Callan

May 10, 2019

Oregon Public Universities Retirement Plans

Retirement Plans Investment Committee Meeting

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Capital Markets Update

First Quarter 2019

Global Economic Update 2019

The Big Picture

Global interest rate policies have yet to converge

- The Fed is largely alone on a path to normalize interest rates, but has paused after 9 rate hikes
- Euro zone may skip this round of tightening entirely, leaving super low rates where they are

U.S. economy remains strong, labor market very tight, reaching the limits of full employment

- Large Q1 increase in GDP (3.2%) a sign of resilience after Q4 market swoon and government shutdown in January
- Consumer spending slowed in Q1, but it may be a blip, reflecting the impact of the shutdown
- Signal from Fed that further rate hikes are on hold have boosted consumer and business confidence
- Full impact of 9 rate hikes to date still working through the economy – borrowing costs are substantially higher than two years ago

The U.S. and euro zone economies diverging again

- Eurozone unemployment has dropped, but economic growth stalled (GDP below 1.5%)
- Geopolitical turmoil across the zone, from Italy to Brexit

China suffering serious slowdown in growth: industrial output, retail sales, implied GDP

- Resolution of trade uncertainty crucial to resumption of growth, far more important to China than the US

Oil prices may (or may not) radically alter inflation outlook

- Wage pressures building in U.S. had yet to translate into headline inflation
- Crude oil prices collapsed in the fourth quarter, but recovered somewhat in Q1, spurred risks posed from the supply side (Russia, Iran)

Total Rebound in Q1 After a Severe Downdraft in Q4 2018

Was Q4 2018 the anomaly, or Q1 2019?

Three sharp declines during 2018

– Full corrections (10% decline) in February and December

– Near-correction (8% drop) in March

U.S. equity market suffered 5% loss for the year; developed and emerging markets fell over 14%

The Fed raised rates four times in 2018, but placed further hikes on pause in 2019

Market has since generated the strongest first quarter since 2009

Wage pressures are building as the unemployment rate stays below 4%

However, CPI fell back below 2% year-over-year in December and remained there through the first quarter

– Oil prices plummeted from $84 to $52 in Q4, seemingly altering the outlook for inflation. Prices rebounded to +$70 in Q1, thanks to supply risks from Russia and Iran

Returns for Periods ended March 31, 2019

	1 Quarter	1 Year	5 Years	10 Years	25 Years
U.S. Equity					
Russell 3000	14.04	8.77	10.36	16.00	9.78
S&P 500	13.65	9.50	10.91	15.92	9.80
Russell 2000	14.58	2.05	7.05	15.36	8.99
Non-U.S. Equity					
MSCI World ex USA	10.45	-3.14	2.20	8.82	5.04
MSCI Emerging Markets	9.93	-7.40	3.68	8.95	--
MSCI ACWI ex USA Small Cap	10.26	-9.48	3.26	11.86	--
Fixed Income					
Bloomberg Barclays Aggregate	2.94	4.48	2.74	3.77	5.33
3-Month T-Bill	0.60	2.12	0.74	0.43	2.54
Bloomberg Barclays Long Gov/Credit	6.45	5.24	5.35	7.23	7.34
Bloomberg Barclays Global Agg ex-US	1.52	-4.13	-0.26	2.46	4.40
Inflation - CPI-U	1.18	1.86	1.47	1.80	2.21

Source: Callan

U.S. Equity Performance

Large Cap U.S. Equity (S&P 500: +13.6%; Russell 1000: +14.0%)

– All sectors delivered double-digit gains with the exception of Financials (+8.6%) and Health Care (+6.6%).

– Surprisingly, Utilities and REITs produced double-digit returns; investors sought yield in the face of a flattening yield curve and the end to rate hikes in the first quarter.

Growth vs. Value (Russell 1000 Growth: +16.1%; Russell 1000 Value: +11.9%)

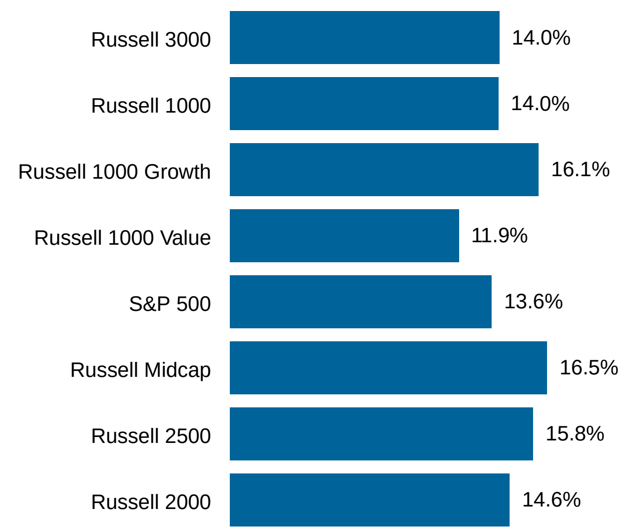
– Investors favored companies with stronger earnings prospects to counter a softer economic environment.

– Technology produced strong results, while the outlook for Financials weakened as the yield curve flattened.

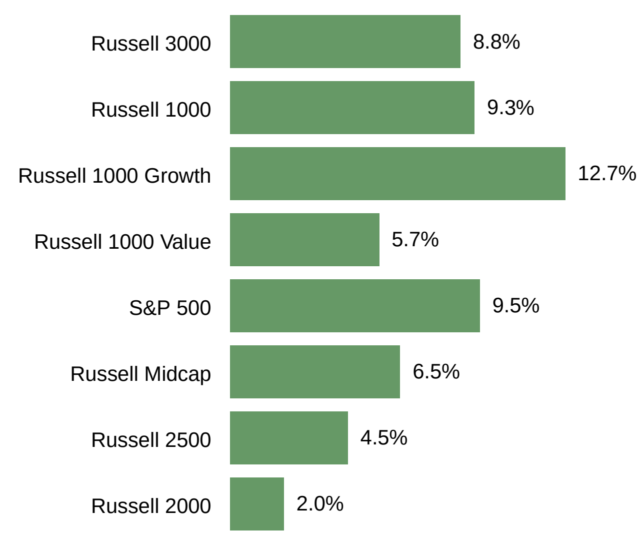
Small Cap vs. Large Cap (Russell 2000: +14.6%; Russell 1000: +14.0%)

– Within the Russell 2000 Growth Index, the three largest sectors (Health Care, Consumer Discretionary, and Technology) surged 19%, 17%, and 23%, respectively.

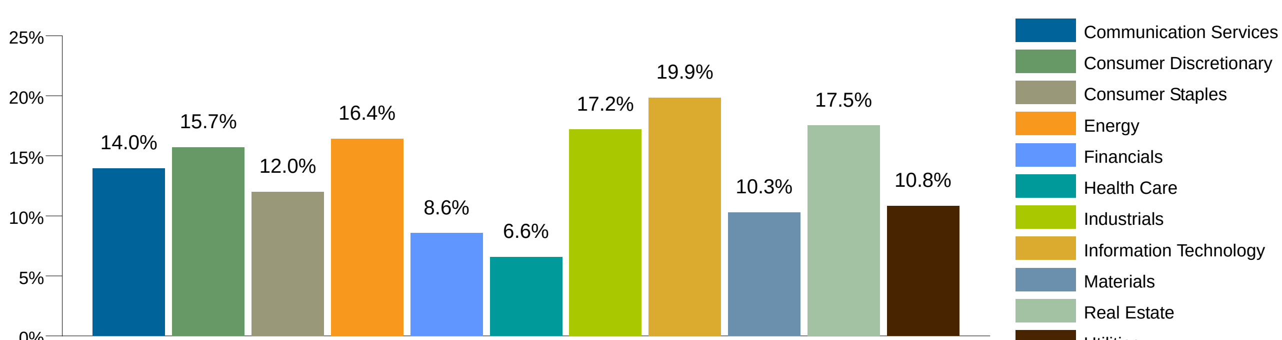
U.S. Equity: Quarterly Returns



U.S. Equity: One-Year Returns



S&P Sector Returns, Quarter Ended March 31, 2019



Sources: Standard & Poor's

Non-U.S. Equity Performance

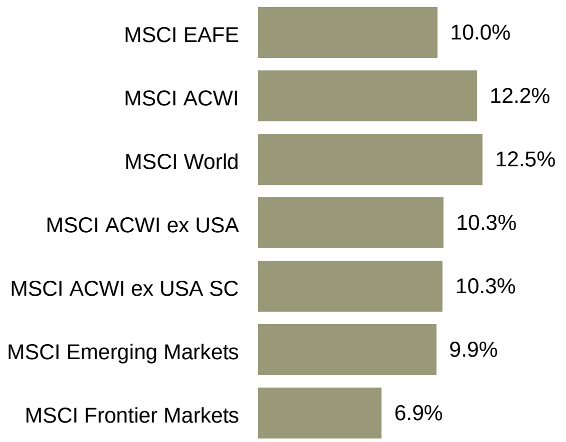
Non-U.S. Developed (MSCI EAFE: +10.0%; MSCI ACWI ex USA: +10.3%)

- Developed markets rallied as central banks around the world expressed more accommodative paths with interest rates and quantitative easing.
- Brexit negotiations continue and a “no-deal” Brexit remains a possibility, but with an extended deadline. The potential for investment paralysis drags on.
- The currency effect was mixed as the U.S. dollar rose against the euro and yen, by 1.8% and 0.9%, but fell against the British pound by 2.3% as a delay in Brexit allowed for a temporary bounce.
- EAFE sector performance was mixed. Information Technology (+15.3%) and Materials (+13.2%) led economically sensitive sectors; Consumer Staples (+12.4%) led defensive sectors. Interest rate-sensitive Financials (+6.9%) and Utilities (+9.0%) trailed the broad index.

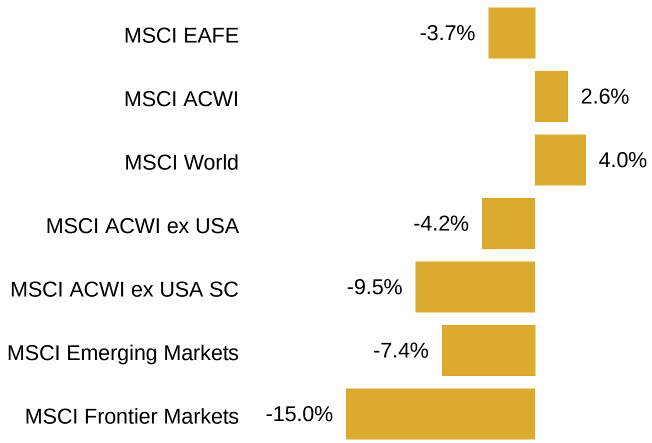
Emerging Markets (MSCI Emerging Markets Index: +9.9%)

- In a big reversal from the fourth quarter, China led emerging markets with MSCI China gaining 17.7% and MSCI China A up 30.9%.
- Trade talks continue but positive indications for a deal buoyed markets; uncertainty on the outcome remains.

Global Equity: Quarterly Returns



Global Equity: One-Year Returns



Source: MSCI

U.S. Fixed Income Performance

U.S. Fixed Income (Bloomberg Barclays US Aggregate: +2.9%)

- U.S. Treasuries rose 2.1% as the yield curve shifted lower across maturities as growth and inflation expectations declined.
- The shape of the yield curve did not materially change during the quarter. The yield differential between the 10-year and 2-year key rates remained positive and traded around a range of +12 to +20 bps. However, the front-end of the curve inverted, with the 5-year offering less yield than the 2-year.
- TIPS outperformed nominal Treasuries as the Fed's balanced stance and unexpected wage pressures stoked higher inflation expectation.

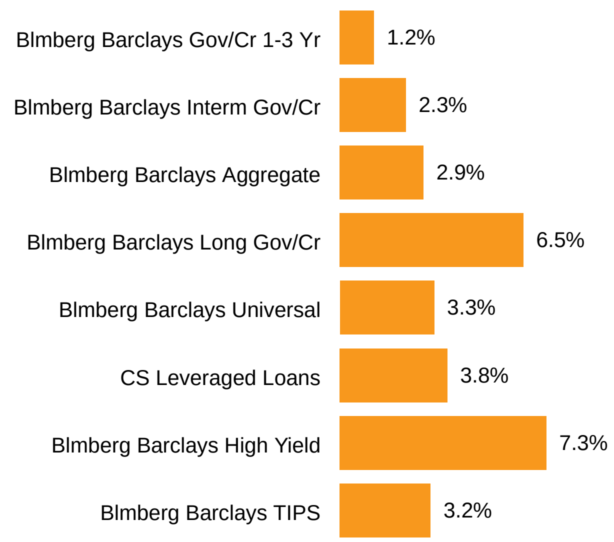
Investment-Grade Corporates (Bloomberg Barclays Corporate: +5.1%)

- Credit spreads rallied on the back of a softer Fed stance, positive economic news, and better than expected corporate earnings.
- Net new corporate issuance during the first quarter of $117 billion was roughly on par with a year ago.
- Surprisingly, Aaa-rated corporates (+5.0%) outperformed Aa- (+3.7%) and single A-rated issuers (+4.7%). BBB-rated issuers were the best performers (+5.7%).

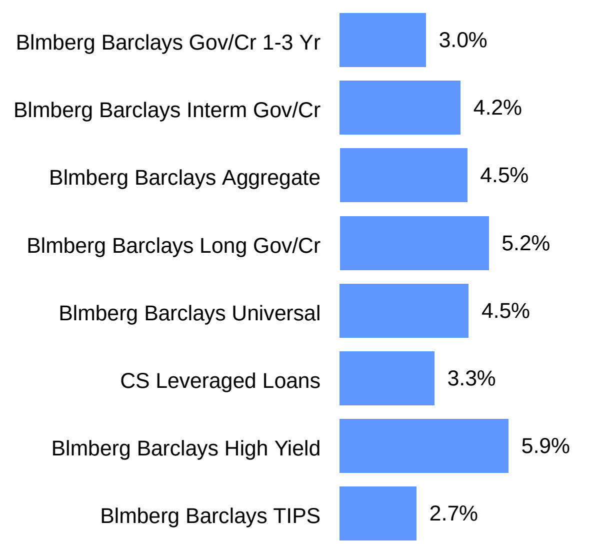
High Yield (Bloomberg Barclays Corporate High Yield: +7.3%)

- Given the risk-on environment, below-investment grade issuers were the best performers, aided by strong asset inflows.
- Ba/B sectors (+7.2%) marginally outpaced CCC by 6 bps; this was an unusual occurrence given that the dispersion between high-quality and low-quality is typically wide during these periods of absolute returns.

U.S. Fixed Income: Quarterly Returns



U.S. Fixed Income: One-Year Returns



Sources: Bloomberg Barclays, Credit Suisse

Defined Contribution Trends

First Quarter 2019

Compensation Applied Incorrectly Costs Big Bucks

Translating the legal definition of compensation, as captured in the plan document, to payroll programming is complex. When it is applied incorrectly, it leads to high costs to calculate and fund missed deferrals or contributions, along with the costs to correct the error via the Internal Revenue Service Employee Plans Compliance Resolution System.

Compensation as a defined term in the written plan documents can be applied differently to various aspects of plan administration—deferrals, employer contributions, and testing can all use different definitions of eligible compensation. And that definition of eligible compensation covers a wide variety of elements, including salary, hourly wages, tips, overtime, premiums for shift differential, and call-in premiums, vacation pay, bonuses, taxable benefits, or severance pay.

In Karlson v. ConAgra Brands Inc., the plaintiff (who, prior to termination, was the senior director of global benefits and a member of its administrative committee) alleged that the plan sponsor should have considered certain post-termination bonuses as eligible compensation. The suit alleges that, according to the plan document, participants could defer from their compensation and the employer would match those deferrals and the plan defined “compensation” to include certain post-termination payments.

The plaintiff alleged that in 2016 the plan fiduciaries altered their reading of the plan document to exclude those bonuses and, therefore, failed to apply elective deferrals from these bonuses and match such deferrals. According to the complaint, the alleged failure could potentially affect several thousand participants.

In the instance of a compensation failure, if too much compensation was recognized, the plan sponsor may have to issue distributions of the excess deferrals plus earnings and matching contributions. If the reverse occurred and all eligible compensation was not included (as alleged in this instance), the plan sponsor may have to make corrective contributions to make up for missed savings opportunities. When corrective contributions are required, the employer is required to fund both the missed deferral and matching components, and related earnings.

The IRS calls out compensation errors in its “Plan Fix-It Guide”. This lawsuit calls out a common plan failure. Plan sponsors should be aware of the issue and take the opportunity to review their plan language against actual administrative practices. It is also important to review compensation when the definition in the plan document changes, when programming is altered, or following changes to the payroll vendor or software.

Lesson from University Lawsuit

Duke University will pay nearly $11 million to settle the 2016 class action filed over management of its 403(b) plan.

Duke University has agreed to settle a lawsuit alleging the university violated the Employee Retirement Income Security Act by causing its defined contribution plan to pay excessive recordkeeping and investment fees. A second lawsuit filed in 2018 alleged that the plan sponsor used plan assets to pay for salaries and fringe benefits of Duke University employees who provided services to the plan. The Duke University lawsuit was one of almost a dozen lawsuits against universities filed by Schlichter, Bogard & Denton in 2016. This represents the 15th settlement out of more than 30 similar complaints filed by Schlichter.

The proposed settlement provides that Duke admits no wrongdoing. In addition to the financial terms of the settlement, Duke agreed to engage an independent consultant to conduct a search for recordkeeping services, make it easier for participants to transfer out of frozen annuity accounts, review the cost of different share classes of mutual funds considered for the plan, and avoid the use of plan assets to pay salaries of Duke employees who work on the plan.

Other defendants in similar university suits have prevailed. Claims against New York University were dismissed after an eight-day trial, although the plaintiffs have appealed. Similar, appeals are pending in claims against the University of Pennsylvania and Northwestern University.

The current litigation environment highlights risks and opportunities for plan sponsors. The cost of litigation is high, and pursuing a settlement may be a viable option for some plan sponsors. Plan sponsors should continue to carefully monitor investment options, confirm plan fees, and follow any written governance documentation, including the IPS. Additionally, plan fiduciaries should document the process and decisions made around vendor selection and fees to demonstrate their due diligence.

Disparate Outcomes in Litigation

American Century defeated a class action lawsuit that challenged the inclusion of affiliated mutual funds in its 401(k) plan. This is contrasted by similar litigation involving Putnam Investments where the allegations were largely defeated at trial, but later reversed on appeal. That case has been appealed to the U.S. Supreme Court.

The American Century 401(k) Plan covered 1,300 participants as of 2016, and the plan's investment options included a selection of American Century mutual funds and collective investment trusts, company stock, and a self-directed brokerage window. During the period in question, the plan offered between 33 and 46 investment options.

The lawsuit, filed in mid-2016, alleged that American Century did not satisfy the duties of loyalty and prudence as the fund lineup was limited to affiliated funds that generated revenue for the company by selecting unnecessarily expensive share classes. The lawsuit contends American Century failed to remove poor performing funds and neglected to monitor third-party recordkeepers.

The ruling was sympathetic to American Century and stated that “the Court finds the Committee members' testimony credible,” while giving “no weight to the testimony of Plaintiffs' process expert.” The court found that American Century did not act disloyally or imprudently by limiting the available investments to affiliated funds in its 401(k) plan. This finding was based on the rationale that the fund selection was prudent and well-diversified, and that the company “truly believed” in the quality of these funds and thought that participants would benefit from familiarity with the funds and access to the people managing them.

The court found that the committee followed prudent processes, including regular meetings, fiduciary tools, and an investment policy statement (IPS). One fund was removed in 2011 for underperformance and six funds in 2017, but the ruling noted that “no other funds were ever removed from the Plan for underperformance, though some funds were removed because they were no longer offered at American Century.”

The ruling also found that it was not imprudent for American Century to offer only actively managed funds instead of lower-cost passive funds, as the “experts in an actively managed fund… had a greater ability to manage risk and lessen the effect of downturns in the market.”

Finally, the ruling indicated that the plaintiffs presented no evidence or testimony, suggesting the company put its own interests ahead of their own. The court asserted that the company had no particular incentive to “push” its own funds because its 401(k) plan represented only 0.35% of American Century's assets under management.

More than 30 companies have been sued over the affiliated mutual funds in their 401(k) plans since 2015. The American Century lawsuit is only the second case filed since 2015 to go to trial. The first, which involved Putnam Investments with comparable facts, similarly found for the defendant although the decision was based on an analysis of the prohibited transaction exemption and the treatment of revenue sharing.

This ruling was vacated in part by the First U.S. Circuit Court of Appeals and remanded back to the lower court for further review of the prohibited transaction analysis to reassess the claim that Putnam violated the duty of prudence. The First Circuit joined the Fourth, Fifth, and Eighth Circuits in holding that once an ERISA plan participant shows a loss allegedly tied to a plan fiduciary's imprudent behavior, the burden to show that the loss wasn't caused by the fiduciary shifts to the fiduciary. The Sixth, Ninth, Tenth, and Eleventh circuits have held differently. Following the appellate court's decision, Putnam filed a petition for writ of certiorari with the U.S. Supreme Court asking it to resolve this issue and opine on the comparison of active and passive benchmarks.

The current litigation environment highlights risks and opportunities for plan sponsors. We recommend that plan sponsors continue to carefully monitor investment options, review plan fees, and follow any written governance documentations, including the IPS. Additionally, plan fiduciaries should document the process and decisions made around vendor selection and fees to demonstrate their due diligence.

Gimme Shelter – Another Legislative Proposal Targets an Annuity Safe Harbor

An annuity selection safe harbor has been the common theme among recently proposed retirement legislation, such as the Family Savings Act and the Retirement Enhancement and Savings Act. While proposals may come and go, this latest iteration illustrates the continued importance of an annuity selection safe harbor to any proposed retirement legislation.

In theory, the promise of guaranteed income in retirement seems like a great idea. The 2006 Pension Protection Act took steps to limit the fiduciary implications of including annuities in defined contribution (DC) plans by removing the “safest available annuity” requirement. However, according to Callan’s 2019 DC Trends Survey, few plans offer either annuities as a form of distribution payment (10.8%) or as an in-plan guarantee (4.1%). Discomfort around the fiduciary implications of such options consistently ranks as the top reason for the reluctance to add an annuity-type option.

Congress has long heard of this hesitation and once again resurrected legislation aimed at providing an annuity safe harbor. On February 28, Reps. Lisa Blunt Rochester (D-DE) and Tim Walberg (R-MI) proposed legislation in the House to ease the way for annuities within DC plans. The Increasing Access to a Secure Retirement Act (H.R. 1439) would provide a fiduciary safe harbor to the selection of an annuity provider. To qualify for the safe harbor, the fiduciary would need to meet several obligations in the consideration and selection of a provider, including that the cost is reasonable and the insurer is financially capable of satisfying the contract’s obligations. The full text of the proposal is still pending.

As DC plans have matured and participants have taken a greater role in building retirement savings, retirement income has become a key consideration. Plan sponsors should consider the plan objectives and how differing retirement income solutions could support participants.

SEC: Investment Managers Must Repay Clients Millions in Settlements

The Securities and Exchange Commission (SEC) announced a settlement whereby roughly 80 investment managers will repay over $125 million to clients who utilized higher-cost mutual funds when cheaper funds were available.

The settlement, announced on March 11, focuses on funds with 12b-1 fees, which are embedded into the expense ratio and paid to brokers to distribute mutual funds. At issue is whether advisors adequately disclosed potential conflicts of interest in the sale of higher-cost mutual funds when lower-cost share classes were available.

According to the SEC: “The advisors placed their clients in mutual fund share classes that charged 12b-1 fees—which are recurring fees deducted from the fund’s assets—when lower-cost share classes of the same fund were available to their clients without adequately disclosing that the higher-cost share class would be selected.”

As part of the settlement, the firms avoided SEC penalties while agreeing to pay back the fees. This marks another instance of the SEC waiving penalties when firms cooperate in investigations. As an additional term of the settlement, the companies will determine which investors should be moved to share classes without 12b-1 fees and to correct any shortcomings in disclosures.

This settlement springs from the SEC’s Share Class Selection Disclosure Initiative. Launched in February 2018, this initiative aims to correct potential harm to investors due to share class selection. Although this settlement affects mainly retail investors, it shows that the SEC is focused squarely on abuses related to fees.

Legislating the Student Debt Tsunami

Proposed legislation aims to sanction student loan repayment programs, allowing employers to support employee efforts to pay off student loan debt—both their own and any debt taken on for their children—while recognizing that paying down debt may hinder employees' ability to save for retirement.

One in four Americans has student loans, and the U.S. student debt burden grew to $1.5 trillion in 2018. This issue impacts new employees entering the workforce, career workers, and parents who have borrowed to finance their children's education. As financial wellness becomes a common theme in employee benefits and as employers look to manage workforce retirement planning, managing student loan debt has become an increasingly significant concern for many employers. Congress has introduced a number of bills that seek to address the widespread student loan debt tsunami. Two key pieces of proposed legislation signal the track that Congress may take:

The Employer Participation in Repayment Act intends to expand the existing tuition assistance program. Currently, the Education Assistance Program only covers workers pursuing additional education, but does not cover employees who have already acquired student loan debt. The proposed expansion would allow employers to contribute up to $5,250 tax free to employee student loans per year. However, employer repayment assistance may be considered an uneven employee benefit, providing additional monetary benefits for only those employees who hold student loan debt.

The Retirement Parity for Student Loans Act would allow employers to make matching contributions under 401(k) and 403(b) plans based on ongoing student loan repayments. This bill follows a private letter ruling (PLR) issued by the Internal Revenue Service in 2018. The PLR confirmed that employers can tie employer contributions under a 401(k) plan to the amount of student loan repayments made by the employee outside the plan. However, the PLR only applied to the specific plan requesting the ruling, and only addressed the specific issue and facts presented by the plan sponsor. The Student Loans Act would treat student loan repayments as if they were deferrals into the defined contribution plan, which could then be matched within the plan (rather than the special non-elective contributions described in the PLR). In addition, the Student Loan Act would clarify nondiscrimination testing requirements and safe harbor plans. This type of legislation promotes retirement readiness while recognizing that paying down debt may limit the ability for employees to save for retirement.

Market forces continue to drive innovation in this area. In addition to the legislation described above, some employers are exploring boosting student loan repayments with forfeited vacation time. This perk complements the reality that most Americans don't use all of their paid time off.

Employers continue to consider how financial benefits support their employees, while looking to balance competing needs. Depending on the employee population and labor planning needs, a student loan repayment program may be a meaningful employee benefit. Plan sponsors should consider how these programs could be implemented, if needed, and how to continually manage them.

Another Higher Ed Plan Faces Court Battle

Brown University has settled a lawsuit for breach of fiduciary duties under the Employment Retirement Income Security Act (ERISA) for $3.5 million as the plaintiff’s bar continues focusing attention on higher education plans.

The 2017 lawsuit was filed with a series of specific claims, including that the plans offered 199 investment choices in 2014 between Fidelity Investments and TIAA. The plans subsequently reduced the number of choices significantly, but still offered a total of 61 investment options, many of which were proprietary funds from the two recordkeepers. The plaintiffs also alleged that the choice of an older version of the TIAA Traditional Annuity was improper, as alternative versions with higher rates of return and greater liquidity were available.

The university did not admit wrongdoing, but in a statement indicated that it settled the lawsuit given the prospect of years of costly litigation.

Higher education plans continue to be the most recent preferred target of the plaintiff’s bar, and the large fund menus offered within the plans are one of the most consistent targets of new lawsuits.

Callan Research
First Quarter 2019

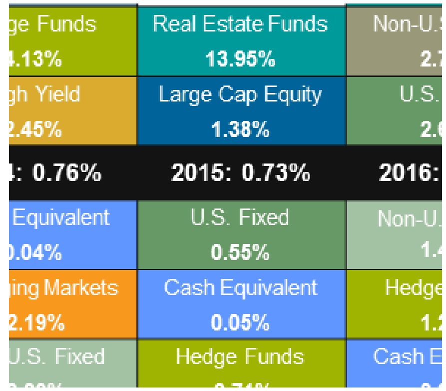
Published Research Highlights from 1Q19

Callan’s 2019–2028 Capital Market Projections

0.80	0.80	0.99	1.00				
0.86	0.86	0.94	0.88	1.00			
-0.22	-0.26	-0.25	-0.23	-0.28	1.00		
-0.10	-0.15	-0.14	-0.12	-0.17	0.88	1.00	
0.11	0.10	0.08	0.09	0.04	0.74	0.93	1
-0.04	-0.08	-0.06	-0.05	-0.09	0.56	0.64	0
0.63	0.62	0.63	0.61	0.62	-0.13	0.02	0
0.01	0.00	0.07	0.05	0.10	0.48	0.53	0
0.57	0.55	0.57	0.54	0.58	-0.04	0.10	0
0.73	0.72	0.71	0.68	0.70	-0.13	-0.04	0
0.92	0.88	0.88	0.86	0.86	-0.30	-0.23	-0

2019 DC Trends Survey

The Callan Periodic Table Collection: Year-End 2018



Two Questions to Help DC Plans Save on Litigation Costs

Popular Blog Posts

How DTS Helps Us Evaluate Bonds

Kevin Machiz

Securities Lending 101

Kyle Fekete and Mark Kinoshita

A Look at the New Communication Services Sector

Irina Sushch

Additional Reading

Private Equity Trends quarterly newsletter

Active vs. Passive quarterly charts

Capital Market Review quarterly newsletter

Monthly Updates to the Periodic Table

Market Pulse Flipbook quarterly markets update

Callan Institute Events

Upcoming Conferences, Workshops, and Webinars

2019 June Regional Workshops

– Atlanta, June 4, 2019

– San Francisco, June 5, 2019

2019 October Regional Workshops

– Denver, October 22, 2019

– Chicago, October 24, 2019

"Callan College"—Ongoing fiduciary education

Introduction to Investments sessions

– San Francisco, July 16–17, 2019

– Chicago, October 22–23, 2019

– Atlanta, TBD

Alternative Investments session

– Chicago, October TBD

Upcoming Webinar:

– Cobbler's Shoes Webinar, June 18, 2019, 11am PST

Webinars: On-Demand now available at https://www.callan.com/ondemandwebinar/

Our library of pre-recorded webinars on specific investment-related topics, such as:

– ESG Adoption and Implementation Trends

– Infrastructure: Real Perspectives on an Evolving Asset Class

– Investigating Private Equity Implementation

"Research is the foundation of all we do at Callan, and sharing our best thinking with the investment community is our way of helping to foster dialogue to raise the bar across the industry."

— Greg Allen, CEO, Chief Research Officer