Legislative Commission on Pensions and Retirement

Review of Investment Return Assumption

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Emily M. Knutson, FSA, EA, MAAA
Mark W. Schulte, FSA, EA, MAAA

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Investment Return Background

Investment Return Background

- **Investment return assumption** reflects what portion of future benefit promises are assumed to be paid by contributions vs. investment earnings

- If investment return assumption is too optimistic, then future contributions will be needed to fund any shortfalls

Initial contribution		Pension payment
$115	→ **7.5%** return for 30 years	**$1,000**
$115	→ **6.5%** return for 30 years	**$760**

Potential $240 shortfall if returns are 1.0% lower than expected annually

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Investment Return Background

- Understand limitations of the assumption
  - Not a guarantee of future returns
  - Current investment mix determines the return assumption, not vice versa
  - Not a “set it and forget it” assumption if always at the high end of what the actuary considers reasonable

Investment Return Background

Many investment professionals expect lower investment returns than historical averages

- Contemporary methods for developing investment return assumption use forward-looking expectations

- These methods are used by both investment professionals and actuaries

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Investment Return Background

- Current process for pension boards' selection of investment return assumption (accounting)

Pension Fund/SBI
Investment policy and asset allocation

Investment Professionals
Develop forward-looking capital market assumptions

→ **Actuary calculates recommended assumption**

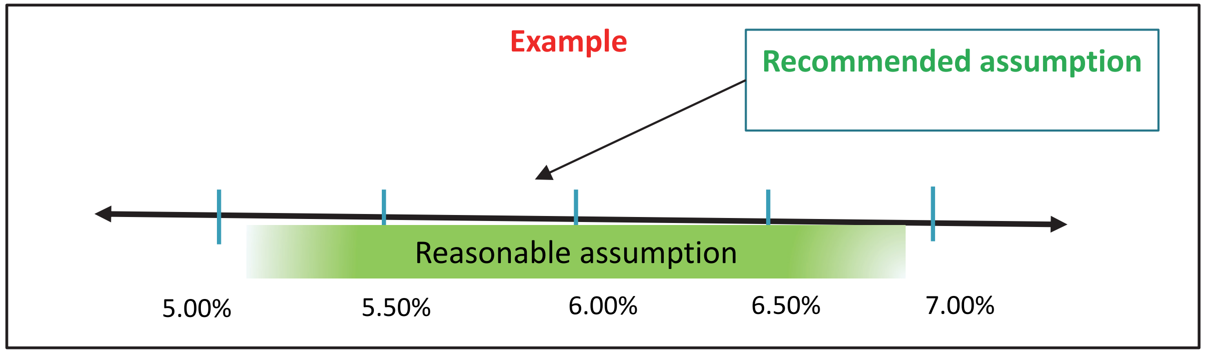
→ **Pension Board selects an assumption based on available information**
(may not be equal to actuarial recommendation)

Investment Return Background

Actuary prepares GASB accounting report using Board-approved assumptions

Actuary must disclose whether any assumptions used in their reports conflict with what they consider to be “reasonable”

Actuary prepares Funding report using statutory assumptions



Current Issues

Current Issues

Different systems may have different expectations (and that's ok!) but ideally each statutory Funding assumption would match the board-approved assumptions

	PERA	MSRS	TRA
Current "Funding" assumption		7.5%	
Proposed "Funding" assumption		7.0%	
Board/Accounting assumption	6.5%	6.75%	7.0%

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Current Issues

- Actuaries are REQUIRED to evaluate reasonableness of assumption annually
- However, this does not mean that assumption should be changed frequently
- Assumption will require fewer future changes if start closer to actuary's recommendation

Current Issues

Commentary from the PERA/MSRS actuary

- "We recommend that PERA consider an investment return assumption in the range of 5.64% to 6.55%. Based on the data reviewed, we can support a discount rate up to 6.84% for the 2022 valuation."
- "PERA should note that the selection of an investment return assumption near the upper end of this range may not be sustainable. A rate near the bottom of the range, such as 5.75%, would be more likely to be sustainable for a longer period."
- "Although investment firms often refer to this period as "short-term" it is important to remember that 10 years is actually a very long time. … [R]eturns during the next 10 years will affect the plans funding materially."

Source: GRS 2022 Valuation Interest Rate Assumption letter dated July 12, 2022

Current Issues

Likelihood of Achieving Return Assumption

	5.64%	6.50%	7.50%
Probability of exceeding assumption	50%	42.2%	33.7%
Probability of being below assumption	50%	57.8%	66.3%

Source: GRS 2022 Valuation Interest Rate Assumption letter dated July 12, 2022

Current Issues

Near-Term Recommendations	Additional Recommendations
▪ Reduce statutory return assumption 7.0% per systems' request ▪ Engage an investment consultant to prepare investment return study with updated recommendation	▪ Move Funding investment return assumption/discount rate from State statutes to LCPR Actuarial Standards ▪ Consider allowing separate Funding assumptions for each plan ▪ Engage investment consultant every five years to provide updated investment return recommendation

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Questions

L/D/C/R: 4/emk/mws