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TO: Vermont Pension Investment Commission

FROM: Eric Henry

DATE: July 21, 2021

RE: CIO Report – Thoughts on recent and expected returns

During the fiscal year ended June 30, 2021, the VPIC portfolio generated a preliminary investment return of 24.62%, well in excess of our expectations and the 7% actuarial assumed rate of return (AROR). These results stand in stark contrast to last year's 4% return. While 4% fell short of both expectations and the AROR, it was a strong result given the COVID-driven downturn and ranked well above median among our peers. Our strong performance in both FY 2020 and 2021 is testament to the work we have done streamlining and optimizing the portfolio to maximize long-term returns within acceptable levels of risk and liquidity. As important, it also highlights the difficulty in accurately forecasting investment returns. Last year's capital market assumptions, for example, implied a long-run investment return of just over 7%, yet we generated an actual return of 4%. This year's capital market assumptions indicated a long-run expected return of just under 6%, yet we generated a return of nearly 25%. As we have discussed, our capital market assumptions are not effective forecasters of returns from year to year.

Our recent performance has indeed been strong, though it does reveal some of the challenges we face in optimizing a portfolio that, in tandem with employee and employer contributions, will equitably fund long-term pension liabilities with minimal volatility in required contribution streams. As we have discussed, optimizing a portfolio is about much more than simply maximizing returns. Rather, we seek to maximize returns while managing volatility to an acceptable level and assuring we have enough liquid assets on hand to meet benefit payment and capital call obligations without being forced to sell discounted assets during an economic downturn. Further, the portfolio should directly inform the AROR to assure intergenerational equity. Yet, as we have discussed, the AROR is not our targeted return.

Four points are relevant as we think about portfolio design and our expectations for future returns.

1. Our capital market assumptions do not represent a budget or forecast for investment returns. Rather, they are the best tools we have, when combined with mean-variance optimization and *Monte Carlo* simulations, for gaining an understanding of how model investment portfolios should perform under a variety of economic scenarios. In contrast, the AROR is simply a discount rate that actuaries use to determine the actuarially determined employer contribution (ADEC). While the two are linked, they are used for entirely different purposes.

2. While investment returns can be volatile from year-to-year, we do not expect the AROR to be so. Making large changes to the AROR based on one year's performance would be imprudent and likely introduce unmanageable volatility into the payment of the ADEC.

3. Capital market assumptions are one input into the establishment of the AROR. The AROR is also informed by recent performance, inflation expectations, and other relevant factors. To the extent that the AROR proves to be either too optimistic or too pessimistic, annual actuarial valuations and periodic actuarial experience studies are designed to calibrate the ADEC along the way to prevent intergenerational inequities in pension funding.

4. Asset valuations are high across most asset classes as measured by most metrics. This implies lower returns going forward. Like forecasting returns, forecasting the timing of a reversion to more normal valuation levels is very difficult. International equities currently have lower valuations than US equities; core bond valuations are high relative to history (and interest rates low); however, history has shown that this has the potential to persist for a very long time.

While FY 2021's results were very strong, they will not solve the unfunded pension liabilities. The reality is that current valuations of both equity and debt instruments imply lower future returns than we have experienced recently. To the extent that our capital market assumptions prove to be too pessimistic, we believe the portfolio is positioned to capture that upside. This turned out to be the case in FY 2021. In the event that our capital market assumptions prove to be too optimistic, we believe the portfolio is well positioned to protect on the downside. This was the case in FY 2020.

As we move ahead, we are focused on identifying and underwriting investment managers to build out our allocations to private equity, private credit, and non-core real estate. At the same time, we are focused on ongoing underwriting of our public market managers' strategies to assure that their risk profiles and investment processes are strategically aligned with VPIC's investment philosophy and the pension plans' liabilities.

We look forward to discussing these issues with you next week. In the interim, please do not hesitate to reach out if you have questions or would like to discuss.