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Public Plans Rally in Fiscal Year 2023

Strong Equity Markets in Second Half Drive Solid Results, Redemption Queues Building for Open End Private Real Estate

by Christopher Rowlins, Partner, Senior Consultant

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Public Defined Benefit (DB) and Other Post Employee Benefit (OPEB) plans often assess their financial progress on a fiscal year (FY) ending June 30. In the most recent fiscal year ending June 30, 2023, the Bloomberg Aggregate Bond Index showed minimal changes. However, domestic equities, represented by the Russell 3000 Index, performed exceptionally well, posting a 19% return.[1] This marked a significant turnaround from the investment numbers reported in the previous fiscal year.

Using the MSCI ACWI and the Bloomberg Aggregate indices as a proxy for investment performance, the difference in returns for a 60/40 portfolio (60% global equities/40% domestic fixed income) over the past two fiscal years is striking.

60% MSCI ACWI / 40% Bloomberg Aggregate	
Period ending	**1 year return**
30-Jun-22	-13.43
30-Jun-23	9.44

Source: FactSet. Data as of June 30, 2022 and June 30, 2023. Indices cannot be invested in directly. The hybrid performance is calculated in PARis, an investment metrics performance reporting system. Fiducient has access to the MSCI and Bloomberg indices used in the calculation. The return series is rebalanced monthly.

This surge in investment returns during fiscal year 2023 led to an increase in the aggregate funding ratio of U.S. state and municipal retirement systems, as reported in the *Public Pension Fund Indexing Report* by Milliman, a global actuarial firm. The estimated funded status of the 100 largest public pension plans rose to 75.8% by the end of June 30, 2023, compared to 74% as of June 30, 2022.[2]

[1]FactSet Data as of June 30, 2023.

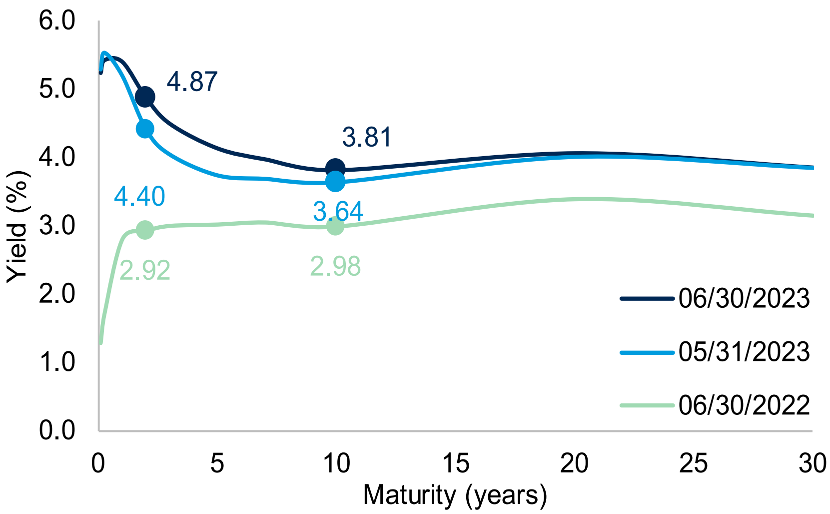
[2]Public Pension Funding Index July 2023 – Milliman, Rebecca A. Sielman and Richard L. Gordon

Higher Interest Rates and Fixed Income Allocations

In our November 2022 edition of the Public Fiduciary Newsletter, we highlighted the potential benefits of rising interest rates for public pension portfolios. For nearly four decades, the bond market experienced one of the longest bull markets, resulting in increased bond prices due to declining yields. To meet their assumed investment returns, many public pensions shifted assets away from fixed income to global equities and alternative investments. They also took on more credit risk by investing in non-investment grade issuers.

The upward trend in yields continued, with the 10-year U.S. Treasury yield rising from 2.98% at the end of fiscal year 2022 to 3.81% at the end of fiscal year 2023. This rise was not limited to U.S. Treasuries; it also affected the broader bond market.

U.S. Treasury Yield Curve



Source: FactSet. As of June 30, 2023.

The yield on the bellwether Bloomberg U.S. Aggregate Bond Index, a proxy for the U.S. bond market, stood at 4.8% at the end of June 30, 2023, while the yield on the Bloomberg Corporate High Yield index stood at 8.5%.[3]

Public pension plans often rely on fixed income to provide stability within their portfolios. The resurgence of higher yields is expected to boost incremental income and align portfolios with their investment return goals and risk tolerance. However, the rise in yields may introduce volatility, prompting Plan Sponsors to reassess their fixed income allocations with regard to duration, credit quality and active vs. passive strategies.

[3] FactSet Data as of June 30, 2023

Alternative Investments: Illiquidity & Investment Policy Statements

"Alternatives" is a broad term encompassing various investment strategies such as private equity, hedge funds and private real estate. These strategies can enhance a portfolio's risk-adjusted returns because they are not closely correlated with traditional stocks and bonds. However, Plan Sponsors should carefully evaluate the alternatives based on risk tolerance, liquidity needs and time horizon.

For public plans that depend on asset liquidation to cover ongoing pension obligations, the illiquidity of alternatives and the differences in public and private market valuations can result in an over allocation to alternatives compared to target allocations. Investment policy statements should include language to address this issue, acknowledging that allocations may deviate from the target due to market conditions and illiquidity.

An example is open-ended private real estate funds with quarterly redemption features. Plan Sponsors may find themselves in a queue for redemptions, and a lack of liquidity can lead to partial redemptions. This scenario can persist until market conditions change. As a result, Plan Sponsors should be aware that certain alternative positions, like private real estate, may remain overweight compared to policy targets for an extended period, potentially leading to performance disparities against stated policy benchmarks.

For additional information on any of the topics discussed in this article, please reach out to the professionals at Fiducient Advisors.

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As a Partner and Senior Consultant, Chris services institutional clients by providing advice and counsel on all areas of fund oversight including policy, asset allocation, manager research, portfolio structure, portfolio rebalancing, performance monitoring and overall investment policy. He focuses on corporate, nonprofit, and governmental retirement plans. Chris is also a member of the firm's Public Funds Defined Benefit Business Council. Chris joined Fiduciary Investment Advisors, LLC in 2010, which combined with Fiducient Advisors in 2020.

Prior to joining the firm, he was President and Senior Investment Strategist for USI Advisors, Inc., a Goldman Sachs Capital Partners Company. Chris also served as an Investment Analyst with the City of Hartford, Connecticut Treasury Office. He received his BA from Boston University.

Outside of work, he volunteers on the Board of Directors for Riverfront Recapture, an organization dedicated to revitalizing the banks of the Connecticut River in Hartford. Chris is also an Investment Committee Member for The Village for Family and Children, a nonprofit providing support services for children and families in the Greater Hartford region and a member of the Government Finance Officers Association and the Connecticut Public Pension Forum.

Definitions and Disclosures

Comparisons to any indices referenced herein are for illustrative purposes only and are not meant to imply that actual returns or volatility will be similar to the indices. Indices cannot be invested in directly. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect our fees or expenses.

Bloomberg U.S. Aggregate Bond Index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

Bloomberg Corporate High Yield index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included.

Russell 3000 Index is a market-cap-weighted index which consists of roughly 3,000 of the largest companies in the U.S. as determined by market capitalization. It represents nearly 98% of the investable U.S. equity market.

MSCI ACWI is a stock index designed to track broad global equity-market performance. Maintained by Morgan Stanley Capital International (MSCI), the index is comprised of the stocks of about 3,000 companies from 23 developed countries and 26 emerging markets.

Material Risk Disclosures

Fixed Income securities are subject to interest rate risks, the risk of default and liquidity risk. U.S. investors exposed to non-U.S. fixed income may also be subject to currency risk and fluctuations.

Domestic Equity can be volatile. The rise or fall in prices take place for a number of reasons including, but not limited to changes to underlying company conditions, sector or industry factors, or other macro events. These may happen quickly and unpredictably.

International Equity can be volatile. The rise or fall in prices take place for a number of reasons including, but not limited to changes to underlying company conditions, sector or industry impacts, or other macro events. These may happen quickly and unpredictably. International equity allocations may also be impact by currency and/or country specific risks which may result in lower liquidity in some markets.

Private Equity involves higher risk and is suitable only for sophisticated investors. Along with traditional equity market risks, private equity investments are also subject to higher fees, lower liquidity and the potential for leverage that may amplify volatility and/or the potential loss of capital.

Private Real Estate involves higher risk and is suitable only for sophisticated investors. Real estate assets can be volatile and may include unique risks to the asset class like leverage and/or industry, sector or geographical concentration. Declines in real estate value may take place for a number of reasons including, but are not limited to economic conditions, change in condition of the underlying property or defaults by the borrow.

Marketable Alternatives involves higher risk and is suitable only for sophisticated investors. Along with traditional market risks, marketable alternatives are also subject to higher fees, lower liquidity and the potential for leverage that may amplify volatility or the potential for loss of capital. Additionally, short selling involved certain risks including, but not limited to additional costs, and the potential for unlimited loss on certain short sale positions.