



**NEW JERSEY STATE INVESTMENT COUNCIL PRESENTATION –
DECEMBER 8, 2011**

Learned members of the NJ State Investment Council:
Thank you for the opportunity to speak at this meeting.

I am Frank J. Abella, Jr., Chief Executive Officer and Founder of Investment Partners Asset Management, an SEC registered investment advisory firm located in Metuchen, NJ and Williamsburg, VA.

I appear before you today because of questions posed by my clients who are covered by the pension funds for whom you act as fiduciaries - teachers, state police, local police, judges and state and municipal employees. Some are retired; others are planning for their retirements.

Their principal question is: “how safe and secure are my pension and benefit plans? In short, can I expect to retire without any modification in the amounts expected?” In years gone by it might have been easy to answer their concerns by saying, “of course your pensions are safe - the system is solvent the plans are large enough, the assets are diversified and conservatively managed and the State’s finances are strong.”

After 2008, I for one have had a gnawing suspicion that the answer should be “I am not sure.”

Our firm prides itself on conducting unbiased research and analysis. We feel that this question is all too important and requires due diligence on our part before reaching a conclusion. Sadly, after much study, I cannot assure my clients that their pensions are safe, that future benefits will not be cut, or that the plan is solvent.

In fact, what becomes painfully obvious is that, in spite of recent reforms, the unfunded liabilities are growing faster than the contributed assets and the expected return on investment in the plans. The strategic gap results from assumptions about a growth in assets from increased contributions from the state and/or employees coupled with substantial significant outpaced investment returns. For decades, the pension assets could be invested in such a way that a portfolio could be concentrated in bonds of various issuers,

including sovereign debt with predictable yields and equity investments representative of underlying growth of the US and global economy.

The growth in assets historically was sufficient to match or exceed the increase in actuarial liabilities. The assumption was that assets could be allocated in such a way that a low risk strategy could be pursued and sufficient predictable income coupled with normal capital appreciation would at least match gross distributions from the plan.

Fast forward to today's yield-starved environment. It seems clear that the growth rate of capital deployed would have to be accelerated to just match the annual gross distributions. It would appear that this mathematical reality is, in part the impetus for the Council's policy shift to greater reliance on annual returns from a portfolio which depends heavily on equities and alternative investments.

This policy can best be described as the pursuit of higher reward with greater risk. This pursuit is explainable only partially because of the low interest environment. In spite of Governor Christie's major triumph in getting the legislation passed requiring most government workers to pay more toward their pension and health care insurance, as well as raising the retirement age for many from 62 to 65 and suspending the cost-of-living adjustments for those workers already collecting a pension, the amount of inflows to the plan do not appear to match the annual gross outflows.

I have found that pension fund recipients for the most part, are largely uninformed, hence ignorant, (not greedy, which is the way they have often been portrayed.) They are ignorant because they have been misguided by governments at all levels, the Federal Reserve and financial advisors in general. While less informed they are not stupid. Innately, pension plan participants know that the plans have been underfunded and that reformation is necessary.

In return for grudging acceptance, they have been promised and indeed are expecting that their pensions are assured, constitutionally mandated and court protected. Those that are better informed know that the basis for their expectations remains uncertain. To eliminate the unfunded liabilities near term is nearly mathematically impossible. Politicians know it. Legislators

know it. The informed public feels it. This year's reform appears to be just the beginning of a much needed trend, a politically necessary first step.

Those who don't know it are the citizens of New Jersey - the 90% in the private sector who likely will be called upon to pay significantly higher taxes in the future for the benefit of the roughly 770,000 members covered by the State's pension and benefit plans.

The question before the Council today is: *Does the New Jersey State Investment Council know it?* In short, what part does the expectation of the need for future contributions by State and pension participants play in determining the need for a higher-risk investment policy?

Before we get an answer to that question, I am assuming the Council has conducted studies that give confidence in the assumption that an 8.25% compound annual investment return is achievable for the foreseeable future.

Does the Council feel that if the investment returns do not match the 8.25% expectation that the State will make up the difference out of the annual budget? If the answer is "yes, the State, hence the taxpayers, will come to the rescue," is there any intention to share this belief with the citizenry?

Does the Council feel comfortable with the use of actuarial government-level accounting in determining the level of underfunding of the State's plans?

Those who have recently studied New Jersey's predicament have weighed in on the underfunding issue. For the past few years, research has been conducted by no less than:

- the Pew Center on the States, a division of the Pew Charitable Trusts,
- the Hall Institute of Public Policy,
- the Cato Institute,
- the Kellogg School of Management at Northwestern University,
- the Bloustein School of Planning and Public Policy at Rutgers,
- New Jersey Policy Perspective,
- and last, but by no means least, the comprehensive work of Eileen Norcross at the Mercatus Center at George Mason University.

Virtually all have concluded that the State's pension liabilities are grossly understated. Indeed, Mercatus concludes that the difference between what the plans have promised to pay public workers and the assets set aside to pay out these benefits is likely growing geometrically.

To quote from the working paper "**The Crisis in Public Sector Pension Plans: A Blueprint for Reform in New Jersey**" co-authored by Eileen Norcross and Andrew Biggs, "The ability of governments to pay for the retirement benefits promised to the public sector workers runs up against the reality of limited resources."

In New Jersey's case, it appears that, in spite of recent reforms, New Jersey has, for now, sidestepped the issue. Using 2008 data, the state reported that the pension system was underfunded by \$44.7 billion when the liabilities are discounted at the 8.25% annualized rate that New Jersey predicts it can achieve on the investment portfolio. However, since the enactment of quantitative easing measures by the Federal Reserve including the more recent adoption of a zero interest rate policy until at least mid 2013, the amount of underfunding, using the 2.5% current yield on 15 year Treasury obligations, rises to over \$200 billion, roughly 500% of New Jersey's total debt and over 35% of the Gross State Product. At that rate, the plans could run out of assets by 2019. If the returns are less than 8%, the plans will be insolvent sooner. If, as has been the case so far in 2011, the net assets of the pension fund decline, the day of reckoning will be sooner yet. According to Joshua Rauh as reported in the National Bureau of Economic Research, the actuaries estimate that under certain assumptions, the plans could be insolvent as early as 2013.

Let me circle back to my question to the Council. Has the State Investment Council known what those studies have suggested?

To what degree has the massive underfunding arrived at by utilizing conventional generally acceptable accounting principles instead of Government accounting influenced the Council to enact a policy of taking on more risk by allocating over 30% of the assets to equities and 38% to alternate investments including hedge funds and private equity?

I hope to get an answer to these questions so that I might be in a better position to address my clients' concerns of how safe, secure and reliable their pensions are.

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