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VERMONT

Vermont State Teachers' Retirement System

July 2009

Retiring TIMES

Volume 9, Issue 1

New Investment Program Off to an Excellent Start

First quarter enrollment figures reflect growing interest

The first quarterly review of the state-wide VSTRS 403(b) Program implemented on January 1, 2009 convinced the VSTRS Board of Trustees that their vision of offering a high quality, low fee investment program to school employees is a success.

To date, 25 supervisory unions have adopted the VSTRS 403(b) Program for their employees. Of this total, 12 have offered the VSTRS plan as the sole 403(b) provider. During the first three months of 2009, 884 participants contributed more than $1.67 million into the plan. In making investment choices, participants have shown a preference for investing in the Profile Funds where the investments are selected for them in a diversified portfolio that is appropriately structured to reflect their anticipated retirement date. Participants also may elect to choose their own indexed investment funds from the slate offered through the program.

"Reality Investing, a component of the program, offers three levels of investment service and is proving to be very popular," said Cynthia Webster, Director of Retirement Policy and Outreach. "The majority of participants have opted to take advantage of the Managed Account Service. This service comes with a sliding fee scale based on the total account balance of the participant. Clearly, having the opportunity to have someone else manage their investment account for a nominal fee is a very attractive feature of the program, and one which we expect will serve participants well in these difficult economic times."

The Board of Trustees is hoping that the indexed investment options, the low, transparent fees, and the optional investment services that are features of the VSTRS 403(b)

Money invested in the 403(b) program may be used to purchase service credit and allow for earlier retirement.

(continued pg. 2)

Does Diversification Still Work?

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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

(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 Vermont State Teachers' Retirement System?

I am happy to report that employment with any employer except a public school or participating independent school in the State of Vermont has absolutely NO impact on continued receipt of your teachers' pension. You may even return to work in a public or independent school in Vermont in any capacity other than as a "teacher." A "teacher" is defined by statute as a licensed teacher, principal, supervisor, superintendent, or any professional licensed by the Vermont standards board for professional educators. Therefore, you could return to employment as a para-professional, for example, and still continue to receive your monthly retirement pension. However, if you do return to employment as a "teacher" in a Vermont public or independent school, your monthly pension benefit may be impacted in several ways.

The law allows a retired teacher to return to service as a "teacher," providing the total compensation received is not in excess of 60 percent of the average compensation for members of the retirement system. We call this allowable earnings for retired teachers. The allowable earnings is recalculated each year based on the total reported compensation of the members during the fiscal year ending on the previous June 30. For the school year just ended, retirees could earn up to $28,700 in a teaching position and still continue receiving their retirement allowance.

The law also states that if you are a retired teacher and earn in excess of the allowable earnings in any fiscal year and you resume qualifying service, the following will happen:

First, your pension will be suspended at the beginning of the fiscal year in which you resumed service. You may not draw it while you are actively employed, and you will not be eligible for a cost-of-living adjustment on the pension while suspended. If you do not exceed the allowable earnings until later in the school year, your pension will be suspended retroactive to July 1. If you received a retirement allowance during the fiscal year in which you resumed service, you must either return the total of all benefits received during that fiscal year, or upon subsequent retirement, your pension shall be suspended for a period necessary to reimburse the system for the pension received during the fiscal year in which you resumed service.

Secondly, you will be enrolled as a contributory member of the VSTRS under a new membership effective July 1.

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 terminate employment once again. 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 school system. 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, you will receive regular cost-of-living adjustments thereafter, if eligible.

If you are considering a return to "teacher" 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.

(403b Program Story, Continued)

Program will encourage more people to participate and begin savings toward retirement.

"With the uncertainty of Social Security benefits in the future, coupled with funding concerns of traditional defined benefit plans, it is more imperative than ever that individuals take an active role in securing their own financial futures," said Webster. "Having money invested for retirement that is separate from other employer-sponsored retirement plans is an excellent beginning."

Money set aside in a 403(b) plan also can serve another purpose in retirement planning. Members of the Vermont State Teachers' Retirement System may retire under a "normal" retirement at any age upon attainment of 30 years of service. At 25 years of service, a member of any age may buy the remaining five years of service in order to retire without penalty. Funds invested in the 403(b) Program may be used to purchase service into the teachers' retirement account while a member is still actively employed, without any tax consequences at that time.

"This is a wonderful tool to use when you are a few years away from retirement. Members who want to retire early can start putting money aside in their 403(b) program to cover the cost of purchasing the remaining five years of service needed for full retirement. If they decide later not to retire early, they will have the extra money available to supplement other retirement income," Webster explained.

Representatives of Great-West, the vendor selected to administer the program, have been meeting personally with school districts around the state.

If a school district has adopted the VSTRS 403(b) Program and would like to speak with a Great-West representative, the district may call their Montpelier office at (802) 229-2391. If employees are part of a school district that has not yet adopted the VSTRS 403(b) Program, they should let their district administrator know of their interest. A Great-West representative for the area will be happy to travel to the district for a meeting.

Questions about the VSTRS 403(b) Program, or comments for the Board of Trustees, may be directed to Cynthia Webster at (802) 828-2302, or via e-mail at cynthia.webster@state.vt.us.

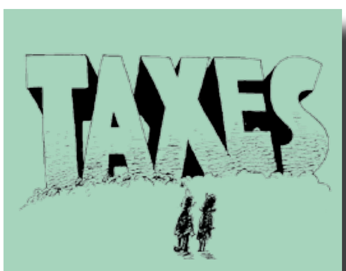
UPDATES FROM THE RETIREMENT DIVISION: *New Tax Tables & COLA Alert*

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.

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.



Direct Deposit of Pension Checks

"Direct Deposit" refers to the transfer of money from the Retirement Office directly to your bank account. It eliminates the need for a monthly pension check, which can be stolen, misplaced, or delayed in the mail. The electronic deposit of your monthly pension check ensures that your money will be available to you on the last working day of each month in your bank account, versus waiting an extra day or two for a check to arrive in the mail. It also means less cost to the system as it costs more to prepare checks each month than it does to send the payments electronically. With electronic deposit, your pension check can be directly sent to any bank account (checking or savings) in Vermont or anywhere in the U.S. There is no cost for this service. As of May 2009, approximately 95 percent of all our retirees are utilizing electronic deposit to receive their monthly benefit payments. With over 12,000 retirees, this means there are still almost 700 pensioners receiving a physical check. For more information or to change to direct deposit, please call 1-800-642-3191. (The toll free number is only available for calls from within Vermont; out-of-state callers must use 802-828-2305.) The form is also available on-line at: www.VermontTreasurer.gov/retirement/forms.html. The form will require your signature, your account number and the bank routing number where your monthly pension payment will be received. Forms need to be received at the Retirement Office by the 5th of the month in which you want the direct deposit to take place.

'Tis the Season to Retire

As school district employees enjoy a well-earned summer break, some colleagues decided to extend that break and retire. Since June 1, 2009, there were 251 VSTRS members who officially retired from service. We wish you the best as you enter this new stage in life!

Legislative Wrap-Up

Very few bills were targeted toward modifying retirement benefits for teachers during this year's session. The Retirement Division, on behalf of the respective retirement boards, introduced 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 Teachers' Retirement System:

Language was added to the definition of "teacher" that requires teachers in nonsectarian independent schools to be licensed by the Vermont standards board for professional educators in order to qualify for membership in the Vermont State Teachers' Retirement System. This has been a requirement for public school teachers for many years.

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

The amortization period for the unfunded liability for the Vermont State Teachers' Retirement System was reset for another 29 years. Although the amortization period was reset a few years ago, this was completed in order to keep the three Vermont public pension plans on the same schedule.

(Diversification Story, Continued)

—one stock was 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.

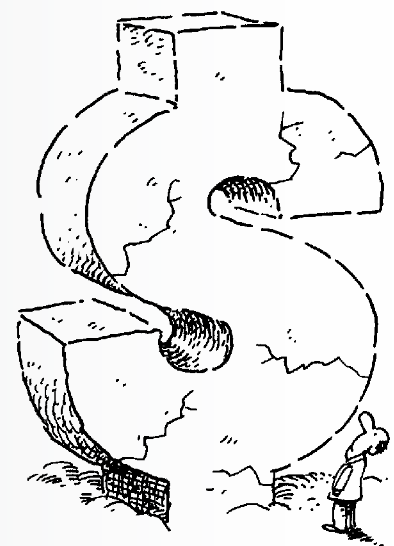
Diversification has not failed

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)

had been taken advantage of."

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 Teachers' Retirement System. Editor: **Lisa Helme**

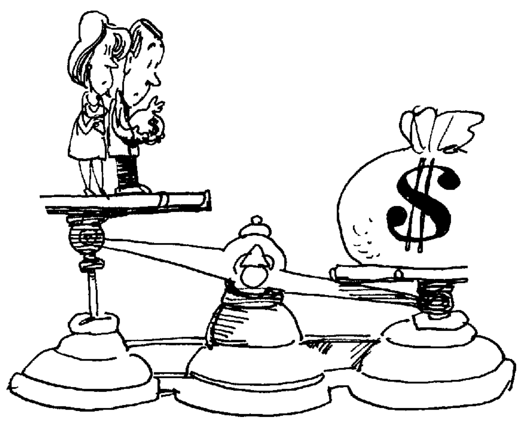
Tackling the Pension Funding Challenge

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 State 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*

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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

(continued pg. 4)