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NEW JERSEY STATE INVESTMENT COUNCIL PRESENTATION

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Learned members of the NJ State Investment Council:

Thank you for the opportunity to speak at this meeting.

I am Frank J. Abella, Jr., Founder and Chief Executive Officer of Investment Partners Asset Management, an SEC Registered Investment Advisory firm, located in Metuchen, NJ. I am also Co-founder of Community Informatics Inc., a firm engaged in data collection and analysis of New-Jersey-oriented government and public-sector data including defined benefit pension plans. I am a 79-year-old, life-long, tax-paying resident of the State with fifty years of professional investment experience.

I have made presentations and commented before the Council on at least three separate occasions in the past six years. As a constant attendee, I have been present at all but three Council public meetings over that time. You may ask: why am I here and why do I care? I am not a municipal or state employee, educator, judge, fireman, or policeman - nor a member of any union.

There are three reasons: 1) to gain a greater understanding of how my New Jersey clients who work in the public sector or have retired from the State are affected by shortfalls in the pension system; 2) to help those clients individually to understand that, without reform, there are serious risks to their retirement plans; and 3) to share my observations and the results of our firm's research and analysis of state and local pensions with the Council and the tax paying public.

Additionally, I believe I have gained an appreciation of how the State's investment process; portfolio construction, asset allocation, and risk analysis are conducted as well as an understanding of the role highly paid consultants, actuaries, hedge fund and private equity sponsors all play in the pension fund industry in general, and the State Pension Fund in particular.

So, I am here today to share some observations and to offer suggestions to the Council in areas that call for improvement in both process and execution. It is my purpose to propose policy solutions that, if pursued, could have meaningful positive financial impact.

Anyone who knows me is aware that I am not reticent when it comes to offering constructive advice where there are complex issues and challenges.

My motivation and efforts have led to the formation of Community Informatics, whose purpose is to have decision makers make better choices utilizing data science techniques within an analytical framework.

What I have learned over the years is that economic reality sometimes has a difficult time surviving in a politically-charged environment. This is particularly true when there is little consensus and understanding of the magnitude of current and future liabilities, the true value of plan assets, reliability of contributions from employees and employers, confidence in income projections, and an assessment of opportunities and risks in growing pension fund assets.

We all read the newspapers and learn from the media that New Jersey has financial difficulties. Some of us realize that the situation has reached crisis proportions. The Governor has one view, the Senate President and the Legislature have another.

Shocking! No. Divisive? Yes.

There are few other words to describe the behavior of elected leaders as they face the reality that we are in multiple crises in this State. The State, financially, is in dire straits and everyone knows this is serious.

However, not everyone in the electorate appreciates yet that necessary reforms will mean joint sacrifices.

Bipartisan Members of the Legislature, with Sub Committees from the Bloustein School of Public Policy at Rutgers University and Non-Legislative Members with diverse backgrounds formed a workgroup (the New Jersey Economic & Fiscal Policy Workgroup) to study five issues, one of which is the need for Pension and Benefit reform. The Group’s report entitled **Path to Progress** was issued in early August 2018.

The Group makes claims based on irrefutable factual data and sound analysis. The Public Pension Plan and other Benefit program liabilities are 400% of the State's Annual Budget, and three times the size of the State's bonded indebtedness.

Further, they point out that over the next four years the cost of Pensions and Benefits will rise by over $4 billion, and annually will eat up 26% of the forecasted State Budget.

I may add, under the most liberal assumptions, tax receipts are expected to grow uninterruptedly by 3.5% per year on average between now and 2024. There does not appear to be any provision or anticipation of what happens if the economy goes into recession.

In point of fact, the **Path to Progress Report**, using the State's own preliminary budget projections see a cumulative funding deficit of $6.1 billion over the same five year period under moderate revenue growth projections, and appropriations under current service needs.

This report comes on the heels of the December 2017 **New Jersey Pension and Health Benefit Commission Report** better known as the Byrne-Healy report.

The Commission was formed in August 2014 because it was felt that pension and health benefit costs were at the center of a budget crisis that threatened not only the continued availability of these benefits, but the State's fiscal health and the property taxes of every State homeowner. The Report concludes with the thought that all parties have to accept the reality that the current situation is untenable and that change is necessary *now*. It also states that the public needs to be better informed and that elected officials should be held accountable for producing a workable solution.

The media has focused on the unfunded lability side of the balance sheet, while a lot less attention seems to have been directed toward the asset side. In spite of being terribly understaffed, the Division of Investment Management, with approximately 60 people and a $12 million budget, has done an outstanding job in growing the assets with average annual growth rates in excess of 7.2% over the past twenty years. It should also be noted that past Councils have prescribed and adopted policies that were contributory to that growth. What past Councils have not done until the last two years is publicly acknowledge the depth of the liability problem and take greater care to risk mitigate the portfolio. They have, however, with the encouragement of the Council's union representatives, lowered fees. In my opinion there is still much work to do on the fee problem.

In spite of all this good performance, the monthly outflows to retirees are approaching $1 billion per month, far out-pacing inflows from dividend and interest income and realized capital gains. Sadly, the upsweep in values from unrealized appreciation of the portfolio, along with contributions from employees, is insufficient to fill the funding gap without the actuarially computed full contribution from the State and additional contributions from current employees.

With that in mind, the principal question that my clients and taxpayers voice is "How safe and secure are the pension and benefit plans?" As a fiduciary, I am compelled to answer the question forthrightly and honestly.

Based on our research, our assessment for many of the future retirees, no matter how pension assets are currently allocated and invested, is that they should not rely on, nor expect to enjoy, the same benefits as current retirees.

When I appeared before you in December 2011 and again in July 2015, the short answer to that question was that the pensions are safe for those who were retired because they are court-protected contractual obligations, constitutionally mandated. Today, I am not 100% confident that in an economic crisis, pension payments could not be reduced. Likely, pre-retirees, those working under age 55, should expect modification to the timing and amounts they could expect as the plans are reformed.

Without reform there is no question that, mathematically, the plans cannot remain solvent. That is the reality. Period. There is no sense sugar coating it. So what can you, as the Council, do to improve outcomes on the asset side of the balance sheet?

Ten Actions that the Pension Council Should Consider.

One: Don't be silent, weigh in on the debate, and recognize that asset allocation should be predicated on dealing with political as well as economic uncertainty. Risk mitigation strategies should be developed and acted upon.

Two: Structure the portfolio with the assumption that either a 'hard landing' transition to a defined contribution plan, as recommended by the Byrne-Healy Commission, or a 'soft landing' by creation of a hybrid plan as suggested by the Economic and Policy Workshop, will happen.

Three: Keep a greater percentage of the portfolio assets as liquid as possible – no new investments in alternative assets such as private equity or hedge funds - until the uncertainty of reform is dealt with by the Legislature and the State.

Four: Consider utilizing passive investments in ETFs and Index Funds as well as actively managed low cost mutual funds. Undertake the task of building historically back-tested models in designing portfolios.

Five: Bolster the capabilities of the NJ Division of Investment Management by petitioning the Treasury to add a minimum of ten additional employees immediately. Two of the new hires should be data scientists.

Six: Begin to make changes to the investment process using data feeds and analytics to test hypotheses with the goal of making better informed decisions.

Seven: Cut down the expenses of high yield, small cap and emerging market advisors and outside consultants by at least $15 million over the next three years.

Eight: Establish an incentive compensation program for employees in the Division of Investment Management as a means of rewarding performance, and stemming the tide of staff out-migration to the private sector.

Nine: Build a process of better oversight of existing illiquid investments, particularly private equity and hedge funds, with attention to ongoing annual as well as performance fees. Report findings to an Audit Committee composed of at least three Council members with accounting experience.

Ten: Provide the public with better written communication of portfolio results at each meeting similar in form and content to reporting from publicly traded mutual funds.

Three Actions that the Individual Members of the Council Should Consider:

One: Become better informed about the issues

Two: Be more visible and outspoken at meetings in your home towns and places where pension fund beneficiaries congregate, or where academicians are discussing benefit program issues.

Three: Accept the Challenges and don't give up hope.
You can make a difference.

In conclusion, we all need to be invested in finding a sensible solution to the vexing problem of the underfunded pension plan. There should be only one view: preserving benefits earned to date, and creating a new plan which does not crowd out other budget priorities nor creates a greater burden on the citizen tax payers of New Jersey.