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To the Members of the Committee:

Texas AFT is writing with regards to Interim Charge 4 for the Texas House's Pensions, Investments, and Financial Services Committee.

**Interim Charge 4: Review and evaluate the actuarial soundness of the Employees Retirement System and TRS pension funds. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the funds. Examine the effect the unfunded liabilities could have on the state's credit. Examine the state's investment policies and practices, including investment objectives, targets, disclosure policies, and transparency.**

In 1936 voters approved an amendment to the Constitution of Texas creating a statewide teacher retirement system (TRS). They recognized the value of providing services and benefits to public school teachers and administrators across the state. In the last 84 years the membership and responsibilities of the system have grown to cover 1.6 million active and retired public school employees, including those in higher education. TRS has become the largest public pension system in Texas, and one of the largest in the country with more than $158 billion in assets, allowing the fund to be competitive in global markets. TRS is a stabilizing force for retirees and for the state's economy, and as a defined benefit system it has ensured public school employees are able to plan for their future and meet their basic needs during retirement. TRS being a defined benefit system has also meant that its participants are better able to weather economic storms, such as the one we are currently in with COVID-19, as compared to Texans relying on 401(k) type plans. This is important at a time where many communities have been hit hard by shutdowns, businesses are struggling to stay open, and thousands of Texans are facing financial hardship.

## Educators Rely on the Legislature as they Retire

Last session, the Legislature made much-needed investments in TRS to ensure it remained actuarially sound. Texas educators are relieved the fund is healthy. TRS reported a funded ratio of 76.4%, just shy of the theoretical gold standard of a funded ratio of 80%, but still higher than the average U.S. public pension fund funded ratio of 69%. The average TRS retiree receives

$2,000 a month, and for the vast majority this is the only income they have to rely on, as most school districts do not pay into social security.

The 13th check retirees received last year helped provide some temporary relief, however it did not make up for decades of not receiving a cost of living adjustment (COLA). Without a permanent COLA many of our retirees will find their buying power depleted as they age, and too many are already living close to the poverty line. Lawmakers must honor the commitments they made to TRS last session to keep the pension system healthy and ensure that Texas is in a position to do more for our retirees as the economic outlook in the state improves. To do this, it is critical that the state maintain the funding and in SB 12.

While the pension fund is sustained primarily by TRS member contributions during their working careers, state contributions, and investment revenues, the state's investment is the fund's most stable source of revenue. With a fluctuating work force, there is only so much local school districts and employees can put into the system before it becomes financially burdensome. Any reduction in the state contribution rate will have a domino effect on the employer and employee contribution rates that could impact the fund's health and will increase the unfunded actuarial accrued liability leading to a longer amortization period. This would risk undoing all the positive gains made during the last legislative session.

## Transparency is Needed for Long-term Success and Preparedness

TRS has a top-rated investment team that have done tremendous work to bring in returns. However, markets can be unpredictable, and TRS' reliance on alternative investments has grown exponentially since 2008. These alternative investments, including hedge funds and private equity funds, make higher gains on investments possible but they also bring greater market risk and higher fees. These investments also come with more barriers to transparency so that it may be harder to assess what TRS is truly getting for their money. The true value of private equity assets often cannot be calculated until after they have been liquidated which may not happen for years or decades. TRS' has received high praise for its investment strategies and fund management by outside evaluators, but it still faces challenges. TRS' average return on investments over the past 5 years has been 6.7% with 8% having been the goal for 4 of those years according to Public Plan Data. Also, over the last 5 years TRS has continued to accumulate unfunded liabilities and the 2019 actuarial valuation estimates that these will continue to increase for the next 10 years before going down. However, if assumptions are met and payroll grows as expected (3.00% per year), then the contributions provided at the increased contribution rate pattern are sufficient to amortize the current unfunded actuarial accrued liability of the system in 29 years. This is good news for the fund, for Texas, and the state's retired teachers as it means costs for managing the fund will decrease over time and TRS will be in an even better position to serve its members.

The Legislature can help safeguard the fund's health by supporting the Sunset Commission's recommendation in its staff report that TRS needs greater oversight of its investments. The Sunset report found:

- TRS could reduce risks in its investment accounting by using a fully independent or automated system to better identify accounting inconsistencies.

- The agency lacks a formalized process for reviewing internal investments.
- TRS should provide stakeholder-friendly information about alternative investments in its Comprehensive Annual Financial Report.

To reflect on the final bullet more thoroughly-TRS and its membership would benefit from publishing its alternative investment holdings in a way that is more user friendly for stakeholders to review than is currently available. TRS should have the capability of sharing the following:

- The name of each vehicle
- When the investment was made
- The amount of capital committed
- The amount of capital contributed
- The Amount of The Capital Distributed
- A measure of the annualized return on capital invested
- Any fees paid in association with the investment as a percentage of the investment

Transparency in this way has been achieved by other state pension systems, such as the California State Teachers' Retirement System, which periodically published a list of these investments. TRS is already making great efforts to address transparency concerns identified by the Sunset Staff report through the TRS Compliance division. Legislation and support by the state would aid TRS in fulfilling the recommendations made by the Sunset Staff and ensure long-term transparency.

Such transparency around TRS' investments may help in identifying areas where small improvements or changes can be made that lead to better outcomes for the system, particularly in the case of alternative investments. Alternative investments, which are common among pension systems in the U.S make up about 21% of TRS' total portfolio. This is a similar ratio to many of TRS' national peers.

| Fund | Assets under management* | % of portfolio invested in alternatives* |
|---|---|---|
| **Florida State Board of Administration** | $206 billion | 13% |
| **State of Wisconsin Investment Board** | $110 billion | 13% |
| **Ohio Public Employees' Retirement System** | $103 billion | 21% |
| **Texas TRS** | $177 billion | 21% |
| **New York State Common Retirement Fund** | $222 billion | 34% |

In 2019, TRS spent $779 million just in fees on alternative investments. While TRS' spending on fees for its alternative investments is about average at 1.2%, it's important that Texas lead in this area. 1.2% in fees may appear a small sum in relation to the total investment portfolio, but every dollar spent on fees is a dollar not going back into the fund benefitting members directly. Some pension funds have been able to reduce alternative investment fees through negotiations with hedge fund managers. For example, in 2016 the New Jersey Pension Fund cut its hedge fund fee structure in half, and reports that nearly all hedge fund managers with which the pension fund does business agreed to these terms. If TRS were to reduce its fee structure by half the fund could see savings of $368 million in the first year and more than $34.8 billion over 30 years. It is understood that these are not apple to apple comparisons but given the size of TRS even a small reduction in fees could mean significant future savings.

## Commitment to Our Public Pensions Now is Commenting to Our Public School Employees' Futures

In many ways we have been fortunate that markets have rebounded faster than in previous recessions and are not reflecting the degree to which our economy has been hurting. As a result, pensions overall are still faring far better than other forms of retirement investments found in the private sector. That said, it would be prudent to be mindful of the realities and limitations our pensions face and to provide support that enables us to live up to our promises to school employees who have devoted their lives and their careers to the children of this great state.

Thank you for the opportunity to provide feedback on this charge.