Richard A. White, Jr.
Retirement Administrator

Telephone: (707) 463-4328
(707) 467-6473
Fax: (707) 467-6472

MENDOCINO COUNTY
EMPLOYEES' RETIREMENT ASSOCIATION
625-B KINGS COURT
UKIAH, CALIFORNIA 95482-5027

Date:	January 15, 2014
To:	Board of Retirement
From:	Richard White, Retirement Administrator
Subject:	Communications to the Board of Retirement

Discussion: Included are articles and items of interest which relate to public pension funds and are presented to the Board as informational items.

1. Weekly Update Reports. Administrative updates provided to the Board of Retirement previously are included for reference.

2. Economic and Market Perspective. Commentary about the economy and capital markets for 2014 prepared by James W. Paulsen, Ph.D. for Wells Capital Management. January 2, 2014.

3. Pension reform discussions:
   a. Judge Rules San Jose Pension Reforms a Violation of Rights. Originally posted at www.CalPensions.com by Ed Mendell. January 2, 2014. A Superior Court ruling overturned key parts of a voter-approved San Jose pension reform initiative.
   b. When it comes to pensions, California is no Detroit. Posted at www.latimes.com by John D.R. Clark. December 29, 2013. Commentary about solving the state's pension troubles if unions and conservatives each give a bit.
   c. Not so fast in applying Detroit bankruptcy precedent – at least in California. Posted at www.pionline.com by Harvey Leiderman. December 18, 2013. Important legal distinctions in California protect public employee pensions in ways that are significantly different to those employees in Detroit and Michigan.
   d. CalPERS officials: Detroit pension ruling won't affect public employee retirement here by Dale Kasler. Posted at www.sacbee.com. December 13, 2013. CalPERS officials doubt the Michigan ruling constitutes a threat to public employees and retirees in California.

4. SACRS press release dated December 11, 2013 which congratulates two SACRS members for being honored in the 2013 aiCIO Industry Innovation Award competition for innovative and positive investment work at a public pension fund.

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Date:	December 16, 2013
To:	Members of the Board of Retirement
From:	Richard White, Retirement Administrator
Subject:	Weekly Update Report

The following is my regular weekly summary of MCERA administrative activity for the week of December 9 through 13, 2013:

- SCHEDULE:
  - This was a normal and full administrative work week for me and our staff.

- MEETINGS:
  - I met with April Allen, Auditor, Mendocino County Superior Court and with Carmel Angelo, CEO, County of Mendocino on December 11.

- ITEMS:
  - **Board meeting agenda packet.**
    - I worked on material for agenda items for the December and January Board meetings and the December Audit/Budget Committee meeting. Legal Counsel, MCERA staff and our professional services providers assisted me with these items.

  - **Pension Administration System (PAS)**
    - The Pension Gold kick-off meetings were held as scheduled on December 10-12, 2013. A six-person implementation team from Pension Gold Retirement Solutions, our project consultant from Linea Solutions and our four member MCERA team participated in these meetings. Further details can be found in the December 18th Administrator report.

  - **Investments**
    - I monitored the rebalancing of the portfolio and worked on the monthly investment report.

  - **Financial Reports**
    - I worked on the monthly financial reports.

  - **Comprehensive Annual Financial Report (CAFR)**
    - I worked on reviewing, revising and preparing the upcoming CAFR.

- **IRS Determination Letter**
    - I spent some time gathering information requested by our tax counsel required in the IRS determination letter process.

WELLS CAPITAL MANAGEMENT

James W. Paulsen, Ph.D.

Economic and Market Perspective

January 2, 2014

Bringing you national and global economic trends for more than 30 years

Some Guesses About 2014???

The new year will certainly be characterized by the Federal Reserve finally backing off from its full throttle approach toward the monetary accelerator. However, we also suspect U.S. and global economic growth will quicken more than most anticipate. Stronger economic growth combined with a further tightening in the resource markets (i.e., expect the unemployment rate to decline toward 6% by year-end and for the factory utilization rate to rise above 80% during the year) may lead to a modest rise in the U.S. inflation rate and produce the first "inflation scare/overheat/can the Fed exit fast enough" panic of the recovery. Consequently, the methodical and well-controlled monetary tapering which greets us here at the beginning of the year may turn to a "panic taper" as the year progresses wreaking havoc again in the bond market, creating a volatile but essentially flat stock market and perhaps producing solid returns for commodity investors.

Could U.S. Nominal GDP Growth Approach 6%?

In the U.S., we expect both real GDP growth and price inflation to accelerate this year. Real GDP growth should reach about 3.5% in 2014. Combined with a rise in the rate of GDP deflator index inflation to about 2.5%, the pace of nominal economic growth may prove the strongest of the recovery close to 6%. Several positive forces should help lift economic growth.

First, the pace of "private sector" real growth is already above 3%. Although overall real economic growth has only been 2% in the last year, excluding the public sector, private real growth has risen by 3.1% in the last year, 3.5% annualized since year-end and by a robust 5% pace in the latest quarter! Therefore, a significant improvement in overall economic growth is forthcoming this year simply because of a smaller decline in the government sector. Since sequester is ending, although public sector spending is not likely to grow much, it also will not likely collapse again as it did in 2013.

Second, both the U.S. and global economic recoveries are broader and more synchronized than at any time in this recovery. For the first time in the U.S., both housing activity and the manufacturing sector are expanding, slow but steady employment gains have led to a chronic decline in the unemployment rate, and consumer confidence is near a five-year high. Slow but synchronized growth is also evident about the globe. Currently, economic growth is positive and accelerating simultaneously in the U.S., Europe, Japan, and among emerging economies. While slow growth continues to characterize the world economy, as we enter 2014, most parts of most economies are finally "growing again" in sharp contrast to the spotty economic record in earlier years of this recovery.

Third, we suspect the new year may finally produce a noticeable improvement in capital spending. The corporate capability to drive a massive investment cycle has been evident throughout this recovery. However, in recent years, when CEOs looked about the globe, they saw a struggling U.S., contractions in both European and Japanese economies, and a significant slowing in emerging economic recoveries, hardly conducive to expanding operations. By contrast, today slow but positive growth is obvious nearly everywhere. In addition, while capacity is still ample, it is beginning to tighten. The labor unemployment rate should decline to about 6% this year and the factory utilization rate should soon breach the 80% level which historically has led to improved capital spending. Finally, throughout this recovery economic growth has been hovering about the widely perceived "stall speed" of about 2%. If real GDP growth finally sustains this year above 3%, corporate animal spirits should begin to awaken.

Fourth, money supply velocity, which has been a chronic contractionary force during this recovery is about to turn supportive for economic growth. The impact of monetary policy is dependent both on how fast the Federal Reserve increases the money supply and on how many times the money supply is turned over during the year with transactions. A single dollar of the money supply will create a dollar of nominal GDP if spent once a year but this same dollar can produce $4 of GDP if turned over (spent) four times during the year. Thus far, velocity has persistently declined during this recovery reducing if not neutralizing the positive impact of quantitative easing. In a research note we wrote in November (Economic & Market Perspective, November 11, 2013), we made our case for why velocity might begin rising this year. If this occurs, monetary conditions may become more conducive for economic growth even as the Fed tapers its quantitative easing program.

Finally, back in September (Economic & Market Perspective, September 13, 2013) we highlighted several under-appreciated forces which are poised to begin "juicing" economic activity including a recent steepening in the yield curve, much improved balance sheets both in the corporate and household sectors, a near record high homebuyer affordability index, continued low inflation stretching consumer purchasing power, a near record low U.S. broad trade-weighted dollar index within the context of a global recovery which has broadened and synchronized, a unique U.S. energy independence dividend, considerable pent-up demands building over the last decade, and finally, after facing this recovery with near record low consumer confidence, we enter 2014 with the highest household confidence in five years!

Controlled Taper to a "Panic" Taper?

We believe a mini-"inflation/overheat can the Fed exit fast enough" panic will likely come to dominate the 2014 economic and financial market climate. If, overheat fears do eventually grip mindsets, what is now a well-controlled, methodical monetary tapering may quickly become a panic tapering.

After years of worrying over sluggish economic growth, potential problematic deflation and a recovery speed which has been chronically disappointing, it is hard to imagine a cultural mindset worried about inflation or overheated conditions. However, traditionally, years when monetary policy finally turns more restrictive have frequently been volatile and characterized by rising anxieties. Moreover, we believe the U.S. economy is slowly stirring a cocktail of overheated fears.

We enter 2014 with the most massive and unconventional monetary policy ever employed in U.S. history with an incoming Fed chair widely perceived as dovish. The U.S. dollar has been very weak in recent months, short-term interest rates remain near zero, long-term yields are still close to record lows, the unemployment rate will soon have a 6-handle, the factory utilization rate will likely break above 80% in a few months, and the six month average annual wage inflation rate is currently at its highest level of the recovery at about 2.1%. Moreover, after declining in the last couple years, most commodity prices bottomed last summer. The CRB raw industrial commodity price index recently rose to its highest level since April and the Baltic Freight Rate Index has surged higher in recent months. Additionally, the growth rate in the M2 money supply has recently accelerated, the U.S. economy is firing on more cylinders than ever, and its annual growth rate may soon rise to the fastest pace of the recovery. Finally, for the first time, real economic growth is positive and improving simultaneously in the U.S., Europe, Japan, and in the emerging world.

Such an environment may be unremarkable with a consensus who has come to expect weak growth and deflationary pressures. However, it could quickly take on a whole new connotation should monetary velocity surprisingly turn higher for the first time in this recovery (see Economic & Market Perspective, November 11, 2013 for why velocity may turn higher this year). Considering the economy possesses an unprecedented almost $4 trillion in excess bank reserves, how would an about face in velocity (given the rest of the inflationary cocktail) change the conversation both inside and outside of the Federal Reserve? Wouldn't the controlled taper be abandoned in favor of just "liquidating excess reserves as soon as possible" (i.e., a panic taper)? What would it do to inflation expectations, the U.S. dollar, commodity prices, the price of gold, and wage demands? How high could bond yields rise if concerns suddenly shifted from getting the unemployment rate down to ensuring inflation does not get out of control? What would this cocktail do to the stock market? Would stocks rally on stronger economic growth or would heightened inflation fears and rising yields produce a correction?

Historically, a major change in the direction of monetary policy has seldom been completed in the controlled, linear, methodical, and calm fashion which today the Fed suggest they can accomplish. Rather, the reversal of an unprecedented and massively stimulative monetary policy is likely to be met with some trepidation if not outright panic.

Do not misunderstand. We are not suggesting the economy faces a significant inflation risk next year even if the cocktail combined with rising velocity stirs such fears. Nor are we suggesting real economic growth is set to explode. Currently, we expect only about 3.5% real growth this year—solid, but hardly explosive. While the inflation rate is likely to rise some this year as global growth and velocity increase, a serious imminent inflation problem within the U.S. or about the globe is not very likely. However, we do believe the cocktail which is currently being stirred does increase the likelihood of a serious "fear of inflation" this year. As history has often demonstrated, an actual inflation problem is not required (simply a change in inflation expectations) to cause considerable fluctuations in the financial markets.

Good Year for Commodities?

Among the three major asset classes (stocks, bonds, and commodities), commodities may provide the best investment results in 2014.

First, value has been restored among most commodity prices as they have underperformed during the last couple years and are no longer over-extended. The "safe-haven" premium embedded in precious metals during the early years of this recovery was dissolved in the last year as evidenced by the price of gold collapsing from almost $1900 to about $1200. A year ago many agricultural commodities prices were artificially elevated because of drought conditions which have subsequently been reversed. Industrial prices have weakened along with emerging economic growth in the last couple years and have cheapened considerably from recovery highs. Finally, after surging earlier in the recovery, most energy prices have been range-bound since 2010.

Second, the biggest challenge facing the commodity markets has been spotty and weak global economic growth. In the last couple years, many economies were either still in contraction (Europe and Japan), experiencing a major recovery slowdown (emerging economies), or were growing but only very sluggishly (U.S.). Global economic activity has synchronized and strengthened nearly everywhere as we enter 2014 which should produce a much better year for commodity investors.

Third, global economic activity has broadened and improved at a time when slack in the U.S. resource markets is beginning to lessen. The labor unemployment rate should near 6% during the year and the U.S. factory utilization rate is set to rise above the 80% level which historically has been associated with cost-push pricing pressures.

Fourth, as it has since the summer, we expect the U.S. dollar to weaken further in 2014. A weak U.S. dollar directly drives dollar-based commodity prices higher. It also should improve U.S. net exports, boost U.S. manufacturing activity and increase the domestic demand for commodities.

Fifth, should money velocity rise and a mini overheat/Fed panic emerge, the commodity markets would be primary beneficiaries of such fears. In fact, a position in commodities would provide investors some protection and diversification against any consensus mid-cycle inflation fear.

Sixth, commodity markets are already showing signs of bottoming. Since October, commodity markets are being led by a surge in industrial prices suggesting improved economic growth is starting to favorably impact commodity prices. The CRB raw industrial commodity price has recently risen to its highest level since early April! Moreover, materials stocks are also doing well. The S&P 500 materials sector stock price index has been outpacing the overall stock market sharply since late summer. Finally, the Baltic freight rate index (a measure of the global rates charged to move materials) has surged since last summer suggesting international commerce in commodities is strengthening.

We are not implying commodity prices are returning to the secular advance they made during the last decade. That is probably over. Rather, we simply believe 2014 will prove a cyclical opportunity to profit from commodity investments. Investors may want to consider some allocation to this class if only for diversification purposes.

Why a Weak U.S. Dollar?

Most expect the U.S. dollar to strengthen as the Fed begins tapering its QE (quantitative easing) program. For several reasons, we suspect the U.S. dollar will surprisingly weaken this year.

First, while QE has been a massive program, it has not noticeably changed the growth of the U.S. money supply. If huge QE additions did not bloat the money supply, why should tapering or even reducing QE balances slow the money supply? And, if the relative growth of the U.S. money supply does not change much vis-á-vis its trading partners, why should ending QE have much impact on exchange rates?

Second, if money velocity begins rising this year, the Fed may not be able to prevent the growth of the money supply from accelerating even if they begin draining QE balances. The biggest monetary surprise this year may be that the money supply accelerates even though the Fed tapers and then reduces its QE program. A rising U.S. money supply (juiced by stronger velocity trends) relative to foreign money supplies would tend to weaken the U.S. dollar.

Third, it is difficult to know how much of a safe-haven premium, if any, has been imbedded in the U.S. dollar during the early part of this recovery and whether it has yet been dissolved. Like gold, we think the value of the U.S. currency has been at least partially elevated by the global economic fears which have persisted since the 2008 crisis. However, as confidence about the sustainability of the global recovery improves, safe-haven premiums are likely to continue to diminish. Consequently, as confidence about the globe improves, the value of the U.S. dollar may surprisingly weaken.

Finally, we expect changes in relative global economic growth rates to impact the U.S. dollar this year. U.S. real GDP growth will likely rise above 3% this year and in isolation this would strengthen the U.S. dollar. However, most other economies are also experiencing acceleration in their recoveries. And, in most cases, improvements in foreign growth rates are more dramatic and by comparison to the U.S., should lead to a weaker dollar. In both Europe and Japan, economic growth is moving from contraction to expansion, a much more dramatic change than the mild acceleration in growth within the U.S. Similarly, most emerging world economies are finally reaccelerating after slowing dramatically during the last couple years. In our view, even though U.S. economic growth will improve this year, foreign economies will likely enjoy more "dramatic" improvements adding to U.S. dollar weakness.

Another Year of REPRICING the Bond Market!?

Throughout this recovery, bond yields have been distorted by persistent Armageddon fears and because of the unprecedented quantitative easing policy enacted by the Federal Reserve. Both have kept yields below normal equilibrium levels which would more appropriately reflect a sustainable economic recovery. Last year, however, the bond market began to normalize because the consensus economic outlook finally "gave up the Armageddon ghost." As household confidence rose to a five-year high, the 10-year bond yield increased from a low early last year of about 1.5% to about 3%. Although the influence of fear in the bond market is starting to diminish and bond yields are more fittingly reconnecting with the economic cycle, we believe this "repricing process" is only about half way completed. Several factors suggest another difficult year in the bond market as the 10-year Treasury yield may rise to about 4%.

First, historically, the 10-year Treasury yield has traded about 2% to 4% above the annual rate of core consumer price inflation. We expect core consumer inflation to rise above 2% this year, suggesting the 10-year bond yield could rise to about 4% just to reach its normal historic range relative to the cyclical inflation rate.

Second, Treasury yields have also had a close relationship with overall nominal economic activity (i.e., nominal GDP growth). When nominal economic growth was rising on a secular basis (e.g., from WWII until about 1980), the 10-year Treasury bond yield typically averaged about 2% less than the annual rate of nominal GDP growth. Since 1980 however, as nominal GDP growth has been slowing on a secular basis, the 10-year bond yield has traded very close to the annual rate of nominal GDP growth. We expect annual nominal GDP growth to accelerate this year possibly approaching 6% by year-end. Assuming the old relationship between rising nominal GDP growth and Treasury yields rules (i.e., before 1980 when the 10-year yield tended to trade about 2% less than nominal GDP growth), 6% GDP growth would imply a 4% 10-year yield.

Third, as the unemployment rate declines towards 6% this year, we think the rate of wage inflation may finally accelerate modestly. While we do not expect a serious wage inflation problem, any uptick in the annual wage inflation rate to between 2.5% to 3% would likely be met with concern among bond investors adding to the upward pressure on yields.

Finally, it is probably reasonable to assume some turbulence in the bond market this year as the Fed begins to taper. The Fed has sold its tapering process and outlook for interest rate policy as well-controlled, well-communicated, methodical, and linear. However, this is not typically how monetary policy works. Usually, at the point in an economic recovery when the Fed finally moves from accommodation towards a more restrictive policy, the bond market has struggled and often a mini-panic results.

The good news for bond investors is the quicker the bond market is reconnected with the economic recovery, the sooner bonds will once again become a viable investment. That is, unlike today, one with reasonably good value and without excessive risk. If inflation stays well controlled in this recovery (say annual core inflation remains 3% or less for most of this recovery), a 10-year bond yield with a 4-handle may again represent a competitive investment alternative. For now, however, portfolios should be minimally allocated to fixed income, keeping bond duration below average and overweighting yield spread markets (which offer some buffer to a rising yield environment) including international bonds, lower credit quality, and structure plays.

Stock Market Turbulence in 2014 .... But Long-Term Bull Still has More Left!?!

We expect a volatile but essentially flat year for stocks in 2014, but also believe the bull market is likely to last several more years.

The velocity of the money supply will likely prove the dominant force behind the stock market this year (for a more detailed analysis of the impact of money velocity on the stock market see the Economic and Market Perspective report from November 11, 2013), and historically, when money velocity first rises in a recovery, the stock market typically has been volatile. We expect this may be the case again in 2014.

Usually, a faster turnover of the money supply initially leads to improved economic momentum and a higher stock market. Is this happening now as we begin 2014? Once it become obvious velocity has indeed turned up, however, both investors and the Fed begin to worry over potential inflationary fallout. Bond yields adjust higher in anticipation of potentially greater nominal activity and Fed policy is altered appropriately. This rather abrupt change in the landscape, combined with an already extended rise in the stock market leading up to the increase in velocity, forces investors to reassess and ushers in a more difficult period for stocks.

In the post-war era, there have been three major recovery cycles, which like today, saw monetary velocity decline during the first several years of the recovery before finally and surprisingly improving. In each case, the stock market typically did well in the months leading up to the bottom in velocity but often struggled once velocity actually began rising. This occurred in the 1960s recovery, the 1980s recovery, and the early-2000s recovery. In the 1960s recovery, velocity first bottomed in 1965 and the stock market suffered a correction in 1966. Similarly, velocity first bottomed in the 1980s recovery in early-1987 and the stock market collapsed that fall. Finally, velocity first bottomed in 2003 and the stock market was flattish in 2004 (and almost experienced a 10% correction).

In the last year, the S&P 500 index has risen almost 30% and money velocity is still widely perceived as declining. However, economic activity has broadened and strengthened in a manner which may suggest velocity has already begun to improve. U.S. real economic growth clearly appears to be rising above 3% and globally real growth is positive and accelerating simultaneously in the U.S., Europe, Japan, and among emerging world economies.

Moreover, the improving global economic recovery has probably been the primary force driving stock markets higher. However, if velocity is indeed beginning to rise, this positive force may eventually turn negative for the financial markets similar to past velocity recovery cycles. That is, could 2014 rhyme a bit with 1966, 1987, or 2004? If velocity rises, will overheating fears surface, will the Fed focus shift exclusively toward its exit strategy, will the 10-year bond yield surge higher toward 4%, and will the stock market after perhaps rising even higher in the first part of the new year (say to around 2000ish) eventually struggle and maybe suffer a correction before the year is over (ending at about where it started the year around 1800ish)?

How should investors play a volatile but flattish stock market in 2014? While pregnant with possibilities, volatile markets are very difficult to trade profitably. For those who are adventurous, and wish to attempt to benefit from the likely market oscillations, timing will be everything. Our advice is to begin the year overweighting economically sensitive sectors (e.g., materials, industrials, financials, and technology) and if and as the S&P 500 rises toward the 2000 area, if investor optimism/euphoria surges and if the 10-year treasury yield breaks above 3.5%, start to alter equity exposure toward more defensive sectors (e.g., consumer staples, utilities, low beta, and high dividend payers). Good luck!

Another approach is to simply ignore what may prove to be an uninspiring overall stock market year. Focus instead on positioning the portfolio during the year to be appropriately allocated for a renewal of the bull market cycle by 2015. If your current portfolio is out of sync with where you would like to be by this year end, consider investing about one-twelfth of the required shift each month during the year. Perhaps it is best not to stress over 2014 and instead use any market volatility during the year to "average in" toward your desired portfolio headed into next year.

Longer-Term Stock Market Potential Still Significant?!?

Most importantly, investors should avoid getting too cute attempting to time the volatility this year less they miss what will likely prove only a pause in an ongoing bull market during the next several years. If inflation spirals out of control (not our forecast), the Fed and bond vigilantes would aggressively increase interest rates and prematurely abort both the recovery and the stock market run. However, should inflation remain reasonably contained (e.g., the annual inflation rate remains 4% or less), the economic recovery will most likely last several more years, and while certainly not a straight line, the ultimate peak of the contemporary stock market bull should prove considerably higher.

With only a single exception (1980), U.S. post-war economic recoveries have not ended before the output gap—the percentage difference between current and potential GDP (currently a very wide -3.5%)—has turned positive. Today, excessive resource slack should allow the economy to grow for some time before shortages and cost pressures emerge. Moreover, confidence among most economic players remains too low to produce serious problems. Recessions are typically the result of stupid economic behaviors. Those which result from excessive confidence, if not cockiness, including excessive spending, overusing credit cards and bank borrowings, stretching into high-priced homes, running down savings and over-allocating portfolios into risky investments. Likewise, confidence among businesses leads to overstaffing and overbuilding operations. While economic players are becoming more comfortable than earlier in this recovery, the full-out "animal spirits" behaviors almost always obvious before recoveries end have yet to surface.

For the stock market, like the overall level of economic confidence, valuations remain only slightly above average compared to historic norms. As confidence continues to rise back to traditional recovery peak levels, so will stock market valuations. A numerical example suffices to illustrate remaining potential. Assume in the next five years nominal GDP growth averages about 5% per year (maybe about 3% real and 2% price inflation?) and S&P 500 earnings grow at about the same pace. Currently, trailing S&P 500 earnings per share are about $106. If they grow about 5% annually in five years, they will be close to $135. If the recovery persist for the next five years (making the recovery only one year longer than in the 1980s and one year shorter than the 1990s recovery), confidence will rise toward peak levels and so would valuations. Assume the price-earnings multiple rises to a peak of about 21 times. This would imply a target price for the S&P 500 index of about 2800 providing investors an annualized return of slightly more than 10% with dividends!

Happy 2014!??

This year will likely prove exciting for the stock market. Perhaps the S&P 500 will reach as high as 2000 before succumbing to a correction returning it close to where we begin the year. Isn't it just like the stock market to turn more difficult just as most are finally beginning to return to stocks for the first time in this recovery? While it may be enjoyed by traders or timers, we suspect it will prove quite challenging and frustrating for most investors. Compared to the bond market, though, a flat stock market may represent a safe haven. At 3%, the 10-year Treasury bond yield is still probably about 1% below a fair equilibrium yield which more appropriately reflects the ongoing economic recovery. Finally, a year characterized by overheat/inflation overtones may surprisingly make the commodity markets the best performing investment.

Most importantly perhaps, investors should remain mindful that while 2014 may prove challenging, we are not likely facing a major inflation risk, we will likely survive beyond the Fed beginning to tighten monetary policy and while we may pause in 2014, the stock market probably still offers considerable upside beyond this year.

Thanks for taking a Look!!

Written by James W. Paulsen, Ph.D. 612.667.5489 | For distribution changes call 415.222.1706 | www.wellscap.com |

Judge Rules San Jose Pension Reforms a Violation of Rights

Local Governments - Exclusive — 02 January 2014

Originally posted at CalPensions.
By Ed Mendel.

A superior court ruling announced last week overturned key parts of a voter-approved San Jose pension reform: an attempt to cut employer costs for pensions earned by current workers in the future.

As the city struggled with large deficits during the last decade, the court was told, annual retirement costs more than tripled to $245 million while basic services were cut and the number of police and firefighters dropped.

Mayor Chuck Reed and other Measure B backers argued that cutting the cost of pensions earned by current workers in the future, while protecting amounts already earned, is needed to get significant savings.

But a series of state court rulings are widely believed to mean that the pension offered current workers on the date of hire becomes a vested right, protected by contract law, that can only be cut if offset by a new benefit of comparable value.

Santa Clara County Superior Court Judge Patricia Lucas *said in her ruling* the question before her court is "one of law, not of policy," referring to a state Supreme Court response to city and county briefs on an Orange County attempt to cut retirement costs.

"The legal question is whether and to what extent Measure B violates vested rights," Lucas said of the union lawsuits challenging the measure approved by 70 percent of San Jose voters in June last year.

San Jose attorneys argued that two provisions in the city charter, which allow the city to "amend" or "repeal" retirement plans at any time, prevent the creation of vested rights for employees in the two city-run pension systems.

The city cited language in an appellate court ruling in support of its position. The judge cited contrary language in a state Supreme Court ruling and a footnote in the appellate court ruling saying it should be limited to the peculiar facts of that case.

"Accordingly, this court concludes that a reservation of rights (to amend or repeal the pension plans) does not of itself preclude the creation of vested rights," Judge Lucas ruled.

The key part of Measure B gave current workers an option: 1) Increased pension contributions of up to 16 percent of pay, but no more than half the cost of paying for the "unfunded liability" debt. 2) A much lower pension for future service.

Lucas rejected city arguments that workers have no vested right to city payment of all of the unfunded liability and that, at times, unions have regarded pension contributions as compensation, which the city can regulate.

A lower pension, avoiding a contribution increase, was similarly rejected with a mention that the plan lacks IRS approval. Orange County has been waiting since 2009 for IRS approval of a lower pension-higher contribution *option negotiated* with unions.

And a cut of San Jose retiree pension cost-of-living adjustments for up to five years, if the city council declares a fiscal emergency, was overturned by Lucas as a violation of vested rights.

After a five-day trial in July and some follow-up action, the judge ruled on a consolidation of six suits filed by public employee unions and retirees challenging 10 of the 15 sections of Measure B, with 11 different causes of action.

Among the parts of the measure upheld by Lucas is the authorization of pay cuts to get equivalent city savings if the lower pension-higher contribution option is ruled invalid.

The city and unions have agreed to delay pay cuts until at least next July 1. Major savings from pay cuts reportedly could be difficult and are likely to face a legal challenge from police, one of the biggest city costs.

"The City Council earlier this month approved 10 percent pay raises for cops, after police officers began fleeing the department for better-paying cities," the San Jose Mercury-News said last week. "The cop exodus has coincided with a huge increase in crime, above the California and national averages, while arrests have dropped in half in recent years."

The judge also upheld tighter eligibility for disability retirement and an elimination of the "13th check" bonus payment to retirees when investment earnings exceed the forecast. A mixed ruling on retiree health care allowed some cuts and rejected others.

Mayor Reed said the ruling protects $20 million in current budget savings from elimination of the bonus check and retiree health care changes. But the invalidation of parts of Measure B "highlights" the lack of flexibility in controlling retirement costs.

"That's why I believe that we need a constitutional amendment that will empower government leaders to tackle their massive pension problems and negotiate fair and reasonable changes to employees' future pension benefits," he said in a news release.

Reed and others are proposing an initiative to put a constitutional amendment on the ballot that would give state and local governments the option of cutting pensions current workers earn in the future, while protecting pension amounts already earned.

A title and summary for the proposed initiative, based on a cost analysis by the nonpartisan Legislative Analyst's Office, is being written by the office of state Attorney General Kamala Harris.

"Breaking the promise by eliminating the vested benefit rights of police officers and other public employees is a non-starter in the courts and with the public," Dave Low, chairman of Californians for Retirement Security, said in a news release.

The leader of the labor coalition said the "more than $3 million in taxpayer dollars" spent on the Measure B legal battle will be the "tip of the iceberg of the legal costs" if the proposed initiative moves forward.

Low said Reed should join "nearly 400 leaders across the state" in negotiating cost-cutting agreements with unions. Reformers say not enough savings result from the typical agreement, higher worker pension contributions and lower pensions for new hires.

Warning that pension costs could "crush" government, the bipartisan Little Hoover Commission said in *a 2011 report:* "The Legislature should give state and local governments the authority to alter the future, unaccrued retirement benefits for current public employees."

A pension reform approved by San Diego voters last year, Proposition B, was designed to bypass the vested rights issue. All new hires, except police, were switched from pensions to 401(k)-style individual investment plans.

For current workers the initiative called for a five-year freeze on pay used to calculate pensions. Unions agreed to the freeze, expected to reduce the $275 million city pension payment this year by $25 million, *U-T San Diego reported*.

But the city pension board declined to immediately include the freeze in cost projections, so current year savings were lost. The city retirement system has projected that Proposition B will save $949.5 million over 30 years.

latimes.com/opinion/commentary/la-oe-clark-california-pension-reform-20131229,0,5603872.story

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Op-Ed

When it comes to pensions, California is no Detroit

The Golden State's troubles are solvable if unions and conservatives each give a bit.

By John D.R. Clark

December 29, 2013

The Detroit bankruptcy court judge's ruling that employee pensions are "on the table" for potential reductions has spurred yet another round of acrimonious debate between those on the right who blame public-sector pensions for virtually all of government's fiscal problems and employee unions that deny there's a problem at all.

Neither side is right.

Most of the pension funds in extreme crisis (including those in Illinois, Kansas, Detroit and Chicago) got that way not because of the pension system itself but rather because elected officials failed to make the annual required contributions needed to keep funds solvent. Skipping these payments was politically expedient during the Great Recession, but the unpaid bills compounded quickly.

SOCAL POLITICS IN 2013: Some rose, some fell -- and L.A. lost its women, almost

The amounts now owed to some of the worst-funded plans, like Detroit's, are beyond the realistic ability of their sponsoring governments to pay. This, of course, infuriates union members who note, accurately, that if the bills had been paid on time, the crisis wouldn't exist, at least in its present proportions.

California has a different problem. Here, it is not possible for local agencies to defer or reduce their required contributions to the California Public Employees Retirement System, or CalPERS. California's pension problems have much more to do with pension enhancements. This was a major factor, but far from the sole cause, of bankruptcies in Vallejo, Stockton and San Bernardino.

Before pension formulas were increased in 1999, the typical police and fire employee accrued 2% for each year of service as long as the employee retired at 50 or later. A person who started as a firefighter or police officer at 20, say, could retire at 50 with 60% of his or her pay. The post-1999 enhanced formula adopted by most jurisdictions statewide was 3% for each year worked if they retired at 50 or later. This meant that those same 30 years were now worth 90% of salary, a 50% jump.

2013 ENDINGS: Columnist Patt Morrison on what she won't miss

On average, cities and counties in California pay about 35% of every police and fire salary dollar as the employer contribution to CalPERS. Employees themselves contribute an additional 8% to 12%. This is why California's pension system is not in a crisis, despite what the anti-union critics say. Our local governments and their employees are making contributions totaling 40% to 50% of salary to keep the state's pension system solvent.

But it's easy to see why governments are having a hard time shouldering the financial burden. That burden has been made harder by CalPERS' decision to slowly ratchet back its investment return and other assumptions to more conservative positions. This will further improve CalPERS' financial situation (which is already pretty good), but employer rates will also rise. The total contributions of employer and employee may one day hit nearly 60% of a salary.

This is the part of the problem that unions have been loath to recognize.

More than 40% of the pension contribution made by cities and counties for police and fire employees is attributable to the increase from pension enhancements, which raised the payout after 30 years of employment from 60% to 90%. For a medium-sized suburb with 100 sworn police officers and 50 sworn firefighters earning an average base pay of $80,000 annually, the difference between the old pension formula and the new amounts to $1.8 million a year.

Reforms enacted last year in California trimmed back pensions for new hires to a level roughly similar to the pre-1999 levels. But the rub for employers is that because these new formulas apply only to new employees, it will take at least 10 years to realize significant savings. In the meantime, governments will be funding the higher-formula employees throughout their working life and retirement.

Still, the new pension formulas will eventually bend the cost curve downward. What they won't do, but should, is require an increase in the percentage that employees have to pay.

It would not be unreasonable to ask the grandfathered employees to increase their contribution to, say, one-third of the employer-employee total. This might mean a very high employee contribution of 20%, but it would still be a bargain considering it buys a lifetime pension of 90% of very generous pay.

In the end, neither side's extreme rhetoric comes close to accurately describing the situation. Conservatives who lay the blame for the bankruptcies of Vallejo, Stockton and San Bernardino solely at the feet of employee pensions must understand that many factors led to these cities' insolvency, including huge losses of tax revenue, population flight and inflexible salary increase requirements embedded in their charters. The vast majority of cities and counties in California are not on the same path as Vallejo, Stockton and San Bernardino.

By the same token, employee unions have to accept that the enhanced benefit formulas for public safety employees are not sustainable without increased employee cost-sharing. It is true that none of these benefit enhancements was a secret deal; they were publicly adopted contracts considered in the full sunshine by elected officials only too willing to curry favor with employee unions at the time, especially police and fire unions. But there is a point at which such generosity is unsustainable when coupled with other major cost generators and tax losses, as we saw in varying degrees in San Bernardino, Stockton and Vallejo.

There is a realistic and moderate solution, however.

Conservatives need to dial down the rhetoric and stop trying to use pensions as a Trojan horse to abolish public employee unions. They also need to accept that defined-benefit pension plans with firm guarantees for the future are good public policy if managed prudently. Union members need to acknowledge that, in order to keep some very favorable benefits, they will have to contribute more of their own pay. They also need to accept that state and local governments have limits: salary, benefits and job security have to remain in line with a city's actual resources.

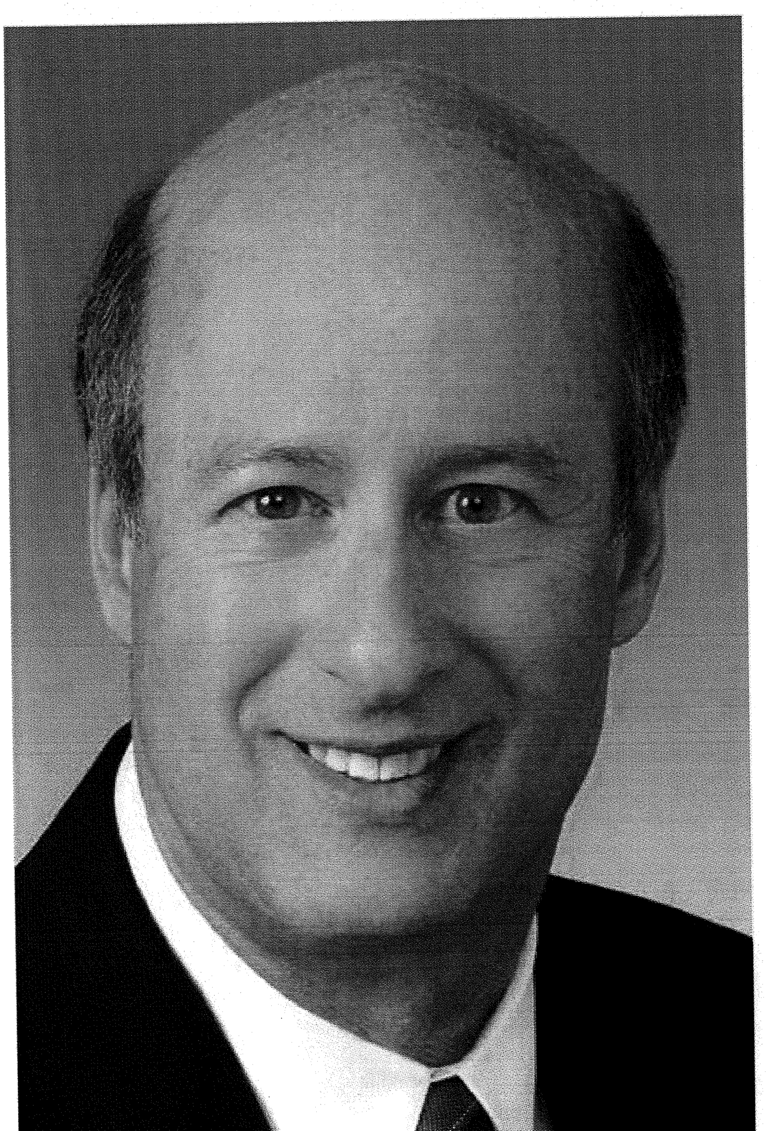
That's all it would take. If only it weren't politically unacceptable to both sides.

John D.R. Clark is human resources director and treasurer for the city of Garden Grove and has worked with public pensions for 20 years.

Pensions&Investments

Not so fast in applying Detroit bankruptcy precedent — at least in California

By: Harvey L. Leiderman
Published: December 18, 2013



Lest California cities in, or considering, bankruptcy get too euphoric over the mileage they might get from the Detroit ruling on public employee pension rights ("Detroit ruling reverberates with pension funds around country," Pensions & Investments Dec. 9), a check under the hood might be useful.

Fifty years ago, Michigan changed its constitution to grant public employees contract rights to their pensions in retirement. The state's employees thought that this would be an ironclad way to protect their pensions against impairment, given the added state and federal constitutional protections afforded contracts. Instead, Michigan inadvertently exposed their public servants' pensions to the chop shop of federal bankruptcy courts, which are in the business of doing just what employees fear — impairing contracts. And Michigan declined to go further in protecting pension plan participants' rights. Indeed, as U.S. Bankruptcy Court Judge Steven W. Rhodes said in his Detroit ruling Dec. 3, Michigan could have added additional protections for retirees. "It could even have explicitly required the state to guarantee pension benefits. But it did none of these." For that reason, it was pretty easy for Mr. Rhodes to conclude that since the only rights pension plan participants had were contract rights, "they are subject to impairment in a federal bankruptcy proceeding."

But here is where California's vehicle for delivering pension benefits has a few options that might give its public pension plan participants better mileage in the long run. In California, retirees do not have a contract with their former public employers. They are not "creditors" of the municipalities for whom they once worked and they don't have "claims" against those

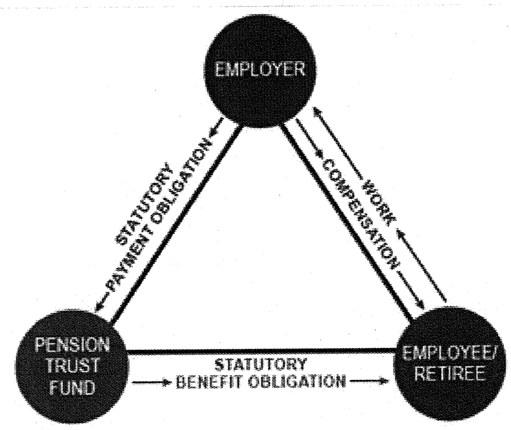
Harvey L. Leiderman is a San Francisco-based partner with the international law firm Reed Smith LLP. He serves as general, fiduciary, litigation and investment counsel for the California Public Employees' Retirement System, California State Teachers' Retirement System and other California city and county retirement systems as well as investment counsel to the South Carolina Retirement System Investment Commission. Among his work, he was fiduciary counsel to the Orange County Employees' Retirement System during that county's Chapter 9 bankruptcy proceeding, filed in 1994. Mr. Leiderman's comments are his own, and not necessarily those of his firm or any of its clients.

municipalities. What's more, the unfunded liabilities on the books of the retirement fund are not even a "debt," according to the California Court of Appeals.

The obligations owed to California retirees to pay their retirement benefits are owed by an independent public agency — the retirement trust fund — not by their former employer. That's by statutory design, not by contract. And the obligation owed by the employer to the pension trust fund is also not one of contract, but of statute. It was the exercise of the state of California of its governmental powers that created these statutory obligations, independent of any contractual rights and obligations between the employer and employee while in the employment relationship.

As a result, there can be no "contract" between a California retiree and a former employer that is in danger of "impairment." And the federal bankruptcy courts may not interfere with the exercise of state political and governmental powers, under the 10th Amendment of the U.S. Constitution and Section 903 of the Bankruptcy Code.

The following diagram might be helpful in understanding these relationships:



Only while the employee is working for the employer is there a contract that can be rejected (a la the Vallejo city bankruptcy proceedings) or impaired by a bankruptcy court. Once in retirement, the retiree looks to the pension trust fund for a monthly benefit check, and the trust fund looks to the employer for full funding. This is the statutory framework in California. In contrast, the Detroit bankruptcy judge was stuck with a Michigan law that only described the contractual relationship of two of the parties, down the right side of the diagram. California law, however, presents the full picture, with all the vehicles' retirement features protected by statute. Call it the California "lemon law" for pensioners.

Detroit's pension guzzler cannot compare with the California hybrid. The California model includes the optional equipment employees in Michigan never got — an explicit guarantee of their pension benefits. California state, county and city pension laws all require full funding of retiree benefits by statutory mandate, not contract, expressly written into the Public Employees' Retirement Law, the State Teachers' Retirement Law, the County Employees Retirement Law, and in virtually every other city charter and municipal code. That's the left side of the diagram. As a result, public agency retirees in California have a statutory engine powering their rights, and need not fear that a bankruptcy court will run them off the road.

So let's be careful when we assume all vehicles for delivering pension promises might run out of gas in federal bankruptcy court. At least in California, your mileage might differ.

Harvey L. Leiderman is a San Francisco-based partner with the international law firm Reed Smith LLP. He serves as general, fiduciary, litigation and investment counsel for the California Public Employees' Retirement System, California State Teachers' Retirement System and other California city and county retirement systems as well as investment counsel to the South Carolina Retirement System Investment Commission. Among his work, he was fiduciary counsel to the Orange County Employees' Retirement System during that county's Chapter 9 bankruptcy proceeding, filed in 1994. Mr. Leiderman's comments are his own, and not necessarily those of his firm or any of its clients.

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CalPERS officials: Detroit pension ruling won't affect public employee retirements here

By Dale Kasler
dkasler@sacbee.com
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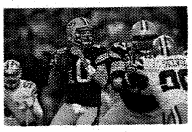
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It was the shot heard around the pension world – a judge's ruling that the city of Detroit can use bankruptcy laws to roll back its promises to employees and retirees.

But CalPERS officials, facing their own potential showdown in U.S. Bankruptcy Court, said Friday they doubt the Michigan ruling constitutes a threat to public employees and retirees in California.

In their first extensive comments on the landmark decision in Detroit, lawyers with CalPERS said California pensions carry major legal protections not found in Detroit.

"The differences between Detroit and the state of California and CalPERS are substantial," said Gina Ratto, the pension fund's interim general counsel, in a conference call with reporters.

Nonetheless, she said, "We're troubled by the Detroit bankruptcy decision, and we disagree with it."

While the Michigan decision isn't legally binding in California, "bankruptcy judges do rely on decisions out of other bankruptcy courts," Ratto said. The ruling "creates concern on the part of public servants around the country."

The issue is hardly academic in California. The bankrupt city of San Bernardino already owes about $14 million in overdue pension contributions and has publicly suggested it wants to reduce its $24 million annual payment to CalPERS.

Despite the opinion of CalPERS' legal team, several experts have said the Detroit ruling could strengthen San Bernardino's legal position as the city negotiates with the pension fund and other creditors.

The Detroit judge said pension promises are essentially the same as contracts, and contracts can be "impaired" in bankruptcy. That means they can be reduced. Detroit hasn't yet submitted an actual proposal for lowering its pension expenses, and the judge's ruling is being appealed by municipal unions.

Unlike Detroit, CalPERS' pensions are safeguarded by state law and the state constitution, according to Ratto and another CalPERS lawyer, Michael Gearin.

"We feel very strong about our case here," said CalPERS spokesman Robert Udall Glazier.

San Bernardino's City Council tentatively approved a plan for dealing with its debts in October, but the proposal is confidential while the city negotiates with creditors under supervision of a mediator. The inital negotiations in late November were "very promising," Ratto said, but she wouldn't elaborate because of the confidentiality ruling. Negotiations will resume Jan. 9 in Los Angeles, she said.

Glazier struck a conciliatory note, saying CalPERS is sympathetic to cities struggling to pay their pension bills. "We're committed to working with them," he said.

On the other hand, Ratto said "it's a criminal act" for a city to make payroll but not make its pension contributions. She said CalPERS isn't planning to seek charges against San Bernardino officials, however.

What's unknown is whether the Detroit ruling will influence the political climate in California. The mayor of San Jose, Chuck Reed, is promoting a ballot initiative to give government agencies leeway to impose cuts in pension costs.

Call The Bee's Dale Kasler, (916) 321-1066. Follow him on Twitter @dakasler.

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For more information contact:
Bob Palmer, SACRS Executive Director
(209) 483-0404

The State Association of County Retirement Systems Congratulates San Bernardino County Employees Retirement Association, 2013 aiCIO Industry Innovation Award Winner. The Sacramento County Employees Retirement System is runner-up for the Award.

SACRAMENTO, CA – Two members of the State Association of County Retirement Systems (SACRS) took first and second place in the 2013 aiCIO Industry Innovation Award competition. Both California county retirement systems were nominated in the Public Pension Plan under $15 billion category.

The aiCIO Industry Innovation Award is given to the pension system that demonstrates the most innovative and positive investment work being done at pension funds around the world. "SACRS is pleased to recognize and honor two of our California county funds for their accomplishments in the pension plan investment arena", said Doug Rose, SACRS President. The San Bernardino County Employee Retirement Association (SBCERA) and Chief Investment Officer Don Pierce won the award based on their income approach to investing and using options to manage risk. Rose added, "This award demonstrates California county retirement systems are indeed worldwide industry leaders among public pension institutional investors." SBCERA has generated a 15.4% year-to-date return and 12.6% three year annualized return.

The Sacramento County Employee Retirement System (SCERS) placed second in the competition. In recent years, SCERS has revised its investment portfolio to enhance diversification, lower risk and perform better across all economic environments.

Congratulations again to both SBCERA and SCERS!

Continued

More information about the aiCIO award process is outlined below:

The aiCIO reviews nominations annually in the following investment categories:

Foundation
Endowment
Corporate Defined Benefit Pension Plan Below $5 Billion
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Public Pension Plan Between $15 Billion and $100 Billion
Public Pension Plan Above $100 Billion
Sovereign Wealth Plan
Healthcare Organization

The aiCIO Methodology:

The aiCIO Industry Innovation Awards are split into two general categories: asset management/servicing and asset owners. Nominations were open from July 8 until August 16, 2013. With input from the aiCIO Advisory Board, made up of previous year's winners, as well as surveys and data where applicable, the aiCIO editorial team makes the final decisions as to nominees and eventual winners.

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