



Date: March 10, 2016

To: Honorable John Chiang, California State Treasurer

From: Mohammad Baki, Overture Financial  
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Re: Response to Controller Betty Yee's Questions about the Pooled IRA Option

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Please find below our responses to the questions posed by Controller Betty Yee to the Treasurer and the California Secure Choice Retirement Savings Investment Board in the letter dated March 7, 2016, regarding the costs associated with the Target Date investment strategy and the Pooled IRA with Reserve Fund. The Controller's letter refers to a Target Risk Fund, but Option 1 in the final report is a Target Date strategy implemented through either managed accounts or mutual funds (Target Date Funds or TDFs). For the sake of simplicity, we refer to Option 1 as the TDF in our responses below.

We have included the Controller's questions verbatim in bold text followed by our responses. Please let us know if you have any further questions.

**1. Some of the most important assumptions for both the Target Risk Fund and the Pooled IRA option, include:**

- **Median long-term inflation rate of 2.5%**
- **Wage inflation of 0.5% (adjusted for inflation)**
- **Estimated U.S. bond compound return is 4.5% and for equities 7.9%.**
- **Ten Year Treasury Note – 4.25%.**

*Why is the 4.25% rate being used when the 10-year Treasury rate is currently 1.84% and the 10-year Treasury rate has not exceeded 4.25% since 2007?*

**Response:** Most capital market assumptions in the pension industry assume a reversion to historic interest rates over the long term, as the Federal Reserve returns slowly to normal monetary policy after the prolonged intervention following the Great Recession. We used these assumptions to project long-term investment returns.

***In addition to the low Treasury rates, the three-year fixed income returns at both CalPERS and CalSTRS have been under 2.5%. What happens to participants' deposits if the assumptions are not met?***

**Response:** To begin, fixed income investments make up a small portion of the Pooled IRA portfolio that we modeled, which we designed to be equivalent in risk to a TDF over a full career. An exception is the initial phase-in period. For the TDF investment strategy, we recommend that participants be defaulted into a low-risk vehicle such as a Stable Value Fund, Treasuries<sup>1</sup>, or money market fund for the first three years. For the Pooled IRA, we recommend an 80% bonds/20% stocks allocation for the first three years. During these initial years, participant account balances will simply experience low investment earnings and low volatility.

More importantly with respect to long-term outcomes, our retirement benefit forecasting model already accounts for potential variation in portfolio returns and provides high and low outcomes in addition to the expected outcome. We used a statistical probability distribution around the mean values listed above to project the 5<sup>th</sup> percentile, 50<sup>th</sup> percentile, and 95<sup>th</sup> percentile income replacement rates for participants. These results were presented in several Board meetings, including on August 24, 2015. For the first generation in the Pooled IRA, we project an average income replacement rate of 22.4%, with a range of 12.3% to 44.2%.<sup>2</sup>

If short- and long-term portfolio returns fall well short of the projected mean, Pooled IRA participants will ultimately earn lower returns, but on average will not be worse off than TDF participants. Indeed, in scenarios where there are far more negative return years than expected, reserves will be exhausted, and participants will generally end up with the same outcomes as if they had been in a conventional balanced fund with the an asset allocation profile that is similar in long-term risk to the TDF that we modeled.

***If wage inflation does not hit the assumed 0.5% do you expect participants to stop contributing?***

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<sup>1</sup> The Treasury instrument underlying the MyRA product, if made available to California Secure Choice, could offer higher returns than a money market fund.

<sup>2</sup> These represent the range of statistically likely market conditions in a single 42-year period. The distribution of probable income replacement outcomes for successive retirement cohorts, over time, will be narrower for the Pooled IRA than the TDF successive cohorts, given the former's smoothing feature.

**Response:** We do not assume that participants will stop contributing if wage inflation does not meet expectations. A greater risk is that if there is another major recession, some participants will be tempted to withdraw their funds prematurely.

- 2. On page 87 of the Report, Overture notes one of the trade-offs of the Pooled IRA, is in the early start-up years, some of the available returns will be diverted towards establishing the desired reserve level, and credits will not “flow” to participants.**

*What impact will this have on participation? Was this clearly explained to and asked of the market study participants? What if the reserve does not accrue as hoped during the first few years? Should there be strong provisions to protect the Board from pressure from participants to credit accounts or increase credits over time?*

**Response:** We do not anticipate a significant impact on participation. The market study only provided basic details about the program to participants and did not distinguish between investment options, except as a test for how participants weigh the risk/reward tradeoff. Since the difference in probable outcomes differs little between the first generation of Pooled IRA participants and the Target Date strategy, we do not anticipate that this will impact participation. There is little or no evidence in behavioral finance research to indicate that such small differences in likely outcomes—for instance, arising from the specific asset allocation glidepath of the default TDF series offered by an employer-sponsored 401(k)—have an effect on opt-out rates.

At the same time, we note strong recommendation from the worker centers and community based organizations that we interviewed that Program education should focus on informing participants about the basic workings of the program and their rights under the law, rather than a deep dive into investment related issues that can be overwhelming. Participants should be given the opportunity to learn more, if they so desire, through an accessible source such as a web page.

During the first few years, in order to protect against a large market shock as participants are getting accustomed to saving, we recommend that the program invest in a conservative portfolio of 80% bonds and 20% stocks (see page 85 of the Final Report, under “Plan Policy”). This is consistent with our recommendation of a low-risk investment for the first three years if the Program is legally allowed to implement the Target Date investment strategy through Managed Accounts. Furthermore, if the reserves do not accrue as hoped, this means that earnings were not diverted into the reserves, but fully credited to participants. Thus participants do not lose anything if fund returns are insufficient to build a reserve. This holds true even if the fund has to reduce account balances due to an ill-timed, large market shock—participants are no worse off than they would have been if they had borne investment risk individually.

We highly recommend that the Board set an iron-clad set of crediting rules at the outset so that they cannot give into pressure to stray from this policy. (The real cause for concern here is not that insufficient reserves will accrue, but that as the reserve grows, there will be pressure to prematurely award excess credits to participants in a way that is inconsistent with Program policy and compromises its long-term capacity to protect participants against market timing risks.) The Board should consider whether this is best accomplished through statute or governmental regulations.

*How would the Board address the equity issue with the first generation of participants who will pass on a share of their returns to the reserve fund? Is there a mechanism to make them whole when the Reserve hits a certain point?*

**Response:** It is important to understand that most of the redistribution through the Reserve Fund will happen across market cycles (such as the late 1990s bubble and subsequent collapse in 2000/2001) rather than across generations, with the effect of evening out sharp differences in retirement incomes based on market timing. Moreover, if the Reserve exceeds a certain level--40% of aggregate account values in our model—the excess value above that level is incrementally credited back to participants.

Nonetheless, there is indeed a statistical likelihood of some transfer of returns from initial participants to later participants. We believe that this is mitigated in large part by the value of a “smooth ride” for even the first generation of participants, akin to a much more expensive annuity product—albeit without the contractual guarantee—and the fact that the sacrifice in returns compared to what participants would earn in a TDF is rather small. The average expected replacement rate of 22.4% for the first generation in the Pooled IRA is only slightly lower than the 24.2% expected from the TDF.

**3. The Pooled IRA fund option has never been implemented. Yet clearly this option entails Board fiduciary duties analogous to board duties at CalPERS and CalSTRS, with respect to investment policy and allocation decisions:**

**Response:** While the fiduciary duties may be more substantial with the Pooled IRA than with a TDF, we believe that the Board’s fiduciary duties with respect to the Pooled IRA will be far below the level exercised by the CalSTRS and CalPERS boards, for reasons explained below.

Traditional defined benefit (DB) plans have to solve for liabilities arising from contractually promised lifetime benefits based on final salary and years of service. This entails a complex set of calculations involving expected returns and discount rates based on asset allocation, and actuarial assumptions regarding workforce turnover, tenure, longevity, and pensionable pay. In traditional DB plans, asset allocation ultimately

functions as a lever with which to balance plan cost and financial risk to the plan sponsor. Even in a cash balance DB plan, the sponsor is explicitly liable for promised benefits—expressed in lump sum rather than retirement income terms—and makes asset allocation decisions accordingly.

In contrast, the Pooled IRA involves making an initial decision to set the asset allocation policy and then establishing and following fixed rules by which to: credit participants past investment returns on their contributions, set aside reserves, and allocate credits from the reserve when investment returns are poor. Unlike a DB plan, there is no financial risk or liability to the plan sponsor for participant benefits under a Pooled IRA arrangement.

Fundamentally, the Pooled IRA is a defined contribution (DC) plan in which benefits are ultimately contingent on employee contributions and investment returns. The main difference between the Pooled IRA and a conventional DC plan is that investment returns are somewhat smoothed over time and across cohorts of participants, rather than purely individualized according to market timing.

While the Board needs to exercise discretion with respect to Pooled IRA asset allocation policy, the level of fiduciary burden here is not dissimilar to the one that the Board would face in setting the default risk level for a default Target Date investment strategy. It should be stressed that even if the Board were to choose an off-the-shelf mutual fund, the Board would still retain fiduciary responsibility over asset allocation by virtue of the fact that participants are being defaulted into the fund.

*If the Pooled IRA option is selected, what would be the estimated cost to hire a consultant to conduct the asset allocation study? Assuming this work would continue throughout the life of this program, should this cost be projected annually?*

**Response:** The Pooled IRA should not entail substantially more monitoring of asset allocation than a Target Date investment strategy. In both cases, the Board should review capital market assumptions and perhaps fine-tune the asset allocation from time to time, with the aid of an investment consultant and actuary. In addition, the Pooled IRA involves monitoring a single fund, as opposed to multiple funds in a TDF series. Therefore, there should be no difference in consulting costs across the two approaches.

Before the program launches, however, some extra actuarial work will be required to ensure that the Pooled IRA crediting policy is well-calibrated to its investment policy. For instance, if the Board chooses to implement a less risky portfolio than the one we modeled in our study, the actuarial consultant should model outcomes to ascertain whether the crediting rate policy should also be adjusted. This work adds an incremental layer of complexity to the standard Monte Carlo simulations that should be run for any California Secure Choice default investment product.

In our study we have budgeted US \$350,000 for investment consultants in the first year of operation and \$250,000 thereafter, for both the TDF and the Pooled IRA options. In the case of the TDF, the incremental US \$100,000 in the first year would go towards fine-tuning glidepaths and product creation and selection. In the case of the Pooled IRA, the same amount would go towards actuarial analysis and establishing the crediting policy. The annually recurring US \$250,000 covers standard investment consulting activities such as monitoring investments and reviewing the investment policy.

*Given the pooled nature of the investment program for the Pooled IRA, would the Board incur additional ongoing (annual) consultant costs analogous to those incurred by the State's pension funds to oversee and help inform the Board of investment performance, investment options, and any legislative directives on divestment?*

**Response:** The short answer is no, but this requires action by the Board to insulate its investment policy regardless of whether the default investment is a TDF or Pooled IRA. The Pooled IRA is still a DC plan. Moreover, investments are pooled in both the TDF and Pooled IRA options. Insofar as the innovative feature of shared investment risk among participants distinguishes the Pooled IRA from a typical DC product, it behooves the Board to carefully delineate its investment policy in a way that insulates it from the kinds of political demands and related costs faced by CalSTRS and CalPERS, and in a manner that parallels the responsibilities of California Savings Plus in managing its proprietary mutual funds for state employees.

Ultimately, we highly recommend setting an investment policy that relies extensively on passive investment strategies. This recommendation applies whether the Board chooses a Target Date investment strategy or the Pooled IRA option, or a custom fund series versus an off-the-shelf fund series. In general, we discourage the Program from engaging in the kind of active investment management practiced by state pension plans. However, we note that for certain asset classes—small cap equities and emerging market equities—active management may produce superior returns. These asset classes may make up approximately 10% of the California Secure Choice portfolio, and the Board should carefully weigh the potential cost of opening up the door to political influence on investment policy against the benefits of active management for these asset classes.

The Board should seriously consider whether codifying a passive management approach in statute or in governmental regulations will help alleviate its investment management burden and, importantly, insulate its investment policy from political influence—and make recommendations to the Legislature accordingly.

**Lastly, I would greatly appreciate an estimated cost comparison of the likely annual consultant, fiduciary counsel, and investment management fees, broken out by service provided, of a pooled program, so all of the costs of the pooled IRA option are identified clearly.**

**Response:** We broke down and explained the annual consultant budget in the last paragraph of the second response under Question 3 above.

With regard to counsel and legal fees, we have budgeted for the second year of operation and thereafter a recurring US \$250,000 in external legal fees, in line with the California Savings Plus budget. Additionally, the cost of in-house legal counsel is built into the internal staff budget. For the first year of operation, we have budgeted US \$500,000 of external legal services in the case of the Target Date investment strategy and an additional US \$1 million for Pooled IRA option. The higher cost of the Pooled IRA option relates to the creation or adaptation of the special purpose legal entity and the issuance of the Secure Choice bonds.

As far as investment management fees are concerned, we have budgeted 18 bps on assets under management. The fees for both options should be comparable because assets are pooled in both cases. Furthermore, given the expected size of the asset base (e.g., US \$1.6 billion in year 1) and the likely reliance on passive investment strategies for a significant part of the investment portfolios, the low fees that we have budgeted are attainable.