from 10-11 a.m. Following STRS meetings will be April 1,2,3; June 3,4,5; September 3,4,5 and November 5,6,7.

Jack Ehnes, CEO, reported that STRS has received the updated information for 2006-07 from the Los Angeles USD. The quality of reports is improving and LAUSD expects to be current in reporting by the end of February.

Jeremy Gould, pension finance consultant and Paul Angelo, Actuary with the Segal Company reported on “financial economics”. Financial economics maintains that liabilities for pension plans should be measured using a risk free investment return between 4 and 6%. Pension plans should be valued like annuities or life insurance both of which use a much more conservative return measure.

Margaret Gaston, President of the Center for the Future of Teaching and Learning, discussed the findings from the report titled, “Teaching and California’s Future”. 90% of the classrooms have qualified teachers, an improvement. The use of teacher interns is growing because that is the quickest way to enter the teaching profession. Most of the teachers lacking credentials are in the inner cities. Teachers most likely to continue in teaching are those who want the education lifestyle and those who are idealistic. Teachers most likely to leave the profession after a few years are second career, older or who are exploring different career options. Presently, California has an adequate number of elementary teachers and a small shortage at the middle and high school. However, elementary numbers will grow over the next 10 years so there is a future need there.

Jack Ehnes, CEO, discussed the Governor’s proposal to guarantee the 80% supplemental benefits in exchange for other reductions. Ken Hewett, CRTA Legislative Chair, read a statement in opposition to the Governor’s proposal. (statement attached)

John Stanton, Federal Legislative Advocate for CalSTRS, made a presentation highlighting his regular written memorandum. The Sudan divestment legislation prohibits State and local governments (including State retirement systems) from investing in business operations in Sudan involving power production, mineral extraction, oil-related activities or production of military equipment. CalSTRS only has investments in one company, which would come under the Sudan divestment legislation. It is unclear whether Iran divestment legislation will move forward this year.

SEC Chairman Cox pushed through a rule barring shareholders from seeking procedures to include shareholder nominees for the board of directors in a company’s proxy materials.

Congress will not move forward with a restructuring of Social Security, and that will hamper efforts to repeal or reduce the WEP and GPO. The main problem is cost. Repeal of the WEP and GPO will cost a total of \$80 billion over ten years.

There is growing Congressional scrutiny of the funding levels of State and local pension plans. Members of Congress no longer traditionally serve in State government before being elected to Congress so they have less knowledge of State government issues. The Governmental Accountability Office (GAO) is studying the risks that investing in hedge funds poses for pension plans and will expand the study to cover all forms of alternative investments. The final Elk Hills payment to the SBMA fund is tied up in litigation. STRS must wait until the court case is resolved before it can seek Congressional appropriation. This concluded John Stanton's report.

# **Report on CalSTRS Meeting, March 6, 2008**

**By Pat Geyer, CRTA Liaison**

## **Teachers' Retirement Board**

The Board heard an evaluation of the Governor's SBMA proposal from Milliman, STRS consulting actuary, and from Ian Lanoff of the Groom law group. Both consultants said that there was enough money in the SBMA fund to pay 80% and 82.5% guaranteed for the next 30 years. It was less probable that the SBMA fund would be able to pay 85% for the next 30 years. The Governor's proposal is to:

1. Guarantee purchasing power at 80%
2. Reduce the State contribution from 2.5% to 2.2%
3. Adjust future contribution rates to provide for full funding
4. Change the July 1 payment date to November 1 and April 1

The STRS staff recommended support of the Governor's proposal if amended to provide for 82.5% purchasing power.

The STRS Board voted to accept the staff proposal with Jerilyn Harris (retiree representative) opposed and Ann Sheehan (Finance) abstaining. David Walrath, CRTA advocate, spoke in support of 85% purchasing power. Lori Easterling, CTA advocate said that CTA actives and retirees supported the STRS proposal.

The Board heard a presentation on AB 1967 (Torrice), SEIU sponsored. AB 1967 would prevent STRS or PERS from investing in a private equity company that is owned in whole or part by sovereign wealth funds that do not meet certain human rights specifications. Since private equity and alternative investments are the investment areas that have enabled STRS to earn a 20% return last year, this legislation would severely limit investment in those areas and significantly reduce STRS investment income. The STRS Board voted to oppose AB 1967. David Walrath, CRTA advocate, and Pat Geyer, CRTA representative, spoke against the AB 1967. Other advocates also opposed the legislation.

# **Report on CalSTRS Meeting, April 1,3, 2008**

**By Pat Geyer, CRTA Liaison**

## **Executive Summary**

- 1. The Committee voted to support AB 1844 (Hernandez), which makes it a crime to make false statements in connection with retirement benefits and requires the Controller to publish a report on the financial condition of public retirement systems...**
- 2. The Committee voted to support AB 2191 (Mullin) which expands CalSTRS 403(b) programs to eligible state employees**
- 3. AB 789 (Mullin) increases the General Fund appropriation to CalSTRS from 2010-11 to 2014-15 to offset a reduced appropriation to the SBMA in 2003-04. CalSTRS is neutral.**
- 4. CalSTRS sponsors AB 1480 (Mendoza) which authorizes CalSTRS to offer a Roth IRA to receive funds rolled over from a Roth 403(b) account.**
- 5. AB 1967 (Torrico) prohibits CalSTRS and CalPERS from investing in a private equity company owned by a sovereign wealth fund whose affiliated countries do not meet certain human rights criteria. CalSTRS has an oppose position.**
- 6. AB 8 (3X) changed the dates for 2008-9 SBMA state payments to November 1 resulting in \$17.4 million in lost interest. (passed and signed by the Governor). STRS and client groups will be working with the legislature and the Governor on the SBMA proposals**
- 7. Possible teacher layoffs, and an increase in retirement incentives will have an impact on the CalSTRS fund**
- 8. The Health Benefits Task Force meets April 18. If the Health Benefits Report is approved it will be presented to the CalSTRS Board in June**
- 9. Since inception (7+ years) the opportunity cost of not investing in tobacco has cost the fund over \$1 billion. Tobacco no longer satisfies the 20 risk factors of the CalSTRS policy. Discussion followed, but no action was taken.**
- 10. The CalSTRS fund stands at \$176 billion.**
- 11. The June 30, 2007 Actuarial Experience Study recommended these economic assumptions: 3.25% inflation, 4.25% wage growth, and 8% investment return.**
- 12. The Actuarial Experience Study found that Life expectancy (years) assumptions have changed from 2003-07. Both male and female educators are living longer:**
- 13. The complete 2007 actuarial evaluation will be presented at the September Board meeting.**
- 14. CRTA members, David Walrath, Betty Soennichsen, and Sandy Healy, spoke to the STRS Board about providing an adequate and equitable pension to retired members.**
- 15. The Legislative Committee is scheduled to meet May 1. The next STRS Board and Committee meetings are scheduled for June 3-5.**

## **Audits and Risk Management Committee**

Between July '07 and March '08 Audit Services issued 34 final and 11 draft school district reports. Work has started on 11 new school district audits. A new audit program has increased efficiency. Audit Services sent out a survey questionnaire to 696 active charter schools so far 26% have responded. The survey has been disappointing due to lack of adequate response.

The contract for Macias Gini & O'Connell, financial statement auditors, has been amended to provide for additional hours. The contract for Dr. Robert Yetman, financial expert, has been extended for one year.

## **Board Governance Committee**

The Committee approved the Strategic Planning Process and Revisions to Board Policy Section 500. The only discussion was the Travel Expense Policy. Board asked that the rules on using State rate for meals and airfare be more flexible. This was especially important for high expense areas such as San Francisco.

## **Legislative Committee**

Jennifer Baker, Director, Government Affairs reported on State legislation. The Committee voted to support AB 1844 (Hernandez), which makes it a crime to make false statements in connection with retirement benefits and requires the Controller to publish a report on the financial condition of public retirement systems. The fraud language mirrors AB 36 (Niello).

The Committee voted to support if amended AB 2191 (Mullin) which expands CalSTRS 403(b) programs to eligible state employees. The Controller wants CalSTRS to administer the 403(b) programs. Other legislation of interest is AB 591 (Dymally), which allows Community Colleges to hire temporary part-time employees to teach up to 67% rather than 60%. (This applies to Compton only)

AB 789 (Mullin) increases the General Fund appropriation to CalSTRS from 2010-11 to 2014-15 to offset a reduced appropriation to the SBMA in 2003-04. CalSTRS is neutral. CalSTRS sponsors AB 1480 (Mendoza) which authorizes CalSTRS to offer a Roth IRA to receive funds rolled over from a Roth 403(b) account.

Committee discussed AB 1967 (Torrico), which prohibits CalSTRS and CalPERS from investing in a private equity company owned by a sovereign wealth fund whose affiliated countries do not meet certain human rights criteria. CalSTRS has an oppose position. The CalSTRS Board discussed the problem with increasing numbers of proposed legislation asking CalSTRS to divest in various companies. Divestment limits the ability of CalSTRS to provide income for teacher benefits. Ann Sheehan, Finance, suggested a panel on divestment. Pat Geyer, CRTA Liaison, spoke on the need for CalSTRS to maximize investment income for teacher benefits.



CalSTRS sponsors AB 2390 (Karnette) which extends the post-retirement earnings limit exemptions until June 20, 2010. AB 8 (3X) and SB 6 (3X) change the dates for SBMA state payments to November 1 resulting in \$17.4 million in lost interest. (chaptered). STRS and client groups will be working with the legislature and the Governor on the SBMA proposals.

### **Benefits and Services Committee**

The committee set the interest rates for the 2008-09 fiscal year. The regular interest rate will be 5.25%; interest credited to the Defined Benefit Program will be 4%; interest credited to the Cash Balance and Defined Benefit Supplements programs will be 5%. These interest rates are less than 2007-08 fiscal year (5% and 5.25%). If the actual investment return for 2008-09 is higher, the Board may declare additional earnings credit.

The Committee accepted the 2008 Purchasing Power Report. 26.8% of CalSTRS retirees receive SBMA payments since their purchasing power has fallen below 80%. SBMA payments start for those who retired in 1989 or earlier.

Ed Derman, Deputy CEO, reported that the possible teacher layoffs, and an increase in retirement incentives will have an impact on the CalSTRS fund.

The Health Benefits Task Force meets April 18. If the Health Benefits Report is approved it will be presented to the CalSTRS Board in June.

### **Client Advisory Committee Meeting**

Jennifer Baker, Director, Government Affairs and Ed Derman, Deputy CEO, discussed State legislation. (see Legislation Committee) In addition there was a discussion on the various SBMA proposals. STRS Board has voted to propose 82.5% Purchasing Power and a guarantee. The CRTA proposal is 85% purchasing power and no guarantee. The Governor's proposal is 80% purchasing power and a guarantee. Also proposed is to reduce the payment from 2.5% of payroll to 2.2% and to change the payments dates to November 1 and April 1.

The Los Angeles Unified School District (LAUSD) reports have all been updated. The new information is in and will be reflected on LAUSD teachers' benefit statements.

Sandy Jimenez, Field Services Manager presented a report on CalSTRS benefits counseling and counselors.

### **Subcommittee on Corporate Governance**

John Chiang, Controller sent letters requesting that the Subcommittee expand the Corporate Governance Policy on environmental strategy and diversity of corporate board of directors. Janice Hester Amey, Portfolio Manager, reviewed the STRS Corporate Governance Policy. CalSTRS Policy also includes a policy on shareholder rights, and executive compensation.

## **Investment Committee**

The semi-annual report showed that CalSTRS had \$19.3 billion or 11% of the total portfolio in California investments. This was a 2.4% decrease due to the downturn in public equity markets. Of the total CalSTRS has \$2.4 billion in emerging California markets, a 13% increase.

The PCA (General Consultant) semi-annual performance report stated that CalSTRS generated a 6 month return ending December 31, of 2.7% - outperforming its benchmark and the median fund return of 1.6%. U.S. equity did poorly, but real estate and private equity were outstanding. STRS earned 11% for the 2007 calendar year. U.S. equity and non-U.S. equity are now working as one market so there is less diversity. CalSTRS is looking at other types of investments including infrastructure to provide more diversity.

Mike DiRe, Director of Real Estate reported that, as of September 2007, real estate outperformed its benchmarks. However, real estate returns will not be as high in the future.

CalSTRS alternative investments earned 35.5% for the year ending September 30, 2007, 4.6% better than the benchmark. However, the worst is yet to come. There are almost no buyout transactions.

Bill Lockyer, State Treasurer, urged CalSTRS to act to convince the three leading rating agencies to reform their ratings for government bonds compared to corporate bonds. Government bonds are rated lower than corporate bonds even though government bond default is lower (Municipal bonds rated Baa have a default rate of .13% while corporate bonds rated Aaa have a default rate of .52%).

Committee reviewed Attachment A, the investment policy for mitigating geopolitical, environmental, and social risks, and the 20 risk factors. The Committee approved Attachment A. Next the Committee heard a report on the use of derivatives to improve the return on fixed income.

The Committee heard an evaluation of the Benchmark Modification Policy. Since inception (7+ years) the opportunity cost of not investing in tobacco has cost the fund over \$1 billion. Tobacco no longer satisfies the 20 risk factors of the CalSTRS policy. Discussion followed, but no action was taken.

Christopher Ailman, CIO, reported that the CalSTRS fund stood at \$176 billion. A double bottom in the stock market index may indicate the end of the bear market. However, the economy may be back to having bear markets every four to five years.

## **Teachers' Retirement Board**

The Board elected Dana Dillon chair and Jerilyn Harris vice-chair.

The Board reviewed the 2008 Benefit Comparison and Adequacy Study. Conclusions are that present CalSTRS educators should (1) earn maximum service credit; (2) earn extra

credit to increase the DBS (defined benefit supplement). (3) contribute to a 403(b) account and (4) build personal savings. These actions would ensure adequate retirement. Serious consideration should be given to continuing the Longevity Bonus and to establishing a health benefit program.

Jack Ehnes, CEO, reported that May 1 is held as a tentative meeting date for the Legislative Committee. There is a approximately \$1 million increase in State Controller costs for supplies, postage, mailing services. STRS continues to work with the Department of Personnel regarding investment officer pay adjustments.

Rick Reed, CalSTRS Actuary, and Mark Johnson, Milliman, reported the June 30, 2007 Actuarial Experience Study. They recommended retaining the economic assumptions: 3.25% inflation, 4.25% wage growth, and 8% investment return. Life expectancy (years) assumptions have changed from 2003-07. Both male and female educators are living longer: Male (age 60) 23.6 to 25.1, an increase of 1.5 years; Male (age 70) 15.5 to 16.1, and increase of 1 year. Female (age 60) 26.5 to 27.3; an increase of 0.8 years; and Female (age 70) 17.9 to 18.4, and increase of 0.5 years. There is also a small increase in the probability of more members retiring with 30 and with 25 years of service. These demographics result in a higher unfunded actuarial obligation, which will be partially offset by gains from investments. The complete 2007 actuarial evaluation will be presented at the September Board meeting.

Jack Ehnes, CEO, reported that there was no change in the budget for the new STRS headquarters project. There are plans for a hotel next to the headquarters building in West Sacramento.

David Walrath, CRTA Advocate, spoke to the STRS Board about providing an adequate and equitable pension to retired members. Betty Soennichsen, CRTA President presented the Pension Equity Resolution and a “check” for 2.4 million hours that retired teachers have volunteered in the last year. Sandy Healy, President, Division 17 (Santa Maria) spoke for her members. About 25 CRTA members attended the meeting.

# **Report on CalSTRS Meeting, June 4, 5, 2008**

**By Pat Geyer, CRTA Liaison**

## **Executive Summary**

- 1. The Corporate Governance Committee approved including Diversity of Corporate Boards in the STRS Corporate Governance Policy.**
- 2. STRS investment counsel, Ian Lanoff, stated that the Committee must, from a fiduciary position, restore tobacco to investments and no longer modify the Benchmark Policy. STRS staff and PCA advisor agreed. The Investment Committee postponed action until the September Board meeting.**
- 3. The infrastructure (fixed assets) policy will be implemented in September. Presently, STRS has an infrastructure investment in two San Francisco Piers.**
- 4. STRS will be adding credit enhancement to the Alternative Investment Policy.**
- 5. Christopher Ailman, CIO, reported that the STRS fund was \$169 billion. 1% GNP growth is possible over the next two years with a STRS return of 5% on its portfolio.**
- 6. AB 221 Iran Divestment Act requires that STRS identify companies for possible divestment. At this time STRS staff has identified 19 such companies valued at over \$1.59 billion.**
- 7. The Mercer Study concluded that it is feasible for STRS or another group to offer a health care benefit program for school employees.**
- 8. The report of the Public Education Health Benefits Task Force recommended Option 1 – a monthly health allowance for retirees.**
- 9. The STRS Board approved the concept of the revised provisions to the SBMA (see Board report).**
- 10. Additional legislation and STRS positions follow in the Legislative Committee report.**

## **Legislative Committee**

AB 591 and AB 1916 both will allow Community College faculty to teach up to 67% of a full-time teaching load and still remain part-time. The two bills will be combined. STRS Board voted to support the measures.

SB 1123 implements three recommendations made by the Public Employees Benefits Commission. STRS supports the bill even though school districts are exempt because districts are covered under another bill.

SB 1488 which would allow retired educators to return to work as substitute teachers without losing any retirement incentive (i.e. Golden Handshake). STRS opposes this bill unless amended.

SB 1550 requires the Controller to develop a climate change disclosure standard for companies doing business in California. STRS supports this bill.

Other legislation that STRS supports are AB 36 which makes benefit fraud a crime; AB 1480 which authorizes STRS to offer a Roth IRA which is rolled over from a Roth 403b account; AB 2191 expands STRS 403b programs to state employees, and AB 2390 extends the sunset date on post-retirement earnings limit exemptions to June 30, 2010.

AB 1967, which prevents STRS from investing in a private equity company that is owned by a sovereign wealth fund, has been withdrawn. SBMA legislation will be discussed later.

### **Subcommittee on Corporate Governance**

The Committee heard a proposal to incorporate the Climate Change Checklist into the STRS Financial Responsibility Criteria (FRC) for investments. Next the committee heard a panel on Diversity of Corporate Boards. Of interest were the following remarks by Robert Rollo, Heidrick & Struggles (executive search firm): 1. Bring in a minority who is qualified and can be respected. 2. Identify the industry, which has diversity in its customers or in its production. The Committee approved a revision of the Corporate Governance Policy to include Corporate Board Diversity.

### **Investment Committee**

The Committee approved the use of Derivatives (such as futures, options) in the Fixed Income Portfolio. Derivative transactions and amounts will be limited.

The Committee heard a presentation by Ian Lanoff of Groom Law Group, Allan Emkin , PCA, and Christopher Ailman, STRS CIO, on the Benchmark Modification Policy for tobacco. In 2000 STRS divested in tobacco because of the following risk factors:

- a. Exposure to product liability judgments that would exceed the industry's net worth.
- b. Threat of industry-wide bankruptcy.
- c. Regulatory actions that would substantially impair industry-wide earnings.
- d. Actions of the institutional investor community that has a deleterious effect on share prices.

Three of the four risk factors must be present for divestment. While tobacco did meet these risk factors in 2000, since 2006 risk factors a, b, and d have fallen below the definition of risk. Factor c remains a risk for tobacco companies in the U.S. only. STRS investment counsel, Ian Lanoff, stated that the Committee must, from a fiduciary position, restore tobacco to investments and no longer modify the Benchmark Policy. STRS staff and PCA advisor agreed. The Committee may wish to consider adding health risks to the policy for country and company risk. The State Treasurer, Bill Lockyer, requested that the STRS keep the tobacco divestment. Discussion followed. Pat Geyer, CRTA liaison to STRS, spoke in favor of changing the policy since the fund had lost some \$1 billion because of the tobacco divestment and that was money taken away from retiree benefits. After more discussion, the Committee postponed action until the September Board meeting.

The Committee heard a panel on Diversity in Investments as part of its semi-annual report. STRS continues to implement diversity in the management of investment in line with the Board's direction to gain strength from a diversity of ideas and people.

The Green Initiative Report was presented. The emphasis is on energy efficiency. Treasurer Lockyer asked for more detail in future reports.

The STRS Investment Resolution was presented. This resolution needed updating. STRS has moved to a more general policy rather than naming specific investments.

Alan Emkin, PCA, presented the Fixed Asset Investment Policy. Basically this is a policy on investment in infrastructure. Presently, STRS has an infrastructure investment in two San Francisco Piers, basically a real estate investment. The returns on infrastructure are not correlated with other returns so it would be a diversification. Also, infrastructure investments are very long term, well suited to a pension fund. The infrastructure (fixed assets) policy will be implemented in September.

The Alternative Investment Policy was reviewed. STRS will be adding credit enhancement to the policy. Under this policy STRS provides credit and liquidity support for municipal bonds that are purchased by short-term investors, typically money market mutual funds. If there are no willing buyers STRS may be called upon to purchase the bonds. In the course of 14 years, STRS has only once had to purchase a bond issue, in February 2008. The Compensation Committee has already approved the Alternative Investment, Credit Enhancement, change.

Under the Global Equity Portfolio Policy, STRS staff proposed increasing the amount that a manager may invest in emerging markets.

AB 221 Iran Divestment Act requires that STRS identify companies for possible divestment. At this time STRS staff has identified 19 such companies valued at over \$1.59 billion. As of July 2009 STRS would be required to stop any further investment in such companies, and by January 2010 STRS would be required to sell these investments, if and only if it is fiducially prudent to do so.

Christopher Ailman, CIO, reported that the STRS fund was \$169 billion. For the fiscal year, so far, US and non-US equities have declined 2%. The Real Estate portfolio was also weak. Private Equity increased in value because of oil, which was up over 80%, partly because of speculation in that market. While the market is working through the financial problems, the biggest risk going forward is oil. Ailman predicts that 1% GNP growth is possible over the next two years with a STRS return of 5% on its portfolio. Prepare for two years of tough times. A more detailed evaluation will be presented at the next STRS meeting.

### **Client Advisory Committee**

The Committee discussed State legislation and the update on the SBMA proposed changes. (These topics are covered in Legislation and Board meeting reports.)

Peggy Plett, Deputy CEO, Benefits & Services, led the discussion on Health Care. The results of the Mercer Study saw it feasible for STRS or another group to offer a health care benefit program for school employees. Savings would depend on all school employees becoming a part of the program. Next Peggy Plett reported that the Kaiser (Pers-STRS) Health Benefit Group is being phased out. Members will change to individual contracts. All inquiries should be directed to Kaiser.

The next Client Advisory meeting will be at the September STRS meeting.

### **Board Education**

The Committee heard a presentation by Arthur Levitt, former Chair of the Securities and Exchange Commission.

### **Benefits and Services Committee**

The Committee adopted the Employer contribution rate of 8.82% for elected officials of employee organizations and reduced workload employees.

Ed Derman, Deputy CEO, reviewed the long-term benefits strategy. The options selected were (1) Extend the longevity bonus. (2) Help younger teachers to save more. (3) Provide some type of health care for educators. Next, Ed Derman presented the Mercer report on *The Feasibility of Offering Health Care to School Employees*.

Ed Derman, Deputy CEO, presented *Health Care Have and Have Nots*, the report of the Public Education Health Benefits Task Force. The four recommendations were (1) a monthly health allowance - \$400 for pre 1999 retirees, \$300 for post 1999 retirees, and \$100 for future retirees with a goal of \$300 per month based on employer contributions, (2) Pay the Medicare Part B Premium, (3) a Medical Purchasing Power Payment for those with less than 85% purchasing power, (4) a Health Security Account paid for by employers. The Task Force recommended option 1 – Monthly Health Allowance.

### **Teachers' Retirement Board**

Jack Ehnes, CEO, reported that the next STRS Board meeting would be on July 10.

Ed Derman, Deputy CEO, reported on the SBMA (Supplemental Benefits Maintenance Account) revised budget proposal. The revisions were: (1) increase benefit to 85%, (2) Reduce state contribution to 2.25% and delay payment from July to November and April. (3) Beginning in 2013 begin biennial actuarial projection of funds available, (4) If benefit cannot be maintained for 65 years, reduce benefit beginning in 2015, but never below 80%, (5) Interest on litigation appropriated now and paid over four years, (6) Member organizations seek annual contribution reduction of \$66 million rather than ¼% rate reduction..

After discussion the STRS Board agreed with concept of the revised budget proposals on the SBMA and directed STRS staff to continue to work with client groups. In addition, if there was extra money in the SBMA fund benefits should go to the pre-1999 retirees.

The Board approved interest on the Defined Benefit Supplement Account of 7.5% in 2006 and 9.16% in 2007. Cash Balance Account interest will be 6.18% in 2006 and 9.44% in 2007. These amounts are based on the earnings of the accounts.

Progress on the new STRS Headquarters Building is on schedule. STRS plans to move to the new building by September 2009.



# **Report on CalSTRS Meeting, July 10, 2008**

**By Pat Geyer, CRTA Liaison**

## **Executive Summary**

- 1. GASB rules require that the Medicare Premium Payment Plan's unneeded funds be counted in the general Defined Benefit Program. Therefore, \$1.6 billion future employer contributions will be counted and will increase the Defined Benefit program funded status by 1%.**
- 2. Jack Ehnes, Chief Executive Officer reported that the fund stands at \$159 billion. We are in a Bear Market**
- 3. After passage of the SBMA legislation, STRS staff will meet with constituent groups, the actuary and fiduciary council to draft new regulations language.**
- 4. After passage, the average SBMA increase will be \$100 a month and will be paid quarterly, beginning as close to October as possible.**
- 5. Julia Durand, CalSTRS-403bComply, said that the latest IRS rulings state that only members employed by an educational institution as of January 1, 2009 or later will be affected by the new 403b requirements.**
- 6. CalSTRS Investment Business Plan is to create a separate research and a separate governance unit.**
- 7. U.S. Equity (40%) and Non-U.S. equity (20%) will be combined into one class named Public Equity. Alternative Investments will be renamed as Private Equity.**
- 8. The fixed asset policy proposes to invest in infrastructure projects such as bridges, roadways, utilities. This will be part of the 20% fixed income portfolio**

## **Audits and Risk Management Committee**

Karen Scott, Director of Audit Services, reported that 75 school district audits are in progress and 40 are completed for this year. Of the audits, the hired CPA firm does some 25 audits. Generally CalSTRS does the preliminary assessment and the CPA firm does the fieldwork. Board member Rogers noted that LAUSD (Los Angeles) may be in continuous audit because of its size. Karen Scott replied that STRS is planning this when they get to full staff. Charter Schools get audit attention. STRS audits the Charter school home office and they look at individual schools. Charter schools that are a part of a district are audited as part of the district. The main Charter school error is reporting STRS members as non-members.

Chris Ford, Chief Financial Officer, reported that as of January 2009 no more changes to the START computer program will be made as STRS moves to a new program. Technology is considering requirements for the new program. GASB rules require that the Medicare Premium Payment Plan's unneeded funds be included in the general Defined Benefit evaluation. Therefore, \$1.6 billion future employer contributions will be counted and that will increase the Defined Benefit program funded status by 1%.

The Audit Department still has a vacancy rate of 18%. There is a shortage of auditors statewide.

## **Teachers' Retirement Board**

The Board approved the Board and Committee work plans for the 2008-09 fiscal year. (See the CalSTRS website, July 10 Board Meeting for specific plans.)

Jack Ehnes, Chief Executive Officer reported that the fund stands at \$159 Billion. We are in a Bear Market. Mr. Ehnes then presented the CalSTRS Business Plan and made the following observations:

Economic Pressures –

- The Bear Market
- Oil Supplies
- The Commodity Controversy (speculators are blamed for driving up the price of commodities including some pension plans)
- Hedge Fund problems
- Residential Real Estate Foreclosures
- Credit Rating Agency problems
- Financial Market future regulations
- Accounting Standard Reforms
- The influence of Sovereign Wealth Funds

Political or Government Pressures -

- Federal and State Investment Rules (such as restricting investment in commodities and restricting sovereign wealth fund investment, restricting emerging market investment, taxes on private equity)
- IRS Initiatives on defined benefit compliance (Looking into defined benefit plans' long-term funding)
- GASB and actuary economic assumptions (Issue of Financial Economics – fixed income best for long-term investments)
- Government Accounting Office initiatives on defined benefit plans.

Media Pressures –

- Credibility of government structures
- Financial Economics challenges
- High risk investments
- Sustainability of public sector benefits
- Divergence from private sector benefits (pension envy)

Next Mr. Ehnes turned his attention to the successes and challenges of CalSTRS. They are-

- Recruiting and Retaining the best employees
- Improving business models and technology
- Moving to West Sacramento
- Moving towards full funding by generating 60 basis points of excess return
- Maintaining financial security for members
- Improving customer satisfaction

Ed Derman, Deputy CEO, reported on implementation of the Budget Act changes to the Supplemental Benefit Maintenance Account. After passage of the legislation, STRS staff will meet with constituent groups, the actuary and fiduciary council to draft new regulations language. Ed stated that the actuary estimated that the SBMA had a 84% chance of paying the amount for 75 years, even with the \$850 million total state reduction. 85% SBMA payments will begin with the 2008-09 fiscal year. The increase will be issued as close to the October date as possible. The average SBMA increase will be \$100 a month and will be paid quarterly.

### **Investment Committee**

The Alternative Investment benchmark will be the Russell 2000 Index plus 3%. The Global Equity policy revision was discussed. STRS has a home country bias in investing (40% domestic equities and 20% foreign equities). More and more domestic and foreign equities behave as one class and do not offer diversification. The proposal is to combine U.S. and non-U.S. equities into one class. CASTRS proposes to change Alternative Investments to Private Equity in order to more accurately reflect the actual investments

Under the 10-year business plan, CalSTRS will create a separate research unit, which will cut across all asset classes so that all can share information. CalSTRS will also create a separate corporate governance unit.

The Committee approved the business plans of the seven investment units.

Chris Ailman, Chief Investment Officer presented the fixed asset financing policy. The policy proposes to invest in infrastructure projects such as bridges, roadways, utilities, pipelines, water systems. Such investments will enhance diversification, provide a hedge against inflation, preserve investment capital, and earn an absolute real rate of return of 5%, not including inflation. This will be part of the 20% fixed income portfolio.

Chris Ailman reported that June 2008 was the worst month, financially, since the Great Depression. The stock market is back down to 1999. Chris predicts a 1% increase in Gross Domestic Product for both 2008 and 2009. The following is the growth of the S & P 500 by decade: 1930's = 5%; 1940's = 10%; 1950's = 20%; 1960's = 8%; 1970's = 7%; 1980's = 18%; 1990's = 18%; 2000's = 1%. The greatest world risks are Internet collapse, war in Iran, or war in North Korea.

AB 2677 (Krekorian) has been reintroduced in the legislature. It states the intent to require divestment in corporations identified as profiting from genocide.

May Harms, retired teacher from California and Michigan spoke in favor of continuing CalSTRS divestment in tobacco.

Summary of Tobacco Industry Panel Discussion  
From CalSTRS Investment Committee agenda By Pat Geyer

“Cigarette smoking has been identified as the most important source of preventable morbidity and premature mortality worldwide. Smoking-related diseases claim an estimated 438,000 American lives each year, including those affected indirectly. Smoking in the United States declined from 60% to 20% between 1965 and 1990. Smoking has remained at 20% since 1990. Today 80% of current smokers worldwide reside in low- or middle-income countries.” (American Lung Association)

At the annual Global Tobacco Conference JP Morgan reported tobacco as an attractive investment because it has lower cost and higher dividend yield than its consumer staple peers. Tobacco has a 12X price earnings ratio and a 5.6% dividend yield.

History of Tobacco divestment at STRS

1. In June 2000 CalSTRS Investment Committee approved the Bench Modification Policy. The Policy seeks to eliminate industries and/or sectors that face judicial, regulatory, and institutional investor pressure that are likely to result in lower corporate earnings and potential industry wide bankruptcies.
2. In the fall of 2000 tobacco became the first and only industry to meet the criteria and was excluded (from the benchmarks).
3. September 2008, Pension Consulting Alliance (STRS Consultant) recommends adding Human Health to the 20 risk factors for investment managers to consider rather than the Benchmark Modification Policy of divesting in tobacco. The policy would read:
  - The risk to an investment’s long-term profitability from business exposure to an industry or company that makes a product which is highly detrimental to human health so that it draws significant product liability lawsuits, government regulation, United Nations sanctions and focus, and avoidance by other institutional investments.

The Law: California Constitution, Article 16, Section 17, California Education Code and Teachers Retirement Law states that “The assets of the retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries, and defraying reasonable expenses of administering the system.”

Pension Consulting Alliance research shows that divestments programs have, in general, had a negative risk-adjusted return on the plan. Studies suggest that measurable financial impact on the companies targeted for divestment has been minimal. CalSTRS total tobacco-free opportunity cost is now estimated at \$1 billion.

There is a concern about the ‘slippery slope’ that divesting for one non-financial cause opens the door to pension funds being urged to divest for multiple social/geopolitical causes. (AB 1967 (Torrico) prohibits CalSTRS and CalPERS from investing in a company owned by a sovereign wealth fund and AB2677 states the intent of the Legislature to require CalSTRS and CalPERS to divest from corporations identified as profiting from genocide = both bills failed to pass in the 2008 legislative session)

# **Report on CalSTRS Meeting, September 4,5, 2008**

## **By Pat Geyer, CRTA Liaison**

### **Executive Summary**

1. The SBMA changes to increase the purchasing power to 85%, is a part of the budget and will be passed with the budget. STRS plans to send out additional SBMA checks to retirees earning the additional SBMA money sometime in October.
2. The STRS fund went from 87% to 88% funded as of June 30, 2007. The biggest changes in assumptions were salaries (increase of 6% rather than 4%) and teacher life expectancy increased over 1 year from the last evaluation.
3. Northern California retirees who have Kaiser premiums deducted from their STRS paychecks need to make other arrangements. They need to contact Kaiser about their health plan options and also contact their district about the possibility of joining their district plan. The Kaiser number is 1-800-777-1370 or 1-866-473-4941.
4. STRS offers 403b Comply program to school districts to help them meet the new IRS regulations. Presently 80 School Districts and 2 Community Colleges Districts have signed up.
5. The STRS portfolio decreased by \$7.7 billion or 3.7% over the last fiscal year (July 1, 2007-June 30, 2008).
6. STRS added human health as a risk factor that must be considered before it invests in stocks such as tobacco.
7. STRS is considering changing their asset allocation to global equity rather than the present allocation of 40% U.S. equities and 20% Non-U.S. equities.
8. Compared to other U.S. pension plans CalSTRS 18.1% contribution is lower than 50% of the other plans (20.6%) who are not covered by social security
9. Social Security reform – GPO and WEP offsets, and Elk Hills final payment are postponed until the next Congressional session
10. The reappointment of Jerilyn Harris, Beth Rogers, and Kathy Brugger; Governor appointees to the STRS Board is still not confirmed by the Senate. Jerilyn Harris represents retirees.
11. The STRS fund is \$157.5 billion
12. The next CalSTRS meetings will be November 5,6,7.

### **Client Advisory Committee**

Jennifer Baker, STRS Legislation, reviewed the bills of STRS interest that have been passed by the legislature and are waiting for the budget to be passed so that they can be sent to the Governor.

- AB 591 (Dymally) allows Community Colleges to hire temporary employees to teach up to 67% rather than 60% of full time. (Chaptered)
- AB 1480 (Mendoza) authorizes CalSTRS to offer a Roth IRA as part of its Pension 2 program

- AB 1444 (Hernandez) Makes it a crime for a person to make false statements in connection with retirement benefits and applications.
- AB 2390 (Karnette) extends the sunset date for the longevity bonus from January 1, 2010 to June 30, 2010.
- SB 242 (Torlakson) appropriates funds to pay for litigation costs and notes intent to appropriate funds for repayment of interest due STRS (SBMA claim)

The SBMA changes to increase the purchasing power to 85%, is a part of the budget and will be passed with the budget.

Ed Derman, Deputy CEO, stated that it is the plan to hold client meetings (CTA, CRTA, ASCA, etc) sometime after the budget is passed. The meetings will work out the details of the SBMA changes. STRS plans to send out additional SBMA checks to retirees earning the additional SBMA money sometime in October.

Rick Reed, STRS Actuary, reported that the STRS fund went from 87% to 88% funded as of June 30, 2007. 2008 will be a down year due to investments but the STRS fund percent will not change significantly because of smoothing (taking the gains and the losses over a 3-year period).

Ginny Johnson, Health Benefits Manager, reported that Northern California retirees who have Kaiser premiums deducted from their STRS paychecks need to make other arrangements. They need to contact Kaiser about their health plan options and also contact their district about the possibility of joining their district plan. The Kaiser number is 1-800-777-1370 or 1-866-473-4941.

Julia Durand, CalSTRS 403b Comply Program, explained STRS Pension 2 Program. This is a saving program to help members supplement their retirement income. STRS offers 403b Compare with product information from some 85 vendors. Secondly, STRS offers 403b Comply program to school districts to help them meet the new IRS regulations. Presently 80 School Districts and 2 Community Colleges Districts have signed up for the 403b Comply program.

### **Investment Committee**

The Committee heard the fixed income performance report. Fixed income earned about ½% less than benchmark because of the flight to quality (anything not a U.S. government security under performed. STRS invests in a variety of investment products.) The update on the state lands reported that STRS continue to work with the State Lands Commission to improve performance of the portfolio.

Alan Emkin, PCA Consultant gave the Semi-Annual Performance report. The STRS portfolio decreased by \$7.7 billion or 3.7% over the last fiscal year (July 1, 2007-June 30, 2008). The STRS loss was less than the benchmark for pension funds. Emkin is concerned about future inflation. The industry predicts 3-4% inflation with commodities up and labor down.

STRS Private Equity portfolio earned 11.3% for the year ending March 2008, slightly below the benchmark. The STRS Real Estate portfolio earned 9.1% for the year ending March 2008, slightly below the benchmark. There has been a slowdown in commercial real estate, which was expected. Emkin does not expect a turn in the market until 2010. Sovereign Wealth funds will be competitors with STRS in investing: however, Sovereign Wealth funds have been helpful in providing capital for the financial markets.

A panel discussion on the tobacco industry was held. (see separate summary following STRS Report) Morris Moore, VP Reynolds stated that cigarette sales had the largest decline, second largest was snuff. Erik Bloomquist, London stock analyst, reported that regulatory and tax issues were more important than possible litigation. The American Lung Association presented a report. Carolyn Widener, STRS Board member, requested a study on engagement with companies and success or failure. Bill Lockyer, State Treasurer and STRS Board member moved that STRS adopt health as a risk factor to be considered by STRS investors. Motion was passed. The health risk factor is: The risk to an investment's long-term profitability from business exposure to an industry or company that makes a product which is highly detrimental to human health so that it draws significant product liability lawsuits, government regulation, United Nations sanctions and focus, and avoidance by other institutional investments

STRS is considering changing their asset allocation to global equity rather than the present allocation of 40% U.S. equities and 20% Non-U.S. equities. The global equity definition would include U.S., Non-U.S. and emerging markets. Markets too small or undeveloped will be called frontier markets and are not included in global equity. Global equity would encourage managers to seek the best investments worldwide. The study will continue for two more meetings.

STRS will issue a RFP to hire investment managers for fixed income financing (infrastructure).

Chris Ailman, CFO, reported that the STRS fund is \$157.5 billion. STRS is over-weighted in private equity and real estate and will look at changing the asset allocation. We are still in recession, most experts think that the economy will continue to contract for another year.

### **Benefits and Services Committee**

Ed Derman reported on CalSTRS deferred compensation program (403b, 457, etc). Rick Reed, STRS Actuary, reported on the actuary assumptions. (See Client Advisory report) The death benefit amounts remain the same \$6163 for retired or coverage A, \$24,652 for coverage B. Compared to other U.S. pension plans CalSTRS 18.1% contribution (employee, employer, state) is lower than 50% of the other plans (20.6%) who are not covered by social security. Private industry retirement benefits increasingly rely on social security and individual 401k savings, even though individual savings average only \$50,000 at age 55-64 years.

Peggy Plett, Deputy CEO, reviewed the CalSTRS disability evaluation process. Member services continue to improve. CalSTRS continues to provide individual counseling and workshops at 27 school districts or county offices throughout the state. This is in addition to on-line information and telephone interviews.

Ed Derman, Deputy CEO, reported that the School Site Project with Washington Unified in West Sacramento continues. STRS is considering expanding the program of counseling, etc to other districts.

Sanday Keaton, UTLA representative, requested more information to educate teachers about the CalSTRS website.

### **Teachers' Retirement Board**

Ed Derman, Deputy CEO, reviewed federal legislation. Congress is considering taxing pension fund gains in commodities as a reaction to the increase in commodity prices. Social Security reform – GPO and WEP offsets, and Elk Hills final payment are postponed until the next Congressional session.

Jack Ehnes, CEO, reported that the Los Angeles USD reporting problems have been corrected. LAUSD will pay \$1.2 million in penalties. The State budget impasse has presented problems with payment to IT contractors and business travel. A survey of 20 leading pension plans showed that STRS lacked authority in hiring, employee classification, and budget compared to other plans. These are not best business practices and cost STRS money.

Rick Reed, STRS Actuary, presented the actuarial evaluation. STRS is 88% funded, but still needs to increase contributions in order to become fully funded. The biggest changes in assumptions were salaries (increase of 6% rather than 4%) and teacher life expectancy increased over 1 year from the last evaluation. There was an increase in inactive STRS members. More teachers are changing careers and are keeping their benefits in STRS rather than withdrawing them.

The CalSTRS operational budget for 2009-10 is proposed to increase 12% with a 2% personnel increase. STRS has a operational budget surplus due to the hiring freeze.

Jack Ehnes, CEO, reported that the STRS headquarters project in West Sacramento was going as planned. STRS plans to move in next September.



## **Budget Signed, 85% Purchasing power for Retirees!**

The CalSTRS Board is allowed to set SBMA (Supplemental Benefits Maintenance Account) benefits of 85% of purchasing power. This right is non-vested and subject to availability of funds.

According to Rick Reed, STRS Actuary, the 85% allowance will be calculated based on 2007 inflation. STRS members who retired in 1991 and before will receive a SBMA quarterly check. (Some 1992 retirees may also receive checks) The additional money will be mailed sometime in October. After that the additional SBMA money will be added to the quarterly SBMA amount. The average increase amounts to about \$100 a month, paid quarterly.

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# **Report on CalSTRS Meeting, November 5,6,7, 2008**

## **By Pat Geyer, CRTA Liaison**

### **Executive Summary**

1. The Investment Committee approved increasing the possible range of each investment class from + or – 3% to + or – 6 % away from the target. The markets have been very volatile and investment values have changed so rapidly that the fund needs more flexibility
2. In 2001 STRS adopted a target of 40% US Equities and 20% non-US equities. Should STRS maintain the U.S bias or should STRS go global? The decision will be made at the February meeting.
3. It is likely that the U.S. will have a prolonged recession of two years of negative GDP similar to 73-74 or 87-89, especially if the unemployment rate goes to 10% or more.
4. The unfunded liability of the STRS fund will increase. Presently the STRS fund is \$129 billion.
5. Staff will bring back a legislative proposal in February to have the earnings limit after retirement be ½ of retirees final compensation. The earnings limit would increase each year based on the increase in cost of living. Presently, the earnings limit is a fixed dollar amount for all retirees who retire and immediately return to work.
6. The Committee directed STRS to consider a counseling service model, which had a combination of STRS offices in large population areas along with the current county office model.
7. SBMA checks for the increase to 85% are being sent out. Retirees who retired in 1994 and earlier will receive the increase.
8. STRS has an advisor to help the 3000 members in the Kaiser group plan, who had their premiums deducted from STRS checks, evaluate coverage options. Information is being sent to the 3000 members.
9. Jerilyn Harris, Retired Teacher Representative on STRS Board, announced Retired Teacher Week, and thanked teachers for all their hard work.
10. Pat Geyer was not able to attend the STRS meetings in person so the reports are from a CD. Paula Weiss, Leg Chair Division 5, attended Client Advisory and the Regular Board meetings. Her report is included. Thank you Paula.

### **Subcommittee on Corporate Governance**

The Committee welcomed Anne Sheehan, the new director of Corporate Governance. Anne was formerly with the Department of Finance and represented the department on the CalSTRS Board.

The Committee approved the revision of the Statement of Investment Responsibility. Basically, the policy states that CalSTRS believes that environmental, social, and

corporate governance issues affect investment performance. CalSTRS may use proxy voting and other procedures to see that these guidelines are followed by companies in which CalSTRS has an investment. Thirty companies have been targeted for proposed shareholder resolutions.

The Committee heard a presentation by the Carbon Disclosure Panel. Global warming is a fact. The North Polar Ice Cap is disappearing and the sea level is expected to increase 3½ feet by the end of this century, causing problems for coastal communities and for the California Central Valley. The burning of fossil fuels equals 85% of the world's energy use. Because more of the world's population will have improved living standards, the world will continue to increase its use of fossil fuels, even if other sources of energy are developed. CalSTRS can be a leader in this policy area.

Anne Sheehan gave the Corporate Governance activity report. CalSTRS will survey managers on corporate governance. There will be a diversity conference in September 2009 and a round table discussion on corporate governance. CalSTRS has filed comments with the SEC (Securities and Exchange Commission) on climate change disclosure.

## **Investment Committee**

The Investment Committee approved increasing the possible range of each investment class from + or – 3% to + or – 6 % away from the target. The markets have been very volatile and investment values have changed so rapidly that the fund needs more flexibility. Most other funds allow a 5 or 6% range. The Committee will re-evaluate this position next year.

The Committee heard a presentation on wording for a STRS policy on divestment. Alan Emkin, PCA Consultant recommended one policy: 1<sup>st</sup> engage with company on issues, 2<sup>nd</sup> refer to STRS fiduciary duty if STRS actually divests. Emkin said that there is no proved linkage between divestment and country change. Both divestments in South Africa and in tobacco have cost the STRS fund. PERS has a new divestment policy. Committee instructed staff to present the PERS policy at the February meeting.

The Global Equity study, part 2, was presented. In 2001 STRS adopted a target of 40% US Equities and 20% non-US equities. Should STRS maintain the U.S bias or should STRS go global. In 1970 U.S. was 66% of the world market. In 2007 U.S. is 42% of the world markets because of the economic growth of emerging countries such as China and India. Arguments for going global are an increased choice of stocks and potential for greater returns. Argument against global is the risk that the foreign currency will lose value against the dollar. James Donald of Lazard and Toni Brown of Callan Associates made the presentation. CalPERS has gone to a Global Equity policy. STRS Board asked to see the PERS Global Equity policy. The decision on Global Equity will be made in February.

Solange Brooks, STRS, reported on the diversity in managers of investments. The survey reported that 60% of the managers were white men. Before 1980 nearly all of the managers were in New York, but this is changing.

The Green Initiative semi-annual report was presented. It will be 3 to 5 years before there is a performance report. The Global Equities Investment Policy revision was presented. Action will be taken in February. Reports on investments in Sudan, Iran, Northern Ireland, and WWII Slave Labor Related Investments were made.

Chris Ailman, Chief Investment Officer reported that the economy is in recession and the stock market has crashed. It is likely that the U.S. will have a prolonged recession of two years of negative GDP similar to 73-74 or 87-89, especially if the unemployment rate goes to 10% or more. Watch the consumer because 70% of the economy is consumer purchases. Also, watch the job loss, as of now most job loss has been in Wall Street and insurance. Another concern for California is that sales tax returns have dropped in 2006, 07, and 08. This affects the State budget. Michigan is in trouble. If even one car company goes bankrupt there could be a 2.5 million job loss in that state.

The unfunded liability of the STRS fund will increase. All asset classes are under performing. Values of private equity and real estate will decrease. As of now there are no comparable sales so it is difficult to value real estate. Some STRS costs will decrease, but STRS staff costs will increase compared to the value of STRS assets. It may take 4 to 5 years for STRS to get back to its high value.

## **Benefits and Services Committee**

The Committee received the Ombudsman report, the Annual Member Satisfaction Survey, and the report on the Supplemental Retirement Investment Program (403b, and IRA). The Committee discussed the Retirement Readiness Assessment. Jerilyn Harris, retired teacher appointee, wants STRS to remember the rural districts and smaller districts that do not have the salaries, benefits, and services of the larger urban districts. Peter Reinke, governor appointee, was concerned that teachers presently have a higher rate of debt and have less money saved for retirement.

Ed Derman, Deputy CEO, reported on rewarding longevity. Statistics show that there are problems with the present longevity rewards (longevity bonus - \$200 at 30 years, \$300 at 31 years, \$400 at 32+ years and career factor credit of up to 2.4%). The problems are that many teachers who enter teaching as a second career would not qualify. It also discriminates against women who take time out to raise a family, and teachers who work part time, especially those in Community Colleges. The trend is to have retirees with less and less years of teaching. Staff is considering establishing an age bonus for those who teach after 63. The idea is to reward age at retirement rather than years of service. Staff then discussed options for reduced workload, work after retirement. Staff will bring back a legislative proposal in February to have the earnings limit after retirement be ½ of retirees final compensation; the earnings limit would increase each year based on changes in the cost of living. Presently, the earnings limit is a fixed dollar amount for all retirees who return to work immediately after retirement

Ed Derman reported that the program, which allows STRS forms to be submitted to field offices, was very successful.

Following a discussion and evaluation of the counseling services for members. The Committee directed STRS to consider a counseling service model, which had a combination of STRS offices in large population areas along with the current county office model. A cost/benefit analysis will be made. Beverly Carlson, CTA retired and Morgan Brown, CTA, asked about the selection of counselors. Are most counselors presently retired administrators rather than retired teachers?

Ed Derman, Deputy CEO, reported that the SBMA checks for the increase to 85% are being sent out. Retirees who retired in 1994 and earlier will receive the increase. Members receiving SBMA checks increased from 50,00 to 85,00 because of the 85% and because of an increase in inflation.

STRS has an advisor to help the 3000 members in the Kaiser group plan who had their premiums deducted from STRS checks evaluate coverage options. Information is being sent to the 3000 members.

The following is the legislative summary of the **STRS Board Meeting** by Paula Weiss.

**Legislative Report, November 2008**  
Paula Weiss, Division 5 Legislative Chair

The following is a summary of what I heard when I attended the CalSTRS Client Advisory and Regular Board Meetings.

I am the bearer of good news. The 85% adjustment to SBMA payments should be going out in a few weeks. The really good news is because of inflation, SBMA supplemental checks are going to go to people up through the year of **1994!**

In my newsletter article I mentioned these words, "subject to availability of funds." I learned what that phrase may mean and that is the not so good news. Right now people are going to get the 85%, but suppose there is a shortage of money. That means that the SBMA supplement can be adjusted downward. It was explained that it wouldn't be a quick jump back down to 80% and the 2% cola adjustment might compensate for some of the loss, but our 85% is not guaranteed. I guess that was the compromise that was negotiated to get the 85% in the first place.

Below is a summary of the proposed regulations to govern the SBMA.

**RECOMMENDATIONS**

Staff recommends the Board provide direction with respect to the drafting of regulations to administer the purchasing power protection benefit program, in accordance with Chapter 751. Specifically, staff recommends the Board direct staff to draft regulations that:

1. Establish a fixed date that the benefit should be targeted for sustainability

2. Establish that fixed date based on a time period of sustainability that reflects an objective to be able to sustain benefits for a specific percentage of members for the duration of their membership in the DB Program
3. Determine the sustainability of benefit program based on a deterministic, rather than stochastic statistical method based on the assumptions adopted by the Board
4. Establish the purchasing power benefit in half-percent increments, rounded to the nearest half-percent increment
5. Limit the amount of any adjustment in any single year to the greater of one-half percent, or one-fourth of the total required adjustment
6. Require that actuarial projections be undertaken every two years, although the Board could decide to undertake a special projection in an off-year

The matter will be dealt with at the February Board meeting of CalSTRS.

At the regular CalSTRS Board Meeting on November 6, 2008 Jack Ehnes, STRS CEO, addressed the board about the financial crisis in the country and STRS's unfunded liability. He spoke about the need to reassure members. He encourages all members to sign up for My CalSTRS where they can find the latest information about current issues.

Mr. Ehnes cautioned the Board about the political issues circling all defined benefit pensions. He mentioned Measure Y in Pacific Grove where voters passed an advisory motion to end their public employee's membership in PERS and replace it with 401k defined contribution plans. Orange County is also exploring that option and the Sacramento Bee continues to complain about public employees "rich" pensions. These happenings are a window to what we need to defend against as our economy continues to struggle.

I again encourage all of you to talk to who ever needs to know and tell them that **WE** pay for our pensions with deductions from our salaries. Tell them that our pensions support the economies of the communities we live in. Tell them a defined benefit program provides security to dedicated public servants as well as being less costly. Tell them you believe that everyone should have a defined benefit pension and that retired teachers are committed to working toward that cause. Tell them too, that the average retired teacher's pension is only 62% of salary and that is not even deemed adequate. Also mention how many volunteer hours retired teachers donate in support of the communities we live in.

**• Study Calculates that DB Plans Provide Retirement Benefits at Half the Cost of DC Individual Account Plans**

Defined benefit pension plans can deliver the same level of retirement benefit at a 46 percent lower cost than a defined contribution individual account plan, according to a recent study by the National Institute on Retirement Security. The study, released in August, is entitled "A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans".

I want to reassure you that we are safe. Our pensions are secure. We just have to be prepared to work hard to keep them secure for those who come after us. CalSTRS reported that investment income and contributions are higher than the \$7 or 8 billion that is spent annually on members. No stocks needed to be sold to make payments and CalSTRS has not invested in those risky products we've been hearing about.

John Stanton, federal legal counsel to CalSTRS, gave a fascinating presentation updating the Board on Federal Legislation and the crisis in the financial markets. I frankly do not understand

the language of "credit default swaps", and "slicing up and bundling derivatives". The new administration obviously will be trying to make the necessary changes and developing the necessary regulations to provide market stability. The caution Mr. Stanton made was that we can expect the business community to resist change and support the needs of individual investors.

Stanton also indicated that regardless of what the regulations are, their effectiveness might depend on having a capable pool of people who are able to supervise and enforce them.

How does all this affect our pension fund? Some of these new rules may limit CalSTRS investments

There has been a lot of discussion about a stimulus package. Stanton said congressional hearings will probably be taking place by March to put in place a new regulatory system.

As far as our pension plan, Stanton told the Board that it needed to keep a low profile. We don't want people to think we are a "pool of money." We also want to maintain our political capital and credibility. "CalSTRS has a constructive working relationship with the Hill and we want to continue it."

As far as the WEP/GPO offsets, the cost of complete repeal would be about \$100 billion dollars over 10 years. Because of that cost we can only hope for some "tweaking" of the offset formulas. We have to take a gradual approach with steps to alleviate the severe consequences to our most vulnerable members. We need to provide some relief to our most needy members who are mostly elderly women who are really suffering.

Another approach is to stress the point that the WEP/GPO discourage mid career changes to teaching and hurts teacher recruitment.

Stanton stated that the Medicare Trust Fund was about to run out of money. The implication is that it is a greater priority than fixing Social Security.

## **CTA interview with CalSTRS Chief Investment Officer Christopher Ailman**

### **CTA: Are the funds in CalSTRS stable since the economic downturn?**

Christopher Ailman: The benefits our members receive do not depend on the size of the CalSTRS investment portfolio. However, the portfolio has more than enough assets to weather today's turbulent market. Also, CalSTRS' 88 percent funding status is well above the 80 percent average considered healthy for a public pension fund.

### **What investment strategies does CalSTRS have in place to safeguard against turbulent markets?**

CalSTRS' main investment strategy for protection from market turmoil is threefold. First, our diversification spreads the risk. Our asset classes are U.S. stocks, international stocks, bonds and other fixed-income securities, real estate, and private equity. Secondly, we are a patient, long-term investor, which has been the most reliable model for investment growth over time. Thirdly, our highly skilled professional staff works with the best asset managers in the world.

### **Can you explain how the funds are protected by law?**

CalSTRS benefits are a contractual right protected not only by the California Constitution but also by the U.S. Constitution. Article 1 Section 9 of the California Constitution and U.S. Constitution Article 1 Section 10 both hold the state to its contractual obligations.

Pensions tend to use a system, which includes actuarial smoothing. Can you explain what actuarial smoothing is and how it results in predictable performance over the life of a CalSTRS pension?

To understand how smoothing affects the CalSTRS fund, you have to keep in mind that the fund makes money in two ways: through contributions by members, school districts and the state of California, and through investment income. So double-digit investment returns the past three years will help cushion us during lean years such as 2007-08. That means CalSTRS doesn't have to ask the Legislature to raise contribution rates because of one bad year.

### **Can you provide any current educational information (online or otherwise) that can assure members of CalSTRS' financial stability?**

Your best bet is to look at the following webpage:

[http://www.calstrs.com/Newsroom/What's%20New/market\\_fluctuations.aspx](http://www.calstrs.com/Newsroom/What's%20New/market_fluctuations.aspx).

There you will see that our size, diversification and legal guarantees mean that our members' benefits will be paid out and that the fund will weather this financial turmoil.

### **Anything else you would like us to include in this brief Q&A for our members?**

Since its founding 95 years ago, CalSTRS has grown and evolved into a sophisticated, well-managed and well-diversified financial institution. CalSTRS is not only built to withstand the difficulties of a struggling economy, but is poised to take full advantage of the coming financial recovery. CalSTRS is dedicated to fulfilling its mission of sustaining the financial security of California's educators.