F I S C A L I M P A C T R E P O R T

SPONSOR: Heaton DATE TYPED: 2-7-03 HJM 2

SHORT TITLE: Combine PERA & ERA Systems SB

ANALYST: Neel

REVENUE

Estimated Revenue		Subsequent Years Impact	Recurring or Non-Rec	Fund Affected
FY03	FY04			
		See Narrative	Recurring	Educational Retirement Fund
		See Narrative	Recurring	Public Employees Retirement Fund

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION

LFC files

Responses Received From

Educational Retirement Board (ERB)
Public Employee Retirement Association (PERA)

SUMMARY

Synopsis of Bill

House Joint Memorial 2 requests a study of the effects of combining the Public Employees Retirement System with the Educational Retirement System.

OTHER SUBSTANTIVE ISSUES

According to a scenario provided by ERA, there is approximately a 30 percent disparity between ERA and PERA retirees. Under the example that follows, an ERA retiree with a final average salary of $38.0 will receive a retirement benefit of $22.3, while a similar PERA employee will receive approximately $29.3. Part of this disparity can be explained by the calculation in final average salaries. However, the major contributor is the variance in multipliers (ERA 2.35% per year vs. PERA 3.0% per year). ERB's benefits package to duplicate PERA's $157,000.0 per year, recurring contributions from ERB employers is needed to fund the increased ERA retirement benefits.

FY02 Investment Returns ERB vs. PERA:

ERB:

Asset Allocation. ERB established its current asset allocation target of 53 percent domestic equities, 17 percent international equities and 30 percent fixed income instruments in October 1999. This allocation was selected as a result of an asset/liability study conducted by its then pension consulting firm. Detailed below is ERB's asset allocation for fiscal year 1997 through 2002. Domestic equities are US stocks that are traded on American stock exchanges, while international equities are non-US stocks traded outside of America. Fixed income assets are primarily government and corporate bonds, while cash is usually overnight deposits and other very short term investments. ERB's asset allocation has shifted to equities thereby increasing its risk exposure. ERB's FY02 ending asset allocation included 48.6 percent domestic equities, 16.6 percent international equities and 31.6 percent fixed income instruments.

Asset Allocation (%)

	FY97	FY98	FY99	FY00	FY01	FY02	FY02 Target
Domestic Equity	50.0	50.0	45.8	52.8	51.4	48.6	53.0
International Equity	N/A	N/A	10.8	14.2	16.2	16.6	17.0
Fixed Income	50.0	50.0	42.0	33.0	32.4	31.6	32.0
Cash	0.0	0.0	1.3	0.0	0.0	3.3	0.0

Investment Performance. ERB's investment performance has lagged behind its peer funds and internal benchmarks over the past two years. Investment returns for FY02 were –8.7 percent missing the benchmark by 187 basis points. The associated cost of missing the policy target in FY02 was approximately $124 million. Similarly, in FY01 ERB missed its benchmark by 400 basis points returning -10.4 percent. Detailed below are ERB's investment returns from FY97 through FY02.

Investment Returns (%)

	FY97	FY98	FY99	FY00	FY01	FY02	FY02 Target
Total Fund	**20.2**	**19.7**	**11.7**	**12.5**	**-10.4**	**-8.7**	**-6.9**
Domestic Equity	35.0	25.1	18.9	14.0	-18.3	-19.1	-15.9
International Equity	N/A	N/A	14.8	32.3	-24.8	-7.4	-8.0
Fixed Income	9.1	13.9	2.3	3.9	11.6	8.3	8.9

In response to the poor investment performance, ERB has taken significant steps to adjust its investment management, including hiring an investment consultant, hiring four new managers and terminating two under-performing managers. Until last year, ERB relied on its investment managers for investment advice, where most large funds hire an investment consultant to advise the board on asset allocation, investment manager selection and performance. With these changes, ERB expects to realize the investment performance that it enjoyed throughout most of the 1990s.

PERA:

Investment Results. The following data presents the allocation for PERA showing the various proportions assigned to the major asset classes for the last five fiscal years.

PERA Asset Allocation (%)

	FY98	**FY99**	**FY00**	**FY01**	**FY02**
Domestic Equity	53.3	48.9	37.4	44.1	36.3
International Equity	8.8	12.6	18.0	14.3	15.3
Fixed Income	37.7	36.0	35.8	41.4	43.3
Cash	0.2	2.5	8.8	0.2	5.1

Domestic equities are U.S. stocks traded on American stock exchanges, while international equities are non-U.S. stocks traded outside of America. Fixed income assets are primarily government and corporate bonds, while cash is usually overnight deposits and other very short-term investments.

Given recent stock market performance, it is noteworthy that the fund's exposure to equities fell from 58 percent as of June 2001 to 52 percent as of June 2002. By comparison, the Education Retirement Association and the State Investment Council funds had FY02 equity components equal to 65 percent and 62 percent of their respective totals. It is therefore unsurprising that PERA significantly outperformed these other funds during FY02. Further, PERA's investment performance has consistently been superior as measured against its peers' returns. Out of an investment universe of 59 funds, PERA has placed in the 98th or 100th percentile for one, five and 10 year horizons.

Another useful metric is how a fund performs relative to its overall benchmark. PERA employs external money managers to actively manage different portfolios and pays them fees higher than would be charged for investments in passive indexes such as the Standard & Poors 500. Therefore, to justify the higher expenses, these managers should outperform the passive indexes for their respective portfolios. Figure 1 shows the one-year, five-year and 10-year performance of the total fund compared to its passive targets. This graph shows the value added by external managers; with the exception of the five-year interval, the fund has substantially outperformed its benchmarks. For example, manager performance added an additional 3.2 percent to FY02 return as a result of PERA's skill in picking investment managers.

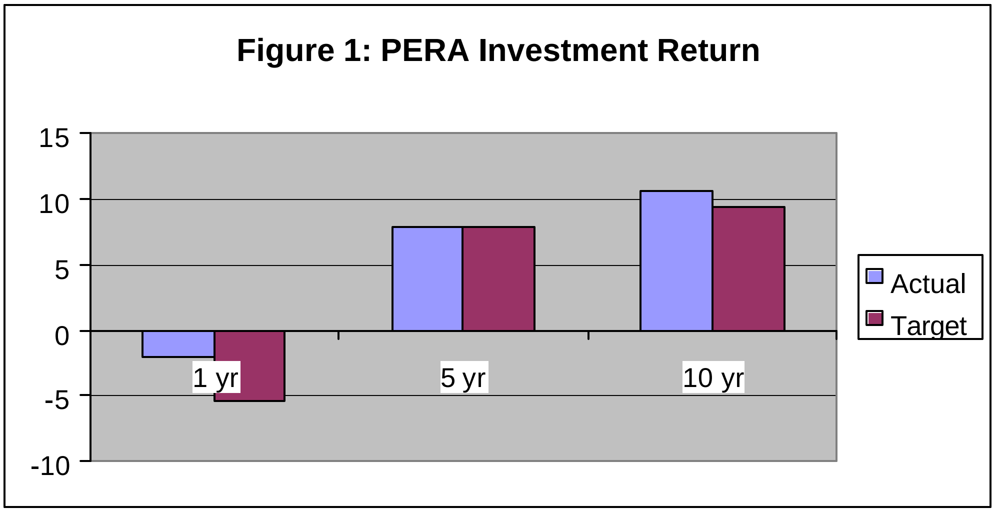
Figure 1: PERA Investment Return
15
10
5
0
-5
-10
1 yr
5 yr
10 yr
Actual
Target