In This Issue:

- Addressing Rising Benefits Costs and Pension Funding
- Details on Retirement Incentive Offering
- Vermonters Cautioned on Investment Fraud
- Update on Legislative Action

Vermont State Employees' Retirement System

July 2009

Retiring TIMES

Volume 9, Issue 1

Retirement Incentive Offered to State Employees

Eligible employees could receive as much as $15,000

Approximately 1,000 State employees are considering whether they will take advantage of a retirement incentive passed in an early June special legislative session and signed into law by the Governor. Interest has remained strong for the program. Employees have until July 31 to turn in their application to the Retirement Division.

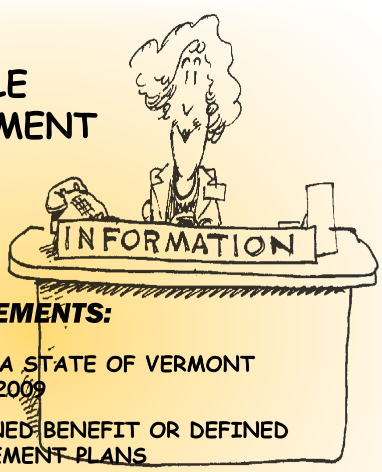
Any active State employees who believe they are eligible for the retirement incentive, but did not receive a mailing, should contact the Retirement Division immediately.

"The idea is that this program will enable the State to decrease the size of its workforce, but in a way that lessens the economic hardship on employees caused by layoffs," said State Treasurer Jeb Spaulding. "Achieving these savings will require administrative and budgetary discipline on the parts of all branches of State government."

Of the potentially 300 positions freed up by this program, the goal is to leave at least one-third unfilled. If that occurs, fiscal projections indicate that the retirement incentive

(continued pg. 2)

ARE YOU ELIGIBLE FOR THE RETIREMENT INCENTIVE?



ELIGIBILITY REQUIREMENTS:

YOU ARE EMPLOYED AS A STATE OF VERMONT EMPLOYEE ON JUNE 1, 2009

YOU ARE IN THE DEFINED BENEFIT OR DEFINED CONTRIBUTION RETIREMENT PLANS

AS OF 7/1/09 HAVE 30 YEARS SERVICE OR ARE AGE 62 WITH AT LEAST FIVE YEARS SERVICE

YOU HAVE NOT INITIATED A PURCHASE OF SERVICE AFTER 5/1/09

APPLICATIONS DUE JULY 31!

Does Diversification Still Work?

Reprinted by permission. Fidelity Viewpoints, June 11, 2009

You followed the rules. You put together a diversified investment portfolio as we—and other financial experts—recommend. Despite that, your portfolio went down along with the rest of the market. Why didn't diversification work? While it may not seem like it, diversification did work. You probably would have lost much more if you hadn't diversified. We'll show you why you shouldn't give up on diversification and why it is still effective.

It helps to know a little bit more about what affects diversification. At the heart of it is "correlation." Simply put, correlation is a measure of how the returns of two investments move together, i.e., whether their returns move in the same or opposite direction and how often. Correlation is a number from –100% to 100% that is computed using historical returns. A correlation of 50% between two stocks, for example, means that in the past when the return on one stock was going up, then about 50% of the time the return on the other stock was going up, too. A correlation of –70% tells you that historically 70% of the time they were moving in opposite directions—one stock was

(continued pg. 4)

Director's Corner

by Cynthia Webster, Director of Retirement Policy & Outreach

This article addresses a frequently asked question: How does a return to work affect the pension I receive from the State of Vermont?

I am happy to report that employment with any employer except the State of Vermont has absolutely NO impact on continued receipt of your State pension. It does not matter how many hours you work, what you earn, or how you earn it, as long as your employer is not the State of Vermont. You may even return to work for the State of Vermont, but only as a temporary or contractual employee. Neither of these types of positions are eligible for retirement benefits; therefore, you may continue to draw your monthly pension. However, if you do return to state employment as either a classified or exempt employee, your monthly pension benefit is impacted in several ways.

- First, your pension will be suspended upon the date of your new hire. You may not draw your pension while you are actively employed, and you will not be eligible for a cost-of-living adjustment on the pension while suspended.
- Secondly, you will be enrolled as a contributory member of the Vermont State Retirement System under a new membership on the effective date of your return to active employment.
- If you work for a minimum of five years after your new membership is established, you will be entitled to a second pension based on your total creditable service and highest three consecutive years of earnings when you once again terminate employment. If you do not work for at least five years under the new membership, you will receive a return of your contributions plus accumulated interest after separation from service.
- Finally, your suspended pension will resume once you again terminate your employment with the State of Vermont. You will not be able to change the option or the beneficiary if you elected a survivorship option on your first retirement. Once your original pension is resumed, if eligible, you will receive regular cost-of-living adjustments.

If you're considering a return to State employment in any capacity, it is always good to call the Retirement Office at (802) 828-2305 to check on how it might impact continued receipt of your pension.

Don't Miss These Upcoming Workshops!

Our Retirement Issues seminar is an all-day workshop for retirement system members planning to retire within the next 10 years. We address financial planning, taxes, legal affairs, Social Security and employee retirement benefits.

Sept. 16 Waterbury

Oct. 14 Burlington

Dec. 15 Montpelier

For questions & to register, call Carol Bourneuf at 241-1114.

(Retirement Incentive Story, Continued)

program should essentially break even in year one and provide significant long-term cost reductions in future years.

Eligibility requirements for the program focus on years of service and the age of the State of Vermont employee. (See box on front page for details.)

Lorna Carty is a personnel administrator for the Agency of Administration and has worked as a State employee for 37 years. She was already considering retirement and said receving the incentive will convince her to retire this year.

"Retiring now will allow me to join my husband, who recently retired, and the incentive will allow us to help our daughter with college expenses," said Carty. "I've talked with several other employees who are eligible for the incentive, but they are just not ready to be done working. I think the incentive is a great idea, but for employees not yet eligible for Social Security, it just isn't enough to sustain them."

Of the potentially 300 positions freed up by this program, the goal is to leave at least one-third unfilled.

The offered retirement incentive provides for a lump sum cash payment distributed in two equal annual installments based on total years of creditable service, as well as a guarantee that the State will pay 80 percent of the premium for medical insurance for a full seven years after retirement. After the seven years, the State's share for the health insurance premium will revert back to whatever percentage is bargained for active members as required in statute.

Employees retiring under the incentive program and who have five or more creditable years of service, but less than 15 years, will receive $750 for each creditable year served. Employees with 15 years or more of creditable service will receive $1,000 for each year of creditable service. The largest cash incentive eligible employees may receive is capped at $15,000.

In early June the Retirement Division sent out a mailing that included a description of the incentive, an application to sign up for the incentive, and a request for an estimate of benefits.

"The original retirement incentive application must be completed and returned to the Retirement Division no later than July 31, 2009 in order for an employee to be considered for the incentive," said Cynthia Webster, retirement and policy outreach director. "Applications that are faxed, or received after that date, regardless of the postmark on the envelope, will not be accepted."

If more than 300 applications are received, a lottery system will be instituted in early August. The 300 employees selected through the lottery process will receive estimates and final retirement paperwork by August 7. The last day on the job for employees voluntarily retiring through this program is generally August 31, 2009, with an effective retirement date of September 1, 2009.

The proposal allows an employer to stagger the retirement dates for up to six months if necessary to continue normal operation of business. There also are restrictions for returning to State employment for at least one fiscal year unless approved by the head of their governmental branch.

The Retirement Division will hold multiple group retirement seminars the week of August 10 in Montpelier for employees retiring through the incentive program. Any active State employees who believe they are eligible for the retirement incentive, but did not receive a mailing, should contact the Retirement Division at (802) 828-2305 immediately for a follow-up determination.

Reality Investing Options Now Available

Participants in the State of Vermont Deferred Compensation 457 Plan may now use a new Reality Investing option. Great-West, the administrator of the 457 Plan, in collaboration with Advised Assets Group, LLC (AAG), recently launched a suite of investment advisory services. This comprehensive service offers three alternatives to plan participants: online investment guidance free of charge; and for a fee, online investment advice and managed account service. To learn more about these options call your Great-West representative at (800) 457-1028 and select option 2, or locally at (802) 229-2391.

Alert on New Tax Tables

In February, the American Recovery and Reinvestment Act of 2009 (ARRA) created the new Making Work Pay credit, a refundable tax credit equal to 6.2 percent of earned income up to $400 ($800 for taxpayers filing jointly) for the 2009 and 2010 tax years. This credit will be included in workers' paychecks through the adjusted tax withholding tables, but it is not available for pension income, which is considered passive income. Even though the credit does not apply to pension income, we were directed by the IRS to implement the adjusted tax tables. Vermont Retirement Systems implemented the new IRS tax tables beginning with the March 2009 pension payment. Please note that the change in the tax tables could result in insufficient taxes being withheld from retiree pensions, which could lead to retirees owing Federal tax at the end of the year. If the tax withholding from your retirement allowance decreased due to the new withholding tables or you are concerned that your current withholding will not be sufficient to cover your actual tax liability, you might consider increasing your monthly tax withholding. If you currently have no Federal tax withholding on your pension, you may not need to take any action. We encourage you to discuss this matter with your tax or financial advisor before making any changes to your withholding. Any retirees who wish to change their tax withholding should complete new tax withholding forms available online at www.VermontTreasurer.gov/retirement/forms.html or by calling the Retirement Division toll-free within Vermont at 1-800-642-3191, or 802-828-2305. All tax withholding changes are due in our office by the 15th of the month in which you want the change to be effective. For example, forms received by August 15 will be reflected in the August 31 pension payment.

Update on Cost of Living Increases

Cost-of-living adjustments (COLAs) are applied to all pension payments in January for those who meet the eligibility requirements. The law states that a pension shall be increased or decreased according to the Consumer Price Index (CPI) for the previous June 30. You should be aware that for the first time in recent history, the CPI has been reflecting a negative rate of inflation over the past several months. **If the CPI reflects a negative rate on June 30, the COLA that takes effect in January of 2010 will actually result in a reduction in the monthly pensions of those eligible to receive a COLA.** Retirees who are eligible for their first COLA would not be impacted, as the law also states that the monthly pension can never go below the original benefit. Final details of the January 2010 COLA will be featured in our December 2009 newsletter.

Legislative Wrap-Up

Very few bills were targeted toward modifying retirement benefits for public employees during this year's session. The Retirement Division, on behalf of the respective retirement boards, did introduce a "housekeeping" bill to address areas that required clarity or better definition for the three systems. Below are the sections of Act 24, formerly H. 431, that impact the Vermont State Retirement System.

Language was added to clarify the consequences if a retiree returns to active employment with the State of Vermont. A full description of these consequences is included in the Director's Corner article.

Option 2 – Allowance Return was eliminated. This was an outdated option that was available at retirement, but was rarely chosen by potential retirees. The Option 1 – Annuity Return is still available, and is the better option if potential retirees wish to protect the contributions they made into the Retirement System prior to retirement.

The amortization period for the unfunded liability for the Vermont State Retirement System was reset for another 30 years. This is a common occurrence in public pension plans when a system is nearing the end of a previously amortization period in order to maintain contribution rate stability.

Language was added to correct an oversight that occurred in 2008 applicable to the group F cost-of-living adjustment (COLA). The correction will allow a newly hired group F member to be eligible for a full COLA when they retire, as was the original intention.

Language was added to clarify the appropriate holding account for money that is received to pay for retiree health care benefits. The new language was necessary to remain in compliance with federal regulations.

Language was added to provide the authority for the board to adopt rules to ensure continuing compliance with federal law requirements.

Language also was included in the H.441 the Appropriations Bill that provides for a retirement incentive for certain eligible State employees. Please read the article on the incentive program starting on page one of this newsletter.

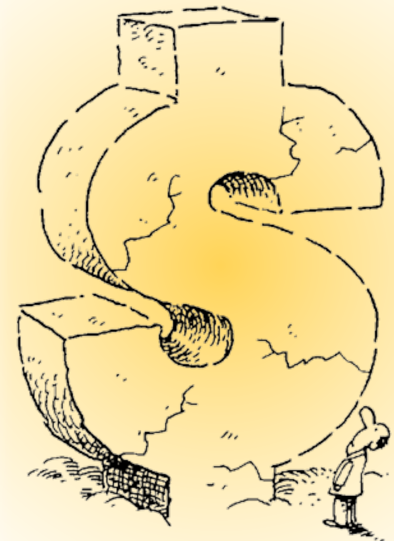
Finally, following the retirement incentive language in H.441 is a section that contains a provision that any permanent State employee who is laid off between May 1, 2009 and January 1, 2011 and who is within one year of eligibility for normal retirement may retire without penalty.

going up and the other was going down. Correlations can change dramatically and rapidly in volatile markets. Assets can become highly correlated, meaning their returns move in the same direction. This reduces the short-term benefit of diversification, which is what happened recently.

A deeper look at recent markets

The correlations of U.S. stocks to several other types of investments increased during the 2008–2009 bear market. The correlations of U.S. stocks to international stocks and high-yield bonds jumped to nearly 90%. Investment-grade bonds and cash went from being negatively correlated to U.S. stocks to being positively correlated. All of this reduced the effectiveness of diversification during this period.

These changes in correlation aren't surprising—it's happened before. For instance, in the 2002 dot-com bear market, correlations increased dramatically. Compared with the previous 10 years, correlations of U.S. equities to developed world stocks, emerging market stocks, and U.S. high-yield bonds went up from 55%, 61%, and 35% to 85%, 84%, and 56%, respectively. What's different about the recent market decline is the increase in volatility in the markets. During the 2002 dot-com decline, volatility spiked, but not as high as last year. The recent bear market's volatility coupled with increased correlations has heightened the impact on investors' portfolios.



Diversification has not failed

While it may feel like diversification has failed in recent months, it hasn't. The major asset classes are not perfectly correlated, only more highly correlated. There's a difference—it means that diversification still helped contain portfolio losses, only the benefit was lower than before the market decline. Consider the performance of three hypothetical portfolios: a diversified portfolio of 70% stocks, 25% bonds, and 5% short-term investments; a 100% stock portfolio; and an all-cash portfolio. By the end of February 2009, both the all-stock and diversified portfolios would have declined. The all-stock portfolio would have lost nearly half of its initial value (–48.2%), however, while the diversified portfolio would have lost just over a third (–33.9%). Yes, the diversified portfolio would have declined, but diversification would have helped reduce losses compared with the all-stock portfolio. The all-cash portfolio (0.02%) would have outperformed the all-stock and diversified portfolios over this 14-month period. While short-term investments performed well last year compared with stocks, investing in all cash limits the future growth opportunities of a portfolio, so it is not an effective long-term strategy.

Now let's look at March and April 2009. Our hypothetical all-stock portfolio would have risen by 19.2%, the diversified portfolio by 11.7%, and the all-cash by 0.03%. This is a good example of how such portfolios can behave in rising markets. If the market continues its upward trend, the diversified portfolio may gain less than the all-stock portfolio and more than the all-cash portfolio. This is what diversification is about. It will not maximize gains in rising markets, but it can help limit losses when the market is turning down.

How to build a diversified portfolio

To start, you need to make sure your investment mix (e.g., stocks, bonds, and short-term investments) is aligned to your investment time frame, financial needs, and comfort with volatility. Next, when building a diversified portfolio, you want to choose investments whose returns are not likely to move in the same direction, and, ideally, those that move in the opposite direction, i.e., highly negatively correlated. This way, even if a portion of your portfolio is declining, the rest of your portfolio may still be growing. In turn, the overall impact of poor market performance on your portfolio can be dampened. We can help you determine an appropriate asset allocation and plan for your investment needs. In conclusion, diversification didn't fail in the recent market downturn. It worked—just to a lesser degree. It's important to remember that diversification can only help reduce portfolio risk, not eliminate it.

(Scams Story, Continued)

Besides making personal loans to the man with little or no paperwork to document the transaction, Kalinowski said his father was also persuaded to purchase investment products that didn't mature until his dad was in his late eighties. Following the death of Kalinowski's father in 2007, an investigation into the financial discrepancies resulted in a Bennington-area man being charged with embezzlement and grand larceny. However, the man passed away before a trial could be held.

FINRA maintains a website on investment fraud. The website is located at SaveAndInvest.org. For complaints or questions on a specific investment opportunity, Vermonters may contact BISHCA by calling (802) 828-3301 or online at www.bischca.info.

109 State Street, 4th Floor, Montpelier, Vermont 05609-6901, (802) 828-2305 or (800) 642-3191 (in-state) *Retiring Times* is published twice yearly by the Vermont State Employees' Retirement System. Editor: **Lisa Helme**

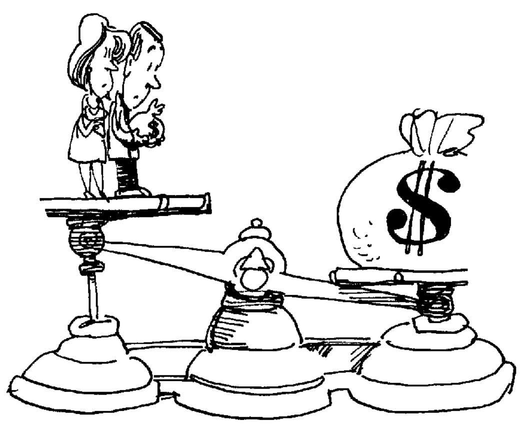
Unsustainable Pension Funding Increases

Answers Sought for Approach that Benefits Retirees and Taxpayers

by Jeb Spaulding, Vermont State Treasurer

States, municipalities, and schools across the country are struggling to determine how they can continue to provide adequate and fair retirement benefits for their employees without busting the budget and taxpayers. This struggle will intensify over the next year and Vermont will not escape the debate. The question is not whether benefits, plan provisions, and contribution levels will be modified; the question is how and to what extent. Importantly, the longer the current unsustainable situation remains unaddressed, the more unpalatable the needed medicine becomes to cure the problem.

How big is the problem? A rough estimate by the State's independent actuary recently indicated that next year's State Legislature will see the actuarially required appropriation for State employee retirement benefits increase from about $32 million to around $45 million. For teachers, the required contribution will rise from about $41 million to $58 million. That would mean an increase of $30 million in one year, a year that already has a budget hole close to $70 million. I would not be surprised if the increased cost is greater than the preliminary estimate. These numbers also do not take into account an equally daunting scenario for retiree health insurance.



What has caused the immense fiscal challenge for public pension plans? There are a variety of factors. Certainly, the across-the-board collapse of financial markets over the past 18 months is a very significant contributor. According to the Center for Retirement Research at Boston College, state and local pension plans have seen their portfolios plummet since October 2007 as a result of the stock market collapse. Assets are down $1.2 trillion from what the total would have been if the market had produced the 8 percent annualized returns that most actuarial calculations assumed. Through May 31, 2009, Vermont pension funds were down close to 24 percent over the previous 12 months, although they had increased about 8 percent since January.

Other factors include demographics, inflation, and accounting changes. Between June 30, 2004 and June 30, 2009, the number of retired State employees, teachers and beneficiaries increased by close to 2,400. Even though retirement benefits for Vermont teachers and State employees are modest when compared to other states, retirement payouts have grown by about $11 million per year for the last several years. In addition, retiree health insurance premiums have increased by several million per year. Recently adopted rules by the Governmental Accounting Standards Board require public sector entities, for the first time, to report the future costs of non-pension post-employment benefits (retiree health insurance). The current unfunded liability is more than $1 billion. While that figure is not due now, we must immediately consider the scope of the problem. If we were to pay for retiree health insurance as the new standards encourage, the increased cost would be another estimated $30 million per year.

Let's work for a win-win process whereby public employees are assured of secure retirement benefits and taxpayers can be assured these benefits are reasonable and affordable.

In recognition of the challenge, this year's legislature created the Commission on the Design and Funding of Retirement and Retiree Health Benefits Plans for State Employees and Teachers, with the State Treasurer as Chair, to review and report on the design and funding of retirement and retiree health benefit plans for the State employees' and teachers' retirement systems. The commission is charged with making recommendations to the Governor and legislature about plan design, benefit provisions, and appropriate funding sources, along with other areas they deem appropriate. Recommendations must be consistent with actuarial and governmental accounting standards; demographic and workforce trends; and the long-term sustainability of the benefit programs. This subject is sure to be a front-burner issue in the next legislative session.

Many union leaders understand that sustaining defined benefit systems is a shared responsibility. Richard Ferlauto, director of corporate governance and pension investment for the American Federation of State, County and Municipal Employees, the nation's largest public employees' union, recently stated, "In a critical situation when budgets need to be balanced, to the extent we need to contribute something — particularly to preserve traditional defined benefit plans — you'll find that our members are realistic about the situation." [1]

Successfully addressing our retirement benefit funding challenge will require understanding and sacrifice by all sides. Several years ago, the Vermont State Employees' Association, the Administration, the Treasurer's Office, and the State Legislature worked collaboratively to enact revisions to pension and retiree health insurance benefits and contribution levels for State employees. These revisions will save the State hundreds of millions of dollars during the next few decades and provide a more significant cost of living adjustment on pension benefits for retirees. This recent model of success is an example we can draw from in our current situation. Let's work for a win-win process whereby public employees are assured of secure retirement benefits for years to come and taxpayers can be assured that these benefits are reasonable and affordable.

[1] *Institutional Investor, June 2009, Public Pensions Facing Big Squeeze*

Vermont State Employees' Retirement System
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Vermonters Urged to Ask and Check Before Investing

"If it could happen to my family, it could happen to any Vermont family." That was one message Vermont State Police Lt. Robert Kalinowski emphasized recently at an educational forum on how to avoid falling victim to investment fraud.

Approximately 300 people attended the June forum that is part of a nationwide educational initiative of FINRA, the Financial Industry Regulatory Authority. FINRA, the State Treasurer's Office, the Vermont Department of Banking, Insurance, Securities and Health Care Administration, and AARP have launched a statewide campaign to make Vermonters more aware of the growing threat of investment fraud.

"No one is exempt from this happening to them."

-Lt. Robert Kalinowski

"Americans have lost more than $2 trillion of their retirement nest eggs and are now desperate to get ready for retirement," said FINRA Foundation President John Gannon. "Unfortunately, that creates the perfect opportunity for scam-artists to pitch their too-good-to-be-true and get-rich-quick schemes."

Workshop presenters recommended Vermonters practice learning to say "no" and ending the conversation, particularly if it is an unsolicited phone call. If someone does decide to talk to a seller, FINRA recommends the person ask whether the firm or individual salesperson is registered with FINRA, the Securities and Exchange Commission, or with BISHCA—Vermont's State securities regulator. The answers given by the seller should be checked with regulators to make sure they are registered investments. Workshop attendees were urged not to be pressured into making a decision.

In Lt. Kalinowski's situation, it was his father, Robert Sr., who lost thousands of dollars. It was only as his father's health was declining that the Lieutenant and his sister learned their dad had been loaning money to a man he had recently befriended.

"Shortly after my mom was admitted to a nursing home, dad was befriended by a man. The man had local ties to our community and he would go to high school sporting events with dad and treated him very kindly," recalled Kalinowski. "However, he began to borrow money from dad to supposedly use it for his new investment company. As my father's health failed, my sister started helping dad with his accounts and discovered discrepancies in some of the investments and in his checking account statements. It wasn't until dad's friend wouldn't return his calls about the money, that dad realized he had been taken advantage of."

(continued pg. 4)