



GABRIEL, ROEDER, SMITH & COMPANY
CONSULTANTS & ACTUARIES

One Towne Square • Suite 800 • Southfield, Michigan 48076 • 248-799-9000 • 800-521-0498 fax 248-799-9020

March 17, 2003

Mr. Stephen L. Nesbitt
Senior Managing Director
Wilshire Associates, Inc.
1299 Ocean Avenue, Suite 700
Santa Monica, CA 90401

Re: 2003 Wilshire Report on State Retirement Systems:
Funding Levels and Asset Allocations

Dear Mr. Nesbitt:

As we did in response to Wilshire's 2002 report, we are writing to express our concerns regarding certain conclusions drawn in the 2003 Wilshire Report on State Retirement Systems. Between us, the authors of this letter have over 50 years of experience in researching, advising, and actuarially valuing state and local retirement plans. Although we are pleased that Wilshire's 2003 report has been expanded to better show the distribution of system funding, we still believe the report's alarmist tone, selective use of statistics, and use of technical terms without better explanation paints a misleading picture of state and state teacher retirement plan funding. Our specific concerns regarding the report follow:

- 1) It is stated in the report that 79% of state retirement systems are currently "underfunded"; however nowhere in the report is the term explained. When people outside the pension profession hear the term "underfunded" they are likely to assume the plan does not have the assets required to pay current benefits or that actuarially determined contributions have not been made. Many people fail to understand that pension funding is intended to be carried out over a long period of time. "Unfunded" accrued liabilities are usually amortized over 20 to 30 years, in a manner similar to paying off a mortgage. However, this is not discussed in your 2003 report or in your earlier reports.
- 2) Using the funding ratio calculations shown in Appendix B, the distribution of funding ratios for the systems studied is as follows:
 - 46% of the systems had funding ratios of 90% or higher;
 - 69% had funding ratios of 80% or higher;
 - 86% had funding ratios of 70% or higher;
 - 14% had funding ratios below 70%; and,
 - Only 3 (2%) had funding ratios below 50%.

While the equity market's three-year decline has negatively affected governmental retirement systems along with virtually all other investors, we do not believe the funding ratios shown above reflect the dire financial condition suggested by your report. As we pointed out in our earlier letter, if the vast

Gabriel, Roeder, Smith & Company

majority of U.S. homeowners had paid off 80% of their mortgages and had another 20 years to pay off the remainder, it would be cause for celebration rather than concern.

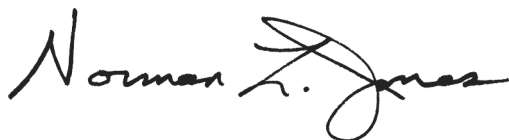
- 3) The general goal of actuarial funding is to accumulate monies in a systematic manner so that contributions can remain reasonably stable over time and plans can take advantage of investment returns that are typical of financial markets. This is true for both corporate and governmental defined benefit retirement plans. As such, the methods employed are designed to reduce the impact of short-term market fluctuations in plan contribution rate determinations through the use of long-term assumptions and asset smoothing methods. As we stated in our 2002 letter, the actuarial approaches used by state plans to fund retirement benefits have worked out well over the last two decades, saving taxpayers almost two trillion dollars. According to data reported by the U.S. Bureau of Census, state and local governmental retirement plan investment earnings amounted to \$1.7 trillion between 1982 and June 2001. These are monies that would otherwise have to be contributed by state and local taxpayers.
- 4) Certain data in the report are represented as being indicative of trends. However, it appears that the trend statistics are not based on the same sets of retirement systems from year to year. In the absence of statistics based on the same sets of systems, it is not possible to determine the degree to which the reported trends result from differences stemming simply from changes in the number and types of systems being studied. As is noted in the 2003 report, the number of systems studied increased from 93 in 2002 to 123 in 2003. The addition of 30 systems might well account for significant changes in average funding ratios between the 2002 and 2003 studies, as well as increases in liabilities. Without a methodology based on the same sets of systems, year-to-year trends cannot be isolated from changes attributable to changes in the sets of systems studied.
- 5) Instead of using the actuarial value of assets to calculate funding ratios, the market value of assets was used in preparing your report. This approach amplifies the effect of market declines on funding ratios, and does not reflect standard, well-reasoned, practice. Most governmental systems value assets for actuarial purposes in a way that smoothes short-term market fluctuations over a three-year to five-year period. This approach reduces the effect of market volatility and helps to stabilize contribution rates. As a result, the funding ratios reported by Wilshire tend to be lower than those calculated using standards of actuarial practice and reported in the systems' financial statements as required by the Governmental Accounting Standards Board.
- 6) The report criticizes assumed investment returns used in the systems' actuarial valuations, which average 8.0%, and forecasts that future return on state pension assets will more likely be 7.5% (up from 7.1% in the 2002 Wilshire report). To obtain this projection of future returns, the report assumed an 8.0% long-term annual rate of return on U.S. equities. However, according to Ibbotson Associates' *Stocks, Bonds, Bills, and Inflation 2002 Yearbook*, the standard reference on investment returns, the average annual return from 1926 through 2001 has been 10.7% for U.S. large company stocks, and 12.5% for U.S. small company stocks. Keeping all else equal and substituting a 10% return for the 8% used in the report for U.S. equities, the overall long-term expected return on state pension assets would be 7.9%, conforming closely to the average actuarial assumptions currently used.
- 7) The report also does not indicate the period over which Wilshire expects 7.5% returns. Pension fund economic assumptions are based on very long term expectations (30 or more years). Long-term assumptions are generally neither increased nor decreased when shorter-term expectations are higher or lower. Furthermore, even if 7.5% returns were to prevail for several years, it may well be in a low inflation environment. If this should turn out to be the case, actuarial asset losses would be largely offset by liability gains as wages and salaries rise at lower than assumed rates.

- 8) In the case of at least one retirement system, the expected return shown in Appendix G is 200 basis points lower than the capital market expectation provided by the system's investment consultant. According to the system's Executive Director, this is due to changes in asset allocations begun in 2001 and which progressed through calendar year 2002. State retirement systems review their allocations on an ongoing basis and adjust them to reflect long-term market expectations. Often these adjustments are implemented over a period of time. Consequently, the asset allocations presented in the report may well be in the process of change. However, the report presents them as being essentially static.

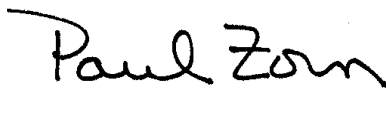
We acknowledge that the equity market's three-year decline has negatively affected governmental retirement systems and it is likely that contribution rates will increase. Plan sponsors and plan members will have to work together to ensure the long-term soundness of their systems. However, even with the market downturn, the benefits offered through the systems remain secure. This is not the case with defined contribution plans, where many participants have seen 40 percent to 60 percent declines in their account balances. Moreover, the fact that governmental employers and taxpayers have benefited substantially as a result of the excellent market returns from 1985 to 2000 supports the continued use of defined benefit plans as vehicles for retirement benefit funding.

As we concluded in our letter regarding the 2002 Wilshire report, we believe the new report contains valuable information that could be useful to the pension and investment community. However, the overall tone of the report is unduly alarmist. By not explaining the basic principles of retirement plan funding and by focusing on near-term rather than long-term expectations, the report paints an incomplete picture of state retirement systems' financial health. Consequently, its findings can be easily interpreted as suggesting the plans are in dire financial condition – as was reported by the Washington Post and Chicago Sun-Times shortly after the report's release. This is not the case. We continue to call your attention to issues we think are important and encourage you to consider our observations when preparing any similar prospective reports on this subject.

Sincerely,



Norman L. Jones, F.S.A.
President & Chief Actuary



Paul Zorn
Director of Governmental Research

CC: National Association of State Retirement Administrators
National Council on Teacher Retirement
National Conference of Public Employee Retirement Systems
Government Finance Officers Association