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Local & business

State pension fund rockets to record 26.2% 1-year return

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Hawaii's largest public pension fund, which has been playing catch-up to dig out of a $14.6 billion shortfall, has achieved what is believed to be the best fiscal-year performance in its 95-year history.

The state Employees' Retirement System, which provides benefits to more than 148,000 members and beneficiaries, posted a 26.2% investment return for the fiscal year that ended June 30 as its assets climbed to a record $21.4 billion, according to a new quarterly report presented to ERS trustees by investment adviser Meketa Investment Group.

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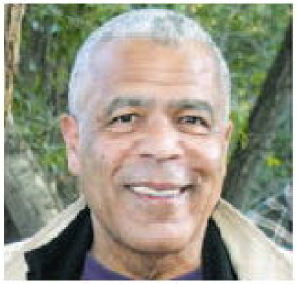
>
> **Thom Williams**
> *Executive director, Employees' Retirement System*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"We will celebrate our achievements this year, but only for a moment," ERS Executive Director Thom Williams said in an email. "There is always uncertainty ahead. I always stress that we are focused on the long term and the investment challenges we face have not abated; in fact, they have grown. The global investment landscape is more complex than ever, making it critical that we have access to the tools and talent needed in order to keep up, but more importantly, to excel."

The ERS fund was established by the state Legislature in 1925 and became effective in 1926. Williams said there have been several custodial banks for the fund over the years and each

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kept its own records. He said its current custodian, Bank of New York Mellon, has records that go back 27 years to 1994.

"But I think it is safe to say that our team has produced the highest one-year investment return in the history of the fund," Williams said. "While overall market direction has played an important and meaningful role in our results, the primary return attribution, at least from my perspective, goes to our investment team. This highly skilled group of investment professionals has constructed a diverse portfolio of assets and has selected from amongst the very best investment managers and opportunities globally available."

The ERS fund capped off the fiscal year with a 5.6% gain in the April-June quarter amid a challenging 12 months plagued by the devastating COVID-19 pandemic and resulting economic uncertainty. The fund outperformed its policy benchmark over the trailing one-, two-, five- and 10-year periods as well as the most recent quarter. The benchmark is a composite of various market-sector returns that are meant to emulate the investments in the ERS portfolio.

The portfolio, however, trailed the median public fund with assets greater than $1 billion over all the aforementioned time periods. The ERS has structured its risk-focused portfolio so that it outperforms its peer funds during market sell-offs and underperforms them in bull markets.

The fund's $885 million asset increase in the April-June quarter from the previous quarter includes a cumulative outflow of $247 million that was primarily used to pay benefits to beneficiaries and, to a lesser degree, administrative expenses.

The fund's private growth category, which purchases higher-returning investments that rely on the private markets, jumped 11.4% in the April-June quarter to lead all segments in the ERS portfolio. Public growth, which includes global stocks and global bond and debt, rose 5.9% during the same period.

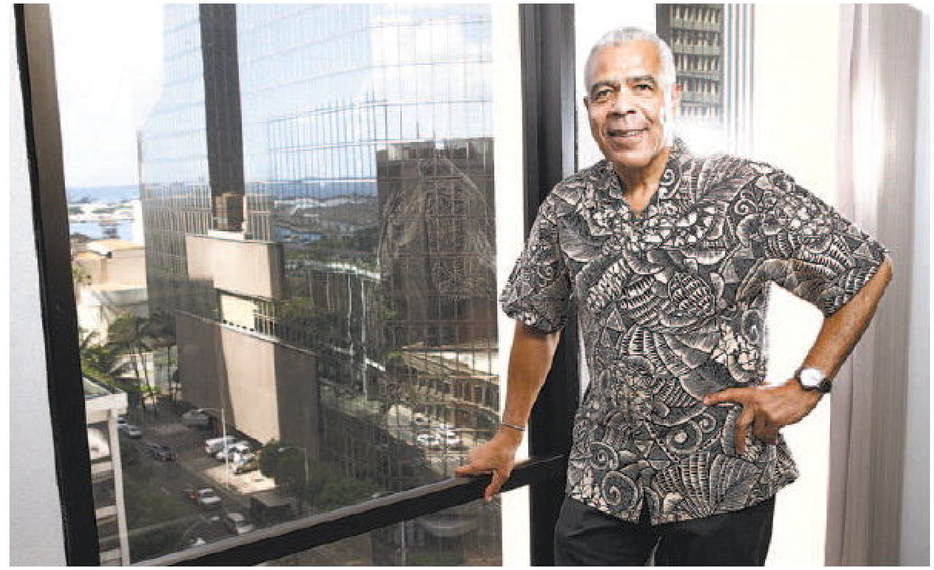
For the fiscal year, private growth soared 55.5% and public growth jumped 33.8%.

"We are well diversified across the portfolio so that our return is not contingent upon any one macro scenario," ERS Chief Investment Officer Elizabeth Burton said in an email. "We always believe in 'diversifying our diversifiers' and continue to evaluate investments across the platform that should perform positively in the event of rising rates but should not harm the portfolio if that does not materialize."

The ERS pension fund is not expected to be 100% funded until June 30, 2046, if all assumptions are met regarding contributions, an average annualized investment return of 7% and mortality expectations, according to the annual report for fiscal 2020 by independent auditor Gabriel Roeder Smith that was released at the beginning of this year.

The portfolio's funded ratio was 55.3% as of June 30, 2020. The annual report for fiscal year 2021 is not expected to be finalized until January.

Williams said the fiscal 2021 blockbuster return should reduce the number of years it will take for the fund to become 100% funded.



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Thom Williams took over as the executive director of the state Employees' Retirement System on Nov. 2, 2015. He is seen above at his office in the City Financial Tower in downtown Honolulu.

TRACKING THE MONEY

Hawaii Employees' Retirement System pension fund investments rose in fiscal 2021 from the previous fiscal year. The investment return does not correlate to the change in total assets due to benefit distributions and contributions.

FISCAL YEAR*	GAIN/ LOSS	TOTAL ASSETS	FISCAL YEAR	GAIN/ LOSS	TOTAL ASSETS
2021**	26.2%	$21.4B	2014	17.4%	$14.1B
2020	1.3%	$17.2B	2013	12.0%	$12.3B
2019	6.0%	$17.2B	2012	-0.6%	$11.3B
2018	7.9%	$16.6B	2011	20.7%	$11.6B
2017	13.9%	$15.7B	2010	11.7%	$9.8B
2016	-0.9%	$14.0B	2009	-18.7%	$8.8B
2015	4.0%	$14.4B	2008	-3.4%	$10.8B

* Fiscal year ends June 30 B = billion

** Fourth-quarter fiscal year return was 5.6%

Source: State of Hawaii Employees' Retirement System

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"I expect our funding level to increase from 55.3% to between 57% and 58%," he said in an email. "More importantly, I anticipate our period to full funding to decline between 2 and 3 years. Our unfunded liability will decline this year, for the first time in decades, years earlier than forecast. Original projections had our unfunded liability forecast to peak in 2026."

A new report from the nonprofit Pew Charitable Trusts, based on 2019 fiscal year data, found that pension systems for state government workers are in their best shape since the Great Recession began more than a dozen years ago. The report attributes the improvement to a booming stock market and states' longer-term steps that include boosting taxpayer contributions to public pension funds and reducing promised retirement benefits, particularly to newly hired workers.

Pew estimated that state retirement systems have enough assets to pay more than 80% of their obligations, the first time since 2008 they have been so well funded. South Dakota and Wisconsin had fully funded state pension systems at the end of fiscal year 2019, while Illinois and New Jersey's plans were slightly under 40%.

Hawaii, whose funded ratio is higher now than the data included in the report, was listed at 54.9% in the study.

In Hawaii, lawmakers passed legislation in 2017 to close funding shortfalls that were created partly due to existing unfunded liabilities, retirees living longer and lower projected investment returns. Those pension reforms included increased contributions from state and county employers, namely taxpayers, that are based on a percentage of an employee's pay. Those contributions were phased in over a four-year period for general workers and police and fire employees. The employees' contributions remained constant.

The new, higher employer rates were intended to remain constant once established. The higher payments will cut into the shortfall in future years.

Williams said the strong return in the fiscal year just ended will accelerate how soon it will take for the fund to meet its financial obligations.

"It is great to exceed investment forecasts, but what's more important is the impact that higher-than-expected returns have on the funding of our obligations," he said. "We have booked 3.5 years of expected future returns in a single year. Assuming investment returns hold and contributions continue at the current level, this improves our funding status and reduces the time it takes to amortize our unfunded liability by almost 3 years!"

Williams cautioned that the investment team can't get caught up with how the portfolio performed this past fiscal year.

"I don't expect a repeat of this year's spectacular returns," he said. "One could argue that we have pulled forward returns expected in future years. Assuming we globally get a handle on the spread of COVID, I expect solid, but nonspectacular growth in the year ahead. I am confident that the Fed will do all that it can to keep inflation in check."

"We are well diversified across the portfolio so that our return is not contingent upon any one macro scenario."

Elizabeth Burton
Chief investment officer, Employees' Retirement System

COURTESY PHOTO

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