COMMONWEALTH OF PENNSYLVANIA

PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Date: **May 26, 2020**

To: **Public School Employees Retirement Board**

From: **Jennifer A. Mills**
Deputy Executive Director of Benefits and Director of Defined Contribution Investments

Subject: **Defined Contribution Committee June Report**

During the Defined Contribution Plan Committee meeting, I will provide a brief update on the Q1 2020 Due Diligence Review meeting held on May 21, 2020 and a fund update of the PSERS' School Employees' Defined Contribution Plan (DC Plan).

The Defined Contribution Plan Committee will be asked to consider the following recommendation during the June 12, 2020 committee meeting.

Action Item

Recommend that the Board:

- Approve the removal of Templeton Global Bond R6 (Templeton) from the Tier 2 Investment Options in the DC Plan.
- Approve such removal without a replacement fund.
- Authorize the notification to participants with a balance in Templeton to move such balances to an alternative option.
- Approve the transfer of such balances into the appropriate default investment alternative, which is the age appropriate target date fund in the T. Rowe Price Retirement Blend Trust series, if such participants fail to act in response to the written notice.

Such recommendation is made pursuant to the policy and guidelines set forth in the DC Plan's Investment Policy Statement (IPS) that requires the continued monitoring and evaluating of performance of the investment options and investment providers in consultation with Cammack Retirement Group and the PSERS Investment Office.

Following discussions and due diligence research with respect to the fund, the various options available to the Board, and the impact to participants, we believe that the removal of Templeton without a replacement fund and the transfer to the default investment alternative is in the best interest of the participants. Please refer to the attached memo submitted by Cammack Retirement Group for an analysis.

Enc.

CAMMACK RETIREMENT

MEMORANDUM

DATE: May 26, 2020
TO: Commonwealth of Pennsylvania Public School Employees' Retirement System
FROM: Cammack Retirement Group
RE: Templeton Global Bond R6

Background:

Templeton Global Bond R6 was originally included in the School Employees' Defined Contribution Plan (the "Plan") investment array as a complementary fixed income option alongside the inflation protected, core-plus and high yield bond funds. This provided additional choices in the fixed income space, offered diversification from U.S. interest rates, and allowed participants to take advantage of a greater opportunity set. With developed and emerging market countries becoming an increasingly larger portion of the fixed income universe, including the world bond asset class in an array was intended to provide participants with the ability to take advantage of different monetary policy cycles, yield curves and corporate bond markets as opposed to having a purely home bias. The inclusion of the asset class also aligned with the investment philosophy of the System's defined benefit plan at that time, which included exposure to world bond.

Fund Strategy:

Templeton Global Bond follows an opportunistic approach to investing in global government bonds and currencies. Value is generated via three main sources: yield curve, currencies, and sovereign credit. The fund's more distinctive style has stood out from its world bond peers, where the manager has traditionally avoided investing in the low- and negative-yielding developed markets in favor of emerging markets countries with positive yields, improving fundamentals and appreciating currencies. While the manager predominately invests in global government bonds, Morningstar re-classified the fund into the nontraditional bond category in 2019 due to the manager's significant flexibility to adjust duration relative to its benchmark, the FTSE World Government Bond Index. This fund differs considerably from its newly assigned peer group, which is dominated by U.S.-centric, low-volatility strategies that invest primarily in corporate credit.

While Templeton Global Bond was originally scrutinized due to a manager change and not performance concerns, the macro environment changed significantly in 2019, causing the fund to experience a performance gap relative to its benchmark and world bond peers. The Fed's change in policy resulted in the collapse of global bond yields as rising trade tensions threatened the global growth outlook. This brought U.S. rates down to historic lows and contributed to the continuation of negative rates in Europe and Japan. The strategy's near-term performance was negatively impacted by the manager's short duration posture as yields declined throughout 2019 and a position in Argentina, who saw its currency collapse in August 2019 as a result of political turmoil. The manager's contrarian approach and currency positioning has led to a volatile experience for investors. While the team has notably reduced the risks in the portfolio, the market environment continues to be challenging for the strategy.

Current Market Environment:

Non-U.S. government bond yields have continued to decline as economies outside the U.S. have not recovered since the last recession. Japan, one of the largest countries in a global bond index, has led the way with yields remaining near zero for much of the last decade. European interest rates were dragged into negative territory a few years after the European debt crisis. At first, Europe's historic move into negative territory was thought as a short-term experiment to jump start their economy. However, it now appears to be a longer-term feature in the global landscape. Given the magnitude of the current crisis driven by COVID-19, rates are likely to remain low for the foreseeable future as policymakers will want to see a sustained recovery before lifting rates from their emergency levels.

While the world bond asset class provides opportunities to invest outside the U.S., the current negative yield environment does not offer value to investors as it guarantees a loss of principal if an investment is held to maturity. The global stock of negative yielding debt rapidly increased throughout 2019, peaking at around $17 trillion by mid-year. While it has fallen slightly since then, a substantial portion of developed market countries continue to trade with negative yields. These countries (i.e. European bloc and Japan) are among the largest constituents in traditional global government bond indices, such as the FTSE World Government Bond index or the Bloomberg Barclays Global Aggregate Index. Considering that forward-looking capital market return expectations are lower in markets outside the U.S., it may be worthwhile to review whether this asset class continues to be suitable for participants.

Low Utilization:

Since the program launched on July 1, 2019 the majority of participants have remained invested in the default target date option (T.Rowe Price Retirement Blend Trusts), which hold approximately 99% of Plan assets. The other 1% of Plan assets are spread across 11 other core investment options. As of 4/30/2020, 5 participants hold approximately $1,371 in Templeton Global Bond R6. Out of total Plan assets of $9,874,777 and 14,210 participants, Templeton Global Bond R6 is not highly utilized among participants.

Recommendation:

Cammack Retirement Group's recommendation is to remove world bond as an asset class and eliminate Templeton Global Bond R6 given the low utilization by Plan participants, the challenging environment negative interest rates creates for investors, and the underperformance and volatility experienced by the fund. This recommendation also aligns with the elimination of the asset class exposure from the System's defined benefit plan.

There are three other bond options currently available in the Plan lineup should participants seek diversifying alternatives in the fixed income category. This includes an intermediate core-plus bond fund (PIMCO Total Return Instl) which invests broadly across the fixed income spectrum in out-of-benchmark sectors, a high yield bond fund (BlackRock High Yield Bond K) which seeks to deliver a higher yield of income from non-investment grade bonds, and an inflation-protected bond fund (PIMCO Real Return Instl) which aims to protect and enhance the investors' purchasing power. Eliminating the world bond asset class does not limit participants from gaining exposure to other sources of diversifying fixed income, if elected. We can certainly revisit this decision if the environment changes at some point in the future.

As there is not a similar investment offering currently in the array that would allow for a true "like-to-like" mapping, we recommend following ERISA best practices by mapping the assets to the default investment alternative, the age appropriate target date fund in the T.Rowe Price Retirement Blend Trust series.

Our recommendation is provided solely for the benefit of the School Employees' Defined Contribution Plan and was developed given the needs, objectives, and circumstances of the Plan and its participants. This recommendation cannot be relied upon by other plan sponsors.

www.cammackretirement.com
New York, NY | 40 Wall Street, 56th Floor · New York, NY 10005 · Tel 212.227.7770 · Fax 212.267.3832