Overview of Pension Divestment and S.42

House Committee on Government Operations and Military Affairs

Chris Rupe, Senior Fiscal Analyst
Joint Fiscal Office

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Pension Governance

- **The State of Vermont manages 3 defined benefit pension systems:**
  - VSERS – Vermont State Employees' Retirement System (3 V.S.A. Ch.16)
  - VSTRS – Vermont State Teachers' Retirement System (16 V.S.A. Ch. 55)
  - VMERS – Vermont Municipal Employees' Retirement System (multi-employer) (24 V.S.A. Ch.125) – NOT FUNDED BY STATE BUDGET
- **Each retirement system is governed by a board of trustees according to statute.**
  - VSERS - 8 trustees (4 government officials, 4 plan member representatives)
  - VSTRS – 6 trustees (3 government officials, 3 plan member representatives)
  - VMERS – 5 trustees (2 employee representatives, 2 employer representatives, State Treasurer)
- **Each board of trustees is responsible for the general administration and proper operation of the systems.**
- **State Treasurer serves as a trustee on all three boards and is responsible for day-to-day operations of the systems and serves as custodian of plan assets. The Retirement Office is part of the State Treasurer's Office.**
- **Vermont Pension Investment Commission (VPIC) is comprised of 9 members (including State Treasurer) and is responsible for investing the assets of all three plans.**
  - 1 chair elected by the other 8 voting members
  - 3 members from the retirement systems (1 per system)
  - State Treasurer
  - 2 Governor appointees
  - 1 appointee from VT School Boards Association
  - 1 from VT League of Cities and Towns

Common theme – representatives of members and employers govern the systems.

Pension Governance

- **The Legislature:**

  - Adopts statutory changes to how pension benefits are calculated
  - Adopts the statutes that specify how the systems are governed and organized
  - Establishes the amortization schedule and funding policy in statute
  - Appropriates the money to fund the annual contributions to the VSERS and VSTRS pension systems (along with the appropriations to operate the Retirement Office and VPIC)

- **The Legislature does <u>NOT</u>:**

  - Set actuarial assumptions
  - Pick and choose specific investments. Legislature created VPIC to invest the pension assets.

VPIC Powers and Duties (3 V.S.A. § 523)

Among other things, VPIC has the authority to:

- Develop the investment strategy, hire investment consultant.
- Develop policies and procedures.
- Set the actuarial assumptions for the investment rate of return, inflation rate, and smoothing method.
- Annually conduct an asset allocation study that reviews the expected return of each fund, including a risk analysis using best practices methodologies to estimate potential risks to the fund's asset values over a 5, 10, and 20 year period and the remainder of the statutory amortization period (FY 2038).
- Asset and liability studies every 3 years.
- Issue annual reports

VPIC's 9 members (and 4 alternates) serve staggered 4-year terms.

- Members and alternatives shall serve not more than 3 terms and can only be removed for cause.
- Chair is limited to 20 years.
- Chair "shall have the financial, investment, leadership, and governance expertise as required by policies adopted by the Commission"

Current VPIC Membership	
Tom Golonka (Chair)	
Kim Gleason (Vice Chair)	VMERS Representative (6/30/25)
Mike Pieciak	State Treasurer
Robert Hooper	VSERS Representative (6/30/23)
Perry Lessing	VSTRS Representative (6/30/26)
Steven Jeffrey	VT League of Cities and Towns (6/30/26)
Jim Salsgiver	VT School Boards Assn (6/30/23)
Mary Alice McKenzie	Governor's Appointee (6/30/25)
Lauren Wobby	Governor's Appointee (6/30/25)
Alternate Members	
Justin Norris	*VSTRS Alternate (6/30/26)*
Jeff Briggs	*VSERS Alternate (6/30/23)*
Chris Dube	*VMERS Alternate (6/30/25)*
Brad Ferland	*Governor's Alternate (6/30/24)*

VPIC Responsibilities

- **Fiduciary responsibility** = High standard of care to act in the best interest of the plan participants – not your own self interest.
- VPIC "shall strive to maximize total return on investment, within acceptable levels of risk for public retirement systems, in accordance with the standards of care established by the prudent investor rule under 14A V.S.A. § 902."
- Prudent Investor Rule:
  - Must invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
  - Decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust.
  - A trustee shall consider:
    - General economic conditions
    - The possible effect of inflation or deflation
    - Expected tax consequences of investment decisions or strategies
    - The role that each investment or course of action plays within the overall trust portfolio.
    - Expected total return from income and the appreciation of capital
    - Other resources of the beneficiaries
    - Needs for liquidity, regularity of income, and preservation or appreciation of capital
    - An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.
  - Trustees shall make reasonable efforts to verify facts relevant to the investment and management of trust assets.

Investment Strategy

Market Value of VT Pension Assets	
VSERS	$2,276,645,124
VSTRS	$2,339,412,945
VMERS	$845,979,471
Total Market Value of Assets	**$5,462,037,540**
Data from FY 2022 Actuarial Valuations, as of 6/30/22.	

- **Pension assets are invested and managed according to an investment strategy.**
- **Among other factors, the investment strategy considers:**
  - Diversification and balance
  - Risk management – try to capture the gains while protecting from losses and inflation.
  - Minimize extreme volatility
  - Liquidity needs – how much cash must be paid out in benefits to retirees/beneficiaries?
- **Common types of pension investments involve foreign and domestic equities (stocks), fixed income (bonds), private equity and credit, real estate, etc.**
- **Investment strategy and performance is periodically reviewed and assets are periodically rebalanced as market conditions evolve.**
- **Short-term speculation is not the goal! Instead, the goal is to prudently and responsibly manage the investments with the best interest of the members of the retirement systems in mind.**
- **The assumed rate of return is a long term assumption informed by economic conditions and expectations for future market performance.**

Investment Strategy

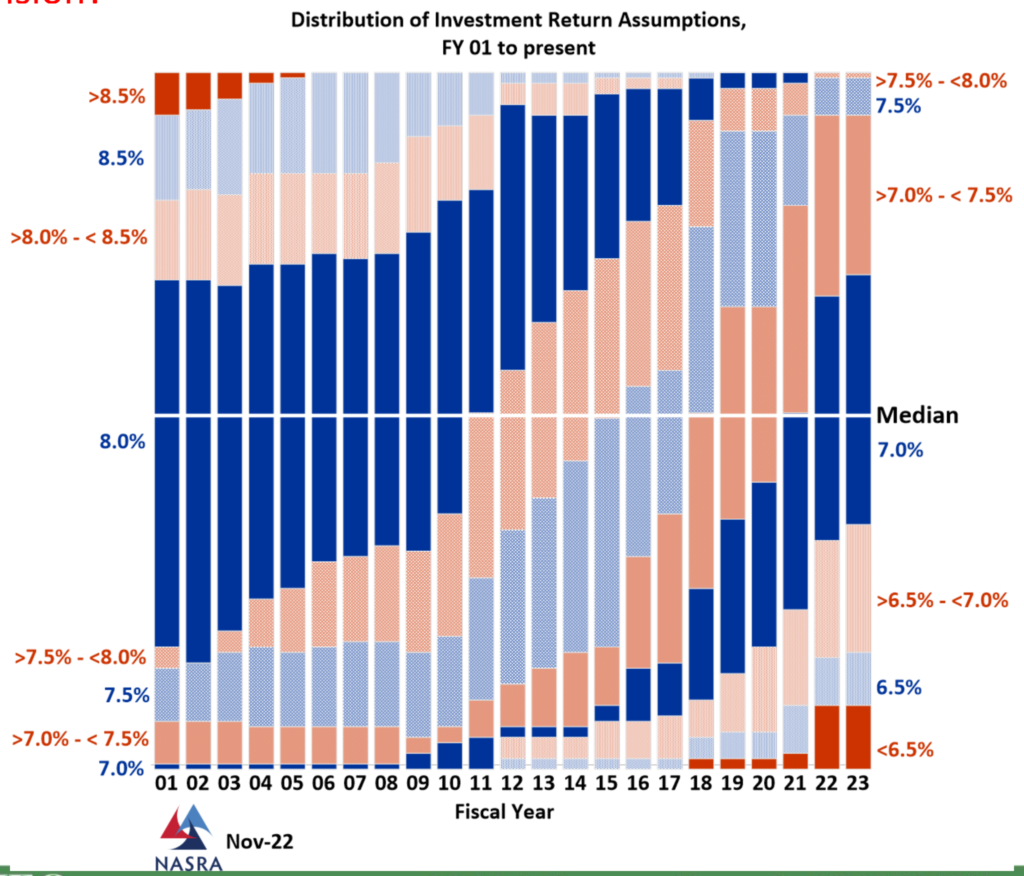
- Assets are invested according to an allocation strategy.
- Allocation strategy aims to maximize total return on investment, within acceptable risk standards, subject to diversification and liquidity constraints.
- Assets are invested in classes aimed at growth, as well as in classes aimed at protecting the system from downside and inflation risk.
- Much of the portfolio is invested in index and mutual funds that aim to track broader market trends at low administrative cost.
- Private equity and credit often perform better than other asset classes, but private investments are typically longer term and relatively illiquid.
- Direct holdings are a relatively small portion of the portfolio.

Asset Class	Target
Global Equities	29%
Large Cap US Equities	4%
Small/Mid Cap US Equities	3%
International Equities	7%
Private Equity	10%
Emerging Market Debt	4%
Private & Alternative Credit	10%
Non-Core Real Estate	4%
Total Growth Assets	**71%**
Core Fixed Income	19%
Total Downturn Hedging Assets	**19%**
Core Real Estate	3%
TIPS	3%
Infrastructure	2%
Farmland	2%
Total Inflation Hedging	**10%**
Grand Total	**100%**

https://vpic.vermont.gov/investment-overview/asset-allocation

Trends in the Assumed Rate of Return

- Public sector pension systems have gradually lowered their assumed rates of return post Great Recession in response to evolving economic conditions and expectations.
- Assumptions about interest rates, inflation, and capital markets inform the assumed rate of return.
- Vermont's current assumption is 7.0% (adjusted downward from 7.5% in 2020). Will the upcoming experience study lead to another revision?



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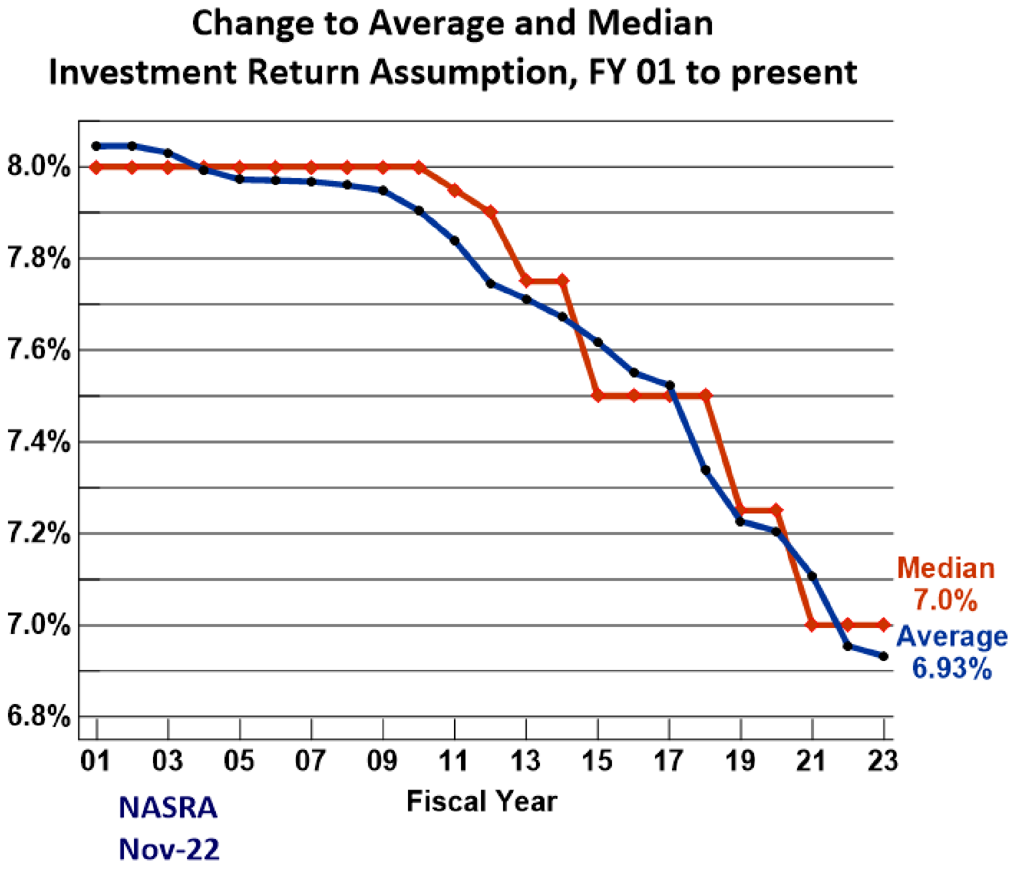

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Why Diversification is Important

Annual Asset Class Performance — As of June 30, 2022

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD
Best	8.44	78.51	27.94	22.49	20.00	38.82	30.14	15.02	21.31	37.28	8.35	31.49	19.96	43.24	18.44
	5.24	58.21	26.85	15.99	18.23	32.39	19.31	9.59	17.13	33.01	1.87	26.00	18.40	28.71	12.49
	2.06	46.78	22.04	13.56	18.06	29.30	13.69	3.20	11.96	25.03	0.01	25.53	18.31	27.11	0.15
	-2.35	31.78	18.88	8.29	17.32	22.78	12.50	1.38	11.77	21.83	-1.26	24.96	16.12	22.17	-6.53
	-10.01	28.01	16.83	7.84	16.35	13.94	5.97	0.55	11.19	14.65	-2.08	22.01	13.16	14.82	-8.92
	-21.37	27.17	16.36	4.98	16.00	8.96	4.89	0.05	9.29	13.96	-3.33	19.59	12.34	14.06	-10.35
	-26.16	26.46	15.12	2.11	15.81	7.99	4.04	-0.27	8.77	10.71	-4.02	18.44	10.99	11.26	-12.34
	-30.15	26.29	15.06	1.81	12.69	7.44	3.64	-0.81	8.52	7.77	-4.38	17.15	10.88	10.10	-14.19
	-33.79	18.91	14.44	0.10	10.94	2.47	3.37	-1.44	6.67	7.62	-4.62	14.32	7.82	6.17	-17.63
	-35.65	11.47	10.16	-4.18	8.78	0.07	2.45	-2.20	4.68	7.50	-4.68	8.72	7.51	5.96	-19.57
	-37.00	11.41	7.75	-5.72	6.98	-2.02	0.04	-3.30	2.65	5.23	-11.01	8.43	7.11	5.28	-19.96
	-37.74	5.93	6.54	-12.14	4.79	-2.60	-2.19	-4.41	2.18	3.54	-11.25	8.39	1.19	0.05	-20.20
	-43.38	1.92	6.31	-13.32	4.21	-8.61	-4.90	-4.47	1.00	3.01	-13.79	7.69	0.67	-1.55	-21.88
	-47.01	0.21	5.70	-15.94	0.11	-8.83	-4.95	-14.92	0.51	1.70	-14.58	5.34	-3.12	-2.52	-23.43
Worst	-53.33	-29.76	0.13	-18.42	-1.06	-9.52	-17.01	-24.66	0.33	0.86	-17.89	2.28	-8.00	-2.54	-24.71

- Total Fund Net (All Plans)
- S&P 500 - US Large Cap
- R 2000 - US Small Cap
- MSCI EAFE (Net) - Int'l Dev.
- MSCI EAFE SC (Net) - Int'l SC
- MSCI EM (Net) - Int'l Emg Mkts
- Bloombrg US Agg Bond - FI
- Bloombrg US Corp Hi Yield - FI
- Bloombrg US Trsy US TIPS - FI
- Bloombrg US Gov Credit Lng - FI
- NCREIF ODCE (Gross) - Real Estate
- FTSE NAREIT Eq REITs Index (TR)
- HFRI FOF Comp Index - ARS
- Bloombrg Cmdty (TR) - Commod.
- ICE BofAML 3 Mo T-Bill - Cash Equiv

NCREIF ODCE (Gross) performance is reported quarterly; performance is shown N/A in interim-quarter months.

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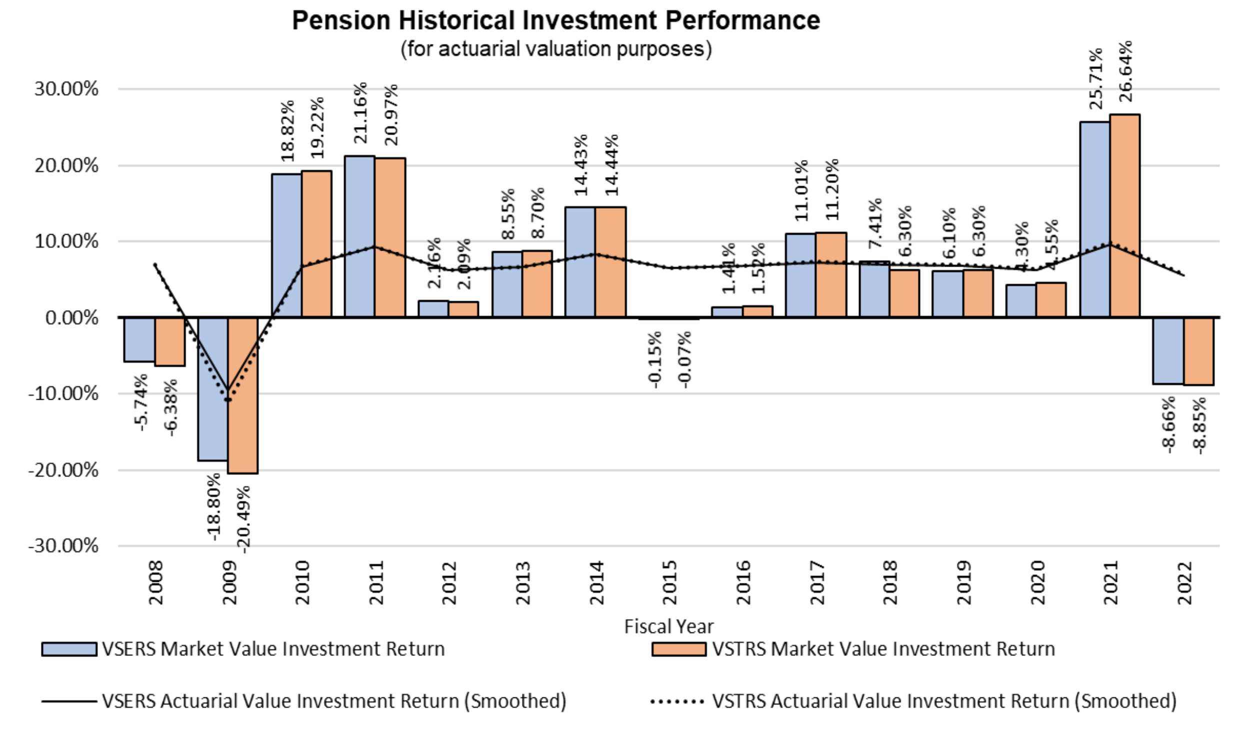
Page 10

https://outside.vermont.gov/dept/VPIC/Shared%20Documents/VPIC%20Website/Investment%20Performance%20Reports/20220630_VPIC_IPR.pdf

Investment Performance

- **The pension systems had negative investment returns in FY 2022 due to global market conditions.**
- **Market investment gains/losses are "smoothed" into the actuarial value over 5 years.**
- **The extent to which investments (as reflected in the actuarial value of assets) exceed or fall short of the assumed rate of investment return (currently 7.0%) determines whether investments cause an actuarial "gain" or "loss" that decreases or increases the unfunded liability.**
    - The FY2021 actuarial investment performance exceeded 7%, causing gains that reduced the unfunded liability.
    - The FY2022 actuarial investment performance fell short of 7%, causing losses that increased the unfunded liability.
    - Positive investment growth can still cause "losses" if investments grow at a rate less than assumed!
- Note that there are small methodological discrepancies between the investment performance numbers reported by VPIC and the numbers reported in the actuarial valuations (which are used for funding purposes).



Source: VSERS and VSTRS Actuarial Valuations.

Historical Investment Performance (FY2022)

	State Employees (VSERS)		Teachers (VSTRS)	
	Actuarial Value	Market Value	Actuarial Value	Market Value
Most Recent 5-Year Average Return	7.00%	6.17%	7.15%	6.35%
Most Recent 10-Year Average Return	7.04%	6.45%	7.14%	6.62%
Most Recent 15-Year Average Return	6.15%	5.38%	6.01%	5.19%
Most Recent 20-Year Average Return	6.44%	6.51%	6.48%	6.55%

Source: VSERS and VSTRS Actuarial Valuations.

Elements of S.42

- **Stated legislative intent is for VPIC, consistent with sound fiduciary practice and subject to any exceptions:**
  - Divest the holdings of VT's three statewide retirement systems from the fossil fuel industry.
  - Establish a long-term goal to divest from any private investments that contain assets in the fossil fuel industry on or before December 31, 2040 *If VPIC determines that such divestment is consistent with sound fiduciary practice.*
  - VPIC must include consideration of any expected increased funding requirements for the ADEC and administrative costs as part of its divestment plans.
- **VPIC would be required to:**
  - On or before December 15, 2023 – **review the carbon footprint** of the holdings of the three retirement systems and submit a report by February 15, 2024.
    - *S.42 does not define "fossil fuel company." VPIC would develop a definition as part of this effort.*
  - **Develop a plan to divest any holdings identified in the review on or before December 31, 2030**. VPIC shall submit this divestment plan by September 1, 2024. The plan shall include consideration of the State's long-term goal of divestment from any investments that are exceptions to the plan on or before December 31, 2040. VPIC shall develop this divestment plan in accordance with sound investment criteria and consistent with fiduciary obligations.
    - Exceptions: Until such time as VPIC deems divestment to be prudent and consistent with sound fiduciary practice, the following are exceptions to the plan to divest by December 31, 2030:
      - *De minimis exposure* to fossil fuel company stocks, securities, and obligations. *De minimis exposure* is defined as "the aggregate amount of all fossil fuel company holdings in the portfolio amounting to less than two percent of the aggregate amount of all funds invested."
      - Private investments that contain fossil fuel company stocks, securities, and obligations.
      - Index funds and mutual funds are NOT explicitly excepted.
- **Annual reporting:**
  - Beginning on January 15, 2025, VPIC would be required to submit annual reports on the progress of divestment.
  - Reports shall include updates on the composition and percentage of exposure of any investments covered by exceptions from the divestment plan, and a summary of the fee impacts and any instance of excessive charges or demands related to the rebalancing of the funds consistent with the implementation of the bill.
  - Annual reports would cease to be required after January 15, 2040.

Fiscal Implications of S.42

Divestment is a policy decision – but it *could* have fiscal implications.

- **Known Implications:**
  - Performing the asset review and divestment plan is expected to cost approx. $100,000 in FY 2024.
  - 1 FTE at VPIC – expected annual cost of $127,000 beginning in FY 2024, paid proportionally from the retirement systems.
- **Unknown Implications:**
  - What actions will VPIC take to comply with the intent of S.42?
  - What impact will those actions have on future administrative costs and investment performance?
  - S.42 requires VPIC to consider impacts to the ADEC and administrative costs as part of its divestment decisions.
- **Range of possible fiscal impacts for investment performance or ADEC changing:**
  - **Rate of Return**: If the assumed rate of return is lowered from 7.0% to 6.5% in response to higher overall management costs and/or more limited future investment expectations, the ADEC would increase by approximately $25.2 million for VSERS and $29.2 million for VSTRS. These costs would recur annually, growing in 3% future increments until FY 2038.
  - **Investment Performance:** If actual yearly investment returns were to deviate from the current 7.0% assumption by 1.0%, the ADEC would be impacted by approx. $4.3 million for the two systems.

Examples of Fiscal Impacts from Investment Risk

$ millions	VSERS (State Employees)	VSTRS (Teachers)
Impact of 1% Difference in Actual Yearly Investment Return on ADEC* (% of payroll)	0.34%	0.29%
Assumed Covered Payroll (FY 2023)	$604.11	$735.72
Assumed Covered Payroll (FY 2024)	$625.26 (3.5%/year growth)	$757.80 (3%/year growth)
Example of Impact of 1% Deviation on FY 2024 ADEC**	$2.13	$2.20

(*) Disregards impacts of five-year smoothing of investment gains and losses.
(**) ADEC impact would recur annually, growing in 3% future increments through FY 2038. Unfunded liability portion of ADEC would be impacted.
Data on investment return risk from actuarial valuations for FY 2022.

Examples of Fiscal Impacts from Lowering the Assumed Rate of Return

$ millions	FY 2022 Baseline (7.0%)	FY 2022 If 6.5%	Change
VSERS – State Employees			
Actuarial Accrued Liability	$3,444.1	$3,653.7	+$209.6
Funded Percentage (AVA basis)	69.9%	65.8%	-4.1%
Total Normal Cost	$74.1	$83.1	+$9.0
FY 2024 ADEC*	$121.9	$147.1	+$25.2
VSTRS - Teachers			
Actuarial Accrued Liability	$4,289.8	$4,548.3	+ $258.5
Funded Percentage (AVA basis)	57.3%	54.0%	-3.3%
Total Normal Cost	$79.7	$90.7	+$11.0
FY 2024 ADEC*	$194.3	$223.5	+$29.2

(*) ADEC impact would recur annually, growing in 3% future increments through FY 2038.
Estimates from Segal as reported in Golonka testimony, February 16, 2023.

Analysis is intended to demonstrate range of possible impacts without presuming that S.42 would lead to diminished investment performance or reductions in assumed rate of return.

Considerations for Legislators

- **Engagement vs. Divestment?**
- **Who should decide investment policy, and how?**
  - Fiduciary duties of VPIC vs. Legislatively driven policy
- **Understanding the current exposure in the portfolio:**
  - Defining “fossil fuel companies”
  - How much is in the portfolio? In what types of investment vehicles?
  - What are the fiscal implications of divesting those assets?
- **Divesting is complicated…**
  - How to deal with exposure within index funds and mutual funds that track broader markets at low cost?
  - Private investments – often perform better than other investments, but comprise relatively illiquid contractual obligations.
- **What actions will VPIC ultimately take to comply with the legislative intent of S.42?**
  - What fiscal impacts will those actions have?
  - What are the administrative costs associated with alternative investment indexes?
  - Private investments tend to over-perform other types of investments (illiquidity premium). Will statutory investment restrictions hinder VPIC’s ability to place these investments moving forward? Will complying with the intent of S.42 lead VPIC to unwind any existing investments? What would the implications of that be?
  - Would complying with the intent of S.42 impact administrative costs, actual investment performance, or expectations for future investment performance (assumed rate of return)?
  - Higher administrative costs, lower investment expectations or performance = higher future ADECs when all else is equal.
- **What about investments of other State funds? S.42 speaks only to the three major pension systems.**

Questions?

crupe@leg.state.vt.us

https://vpic.vermont.gov

https://ljfo.vermont.gov/subjects/pensions-and-state-debt

https://www.vermonttreasurer.gov/content/retirement