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Public Plan Sponsor of the Year: The Oregon Trail

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"We have a willingness to be a pioneer," says Ron Schmitz, Director of the Oregon State Treasury Investment Division, about the Oregon Public Employees Retirement System. "I guess that is part of being an Oregonian."

That pioneering spirit helps guide both Oregon PERS' investments and its retirement-plan design. Thanks mostly to strong performance results and bold system reforms made by lawmakers in 2003, Oregon has wiped out the $17 billion unfunded actuarial liability it had at that point. The $60.7 billion PERS system, which covers 95% of all public employees in Oregon and has 315,000 participants, now has a $1.75 billion surplus.

Oregon Governor Ted Kulongoski, in an interview with ***PLANSPONSOR***, points to that as evidence of a turnaround (see "Defined Benefit Plans: A Governor's Perspective," page 42). "But what is most important is the long-term projection that employer-contribution rates will continue to decline," he says. "When we started this reform effort, the rates were at 14% to 15%, and projections were that they would go to 27%. You are talking about $800 million in annual overhead costs."

That $17 billion in underfunding stemmed from the early-decade market downturn, but was compounded by plan-design features like the one that guaranteed most participants an 8% annual return on their member accounts, regardless of actual results. That meant Oregon PERS could never take advantage of good investment results to boost its funding, Executive Director Paul Cleary says. "We tried to fill the hole with good earnings, but we also kept digging it with earnings crediting to members," he says. "You cannot get out of a hole if you keep digging."

The reforms also allowed the retirement system to take advantage of good investment earnings to improve its funding status, Cleary says, and Oregon PERS has a long history of exploring fruitful new investment areas for public funds. "We were one of the first public funds in U.S. equities in the 1960s," Schmitz says. International equities, real estate, and private equity followed.

Impressive returns followed, too: In the past three years, its average return "ranked number one in investment returns for public funds with assets greater than $10 billion," according to a November 2006 report issued by Oregon called "PERS: By the Numbers" that gauges its results versus Wilshire Associates' TUCS (Trust Universe Comparison Service) group of large public funds. The portfolio currently holds 35% of its assets in U.S. equity, 27% in fixed income, 20% in international equity, 10% in private equity, and 8% in real estate.

Why has the Oregon fund's performance thrived while many other public funds have struggled? "I would characterize these guys as being thought leaders. They are almost anticipating changes in the marketplace," says David Fann, a La Jolla, California-based Managing Director at Pacific Corporate Group Asset Management, which works with Oregon on its private-equity investments.

Asked what about its process leads to Oregon's strong performance, investment consultant Mike Beasley answers without hesitation: objectivity. "They are not subject to trend-following, the feeling that, 'Others are doing it and therefore we should,'" says Beasley, who works with Oregon as a San Francisco-based Managing Director at Strategic Investment Solutions. "Their process is disciplined."

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A Crisis Averted

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Oregon's public pension system has faced many of the same problems that dog a lot of its peers, like unsustainable costs and sometimes-ineffectual leadership. "By 2002 and 2003, the plan's funding status was looking grim. The issues they had were a little more pronounced than in a lot of other states," recalls Keith Brainard, Austin, Texas-based Research Director at the National Association of State Retirement Administrators. "They turned their funding situation around. Oregon has done an exemplary job of displaying the types of changes that can be made to preserve traditional pension benefits, while making the necessary changes to keep that plan design sustainable."

Under the pre-reform defined benefit plan, participants got a 1.67% multiplier formula benefit, or a money-match benefit, where their 6% contribution went into an account that had a guaranteed return of 8%, but that also gave them the upside. So if the retirement fund earned 20% in a year, the participants got close to 20% earnings credited to their member account. If the fund had negative returns, they still got 8% earnings credited to their accounts.

"From members' perspectives, it seemed like a good deal: 'Heads, I win; tails, I win,'" Cleary says. "We had 30-year career members going out on retirement benefits that were equal to their final salary. The system was not designed to do that. We almost had a defined contribution plan wrapped in a defined benefit blanket: They got all the upside, but they also had the blanket that protected them from the downside."

Pension-reform legislation in Oregon addressed those issues head-on in 2003, making fundamental plan-design and governance-structure changes. By the most recent valuation in December 2005, the system was 104% funded (including advance deposits from employers held in side accounts). Crisis averted, it appears.

The legislation switched new hires to a defined benefit plan with an individual-account component as of August 2003. The plan includes a more modest 1.5% multiplier formula benefit, and the participant contribution of 6% of salary goes into an individual account with no earnings guarantee or employer match. Creating the hybrid plan "greatly slowed the growth of future liabilities," Cleary says.

Some of the other changes also affected current employees and retirees. The 2003 reforms included restrictions on crediting more than an 8% investment return for most participants, and redirection of current-employee contributions to the individual-account program. Oregon PERS also updated its actuarial tables for the first time since the late 1970s, to reflect longer life expectancies. The updated tables and other reforms reduced participants' benefit payouts: The average annual retirement benefit for 2005 retirees equaled 51% of final average salary, versus 68% for those who retired in 2002. Now, he adds, Oregon PERS will update the actuarial tables every two years as needed.

"One of the things that distinguishes our reforms is that we applied changes to existing members rather than just prospectively," Cleary says. "We are also recouping overpayments made to about a third of our retirees."

Members and retirees sued over the reforms, but Oregon has prevailed on the major components in both the state Supreme Court and the 9th Circuit Court of Appeals. "We had to enact some things that were certainly unpopular," Cleary says, "but our members are starting to understand. They can see by reading the newspapers that, for other entities, 'reforming the system' can mean abandoning it entirely."

Lawmakers also changed the fund's governance structure. The Oregon Public Employees Retirement Board "was probably similar to a lot of public retirement boards," Cleary says. "There were a lot of employer and member representatives, and the size of the board had grown over time." The former board "was too large to be effective," says Vice Chair Brenda Rocklin, who joined the board amid the reforms in 2003.

To ensure that the new system did not get into the same problems as the old one, Cleary says, the board needed more objectivity. The reforms reduced the board size from 12 to five people, three of whom cannot have any connection to PERS. "They are all private-sector business folks with experience in HR, finance, pensions, or money management," Cleary says of the latter three people. The board members, appointed by the governor and confirmed by the state senate, have staggered three-year terms.

Since the reforms, the board has made some tough decisions. They continued defending the reforms in the participant lawsuits, when some members and retirees argued against that. They decided to recover the $800 million in overpayments from retirees, spread out over the retirees' lifetimes; as of the 2005 valuation, Oregon PERS proactively moved to fair-market valuation of assets and shorter amortization periods. Because of the volatility that could result, PERS has a rate collar on employer contributions: So long as the system is 80% to 120% funded, the employer rates cannot go up or down more than 3% every two years.

Advice from PERS' actuary helped motivate the fair-market move, Rocklin says, as well as a desire to make the system more transparent. "We have tried, from day one, to make the system as simple as it can be, so that people can figure out what things mean and see where we are going," she says.

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Leading-Edge Asset Classes

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Oregon's equally innovative investing approach breaks down into several different aspects, but appears to hold true across asset classes. Among the keys to its investing strategy:

Taking chances on new types of investments Oregon's best-known forays have been into private equity and real estate, and it started investing in each more than two decades ago. "Among the larger systems in the country, Oregon has a much higher-than-average allocation to nonpublic securities," Beasley says. "Those two categories have brought not only good returns, but added some very meaningful diversification."

The opportunity set and return potential of public equity intrigue Jay Fewel, who has been with the Oregon Treasury since 1989 and oversees both the public and private equity investments. "If you believe in the efficient-market hypothesis, with private equity, there is less efficiency than in the public market," says Fewel, a Senior Equities Investment Officer. "Every fund has its unique characteristics."

The diversification benefits also attract Schmitz. "While they may be risky compared with bonds, there is a certain advantage to the pricing mechanisms," Schmitz says of private equity. "You do not have the day-to-day volatility. That dampens the volatility of the overall portfolio, and it allows you to have a more aggressively positioned portfolio, and more ability to positively impact performance." The numbers back that up. Oregon's real estate holdings have averaged returns "north of 25%" for the past three years, and 19% over five years, says

Brad Child, Senior Real Estate Investment Manager with the Oregon Treasury. And its average annual returns in private equity over the years have exceeded 17%, Fann says.

Finding good new managers and firms early Oregon's 1980 entry into private-equity investing came with a then-fledgling buyout firm, Kohlberg Kravis Roberts & Co. (KKR)—now the sector's 800-pound gorilla. "If we were not the first, we were one of the first," Fewel says of pension funds investing in private equity. "We helped put KKR on the map." He also helped build ties with another newcomer-turned-behemoth: "With TPG [Texas Pacific Group, Inc.], we were one of the first investors, and we have been with them throughout their history."

Oregon maintains strong bonds with both KKR and TPG. At the same time, Schmitz says, it puts a lot of effort into finding really good up-and-coming managers. These folks "are not afraid to invest in a start-up," says Jay Rose, a Senior Vice President at Pacific Corporate Group Asset Management who also works with Oregon PERS. "They can identify some of the industry's future leaders years before others can." Most of the up-and-comers seek out Oregon, rather than the other way around, due to its long history with private equity.

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Bucking the passive-management trend

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Oregon does not buy into the prevailing wisdom that active management usually does not pay, relative to a more passive indexing approach—and it puts its money where its mind is. Its fixed-income portfolio is 96% active and 4% passive, for instance.

On the equity side, Oregon remains a big fan of active management and the semi-active management that comes with enhanced-indexing funds (see "**A New Recipe,**" PLANSPONSOR, September 2006). "We have increased active management in the past few years," Schmitz says. "When I came on board, we were 50% active and 50% indexed in our U.S. holdings. Now we are 25% indexed, 25% enhanced indexed, and 50% active. On international, we had 30% indexed and 70% active. We have eliminated the passive, and the 30% is now enhanced indexing."

The strategy goes "a bit against the tide," Schmitz acknowledges. He attributes that partly to a small-cap overweighting and partly to more-fundamental beliefs about the market's recent direction. "We saw that the market was going to be more of a flat trading environment," he says. "In that environment, active management makes a lot of sense."

Doing their homework, then making big bets

The Oregon staff has an interesting take on modern portfolio theory (MPT), Rose says. MPT suggests that return stems mostly from asset allocation, and less so from manager and stock selection. Oregon flips that thinking on its private-equity investing, he says. "It is all about manager selection," he says. "Seventy-five percent of the alpha is from manager selection, and that is what they are best at. They are willing to put bigger bite sizes into funds, because of the time they put into due diligence. They make concentrated bets on a few key players."

Oregon's belief in concentrated bets goes beyond private equity, across the portfolio. To Schmitz, it just seems logical. "A good manager who is generating alpha, by definition probably is getting it from his or her best bets," he says. "Managers tend to hold too many stocks, for risk-control purposes, more because of business risk than financial risk. There have been a number of studies that show that, after 30 to 35 stocks, you do not get much risk diversification by adding new stocks."

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Having an investment board of business pros

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Schmitz likes the "NIFO" philosophy—noses in, fingers out—of staff oversight by board members that one Oregon Investment Council member recently expressed to him. He says, "Unless something does not smell right, do not get involved."

Asked what about Oregon's culture allows it to be an investing pioneer, Beasley cites the fund's decisionmaking structure. "The staff is quite stable and quite experienced, and they have an investment council made up of successful individuals in business in Oregon," he says. "They have a business background, so consequently they are less concerned about politics, they learn faster, and they take a long-term view of their obligation to generate returns."

The lack of politics and micromanaging helps. "They have a board that is open to new ideas, encourages them to think out-of-the-box, and understands the nature of investing and the need to diversify and get beyond basic equity and fixed income," Fann says. "The board encourages the staff to be proactive rather than reactive."

Being unafraid to change gears

Oregon looks ahead a lot, and makes changes proactively to adapt to changing opportunities. For Oregon's private-equity holdings, that could mean putting more money into distressed investments this year, as economists forecast a softer market ahead. For the real estate holdings, the investment beyond the United States appears likely to rise from one-quarter of the $3.9 billion portfolio in 2006 to one-third in 2007. And on the fixed-income end of the portfolio, this year Oregon may relax the maximum percentage that its outside managers can invest in non-investment-grade bonds (now 30%), as well as make its customized benchmark (90% Lehman US Universal/10% SSBI Non-US World Government Bond Hedged) modestly more aggressive.

Bigger changes could be in store, too. As part of a current long-range strategic-planning review, Schmitz says, Oregon is considering doing some equity management in-house. It could be a cost-effective move for Oregon, Schmitz says. "We would not try to do a full active portfolio. We would do enhanced indexing," he says. "Initially, we may manage $500 million to $1 billion internally and, ultimately, that could grow to $4 billion or $5 billion."

What about the next chapter in Oregon's history of pioneering new investment areas among public funds? Says Schmitz, "Until they start offering Martian equities, I am not sure if there is a next big thing out there for us."

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SIDEBAR: Defined Benefit Plans: A Governor's Perspective

As a former labor lawyer, Ted Kulongoski is not the most obvious person to lead a painful reform of a troubled state retirement system. Then again, maybe that gave Oregon's governor credibility as he sought support for some unpopular changes.

"He cut his teeth working in the labor movement for years," says Paul Cleary, Oregon PERS Executive Director, of the lawyer-turned-politician. "Because of that, he had a door open to folks to show them that the system was not sustainable."

Kulongoski works "in a solidly Democratic, pro-labor state, yet he was willing to make the reforms necessary to put the PERS on solid financial footing," says Keith Brainard of the National Association of State Retirement Administrators. "He made himself the point-person on PERS reforms and took the political heat that accompanied these changes."

Kulongoski came into Oregon's 2003 pension-reform battle with a couple of fundamental beliefs: that the state should preserve its defined benefit plan for public employees, and that the program had to change to survive.

A former trustee of several pension plans, Kulongoski believes firmly in defined benefit plans for Oregon's public workers. "I like the certainty; it is better for employees," he said in a January interview with PLANSPONSOR. "A defined contribution plan is not as secure, as far as what the retirement income will be."

And yet, the state's then-recession made addressing PERS' funding problems urgent. The growth in PERS' unfunded liability meant a rise in state employers' contributions, which increased the state's overhead. Every 1% boost in employer-contribution rates translated into a $62 million cost increase for the state, Kulongoski says. With the state having lost about 25% of its general-fund revenue during the economic slowdown, Oregon found itself in a big financial bind.

"I was going to be putting more and more money into overhead, and less money into programs," Kulongoski says. "It was a crisis situation, and we had to do something dramatic."

Three Tips

Since then, other governors in states facing their own public-pension crises who ask Kulongoski for his advice get three tips.

First, look at the retirement system comprehensively, and prepare to make tough calls. "Most reform efforts are all about new employees. I came into it with a different view: To address this $17 billion liability, we had to look at retirees, current employees, and new employees. We spread the reform effort out to all three of those groups. Politically, that is an extremely difficult task."

Most employees knew that a change had to be made, Kulongoski believes. "The replacement ratio became so outrageous in Oregon, where people were retiring at 108% or 120% of their pre-retirement income," he remembers. But he also acknowledges the human cost of the reforms. "I am not arguing that there were not sacrifices made. There were," he says. "I do not want to downplay that."

Second, Kulongoski recommends taking a very close look at the retirement system's overseers. "You have to make sure that you have people with an independent view of the program," he says. "When this crisis occurred, our public employee retirement board had 12 members, and every one but three had a direct interest in the program." These retirement systems also need an executive director with the courage to talk candidly with the governor and board about the system's problems, he adds.

Third, Kulongoski advises paying close attention to political realities. "You have got to work with the legislature to get them to understand that this is something that has to be done," he says. When a private-sector pension plan needs changes, he says, the plan sponsor and plan administrator work together to get it done. "On the public side, I have another group of plan managers: the 90 legislators," he says. "That is the difficult part."

Indeed, Kulongoski considers Oregon lucky to have faced its retirement-system crisis when it did. "I have followed this issue across the country, and talked to other governors," he says. "The reality is that, if I had to do what we did today—with the economy much better, and Democrats in control of the legislature—I am not sure that it would work. I had a perfect storm."

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Judy Ward
editors@plansponsor.com

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