Brothers and Sisters,

Last year, our Union sent out via the Daily Blast, an invitation to watch the PBS Frontline documentary titled “The Pension Gamble”. The documentary chronicled the events that led to Kentucky becoming one of the nation’s worst funded pension systems. Local 2 has not, to my knowledge, provided any commentary on the documentary. I have been asked what I thought of the documentary. Not knowing what, if any, message Local 2 was trying to communicate to its members, I will attempt to provide a brief summary of relevant items mentioned in the program followed by some issues on at least three themes that intrigued me during the program. The first issue that was addressed that I found relevant was the investment decisions, followed by the legislative shenanigans that took place within the Kentucky Legislature, and lastly the contrast between moral and legal standards throughout the entire documentary.

A summary of the relevant timeline presented in the program follows:

* *In 1999, the Kentucky Retirement System (KRS) pension fund was nearly 100% funded.*
* *In 2000, the dot-com bubble burst, creating some real harm to the KRS pension fund and the Kentucky economy.*
* *The Kentucky Legislature continued to spend money on roads, bridges, libraries and other projects but decided to divert funds for pension contributions. A reporter in the program was quoted as saying “they have effectively raided the pensions fund, and by raiding it means that they have simply not made the payments that they are morally required to make to fund the retirement promises that they made.” Another reporter commented about the legislators diverting adequate funding away from the pension funds “they realize nobody is paying attention, they get a little bolder about it…they realize no one is looking”*
* *The commentator states that by 2008 Kentucky’s pension system was in very bad shape, then in 2008, the economic crisis crippled the funding status of the KRS.*
* *KRS trustee Betty Pendergrass states the Board is feeling pressure to get the returns up and confirms that the KRS Board decided to swing for the fences. So, starting in the Fall of 2009, the Board decided, in order to dig out from under, they would invest in some of Wall Street’s more exotic and risky vehicles, like hedge funds.*
* *During this section of the program, the producers focus on the Board’s lack of investment experience and make the following assessment: “Some trustees have financial experience, but others are police and firefighters appointed to the board to represent their co-workers, often not trained in portfolio management…….on Wall Street they call pension funds dumb money.” Former Chair of KRS and currently an investment manager states “…..some of those trustees openly admit they aren’t even sure what they are voting on.”*
* *The KRS Board made some poor decisions that appeared to be caused by a lack of understanding of portfolio construction, an unwillingness to ask tough questions and substantial deficiency in transparency.*
* *KRS invested $100M in one hedge fund that failed and closed down; the pension fund was able to recoup this money. There were other investments made in other hedge funds, but it wasn’t stated how well they performed, and the emphasis was placed on the excessive fees.*
* *The producers make the point that hedge funds are not considered by investment professionals as appropriate investments for public pensions due to their lack of transparency and excessive fees.*
* *In 2013 Kentucky lawmakers changed the pension system to a hybrid system for all new hires for police, firefighters and other public servants; new teachers were not included in the new plan. The new law removed the defined benefit plan. A Kentucky State Senator defined the plan as ”you no longer get a defined benefit type plan, but a hybrid cash balance plan….basically a 401k type plan, better than a 401k but not as good as defined benefit plan.” (This is a similar strategy the Illinois Legislature took when they implemented Tier II for new CFD hires starting after 2010, although it wasn’t as draconian as the Kentucky version.)*
* *In 2015 Matt Bevin, described as a former hedge fund manager and Tea Party favorite, is elected Governor. According to KRS trustee Pendergrass the new governor’s campaign promise was that if the pension fund is bankrupt then the pension contract is not enforceable. However, once in office Governor Bevin started to properly fund the pension fund, commonly referred to actuarially required contribution, (ARC). The ARC payments put severe strain on the State’s budget.*
* *Governor Bevin prepares a plan called “Keeping the Promise” to move new teachers, that were previously excluded, to the hybrid plan that other new public servants are subject. Current teachers will also be required to contribute more to their pensions under the plan.*
* *The legislative bill supporting the “Keeping the Promise” language was presented in Committee and committee members were asked to vote on it before having a chance to read it. The Governor’s Republicans controlled the committee and essentially rammed the bill through committee. One Democrat committee member questioned the legality of the move. Another Democratic legislator called the Chairman ‘out of order’ and referred to the statute as proof. (As someone who has been personally involved in public body proceedings, I can assure you, rules and laws do get broken, even in view of many people in an open meeting. It is imperative, in my opinion, that someone stays alert to keep people honest.)*
* *After the bill’s passage out of committee, 5,000 teachers showed up at the State Capital to protest. The Legislature proceeded to debate how to cut the budget to shore up the pension fund. Many of the cuts proposed were to public education. The question proposed by the producers became what is going to happen to the next generation of school children if the budget cuts are made to public education in order to shore up the pension fund. Author of The Plot Against Pensions, David Sirota summarizes the situation when he states “State lawmakers don’t want to raise taxes. Voters don’t want to accept tax increases. Retirees don’t want to accept cuts to benefits they were promised.”*
* *Governor Biven made a comment on radio stating he was being attacked by the people he was trying to save and that teachers are like a drowning victim and that it was necessary to knock them out in order to save them and keep them from pulling you under.*
* *The bill supporting the Governor’s “Keeping the Promise” never passed. Another reporter concludes pension are on the way out and what we will have here in the next generation are Americans that will have terribly insecure retirements.*
* *The final question is posed to a teacher ‘What happens if you have no pension?’ She responds: “I don’t want to think about it. I have no savings, without it I won’t survive.”*

**INVESTMENTS** – I think any casual viewer of this documentary will recognize the Kentucky Retirement System (KRS) ran afoul of good oversight of the fund assets when it pursued an overly aggressive investment strategy in the hopes of making up for inadequate funding. In addition, the trustees were portrayed as not being very investment savvy and unwilling or unable to ask critical questions of the investment advisors they had hired. It is only natural that a FABF member would ask if such reckless decisions could be made at our fund. My answer is probably not, and the reasons are as follows:

We are a transparent and well-balanced board that maintains a healthy amount of friction creating an environment that helps prevent collusion. The Retirement Board is made up of four labor trustees and four City trustees. The fund is required to abide by the Open Meetings Act, and for the most part, strictly abides by that law. We employ the services of a full-time chief investment officer and the services of both an investment consultant and fund counsel. I personally, for the benefit of the fund members, would prefer that trustees and hired fund professionals, all remain professionally skeptical of one another. It has been shown again and again, in my opinion, that embezzlement and poor public decisions occur when there is collusion and stakeholders are too chummy with one another.

The pension code requires us to act as fiduciaries and specifically ‘by diversifying the investments….so as to minimize the risk of large losses.’ ‘…with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity...’

We follow a well-established theory of portfolio construction, Modern Portfolio Theory, when constructing our portfolio and determining asset class allocations. The major tenants of portfolio theory are asset class diversification and differing correlations among asset classes and securities. The theory does not put much value in security selection and places an emphasis on the efficient market hypothesis. Although some past stakeholders in the process discounted the theory, there were other stakeholders, including myself, that tried to make sure we abided by the theory’s principals. In short, having educated parties involved in the investment process, conducted in a transparent manner, forces a consistent approach to constructing a portfolio and prevents the radical departure from prudent investing that was displayed by KRS in the documentary.

On a side note, I have previously written that I do not advocate searching for investment managers that can consistently generate alpha ( a return greater than the market with equal risk), not because I don’t believe those managers exist; I have seen them up close and personal, but because finding them is difficult, and you run the risk of employing a money manager that provides less return for greater risk.

A majority of our investments are transparent. We invest mostly in publicly traded assets that provide a level of transparency that private equity and hedge funds do not, the very asset classes that got KRS in trouble.

Another point that a viewer may have taken from the series is that two major market corrections - the dot-com bubble and the economic crisis beginning in 2008, were major contributing factors to the mess KRS now finds themselves. I strongly disagree with this assessment and urge all the members to disavow this line of thinking. Properly funded pension funds, especially those sponsored by government entities, are designed to handle economic shocks and market corrections like those we’ve encountered in the last 20 years. KRS ran into trouble not because of the economic shocks it encountered, it ran into trouble because the Kentucky executive and legislative branches decided to divert funding from the pension fund after the economic downturn. Does this sound familiar? Please, as a member of the FABF, don’t ever believe it is acceptable for the City to underfund our pensions. Any leader that stands by while the City underfunds our pensions is no friend of Labor. We are all in this together - Tier I, Tier II, firefighter, paramedics, strikers, the big class, those getting a lifetime 3% COLA and those receiving only a limited 1.5% COLA. And by ignorantly accepting the argument that an unfunded pension is ok, because the Illinois Constitution guarantees our pension, you are putting all our family’s financial security at risk. As a member of the FABF you have a responsibility to stand up and make certain our retirement benefits are properly funded, because as history has shown, the politicians won’t do it.

**LEGISLATIVE PROCESS**. It was interesting to see how the producers portrayed the legislative process being conducted behind the scenes, in a very partisan non-transparent manner. This is not unlike how Tier II was forced upon our membership. In Kentucky, it was the Republicans using a heavy hand against the Democrats to box them out and make draconian changes to retirement benefits. What I find interesting about that is, here in Illinois, we have had Democratic majorities for such a long time that the casual viewer might wonder why a pro-union Democratically controlled government, like Illinois, would have neglected pension obligations for so long.

How an entity governs itself can tell a lot about how successful and effective that entity may be. Whether it is how you govern your personal life, your fire company, the fire department, the State Legislature, City Council, Local 2 Executive Board and our very own pension board - poor governance hurts us all. Good governance requires participation, clear authority, professional ethics, professionalism, consistency and accountability. These characteristics are not something we see in our leaders or institutions that govern our livelihood.

It is important to recognize that here in Illinois, the State Legislature writes the laws concerning the funding of our pension fund, but the City is the sponsor of the pension fund and must make the payments required by state law. This set-up of having two separate governmental bodies, one making rules, the other having financial responsibility for our pension fund is concerning. It affords the politicians a form of political cover by claiming it isn’t entirely their fault; City Hall will blame Springfield and Springfield will blame City Hall. I have not heard one politician stand up yet and say “unfunded pensions? Yep, that was my fault, sorry.” It is, as if, unfunded pensions are a natural disaster and not caused by human nature’s ugly side of negligence and need for immediate gratification.

It is for these reasons, I have previously stated, that engaging in the political process as Local 2 has been in the past, is a losing proposition. The way this State governs itself makes the tactics Local 2 utilizes as ineffective. Trying to curry favor for additional benefits is foolish when you can’t even secure funding for the benefits that have already been promised. It is like constantly loaning money to your drunk degenerate gambling uncle because you truly believe this time it’s going to be different. The previous governor and the current governor are both billionaires, spending hundreds of millions of dollars on their campaigns and that of half the Legislature. I’m not sure a $10,000 donation from Local 2, to “Friends of the 14th Ward”, is going to have much influence.

**MORAL vs. LEGAL ARGUMENTS** – Throughout the program, the term legal and moral are used to describe both actions and responsibilities. The use of these terms is a very informative way to frame the issues facing our pension fund. For example, it can be argued the City is legally making required contributions but morally they are not making adequate contributions. Legally the money managers didn’t violate the law, but morally they should have known the investment vehicles were too risky for a public pension fund. Legally a pension fund trustee is in compliance with the law, but morally they are not acting as a fiduciary would be expected. A politician may have legally accepted money from another politician or constituent, but morally they crossed a line that the general public would not expect of an uncompromised leader.

Whenever an issue regarding the pensions come up, I often view it in both legal and moral terms, and I think it is important our membership does as well. As the public discourse on public pension funding continues, and we are pitted against the taxpayer, the moral argument and the legal argument will be two tools that will be employed by all sides. It is immoral, for any of us, to downplay the real crisis by cherry-picking facts to fit a narrative that is more comfortable to you. Every year that the State allows the City to fail to at least cover the normal cost of our retirement benefits, it is immorally, without consent, burdening future generations of firefighters and paramedics. I caution the membership, that believing your promised retirement benefits should be guaranteed because of solid moral arguments, will be sorely disappointed when that argument loses to legal arguments. The current mayor, and some mayoral candidates, have supported a change to the constitutional clause guaranteeing our earned pension benefits. If such a proposal succeeds and resulting legislation allows a diminishment of previously legally guaranteed pension benefits, any and all moral arguments will be trumped. If you have been paying attention to the mayoral race and the circus surrounding the phone and wire taps, you can see this exact argument playing out. As mayoral candidates scramble to return ill begotten campaign contributions, it is done with the caveat that the contributions were legal. Lawyers allow politicians to operate in this immoral but legal environment. Such actions may violate the moral code you and I live by, but it is legal in a court of law. When Shakespeare wrote “First thing we do, is kill all the lawyers” generations of scholars have argued what that meant. Taken literally, it means what it means, lawyers are a cancer on civilized society. Taken in context, it has been argued that lawyers are the buffer between civilized society and mob rule. Unfortunately, in this town, it is the literal interpretation that should prevail; lawyers have allowed legislators to operate between the crevices of what us common folk would call honest work. Brothers and Sisters, we can have the strongest moral argument on our side, but it is a legal argument that can diminish our retirement security; please stay involved and aware of our retirement benefits.

Fraternally,

Tim McPhillips

Firemen’s Annuity and Benefit Fund, Active Trustee