Letter from the Executive Director

Before reviewing the events of 2003 and the state of the Massachusetts Public Pension Systems I would like to offer the heartfelt gratitude of PERAC and its staff to Bob Tierney, our former Chairman. Bob assumed that position under difficult circumstances following the untimely passing of Liz Laing and provided thoughtful insight, keen understanding, and diligent leadership during his tenure. His contributions to the pension community are continuing in his new role as Executive Officer of the Boston Retirement Board.

I am pleased to note that the Honorable Domenic J.F. Russo has been elected by the Commission as Chairman of PERAC. During his distinguished career as a jurist, Judge Russo, a graduate of Boston University and Boston University Law School and a retired Lieutenant Commander of the U.S. Naval Reserve, served as First Justice of the Milford Division of the District Court and Managing Justice of the Peabody Division of the District Court Department Jury of Six Sessions as well as Managing Justice of the Lawrence and Lynn Divisions of the District Court Department of the Massachusetts Trial Court. He is a recipient of the "President's Award" for Judicial Excellence from the Massachusetts Judges Conference. Judge Russo has already brought a fresh perspective to the Commission's deliberations and we look forward to working with him in the years ahead.

The year 2003 contained new challenges, a welcome change in the capital markets, and unfortunately, new controversies for our retirement systems. Chapter 32 itself has become controversial with some perceiving that it is antiquated, overgenerous, and unfair. In

Joseph E. Connarton
Executive Director

response to these perceptions, for the first time in memory, a benefit was eliminated, that of the so-called "spousal benefit". Proposals incorporating a cap on benefits are being considered and other changes are possible in the years ahead.

After the experience of the last several years of declining markets, reduced assets, and the resulting increases in appropriations for the state and its cities and towns, it is not surprising that a renewed focus on the pension law, as well as the costs associated with the system, has taken place. All too often, however, the public discourse failed to consider the full picture. These trends were not unique to our systems, as similar developments have been the norm in other public and private pension

At the same time as the market decline, the state and its cities and towns have been confronted by a budget crisis. This has added to the scrutiny of the pension systems.

plans across the country. The financial status of the systems is more or less hostage to the fortunes of the markets and the general economy. As these have improved, the funding status of the systems has also improved.

At the same time as the market decline, the state and its cities and towns have been confronted by a budget crisis. This has added to the scrutiny of the pension systems. Ironically, in many cities and towns, the impact of the asset losses has been exacerbated by the nature of funding schedules adopted in earlier years often over the objections of PERAC and the retirement boards. Municipalities, even in good times, sought relief in the pension appropriation through the establishment of funding schedules that deferred payments. As a result, the cost was artificially reduced in the early years of the schedule and costs have increased as the years have passed. This has made a bad situation worse. In contrast, those cities and towns that were more aggressive during the good times can now cushion the impact of the last few years because of the flexibility resulting from that approach. It should not be forgotten that the method of dealing with pension costs could have a far greater impact on the financial condition of a city or town than the particular provisions of Chapter 32 itself.

In all these matters, the pension community must be proactive. We must recognize that inequities as well as antiquated approaches do exist in Chapter 32. These include the ability to receive a substantial benefit for a relatively short-term period of service and the ability of the employer to manipulate the system for non-retirement purposes. In the latter category, it should be noted that establishment of an early retirement incentive adds pension cost while savings are realized elsewhere in the budget. The employer's refusal to accept disabled retirees deemed able to return to work increases the retirement bottom line, as does the employer's use of the system to reward friends and punish enemies or to entice problem employees to retire.

One of the worst bear markets in history came to a dramatic end in 2003. In spite of mutual fund scandals, continuing concerns about corporate governance, and the uncertainty of international events, investors renewed their commitments to U.S. equities in a major way. Massachusetts public pension funds significantly exceeded their targeted rates of return for the first time this decade. The Dow Jones closed at its highest level in over twenty months, having rebounded 43% from its low of October 2002. The S&P 500 Large Cap Index was up 26.4% for the year, but, for the fourth consecutive year small cap stocks out performed large caps as the Russell 2000 Index enjoyed its best year ever, up 45.4%. In style analysis, there was little to choose between value and growth for the year, although value had the edge for the 3, 5, and 10 year periods. The NASDAQ Composite registered a remarkable performance, up 50% for the year in its third biggest gain since 1971.

Just as all major regions of the world economy suffered through the past recession, the current recovery has also been synchronous worldwide. Aided by the weakness of the US dollar, which was down 20% vs. the Euro and 10% vs. the yen in 2003, the MSCI-EAFE

Index—up 38.6% for the year in US dollar terms—outperformed the S&P 500. Over the trailing ten-year period, however, international stocks have badly lagged the S&P 500, under-performing by an annualized 6.6%.

The fixed income market registered positive returns but failed to beat the equity market for the first time in four years. The Lehman Brothers Aggregate Index of investment grade securities was up 4.1% for the year. Although Treasury bond rates rose for the first time since 1999, their total return was still modestly positive. The yield on the benchmark 10-year note began the year at 3.8%, reached a 45-year low of 3.1% in early June as talk of deflation remained strong, but rose as high as 4.6% before settling at 4.2% at year-end as both the economy and the stock market dramatically improved over the remainder of the year. While returns on mortgage-backed securities were also only modestly positive, investment grade corporate bonds were the major drivers of performance as quality spreads narrowed in sympathy with the improving economy. In its best year since 1991, the high-yield ("junk") sector was clearly the best place to be as returns for the year approached 30%.

Real estate delivered another year of positive performance. Publicly traded equity REITs returned 37% for the year. It was the fourth straight year that REITs have outperformed the S&P 500. Returns on privately held real estate were more down-to-earth, with annualized returns in the range of 9%.

As the market for initial public offerings began to show signs of life in 2003, spirits improved and performance appeared to be stabilizing in the beleaguered venture capital industry. The industry was still digging out from the rubble of the late 1990s bubble, but after many firms cut the size of recent funds and returned money to limited partners over the past year, new fundraising was underway and new investment was stabilizing at pre-bubble levels. According to Venture Economics, composite partnership returns in 2003 were 8.1% for venture capital and 18.3% for private equity.

For Massachusetts' Pension Funds, 2003 returns benefited from the market turnaround. The composite return for all systems was 24.9%. The median Massachusetts return was 21.1% as compared with the a median return for pension funds in TUCS (Trust Universe Comparison Service) of 22.8%. Returns in general ranged from 12.2% to 28.5% with one exception due to circumstances unique to that system.

System returns in 2003 all exceeded actuarial assumptions. In 2003 the number of systems that failed to achieve a return above 8% over the long term fell from 9 to 0. The impact of these 2003 returns on system financing has already been reflected in the recently completed actuarial valuation of the State Employees Retirement System, which had a return of 26.43% and achieved an improvement in funded ratio from 79.5% to 83.9%.

Please turn to page 71 for a more complete discussion of 2003 investment performance.

The Commission believes that the most important aspect of its audit function is to assist the boards in improving the management and administration of the retirement systems.

PERAC has taken several actions recently to remind boards of their investment responsibilities and the regulatory environment. Several memos have been sent to boards directing them to review the status of any investments made in or with the firms that have been caught up in the unfolding scandals relative to late trading, market timing, and corporate governance. We have issued a new set of investment forms that address competitive process, consultant advice, and disclosure. Revised exemption applications for alternative investments, real estate, and international investments require prospective managers to respond to general questions and provide basic information on their organization, investment philosophy, and overall capability. For the first time, appropriate forms pertaining to Hedge Funds and Fund of Funds have been developed.

In addition, we have made changes in other areas. A new Competitive Process Notification Form replaces the letter that boards previously sent to PERAC when hiring a new vendor. There are now separate Disclosure Forms for consultants and investment managers. Besides asking for previously requested information in a more concise and better organized manner, the new forms require the disclosure of any financial relationships between consultants and prospective investment managers.

PERAC has also recently sent out two important memos related to investment. The first reminded boards of their obligation to review their relationship with a consultant every five years and to file the appropriate forms and disclosure with PERAC. The second asked that the boards notify PERAC of compliance with regulatory requirements that the boards conduct quarterly portfolio reviews, meet with each manager annually, receive quarterly reports from each manager, review brokerage, and require managers to provide notification of personnel changes. That memo included a request for information relative to the board's annual determination as to whether the manager continues to comply with its contractual mandate.

In spite of overall positive trends in pension funding, some systems have stubbornly continued to maintain funded ratios below 50% and in some cases, below 40%. PERAC has initiated an internal analysis to determine what factors contributed to this situation. Although investment return appears to play a role, we may find that funding schedule and appropriation history play a greater role.

PERAC continued its efforts with respect to post retirement monitoring of disability retirees. A streamlined process instituted for the 2003 filing and now fully implemented for the 2004 filing has sharply reduced confusion as well as inquiries from those retirees who are required by law to file Annual Statements of Earnings with PERAC. Although that requirement can be an added burden on retirees, PERAC has made great progress in simplifying the process and maintaining communication with those who must file.

PERAC receives, processes, and reviews over 15,000 earnings report submissions each year. Through the 2002 reporting year, PERAC had recovered $15,538,722 for retirement systems as a result of excess earnings, non-compliance, return to work and pension waivers. In the 2002 reporting period, 3,760 retirees reported earnings while only 162 of those individuals had earnings in excess of the statutory limit. (Pension plus earnings cannot exceed the salary for the position from which the member retired plus $5,000). An additional 93 retirees failed to comply with the reporting requirements. Exclusive of the City of Boston, $1,473,334 of excess earnings was recouped and $655,379 was recovered for non-compliance.

During 2003 PERAC conducted 38 audits of the retirement systems and issued 54 extensive audit reports. The Commission believes that the most important aspect of its audit function is to assist the boards in improving the management and administration of the retirement systems. Audit reports are more of a teaching tool than a critique of performance. The initiation of direct and timely follow up to ensure that findings are acted upon also makes the expertise of PERAC auditors available to the boards at a time other than during a triennial audit.

One of the ongoing issues revealed in the audits is the difficulty boards have in ensuring that parties on whom the boards rely perform the functions that the law assigns to them. This is particularly true in the failure of Treasurers to reconcile retirement fund cash accounts, a function that best financial management practice requires be conducted by someone other than the board. In addition, in county and regional systems where the board must rely on the employing unit to submit member contributions, employers often fail to accurately report contributions and other important salary information. Beyond these concerns, employing units, on an all too frequent basis, fail to pay appropriations in the amounts and/or at the times specified in the funding schedule. Other matters that arise in audits on a regular basis include incorrect withholding of the added 2% on the amounts above $30,000 in regular compensation and maintenance of minutes.

The audit unit also provides Annual Statement Training seminars across the state to assist boards in preparing the Annual Statement required by law. 2003 also saw the initiation of a project to standardize common audit findings.

PERAC is responsible for the establishment of medical panels to review disability claims as well as the orderly processing of those claims. The review of disability applicants by independent, qualified, and objective physicians is the key to insuring fairness to the applicant and taxpayers. In 2003, PERAC processed 868 medical panel requests. 122 ordinary disabilities were approved, and 626 accidental disabilities were approved. In addition, the Commission approved 105 accidental death cases.

The medical aspect of the Commission’s responsibilities extends to the review of those already retired for disability. In 2003, PERAC conducted 1,526 Comprehensive Medical Examination Reviews leading to the medical examination of 86 members for return to service. Ultimately, 6 members were restored to service last year.

PERAC continued its commitment to education in 2003, presenting seminars on Annual

We must be prepared to consider change with an open mind while maintaining a firm commitment to ensuring retirement security for public employees across the state.

Statement Preparation, Early Retirement Incentive Programs, and the Pension Holiday Legislation. 308 Board Members and Administrators attended these sessions that were held at locations across the state.

In the latter part of the year, we disseminated a *Compensation Questionnaire for Chief Retirement Administrators* that asked boards about their personnel practices. Results were distributed early in 2004. We also surveyed boards regarding the PERAC Web Site and their educational preferences.

In an effort to streamline and simplify the benefit application process, PERAC revised General Membership Forms and Disability Forms.

As the Massachusetts' public pension community confronts the future, we must be prepared to consider change with an open mind while maintaining a firm commitment to ensuring retirement security for public employees across the state. No doubt controversies will arise and challenges will be presented, but with the same dedication and professionalism exhibited in overcoming the negative experience of the past few years, I am confident our pension system will remain strong and vital.

Sincerely,

Joseph E. Connarton

Joseph E. Connarton
Executive Director