

Chief Investment Officer's Report



Missouri State Employees' Retirement System

Mailing Address: PO Box 209, Jefferson City, MO 65102-0209
 Phone: (573) 632-6100 • (800) 827-1063 | Fax: (573) 632-6103
 MO Relay: 7-1-1 (Voice) • (800) 735-2966 (TTY)
 Website: www.mosers.org | Email: mosers@mosers.org
Visit us at 907 Wildwood Drive, Jefferson City, MO

October 16, 2017

Dear Members:

I start this letter by thanking the MOSERS Board of Trustees and executive director, John Watson, for allowing me the honor of leading the investment effort at MOSERS.

MOSERS' fund returned 3.5% this fiscal year, which is 1.9% more than expected from passive investing. The extra return was made from decisions MOSERS' investment staff implemented through the year. We achieved this excess return while also cutting about \$7 million in management fees (about 12% savings). Finishing with higher-than-expected returns and reducing fees are the two things staff has the most control over and, by those measurements, this year was a success.

However, our absolute return is lower than what most other pension funds experienced. The reason for the performance difference is because we do not own what they own. By way of analogy, investment portfolios are like recipes. Think of the recipe for a chocolate chip cookie. Now, think of the recipe for a brownie. The two recipes contain many of the same ingredients, but the outcomes are distinct. In 2012, MOSERS chose a cookie recipe for portfolio returns, but all other pension funds chose a brownie recipe. Therefore, since the recipes are different, it follows that MOSERS' outcomes will be different.

So far as I can tell, having foresight about which recipe will be most rewarded in any given year is impossible. This year stocks, the most common ingredient in the other pension recipes, were the highest returning asset. As a rule of thumb, other funds have 85% of their outcome linked to stocks. MOSERS has only 40% of our outcome linked to stocks. When stocks are up 18%, having 85% of your outcome linked to equities is a good thing. However, equities do not always provide these returns. In fact, sometimes they lose money. In losing environments the preference will be for fewer stocks.

Why is our recipe different? In 2012, when the recipe was changed, MOSERS had one of the highest return hurdles in the country. Speaking technically, our "real return assumption"—that is, what we assumed our return would be after adjusting for inflation—was tied for the highest in the U.S. at 5.5%. At that time, using a recipe similar to other public pension funds would not have achieved the high return. So, in order to clear the hurdle, the portfolio had to shift to something that was different. That's why we chose a different recipe in 2012.

Now, let's talk about where MOSERS is going. Over the last two years, the MOSERS Board of Trustees has lowered the real rate of return assumption. For fiscal year 2017, the board lowered the rate from 5.5% to 5.15% and for fiscal year 2018 the board adopted a rate of 5%. It is important for MOSERS' return assumptions to be economically viable, because it will increase the likelihood of MOSERS achieving that return. There is currently a plan to continue reducing the return assumption in the future and this will increase the economic viability of MOSERS' assumptions.

In addition, lowering the return assumption reduces the need for our portfolio to be different from the pension plan universe. Accordingly, we will begin discussions to consider a deliberate transition to a portfolio with a more comfortable risk profile.

■ Investment Section

However, as we move down this path, we have to be careful to make these moves in deliberate installments which can be tolerated by all MOSERS' stakeholders. Our current situation accrued over a period of many years, so no single year will resolve the challenge. Ignoring this challenge is no longer acceptable, but we also have to acknowledge that all solutions require time. The great thing about defined benefit plans is this—we have some time. As the old saying goes: "Rome wasn't built in a day." Well, neither are solutions to pension plan funding. I am convinced that working together, MOSERS' Board of Trustees and staff members will develop a plan that answers these challenges.

Sincerely,

A handwritten signature in black ink, appearing to be 'Seth Kelly', with a stylized, cursive script.

Seth Kelly
Chief Investment Officer