

Report on STRS Committees and Board Meeting, February 4-5, 2004

By Pat Geyer, CRTA Liaison with STRS

Subcommittee on Corporate Governance

The STRS staff reported on the monitoring of financial market reform. STRS staff continues to write letters and meet with appropriate groups. Reform of mutual fund discounts and disclosure requirements were added to the reform matrix. Of special interest was a discussion of the prolonged employee strike against Safeway and other supermarkets in Southern California. Letters have been written urging Safeway to make all effort to end the strike because Safeway stock was deteriorating. The letters also urged Safeway to continue employee healthcare. It was mentioned in the meeting that if Safeway and other grocers dropped health care, that might be an excuse for school districts to drop or limit health care also.

The Ad Hoc Committee on Corporate Governance reported that they were working with PERS to identify joint projects, share reports, and costs.

Investment Committee

For the benefit of the new STRS Board members, staff presented a review of the Investment Policy and Management Plan. State Treasurer Angelides requested that the Investment Committee **add a study of Environmental and Energy Issues** related to investments for the next six months. The Committee recognized the need for such a study but did not come to a conclusion about what to leave out of their six-month work plan. The issue was put off to a future meeting.

Much of the remainder of the committee meeting centered around a discussion of **investments in emerging markets**. Recently, **emerging markets have brought the largest return on equity**. STRS staff believes that there is a need for emerging market investment in order to maximize income, as well as diversify. However, STRS does not have an emerging market policy that covers all the variety of STRS investments: fixed income, equities, private equity, and real estate. STRS needs to develop such an emerging market plan.

Chris Ailman, Chief Investment Officer, reported that the **STRS Fund has \$114 Billion in assets**. The fund has finished 11 months of positive returns and is approaching the \$116 Billion, which was the high-point of STRS fund before the recession.

Benefits and Services Committee

Ed Derman, Deputy CEO, reported that Medicare sent out a letter to retired teachers stating that STRS was no longer paying Medicare Part A. The letter was in error and should be disregarded. **Retired teachers who have questions about Medicare Part A payments should call STRS.**

Peggy Plett, DCEO of Benefits and Services reported that service at the Call Center dropped in December and January because of increased questions about the annual statement, staff vacations, and a hiring freeze. Level of service has since improved.

Ed Derman led a **discussion of the Medicare Prescription Drug Legislation**. Mr. Derman believed that **STRS' role should be one of education**. Elizabeth Mackenzie presented a chart on the individual costs of the legislation and emphasized that there was a need for education since the plan was very complicated.

Audits and Risk Management Committee

The name of this committee has been changed to reflect the increased role of audits. The budget will be covered in the STRS Board Meeting. A school district status report of audits ending June 30, 2003 was presented. The firm of Macias Gini & Company was selected as the independent auditor for STRS.

Teachers' Retirement Board

Gary Lynes was elected Chair of the STRS Board; Carolyn Widener was elected Vice-Chair.

Jack Ehnes in the Chief Executive Officer Report announced that the **Governor is planning to make the 5 additional appointments to the STRS Board in the next 30 days. This includes the Retired Teacher appointment**. Next Jack announced that the vacancies on the STRS staff had decreased from 140 to about 85. However, the hiring freeze is not over so continued hiring will be difficult. STRS staff is outgrowing their present facilities. At the present time STRS is making use of the office building one block east of the present site. The call center and member services will be located in that building.

Ed Derman, Deputy Chief Executive Officer reported on legislation. STRS is proposing two bills. **One bill would eliminate the requirement for witness signatures on the beneficiary designation forms**. This would simplify the form and witnesses are not required by other agencies. **The second bill changes the requirements for mandatory membership in STRS defined benefit program**. The requirements will be changed from 50 to 60% service for the whole school year not one month in the adult education and community college programs. The requirements for K-12 would remain at 50%. This would give part-time adult education and community college employees more options.

SB 1137 introduced by Senator Burton authorizes the retired member of the STRS Board be elected by retired participants and those receiving disability allowance. The retired Board member shall be elected by January 1, 2006.

AB 1852 (Mullin) allows up to 2/10 of a year of sick leave to be used for the longevity bonus and other benefit enhancements. It allows a member to retire with 25 years of service at the age of 50 rather than 55. It gives service credit to those teachers who are called to military duty after 9/11. Finally, it allows teachers to use any 3 years of

teaching to compute their final service credit. In Client Advisory Meeting, Pat Geyer asked about the fiscal impact to the STRS fund of this bill. The STRS staff will compute the cost to the fund. The bill is sponsored by CTA and CalSTRS.

This year's Governor's Budget does include the \$500 million yearly payment to the Supplemental Benefit Account for purchasing power protection. In the Client Advisory meeting it was reported that the Court Case was going forward to sue for the \$500 million that was not given last year. CRTA has also joined the suit. There is still hope that AB 265 (Mullin) which repays the 2003-4 \$500 million will be passed by the legislature.

The appropriation for the Elk Hills payment of \$36 million was not included in President Bush's budget. The Federal Government still owes STRS \$108 million. Ed Derman is optimistic that the money will be appropriated. Derman is going back to Washington D.C. to work with the STRS lobbyist on getting the appropriation. The Elk Hills money is used to fund the supplemental benefit account for purchasing power protection.

Client Advisory Committee Meeting

Ed Derman and Jim Zerio continued the discussion of legislation, which is reported under the Board minutes above. Virginia Johnson, Health Benefits Manager, reported on the health benefits survey of employers. Just under half of the retired employees have their health benefits paid by the employer. Most of those are retired from Los Angeles Unified or Community College Districts. Sacramento Unified also pays retiree health benefits. The other districts pay some or none of retiree health benefits. Health benefit costs are rising and payments by districts to retirees may be reduced or disappear. The Medicare Prescription Drug Legislation was discussed, but no one is sure how that legislation will affect teachers. **Again, STRS sees their role as one of providing information on health benefits and options.**

The **403b Compare web site** is being prepared. It will be in full operation by July 1, 2004. The web site will provide a list of registered mutual fund vendors, information on the funds, and a list of what funds each school district employer will allow for 403b investment.

Report on CalSTRS Committees and Board Meeting, March 3-4, 2004

By Pat Geyer, CRTA Liaison with STRS

Audits and Risk Management Committee

The committee heard a presentation by William Ashby of KPMG on the audit committee roles, responsibilities, and best practices. Next Way Lee of STRS reported on the audit report from Price Waterhouse on STRS as of June 30, 2003. Areas for improvement are: 1. Response to members, and 2. Prompt benefit payments. Mathias/Gini & Co. will be the new STRS auditor.

Investment Committee

The Investment Committee revised their workplan to include a study of energy investments and disclosure of environmental risks. These additions were at the request of Treasurer Angelides who stated that he supported STRS hiring additional staff for the project.

Allan Emkin, PCA, presented the semi-annual performance report. **2003 was a good year for STRS investments. The fund was up 23% or \$24 Billion.** The asset allocation was good. STRS performed in the top 1/3 of all like funds. Of special mention was the Real Estate sector which outperformed its benchmark. However, STRS has been selling real estate because capitalization rates are high, vacancies are increasing, and there is a possibility of increased interest rates. Alternative investments/private equity also did well, outperforming its benchmark.

Chris Ailman, Chief Investment Officer reported that the **STRS fund is presently at \$115.5 Billion. Since July the fund has increased 15.6%.** In the Disney Company vote, STRS voted against Eisner as did 43% of the other stockholders. STRS is against having the same person be President of the Company and also Chairman of the Board. STRS is concerned that the Safeway, Albertsons, Vons settlement of two-tier salaries will spread to other sectors. Finally STRS has invested in the vacant land near the Renaissance Towers in downtown Sacramento. That property will become apartments with the bottom floor being retail stores.

Benefits and Services Committee

It was reported that the purchasing power (**Supplemental Benefits Fund**) is **adequately funded for the next 30 years. Teachers who have retired in 1986 and before receive supplemental benefits to bring their purchasing power up to 80%.** The STRS Board requested to see the costs of increasing purchasing power beyond 80%.

Ed Derman, DCEO, reported on a 457 plan, which is similar to the 403b plan. STRS will explore offering such a plan and will get bids from potential plan administrators. The website, 403bCompare.com is up and running. Complete information on 403b vendors will be on the site as of July 1, 2004.

The call center reported that calls and correspondence had continued to increase. STRS receives over 1000 calls a day. As a result the percent of calls answered in 1 minute was down from 80% to 72%

Teachers' Retirement Board

Mark Johnson, Milliman USA, reported on the 2003 Actuarial Study. Changes reported were a lowering of the inflation from 3.5% to 3.25%. The predicted investment return of 8% was unchanged. Wage growth is predicted to be 4.25% a year. Retirements were up during the last 5 years. However, since STRS does not expect continued changes in benefits, the actuary recommended a slight upward change in predicted retirement dates. Finally, the rate of teachers leaving the profession in the first 10 years was lowered.

Ed Derman reported that the Senate passed the Social Security Program Protection Act of 2003 (H.R. 743). STRS will be required to inform new employees about the impact of the offset. There is also a modest change to the GPO. This legislation is expected to pass and be signed by President Bush.

The Elk Hills appropriation is not in the Administration's proposed Budget. STRS and others continue to work to get the \$36 million appropriation inserted into the Budget.

SB 1137 (Burton), which authorizes the election of a retired member of the Board, has been introduced in the Senate. The STRS Board is prohibited by law from endorsing the bill. Individual Board members expressed support. The Department of Finance and the Treasurer's office also voiced their support of the SB 1137.

The next CalSTRS Board meeting will be May 5-6, 2004.

Summary:

1. STRS fund was presently at \$115.5 Billion. Since July the fund has increased 15.6%.
2. (Supplemental Benefits Fund) is adequately funded for the next 30 years. Teachers who have retired in 1986 and before receive supplemental benefits to bring their purchasing power up to 80%.
3. The call center reported that calls and correspondence had continued to increase. STRS receives over 1000 calls a day. As a result the percent of calls answered in 1 minute was down from 80% to 72%
4. Ed Derman reported that the Senate passed the Social Security Program Protection Act of 2003 (H.R. 743). STRS will be required to inform new employees about the impact of the offset. There is also a modest change to the GPO. This legislation is expected to pass and be signed by President Bush
5. The Elk Hills appropriation is not in the Administration's proposed Budget. STRS and others continue to work to get the \$36 million appropriation inserted into the Budget.
6. SB 1137 (Burton), which authorizes the election of a retired member of the Board, has been introduced in the Senate. The STRS Board is prohibited by law from endorsing the bill. Individual Board members expressed support. The Department of Finance and the Treasurer's office also voiced their support of SB 1137.

Report on STRS meetings, May 5-6, 2004

By Pat Geyer, CRTA liaison

The **Subcommittee on Corporate Governance** met and reviewed the financial market reform plan. STRS continues to monitor actions by the SEC and federal bills which target mutual fund reform.

The **Audits and Risk Management Committee** heard an extensive presentation by Mr. Rick Funston of Deloitte & Touche. He mentioned the following items which produce risk: inadequate governance, lack of timely, shared information, management overrides the rules, toxic culture, lack of independence, lack of integrity, lack of preparedness. Today many companies are concerned with protecting existing assets and not looking at future risk. To reduce risk means to reduce variability; however, money is made when there is change. Companies need to know: (1) Where they may fail, (2) What are the causes of failure, (3) What is the organization doing about failure, and (4) Are they successful?

The **Investment Committee** heard a presentation on **expanding the locations for investment beyond the United States, Canada, United Kingdom and Continental Europe. No decision was made on the expansion. Alternative Investments target allocation was changed** from 15% International and 85% United States **to 25% International and 75% United States.**

Chris Ailman, Chief Investment Officer, reported the STRS fund at \$114 billion. Last week the STRS fund was at \$116 billion, which was an all-time high. The stock market has been stuck in a trading range since February; Chris does not see the stock market breaking out soon. Stocks are still 20% off their highs. Commodities hit their low in 2002 and have been increasing in price since. Consumer prices are predicted to rise especially because of the increase in the cost of oil.

The **Benefits and Services Committee approved changes in interest rates for 2004-5. Regular Interest rate goes from 6% to 4.5%** (This is the rate charges to members who want to redeposit contributions.) **The Defined Benefit interest rate goes from 2.5% to 1.75%.** (This is the interest credited to members accounts and is based on passbook savings accounts.) **Rates for the Cash Balance and Defined Benefit Supplement Program go from 5.25% to 5%** (Cash balance is a program for employees who do not qualify for STRS but want to put aside money for retirement. The defined benefit supplement account is a savings account of 2% of contributions from active teachers.)

Levels of service have improved in March. The call center has been more successful in getting vacant positions filled. There is an increase in requests to purchase service credit since the costs of purchase will increase July 1. A discussion was held on simplifying the number of retirement and annuity options. When such changes are made present retirees would be able to change retirement plans, but retirees would have to pay any costs.

New STRS Board members were introduced at the Teachers' Retirement Board meeting. They are Jim Grey (representing school boards), Kathy Smalley (public), Mark Battey (public), and Gloria Hom (representing retired teachers).

Jack Ehnes, Chief Executive Officer, gave a tribute to Marty Mathiesen, STRS Board member from 1996 to 2002. Marty passed away in 2004. Eva Hain, President of CRTA, also spoke about Marty's work on behalf of retirees and his contribution to education.

Ed Derman, Deputy Chief Executive Officer gave the legislative report. **AB1852 has been amended. Three non-consecutive years for final compensation, and retirement at 50 with 25 years of service were out because of the cost. Payment of the longevity bonus as a lump sum and one-year contributions for military service between 01-05 remain. AB3094 allows state and county retirements systems to recover funds from bank accounts if the funds were sent after that person's death. The Elk Hills payment of \$36 million is in the Federal Budget. No mention was made of Social Security legislation.**

Chris Ailman presented information on a new Portfolio Manager classification. These positions will be under the Investment Director. The Portfolio Manager will have a salary from \$70,000 to \$125,000 and will be paid a bonus based on how much the securities under his/her management increase.

Pat Geyer, CRTA liaison with STRS welcomed the new STRS Board members and passed out CRTA pens to STRS Board and staff.

Report Summary

- 1. Alternative Investment target was changed to 25% international, 75% U.S.**
- 2. STRS fund is \$114 billion.**
- 3. For 2004-5, STRS interest rates paid are: regular-4.5%, defined benefit-1.75%, cash balance and defined benefit supplement-5%.**
- 4. Levels of service improved in March.**
- 5. New STRS Board members are Jim Grey (representing school boards), Kathy Smalley (public), Mark Battey (public), and Gloria Hom (representing retired teachers).**
- 6. Tribute to Marty Mathiesen, STRS Board member representing CRTA, 1996-2002.**
- 7. AB1552 amended to drop final compensation and retirement at 50 changes.**
- 8. Elk Hills payment is in the Federal Budget.**

Report on STRS Meetings, June 2-3, 2004

By Pat Geyer, CRTA Liaison with STRS

Investment Committee

The Committee began with three finalist interviews for the position of General Consultant to the STRS Board. We heard from EnnisKnupp, PCA (Pension Consulting Alliance), and Callan. The Board selected PCA. Allan Emkin, managing director of PCA has served as consultant to STRS for almost 20 years. In addition PCA's charges would be 50% lower than the larger, other finalist firms.

Concluding the Alternative Investments Study, STRS Board voted to expand the alternative investments market to include all countries. However, STRS will take a measured approach and expand only to Japan and Australia. Presently, alternative investments are limited to the United States, Canada, United Kingdom, and Continental Europe. Cambridge Associates will be the advisor for the new Alternative Investments in Japan and Australia.

Cambridge Energy Resource Advisors (CERA) made a presentation on Clean Energy/Technology – Alternative Investments. They discussed the many opportunities for investment in the energy sector. Treasurer Angelides pushed for more investment into clean technology, and introduced Bob Epstein of Environmental Entrepreneurs. This was only an information item. No action was taken.

Action was taken to allocate money to firms with investment strategies that concentrate on active corporate governance intervention to add value over the benchmark. Therefore, \$100 million was invested with Sterling Capital (mid-cap value manager) and \$700 million in Relational Investors who purchase 1% to 5% of company shares in order to influence corporate management.

Due to the length of the meeting the Chief Investment Officer Report was not discussed. However, it was reported that the STRS fund presently stands at \$113 Billion.

Audits and Risk Management Committee

The Committee discussed their proposed charter. Members expressed concern with the scope of the Committee responsibilities and the difficulty in completing all the suggestions in a timely fashion. Staff will continue to refine the charter at the Committee's direction.

Staff presented the quarterly audit status report, internal audits final report, and school district final audits. Staff continues to work with school districts to improve accuracy in reporting. A sample of 120 benefit payments (2002-3) found an error rate of 12.5% (9 underpayments and 6 overpayments). This error rate will not have a material impact on the STRS finances. However, management is concerned. Staff will review the START (computer program) data to improve accuracy in benefit payments to members. A larger sample from the fiscal year of 2004-5 will be taken to determine if payment errors are still occurring.

Benefits and Services Committee

The Committee approved a plan to simplify the benefit options for retirement. Retired members can elect to change their option during the six-month window period (January 1, 2007 through June 30, 2007). Members electing to change must meet the following:

- Name the same option/annuity beneficiary
- Option/annuity beneficiary must still be living
- Member/participant or option/annuity beneficiary cannot be afflicted with a known terminal illness
- The member's/participant's spouse provides written consent to change the option/annuity
- A revocation or change of an option/annuity may not be made in derogation of a spouse's or former spouse's community property rights as specified in a court order.

More details on the new benefit options will be coming.

The death benefit amount remains the same at \$6,163.

Customer Service reported that calls answered within 3 minutes dropped from 90% to 76% because there was a significant increase in number of calls. During the school year, the best time to call is in the morning or early afternoon when active teachers are in the classroom. The customer service survey reported that retired teachers were generally delighted with CalSTRS service and gave the service higher marks than did active teachers.

Teachers' Retirement Board

The Actuary (Mark Johnson of Milliman) presented the Actuary Valuation Report as of June 30, 2003. The Defined Benefit Program has an unfunded obligation of \$23 Billion and a funding ratio of 82%. The causes are:

- Investment returns of -6% and 4% for 2001-2 and 2002-3 respectively. Fund predicts an average return of 8%.(\$12.4 Billion)
- Earnings by active members in 2001-2 and 2002-3 were 2.5% higher mainly due to salary increases. (\$2 Billion)
- \$2.8 Billion of the \$23 Billion was due to revised assumptions (demographics, etc) adopted by the STRS Board.

The Actuary stated that the fund would need a contribution rate of between 20.6% and 21.8% to become fully funded in 30 years. Presently, the contribution rate is between 17.4% and 17.5%. There is a need to identify additional sources of income for the DB fund.

By law the State is required to contribute .524% of total membership salaries if the unfunded obligation falls below the obligation for benefits in place in 1990. Such is the case and the State will need to begin payments of approximately \$92 million quarterly beginning next fiscal year. STRS plans to do a June 30, 2004 actuary valuation. However, the predicted changes in the income will not significantly change the unfunded obligation.

The Defined Benefit Supplement Fund and the Cash Balance Program will grow out of their unfunded obligations because they can reduce the interest credited to those accounts.

Ed Derman reported on legislation. AB 1852 (Mullin) received a STRS Board support position. It will give teachers called to military service from 9/11/01 to 7/30/05 1 year of service. STRS will pay teacher's contribution, district will pay their contribution. On the Federal level the Elk Hills payment for this year is in the budget. The proposal for the revision of the WEP of Social Security (HR 4391) will be discussed at the July meeting.

Bids were approved to provide for furniture, refurbishing, for the East Building. STRS has moved the Member Services Department to 7919 Folsom Blvd. This building is just east of the STRS building and across Hornet Drive.

Report Summary

- 1. Allen Emkin of PCA was selected to continue to serve as consultant to STRS**
- 2. STRS voted to expand alternative investments to include all countries. However, at the present time STRS will add only Japan and Australia to the list.**
- 3. Benefit options for retirement have been simplified. Retired members may make changes between January and June 2007.**
- 4. STRS Defined Benefit Fund as of June 30, 2003 has an unfunded obligation of \$23 Billion and a funding ratio of 82%**
- 5. Poor investment returns account for over half of the unfunded obligation, salary increases and revised assumptions accounted for under one fourth.**
- 6. The DB Fund will not be fully funded in 30 years; there is a need for additional income sources.**
- 7. STRS will discuss legislation to revise the WEP of Social Security (HR 4391) at the July meeting.**
- 8. STRS fund is \$113 Billion.**

Report on CalSTRS meetings, July 7-8, 2004

By Pat Geyer, CRTA Liaison with STRS

Subcommittee on Corporate Governance

This committee reviewed their workplan for the next fiscal year. In addition to the general review, the emphasis will be on Executive Compensation and on Environmental Concerns. In the spring, staff will evaluate and vote 2700+ proxies.

One of the companies in the S&P 500 is CACI International. This is an information technology company that consults with the US government. There are allegations that some of CACI's employees were involved in the abuse of Iraqi prisoners. STRS has sent a letter requesting an explanation and is waiting for a response and the results of the investigation before taking action. STRS holds CACI shares because it invests in the S&P index, which includes all the S&P stocks.

Benefits and Services Committee

Staff demonstrated the *myCalSTRS* website. In addition to general information *myCalSTRS* offers a secure process for members to access their direct deposit statements, their calendar year-to-date payment information, their 1099 forms, and the ability to update their personal information. Members are urged to visit the site. Pat Geyer asked for a simple, one-page guide for website use for retired members.

Disability services reported that there are presently about 4600 CalSTRS members on disability. The number of members requesting disability is steadily increasing. There were some 800 applications this year. The most common categories are Muscular, Nerve, and Mental (usually depression).

The level of service (calls answered within 1 minute, e-mails responded to in 1 day) has dropped from 75% to 55% from April to May and June. One of the reasons has been the large increase in applications for purchase of service credit requested before the July 1 deadline when the cost of service credit increases.

Investment Committee

The Investment Committee reviewed the Investment Business Plans. Some points of interest were

- The mix of U.S. passive managed stocks (index funds like Standard & Poors) was changed from 80% to 70%. Active managed funds were changed from 20% to 30%. In today's more difficult market, STRS management believes that active managers will beat the indexes.
- STRS, at 8.6 basis points of cost, has the second lowest cost in the world of pension funds. Only New York Teachers Fund is lower. However, STRS may have to look at spending more to make money. Active managers cost money.

- Under Alternative Investments, Private Equity such as limited partnerships, offers the best chance for income. However, there are fewer good investments so the opportunity to invest is limited.
- STRS continues to use “soft money” for research information. “Soft money” is rewards that stockbrokers give to large purchasers for their business. This practice is being criticized; however, until the practice ends STRS has to use the “soft money” or be criticized for leaving earned income. Emkin, PCA advisor to STRS, reported that the practice of “soft money” will eventually stop.
- Real Estate does not presently offer opportunities for good investments. The real estate class is changed as more private equity and other types of investments are offered. Real Estate may evolve into an alternative investment.
- It was decided to change to Alternative Investments from US and EAFE to world. This change will add some investment in emerging markets. STRS is working on an evaluation for emerging market purchases. At this point 75% will be market (economic factors) and 25% will be country (human rights and environment factors). More discussion will be held in September.

Chris Ailman, Chief Investment Office, reported that the STRS fund is at \$116.25 billion. The fund has fully recovered from the 2000-01 bear market, up 16.5% this fiscal year. It is one of the few pension funds that have fully recovered. Under customer service, Mr Ailman reported that they had hosted four CRTA tours and that he had spoken to CTA-Retired, UTLA-Retired, and CRTA.

Audits and Risk Management Committee

The committee discussed the work plan and charter. Staff continues to refine the STRS database to correct inaccuracies. However, school districts have problems in sending correct data to STRS. Since there are some 1200 school districts and only 30 are audited by STRS each year, many problems are not corrected promptly.

Teachers’ Retirement Board

Jack Ehnes, Chief Executive Officer, reported that PERS is looking at ways to increase state employee contributions. One proposal is to have employee contributions put in a separate account for the first four years, at the end of that time employees may either cash out or go into PERS. (It is hoped that employees will not go into PERS and thus save the fund money.) The hiring freeze is over so STRS can now hire for vacant positions.

STRS Board adopted the actuarial evaluation for 2003. The unfunded obligation is \$23.1 billion. The fund is funded as of June 30, 2003 at 82%. The causes were (1) investment return 18 percentage points lower than the 8% return over the last few years; (2) higher educator earnings; and (3) revised actuarial assumptions about educator demographics. The present teacher and school district contribution rate of 17.3% would have to be raised to 21.8% to make the STRS fund 100% funded in 30 years.

Because STRS has an unfunded obligation based on the 1990 benefits (before benefit raises) the State is obligated by law (Elder Full Funding) to contribute .524% of creditable compensation for the next fiscal year. It is estimated that the payments would be in the amount of approximately \$30 million each quarter.

Ed Derman, Deputy Chief Executive Officer, reported on legislation. AB265 (Mullin) which repays the \$500 million to the Supplemental Benefits fund is alive and in the Senate. AB1852 provides for a partial lump-sum payment and pays employee contributions to STRS for one year for educators called into the military. AB1852 is in the Senate also. Also moving are two bills (AB2554 and AB2753) which modify restrictions on retired educators returning to education work. SB1137 (Burton) is on the Assembly Floor and is expected to pass and go to the Governor. SB1137 authorizes the election of a retired member to the STRS Board.

Under Federal legislation, the Elk Hills payment has passed the House and is on the floor of the Senate. Social Security reform is moving forward slowly.

Client Advisory Committee

The Client Advisory Committee met during lunch with members of the STRS Board. At the meeting following lunch, the committee reviewed the actuarial valuation of the STRS fund and legislation. Pat Geyer suggested that STRS might consider Reverse Mortgages as an addition to the STRS Home Loan Program.

Report Summary

- 1. Executive compensation and environmental concerns are the 2004-05 emphasis of the Corporate Governance Subcommittee.**
- 2. The myCalSTRS website offers secure access to members' personal information.**
- 3. The number of members requesting disability is steadily increasing.**
- 4. US stocks will now be 70% passive and 30% active managed.**
- 5. At 8.6%, STRS has the second lowest cost of all large pension funds.**
- 6. STRS will now invest in the world market; formerly it was U.S., Europe, Asia, and Far East.**
- 7. STRS fund is \$116.25 billion.**
- 8. STRS adopted the actuarial evaluation as of June 30, 2003. The unfunded obligation is \$23 billion. STRS is funded at 82%.**
- 9. Under the 1990 law, the State will contribute approximately \$30 million a quarter for the next year.**
- 10. AB265 the \$500 million payment for SBMA and SB1137 retired member election to STRS Board are both still moving through the legislature.**

Report on CalSTRS meetings, November 3-4, 2004

By Pat Geyer, CRTA Liaison with STRS

Audits and Risk Management Committee

The committee heard a detailed presentation of the STRS financial statements for the fiscal year ending June 30, 2004. Auditors also agreed with the STRS statements, and the results were accepted by the Board. A discussion followed on the need for additional school district audits. Given the additional requirements for reporting and school district staff turnover, it is believed that there are significant errors in reporting. Presently STRS has six auditors, which are insufficient to audit the approximately 1200 school districts on a regular basis. STRS plans to audit the 113 high-risk school districts in the next 2.5 years. It will also investigate other possibilities for additional audits.

Subcommittee on Corporate Governance

The statement of investment responsibility has been in existence since 1978. Controller Steve Westly requested that the policy be reviewed in light of the accusations of torture of prisoners in Abu Garib Prison by employees of CACI. The following statement was added under the section on Corporate Practices, Suppression of Human Rights: *The rendering of services that are used in a manner that denies or suppresses human rights in violation of international law or the Geneva Conventions where the company has failed to take reasonable steps to ensure that the services would not be used in that manner.*

A staff presentation on the rationale and rewards for STRS involvement in Corporate Governance was presented.

Investment Committee

Richard Rose of STRS reported that credit enhancement had not increased in 2003-4. There were many more investors so there were not many outstanding investment opportunities. Credit enhancement is where STRS underwrites a loan or bond made by another institution. This enables the institution to get a lower rate of interest on the loan and STRS gets a commission fee. Controller Westly asked whether STRS should take more risk in order to increase income. STRS will study the risk/income exposure in all investment categories.

The committee discussed the issue of excluding an individual stock from the investment portfolio. Treasurer Angelides wants this to be discussed in the future because even the threat of excluding the stock could have the effect of changing company direction. Advisor Alan Emkin noted that it had been the policy of STRS to vote proxies rather than to divest when there was a company problem. No action on this issue was taken.

A report was made on the possibility of investing in Clean Technology/Energy. It was reported that there were opportunities to invest up to \$50 million in clean technology venture capital funds and up to \$200 million in clean energy-related projects.

Ellen Okada of STRS presented a discussion on investing in emerging stock markets. Markets were evaluated in terms of Quantitative Risk Factors (accounting, securities regulation, banking supervision, etc) and Qualitative Risk Factors (human rights, civil liberties, discrimination, etc). Using the US Department of State Reports the emerging market countries were scored. Generally, with several exceptions, countries with large stock markets (South Korea, India) scored at the top of the list while countries with small markets (Egypt, Columbia) were at the bottom. All agreed that active managers were essential in emerging stock markets. No decision was made on where to draw the line for investment in emerging stock market countries or whether to leave the decision up to active stock managers.

Chris Ailman, CIO, reported that as of November 3, 2004 the STRS fund was \$120 billion.

Benefits and Services Committee

An overview of survivor benefits was presented. Suggestions were for STRS to look into providing benefits to dependent children if there was no surviving spouse (as of now they are not offered). The death benefit became taxable in the early 1990's where the federal law was changed. A change would require a new federal law. There has been a steady increase in the number of death notifications (a 4% increase from the same time last year). STRS will continue this study and report again in April.

STRS is considering expanding the Call Center hours to evenings to accommodate active teachers.

Ed Derman, Deputy CEO, presented a report on the adequacy of CalSTRS benefits. The last study was made in 1998 before the additional benefits of career factor, longevity bonus, and increasing age factor after 60. Retirement benefits for STRS members who retire with at least 30 years of service after the age of 60 have found that their benefits have increased by some 20 to 34% compared to retirees in 1998 or before. Compared to other retirement systems STRS pays among the highest monthly benefits in the nation for members who retire between the ages of 62 and 65. For example:

1. A STRS member who retires at age 60 with 30 years of service will receive 69% of his salary in retirement. A STRS member retiring in 1998 or before would have received 58% of his/her salary.
2. A STRS member who retires at age 63 with 35 years of service will receive 90% of his salary in retirement. This is compared with a STRS member retiring in 1998 or before who would have received 67% of his/her salary.

In addition to STRS members who retired before 1998, present STRS members who either retire before age 60 or do not have at least 30 years of service do not receive these additional benefits. Finally, these additional bonuses and supplements, including the DBS accounts, sunset after 2011.

Affordable health care will also impact retired teachers. Members without employer-paid health care can expect a 10 to 20% decrease in income due to increases in health care costs in 20 years. Medicare Part B premiums are expected to increase from \$700 a year in 2003 to \$4764 a year in 2023. Long-term or nursing home care is expected to have similar increases.

Finally, high inflation could reduce the purchasing power of STRS pensions down to the 80% replacement value. The 2% COLA would not be enough in periods of inflation.

The results of this study illustrate inequities in retirement benefits based on year of retirement, age of retirement, and years of service. In addition, the Georgia State study indicates that retirees need 81 to 88% of their salary to maintain their standard of living. Therefore, with the exception of STRS members who retire from 1999 to 2011 at age 60+ with 30 or more years of service, STRS members need to rely on other savings or plan to work after retirement.

Teachers' Retirement Board

Jack Ehnes, CEO reported that STRS has scanned 7 million out of the 25 million records that are not on the computer. Two new ad hoc committees were established. They are Board Governance and Compensation. These committees will meet off site in January. Because of the higher audit standards, the audit services budget was increased by \$800,000. This will be offset by savings in date entry.

Chris Waddell, General Counsel, discussed the Proposition 162 policy update which is to increase STRS independence from State control.

Client Advisory Committee

Ed Derman, Deputy CEO reviewed the legislation passed by the last session and signed by the Governor. Next he discussed the Proposed Assembly Constitutional Amendment by Assemblyman Keith Richman. If passed, this amendment would prohibit defined benefit plans for state, local government and special districts. After July 1, 2007 all new state, local government and school employees could only enroll in a defined contribution pension plan. Current employees could voluntarily convert to the new plan.

The next Client Advisory Committee will be on February 3, 2005.

On Wednesday, November 10 Pat Geyer talked to Joseph DeLuca of the STRS Home Loan Program. Information on Reverse Mortgages will be posted on the STRS web site in December. General information on reverse mortgages will also appear in the future STRS bulletin for retirees. In March or April STRS will decide whether they can offer Reverse Mortgages through their Home Loan Program.

Report Summary

- 1. There is a need for additional school district audits because there are errors in school district reporting as discovered in the few districts that are audited. Otherwise the STRS Financial Statement the fiscal year ending June 30, 2004 was accepted as reported.**
- 2. A section on violation of international law or the Geneva Conventions by companies was added to the statement of investment responsibility.**
- 3. STRS fund is at \$120 billion**
- 4. Retirement benefits for STRS members who retire with at least 30 years of service after the age of 60 have found that their benefits have increased by some 20 to 34% compared to retirees in 1998 or before**
- 5. In addition to STRS members who retired before 1998, present STRS members who either retire before age 60 or do not have at least 30 years of service do not receive these additional benefits. Finally, these additional bonuses and supplements, including the DBS accounts, sunset after 2011.**
- 6. Members without employer-paid health care can expect a 10 to 20% decrease in income due to increases in health care costs in 20 years.**
- 7. High inflation could reduce the purchasing power of STRS pensions down to the 80% replacement value. The 2% COLA would not be enough in periods of inflation.**
- 8. Therefore, with the exception of STRS members who retire from 1999 to 2011 at age 60+ with 30 or more years of service, STRS members need to rely on other savings or plan to work after retirement.**
- 9. Proposed Assembly Constitutional Amendment by Assemblyman Keith Richman would prohibit defined benefit plans for state, local government and special districts. After July 1, 2007 all new state, local government and school employees would only enroll in a defined contribution pension plan. Current employees could voluntarily convert to the new plan.**
- 10. Next STRS meetings are December 1-2, 2004.**

Report on CalSTRS Meetings, December 1-2, 2004 By Pat Geyer, CRTA Liaison with CalSTRS

Teachers' Retirement Board

Ed Derman, Deputy CEO, discussed options for bringing the STRS fund up from 80% funded to 100% funded. Due to increased benefits, increased salaries, and stock market decline the STRS fund went from over 100% funded to 80% funded. As of June 30, 2003, the unfunded obligation was \$23 billion. This amount equals 4.984% of creditable salaries each year. Since it has been determined that there is no way that the fund can invest its way out to the deficit, there will have to be an increase in contributions, a pension obligation bond, a change in benefits or some combination of each. The following are possibilities:

1. **Issue a pension obligation bond.** If the State issues a bond at the rate of 5.25-5.5% interest and STRS can reinvest that money to earn 8% interest, then the additional income can help to pay off the obligation.
2. **Amortize the unfunded obligation over 40 years instead of 30 years.** This would reduce the unfunded obligation by .8%
3. **Base final compensation on highest 3 years rather than 1 year of compensation.** This would reduce future retiree benefits by about \$136 a month and would reduce the unfunded obligation by .173%
4. **Eliminate the addition of the Career Factor to the Age Factor.** The career factor adds two-tenths of a percent to the retirement benefit for each additional year of service after 30 years. This is not to exceed 2.4% total. This would cost eligible members \$383 a month and would reduce the unfunded obligation by .173%
5. **Reduce the age factor to 2% after age 60.** Under current law the age factor is increased from 2% to 2.4% total for a teacher who continues to teach until age 63. This reduction would cost eligible members an average of \$511 a month and would reduce the unfunded obligation by .679%
6. **Do not convert unused sick leave to service credit.** This would reduce the monthly benefit by an average of \$143 and would reduce the obligation by .045%
7. **Eliminate the 2 percent member contribution to DBS (defined benefit supplement fund).** At the present time 2% of each members contribution goes into the DBS fund rather than the STRS retirement fund until January 2011. This would cost each active member \$143 average a month and would reduce the obligation by .151%
8. **Reduce or eliminate employer contributions to the DBS fund for excess service and credit the contribution to the STRS fund.** Presently employees who work more than 1 year (summer school, etc) have the 8% employee contribution go into the DBS fund which they can use when they retire or leave teaching. This would amount to a reduction of \$54 at retirement and would reduce the obligation by .197%
9. **Eliminate the 2% annual benefit increase (COLA).** If eliminated for all members it would reduce benefits by an average of \$94 a month and would reduce the obligation by 2.394%. However, it would mean that more

members would be eligible for the supplemental benefit payment because their pension would have been reduced below 80% sooner. This could bankrupt the supplemental benefit fund. Other options are to reduce the COLA for only new hires or some combination.

10. **Do not extend the Medicare premium payment program.** This program is for teachers who do not qualify for Medicare. There are a few teachers hired prior to 1986 who have yet to reach 65 and would have to pay the penalty. This would cost the retirees effected \$343 a month and reduce the obligation by .159%.
11. **Impose employer contributions when members work after retirement.** Presently employers do not have to contribute 8.25% to STRS for teachers who work after retirement. This would cost employers a total of \$17 million annuals and would reduce the STRS unfunded obligation by .07%
12. **Increase the contribution rate.** If the contribution rate for new STRS members was increased from 8.25 to 9.25% this would cost the active STRS member about \$54 a month and reduce the unfunded obligation by .33%. If the contribution rate of the school districts were increased from 8.25% to 9.25% this would reduce the unfunded obligation by 1%. If the State contribution were increased from 1.975% to 2.975% this would reduce the obligation by .898%.

No one option will solve the unfunded obligation. When the STRS Board and Client Advisory meet in April, it is hoped that member groups will respond and give their evaluation of the options. Eva Hain, President of CRTA spoke on the need to retain the COLA for retirees.

Jack Ehnes, CEO reported that CalSTRS and PERS will be sponsoring an environmental workshop in San Francisco on March 17-18.

Ed Derman, Deputy CEO reported on proposed state legislation. STRS will have a bill to simplify the administration of benefits. Another proposed bill with extend the Cash Balance Program to classified employees if the employer offers it and the employee accepts. The third proposed bill would be to have the State repay the \$500 million that it has failed to pay in 2003-4.

On federal legislation, the Elk Hills money of \$36 million is being paid this year. There will be a new form that each newly hired school employee will be required to read and sign which informs the member of the effects of the GPO and WEP on future social security payments for STRS members. Social Security reform is on the national agenda for next year. STRS will be watching the results carefully so that it does not affect STRS pensions.

Benefits and Services Committee

The Committee voted to extend the payments of Medicare part A for qualified STRS members who retire before July 2006. STRS will look into getting a State law passed to make the STRS death benefit tax-free.

Service standards have continued to improve now that the rush to purchase service credit is over. There is a new retirement guide and application forms for STRS members.

403(b)Compare site is up and running. 403(b)Compare gives information on mutual funds and fixed, variable and equity indexed annuities. It includes the fees charged and the funds available to employees of specific school, community college, and county offices. The site can be reached through STRS website or www.403bCompare.com.

Audits and Risk Management Committee

Bill Ashby of KPMG reported on the risk assessment of the STRS Information Technology (IT). The conclusion was that, compared with other industries, STRS is a low risk. However, controls to prevent risk are in place, but they need to be documented. Specifically, KPMG is concerned that the START program is processing correctly and that the data is accurate. STRS staff should be taking over the IT from the Project Manager. KPMG did not evaluate the IT of the investments program.

The audit of the Voluntary Investment Program was completed. No problems were found. Way Lee reported that all unfilled audit positions have been filled. They also have 7 new positions approved. They are on schedule with the school district audits.

Subcommittee on Corporate Governance

There was a panel discussion on the importance of environmental risk. Jon Naimon of Light Green Advisors, Seattle; Mindy Lubber of Ceres, and Chris Walker of Swiss Re presented information about the importance of good environment practices.

Executive compensation will be a priority in the next year. However, STRS will look at corporate underperformance first and then excessive executive compensation in considering a proxy vote.

Investment Committee

The committee again discussed the issue of where and how to invest in emerging markets. No action was taken.

The Currency Hedging Program had no hedging this year. The program was successful because the dollar fell in value against other currencies.

Chris Ailman, CIO discussed ideas for income enhancement to reduce the STRS unfunded liability. There is a 20% chance that the investment portfolio might increase enough in the next 20 years to overcome the STRS deficit. STRS needs to do something more. Suggestions were: (1) reviewing the fixed income policy to take a more active role; more active management – especially in the enhanced index portfolio and additional use of hedge funds.

Beginning in January 2005 CalSTRS will require each Investment Manager to begin an energy tracking/benchmarking program using Energy Star tools. The objective is to lower operating costs, increase asset value, and promote a cleaner environment.

Pat Geyer, CRTA Liaison and Loretta Toggenburger, UTLA, Retired met with Gloria Hom, STRS Board member representing retirees. Possible solutions to fund STRS were discussed. Pat emphasized the need to keep the COLA. Pat mentioned the need for more in-depth information explaining the deposit statements for retirees. Gloria asked Loretta if there was a need for a STRS office in Southern California where teachers could go to ask questions.

At the Benefits Committee Pat Geyer talked with Peggy Plett, Deputy CEO, about the need for more explanation on deposit statements. Peggy will have an article in the next Retired Teacher publication.

Report Summary

- 1. Possibilities for reducing the \$23 billion STRS unfunded obligation:**
 - **Issue a pension obligation bond**
 - **Amortize the obligation over 40 years instead of 30 years**
 - **Base final compensation on highest 3 years**
 - **Eliminate the career factor**
 - **Eliminate the age factor**
 - **Do not convert unused sick leave to service credit**
 - **Eliminate the 2% contribution to the DBS**
 - **Eliminate the 2% annual benefit increase (COLA)**
 - **Do not extend the Medicare premium payment**
 - **Increase employer contribution when members work after retirement**
 - **Increase member contribution rate, increase employer contribution rate, increase State contribution rate**

The present value of the STRS fund is \$118 billion.

The next STRS meeting is February 2-3, 2005

If you want to receive a copy of the STRS report please send your e-mail address to PatGeyer@AOL.com