PAPERS

Pennsylvania Association of Public Employee Retirement Systems

PO Box 61543, Harrisburg, PA 17106-1543

Website: ***www.pa-pers.org***

Winter 2023

In This Issue

Hybrid Format Conferences

PAPERS has reaffirmed its earlier decision to continue offering both of its two annual conferences – *Spring Forum & Fall Workshop* – in hybrid format. Some sessions will be offered only in virtual on-line format while other sessions will be available both in-person and on-line.

Th 2023 Spring Forum will take place May 17-18 and May 23-24. The in-person portion of the 2023 Fall Workshop is scheduled for Nov. 9th; the virtual dates are not yet confirmed.

Registration begins about two months prior to each conference. watch for details to be posted on the PAPERS website www.pa-pers.org.

2023 PAPERS Spring Forum

Held in Hybrid Format

Virtual Sessions May 17 & 18, 2023

(mornings only)

In-Person Sessions May 23 & 24, 2023

@ Harrisburg Hilton Hotel

Registration begins March, 2023

Forum Opportunities for PAPERS' Corporate (Associate/Affiliate) Members

Become a corporate sponsor –

Details at: **http://www.pa-pers.org/newweb/documents/Membership%20and%20Sponsor%20Fees%202023.pdf**

- Platinum - $5,000
- Gold $3,000
- Silver $2,500

Submit a proposal for a workshop/speaker –

Proposals must be submitted in writing to PAPERS no later than Feb. 10, 2023, to be considered for the Spring Forum. The application form may be found by clicking on: **http://pa-pers.org/newweb/documents/Speakerapplication.pdf.**

New Certification Program

A Cooperative Effort between PAPERS & Penn State

PAPERS is proud to announce its partnership with Penn State University on its new Certified PA Public Retirement Plan Professional program. This certification is an ideal way to better understand your fiduciary role and how to carry out fiduciary responsibilities.

Is your PA retirement system meeting its obligations to employees and their families? If you're in a decision-making role on behalf of your PA retirement system plan, it's your legal responsibility to ensure that decisions are being made in the best interests of plan participants and beneficiaries. What's more, as a fiduciary you may be personally liable for the decisions made by the plan. With increasing news headlines and legal and regulatory pressure on public retirement plans, now is the time for comprehensive fiduciary education.

The certification program provides participants with exposure to a diverse and comprehensive curriculum of fiduciary and plan management topics in a three-part process:

1. Complete an on-line introductory fiduciary process course developed by PAPERS and the Penn State University
2. Attend program sessions at PAPERS conferences focused on regulatory updates, plan management best practices and service provider due diligence.
3. Meet continuing education (CE) requirements with additional on-line education modules and content library resources.

Make a difference! Become a Certified PA Public Retirement Plan Professional.

More details will be posted on our website as they become available: **http://www.pa-pers.org**

Contact: Karen K. Deklinski, PAPERS Executive Director 717-979- 5788 kdeklinski@msn.com

Becoming a PAPERS Member is Easy

For details about PAPERS four membership categories and/or the simple process to apply for membership, check the "Join Now" section of the PAPERS website **www.pa-pers.org** or contact:

- **Mail - PAPERS, PO Box 61543, Harrisburg, PA 17106-1543**
- **Phone – (717) 921-1957**
- **Email - douglas.b@verizon.net**

The website gives complete details for three ways to submit the dues payment.

Membership Categories

- **Participating** ($125/year early bird rate; $150/year after 3/31/2023) - *Public employee retirement systems (pension funds)*
- **Associate** ($1,500/year) - *Corporate providers of legal and investment services to pension plans*
- **Affiliate** ($750/year) - *Corporate providers of other services, exclusive of legal and investment services, to pension funds.*
- **Sustaining** ($75/year) - *Individual membership open only to those persons with an interest in public pensions but not affiliated with an organization which qualifies for group membership in any other category above*

From the PAPERS Board President

Happy New Year!!!

As we embark on a new year, let me say 2022 was a year of transition. We are beginning to recover from the restrictions of COVID and held highly successful hybrid virtual and in-person conferences in May and November. Many thanks to Executive Director Karen Deklinski, Office Manager Doug Bonsall, and the Education Committee for all their hard work and efforts to put all the pieces together to present a great program. In addition, many thanks to our presenters for informative and timely topics and special thanks to our sponsors who helped make the conferences possible.

Moving forward our Forums, if no new restrictions are in place, will be a combination of in-person and virtual presentations. Look for details in the future.

As new proposed regulations and laws are coming at a rapid pace, now more than ever PAPERS is vital to keeping Trustees informed and up to date. Participation in these Forums is important to both PAPERS and your respective Retirement Plans.

As I write this article final details are being completed for our new Trustee Program developed in conjunction with Penn State. This program will be great training for Trustees and will comply with the required Training necessary once the State passes the mandatory Trustee Training Bill.

In closing, let me say that as the world of rules and regulations relating to Retirement Funds and Investments is changing constantly, PAPERS is here to help you better understand these new regulations.

Have a great rest of winter and spring and see you in May at the Forum.

Bob Mettley

PAPERS Board President

REITS: A Timely Opportunity for Real Estate Investors

By: Uma Moriarity, CenterSquare Investment Management

Uma Moriarity, CFA *is the Senior Investment Strategist and Global ESG Lead for CenterSquare Investment Management. She focuses on investment strategy across the firm's public and private real estate investment platforms and is an active thought leader for the firm. Uma graduated from The Pennsylvania State University and holds a B.S. in Finance, B.S. in Accounting, and Master of Accountancy. She is a CFA charterholder and member of the CFA Institute, a LEED Green Associate, and a member of the ULI San Francisco Sustainability Committee. She currently serves on the Board of Directors for Green Building United and the Penn State Smeal Sustainability Advisory Board.*

The statements and conclusions made in this article are not guarantees and are merely the opinion of CenterSquare and its employees. Any statements and opinions expressed are as of the date of this article, are subject to change as economic and market conditions dictate. Material in this article is for general information and is not intended to provide specific advice or recommendations for any purchase or sale of any specific security or commodity.

Capital markets have been assaulted in the last year by a multitude of unprecedented economic and political drivers that have left investors staring at a global recession amidst levels of inflation many of us have never seen in our careers. In response, the public market has repriced risky assets and fixed income but has yet to reprice private real estate. To wit, in response to the drastic shift in debt costs, publicly traded REITs posted a -16% return over twelve months ending in September of 2022. During that same time, private real estate, as measured by the NFI-ODCE index, posted a +21% return.

Both "realities" cannot be true, and with the 10-year now hovering around 3.5%, up from 1.5% at the beginning of last year, we believe that the public REIT market is closer to correct in its valuation; REIT implied cap rates (the capitalization rate implied by REIT market pricing) expanded by 155 basis points through the course of 2022 in response to the changes in debt costs. We have yet to see this valuation adjustment occur in the private markets, resulting in public markets today trading at steep discounts by comparison. While public markets can initially overreact (hence creating opportunities), we believe they provide directional insight into how valuations for real estate may change over time. We have consistently noted that when public REITs are trading at these deep discounts, one of two dynamics is at play: Either private market valuations are going to fall to align with the market decline, or public REITs are misaligned, trading at a true discount and will rebound. In either scenario, the marginal dollar is better invested in the public REIT market.

The discrepancy in returns between the public and private real estate markets is not a new phenomenon. In fact, we have observed this relationship repeatedly in the past. The public market rapidly incorporates changes in valuation, then the private market follows at a meaningful lag. This trend has historically resulted in the private market peaking while the REIT market is concurrently bottoming, creating an opportunity to tactically reallocate capital between real estate exposure in a different wrapper. In fact, looking at total returns since 1978, after the REIT market bottoms, the historical outperformance REITs versus ODCE funds in the following year has been 42.8%. Even excluding the outsized impact of the GFC, the outperformance of REITs versus NFI-ODCE funds in the following year after the bottom has been 26.2%.

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REITS: A Timely Opportunity for Real Estate Investors

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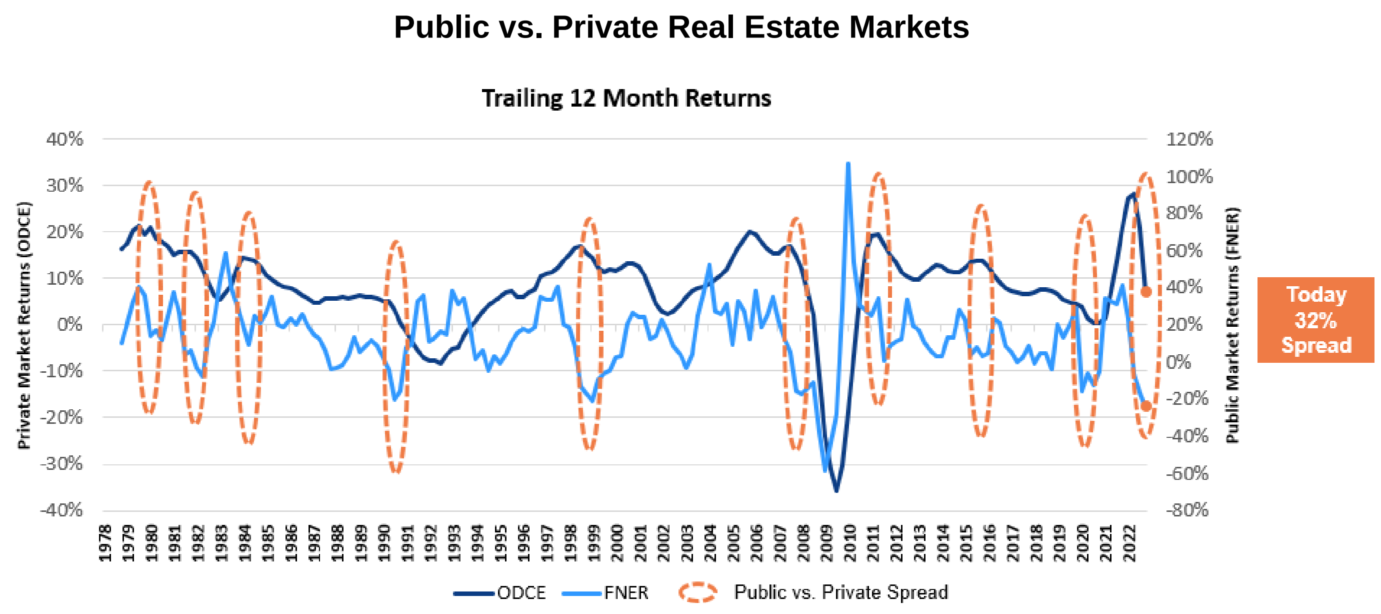

Source: Bloomberg, CenterSquare as of December 31, 2022. Private Real Estate represented by NFI-ODCE Index; REITs represented by FTSE Nareit All Equity REITs (FNER) Index.

To capture the upside of market volatility, an actively managed REIT strategy provides an attractive option for investors today. Including it in a real estate allocation is a smart approach to recognize and act upon price dislocation in both the private and public markets in real time. Furthermore, the stability of REIT cash flows relative to equities is a nice counterbalance to an uncertain macroeconomic environment. To exclude or misplace a REIT allocation is omitting a valuable instrument in a performance toolkit, especially during times of market fluctuation, which feels more permanent than ever before.

Short Duration Convertible Bonds:
A Compelling Alternative to Traditional Fixed Income

Submitted by: Palisade Capital

Executive Summary

When considering allocations to fixed income, convertible securities should not be overlooked. We believe an allocation to short duration convertible bonds can provide investors with an attractive risk-reward, particularly in a “higher rates for longer” environment.

Use the following link to access the complete white paper on this topic:

https://palisadecapital.com/news-insight/detail/short-duration-convertible-bonds-a-compelling-alternative-to-traditional-fixed-income

Public Plans Struggle in Fiscal Year 2022

Restoration of Higher Bond Yields Will Be Welcome Relief for Public Plans

By: Christopher Rowlins, Fiducient Advisors

Christopher Rowlins *began his career in the public sector within the pension division of the City of Hartford, CT. Chris co-heads Fiducient's public pension practice and provides strategic advice and counsel on all areas of portfolio oversight including, asset allocation, manager research, portfolio structure, investment policy and fiduciary training for Committees entrusted with public funds. Chris is also a member of the firm's Defined Benefit Business Council. He is member of GFOA PA; GFOA CT; CTPPF and MACRS. He received his BA from Boston University.*

Executive Summary

Public defined benefit pension plans typically measure their financial progress on a fiscal year (FY) that ends June 30. After a strong FY in 2021 produced outsized investment returns that resulted in improved funded statuses for most public pension plans, FY 2022 proved the opposite. As a result of sharply lower investment returns for FY 2022, U.S. state and municipal retirement systems will likely see their aggregate funding ratio make their biggest decline since the global financial crisis in 2009, according to a report from Equable Institute, a bipartisan nonprofit that provides data and analysis about public pension funds. The investment losses in FY 2022 will likely offset most of the investment gains from FY 2021. However, most public pension plans utilize asset smoothing mechanisms for purposes of plan funding so the impact on the funded ratio and Actuarially Determined Contribution (ADC) will be minimized.

While 2022 proved to be one of the worst years on record for bonds, the silver lining around the rapid increase in interest rates (and the other side of the fixed income bear market coin) is the restoration of a better yield structure with the potential to benefit public pension portfolios in the long run. Public pension plans rely on fixed income to provide that ballast within a portfolio setting. Today's bond market today offers better value, and the spike in yields may present an attractive opportunity to bring the fixed income portion of portfolios back into balance. For public pension plans with a long-term portfolio context, bonds provide income, and they can have inherently less volatility than equities.

As market conditions evolve, it is important for stewards of public pension portfolios to review their existing asset allocation to reaffirm it aligns with the plan's investment return assumption and tolerance for downside risk. As we have observed over the last few years, many public plans lowered the return assumptions that inform their investment decisions as interest rates had trended down for more than two decades while equity valuations had increased. Lowering the investment return assumption to more achievable targets also can decrease the likelihood of accruing unfunded liabilities in the future.

Despite the trend of lower investment return assumptions, pension funds continued to reallocate away from low-yielding fixed-income investments to equities and alternatives to achieve their return targets. Today's higher interest rate environment, combined with lower pension investment return assumptions, could result in a reversion back to higher fixed income allocations for public plans. Other plans may opt to maintain their existing asset allocation to shore up funding shortfalls.

Use the following link to access the complete white paper on this topic:

http://www.pa-pers.org/newweb/documents/Winter%20%202023%20-%20Fiducient%20full%20article.pdf

New Content Coming to Your Annual Valuation Report in 2023 and Beyond

By David Driscoll, Buck

David Driscoll FSA, MAAA, EA, FCA *is a Principal and Consulting Actuary at Buck, where he also serves as National Public Sector Consulting Leader. He joined Buck in 1999. David has more than 30 years of actuarial consulting experience. Prior to joining Buck, David worked in the actuarial consulting division of a major insurance company. He is a frequent speaker on actuarial aspects of retirement systems, and has spoken in recent years at gatherings of the Society of Actuaries, the National Conference on Public Employee Retirement Systems, the National Association of State Treasurers, and the Actuaries' Clubs of Boston and Hartford/Springfield. David is frequently quoted in press coverage on matters related to public retirement systems in such publications as the New York Times, USA Today, the Miami Herald and Pensions & Investments*.

In December 2021, the Actuarial Standards Board (ASB) adopted a revised version of Actuarial Standard of Practice No. 4 (commonly referred to as ASOP 4), *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions.*

The new version will be effective for valuations performed as of dates (and completed) on or after February 15, 2023 and reflects a number of technical changes designed to improve the quality of information provided in actuarial valuation reports. For the most part, these changes may not be obvious to non-actuarial readers. There is one conspicuous exception: Reports on actuarial valuations made for the purpose of determining funding requirements will have to include a disclosure of a low-default-risk obligation measure for the plan.

What is LDROM?

A low-default-risk obligation measure (LDROM) is a calculation of the value of the benefits attributed to past service as of the valuation date. The assumptions used in calculating the LDROM will generally be the same as those used in the calculation of funding requirements, except that the interest rate used to discount future benefits is to be "derived from low-default-risk fixed income securities whose cash flows are reasonably consistent with the pattern of benefits expected to be paid in the future." The revised standard provides five examples of potential discount rates:

1. US Treasury yields
2. Rates implicit in settlement of pension obligations including payment of lump sums and purchases of annuities from insurance companies
3. Yields on corporate or tax-exempt general obligation municipal bonds that receive one of the two highest ratings given by a recognized ratings agency
4. Non-stabilized ERISA funding rates for single employer plans
5. Multiemployer current liability rates

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New Content Coming to Your Annual Valuation

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Public retirement systems affected

While plans subject to the funding requirements of ERISA already calculate liabilities that could be used to satisfy this requirement, public-sector plans have almost never had a need to calculate liabilities on such a basis. For both funding and accounting purposes, liabilities for public retirement systems have generally been based on discount rates equal to long-term expected returns on the assets they hold. Calculating an LDROM for public retirement systems will likely entail recalculating their accrued liabilities using a discount rate that meets the criteria above.

ASB's rationale

In the transmittal memorandum accompanying the adopted version of the revised ASOP 4, the ASB stated its rationale for the LDROM disclosure requirement as follows:

> The ASB believes that the calculation and disclosure of this measure provides appropriate, useful information for the intended user regarding the funded status of a pension plan. The calculation and disclosure of this additional measure is not intended to suggest that this is the "right" liability measure for a pension plan. However, the ASB does believe that this additional disclosure provides a more complete assessment of a plan's funded status and provides additional information regarding the security of benefits that members have earned as of the measurement date.

In requiring the disclosure of the LDROM, the revised standard emphasizes the importance of accompanying it with "commentary to help the intended user understand the significance of the low-default-risk obligation measure with respect to the funded status of the plan, plan contributions, and the security of participant benefits" and adds that the actuary "should use professional judgment to determine the appropriate commentary for the intended user."

Plan sponsors and their actuaries should collaborate to develop appropriate language to frame LDROM disclosures in future valuation reports, to minimize the risk that they will be misconstrued by readers of the reports.

To learn more, contact us at **talktous@buck.com** or **866.355.6647**

Further information about Buck may be found at: Buck | Human resources consulting, administration, technology

Healthy Returns = Healthy Lives: The Perfect Storm

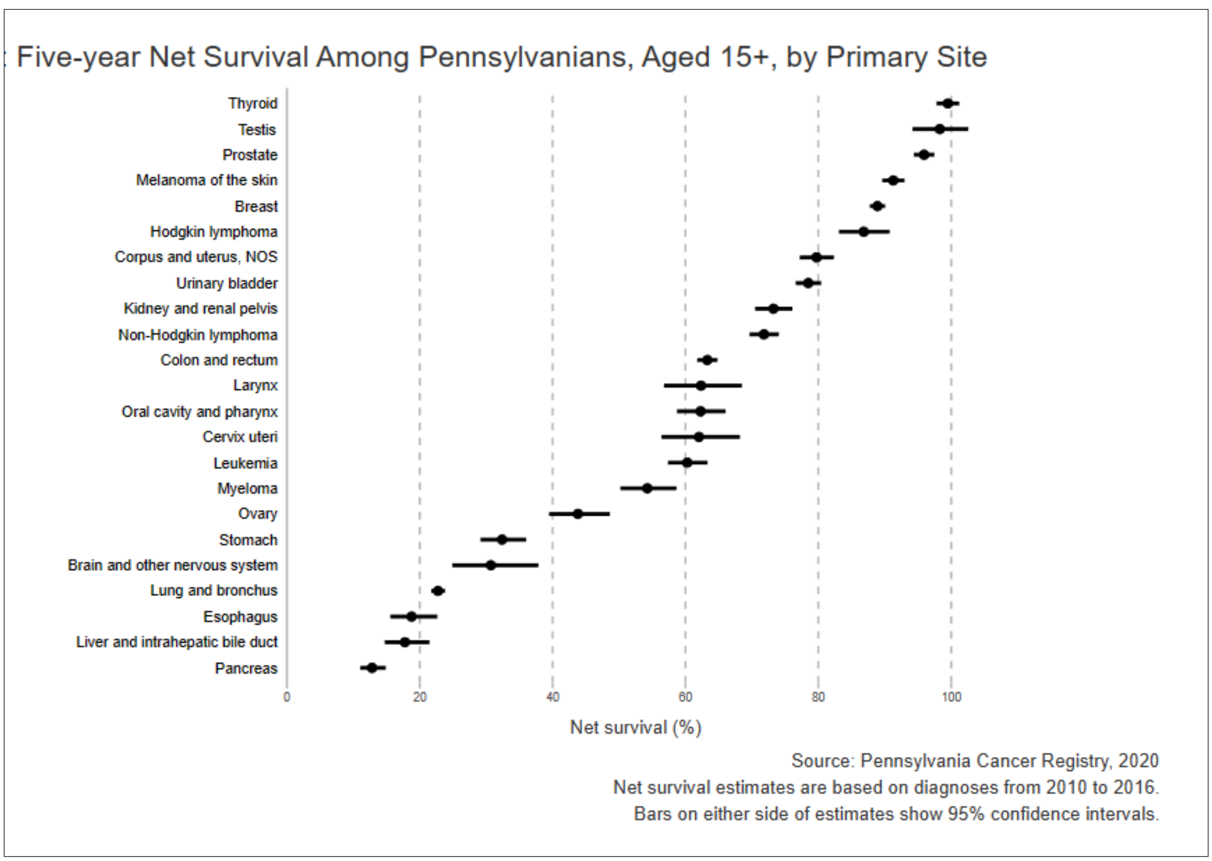
By Michele Colucci, DigitalDx Ventures

Michele Colucci, Esq. *is Founder & Managing Partner of DigitalDx Ventures, a majority woman owned venture capital fund in Silicon Valley investing in the future of AI and Healthcare. She presented her views on how technology was changing healthcare at the PAPERS Conference in Harrisburg, PA in November, 2022. She can be reached at Michele@DigitalDx.com.*

Everyone gets sick. 85% of the adult population has at least one chronic illness; 60% have two. (1) By 2028 the cost of the US Healthcare System is estimated to be $7.4 Trillion dollars.(2)

Yet, access to healthcare is elusive for many, and very expensive, often reserved for the rich. Low income and poverty are also associated with “adverse health outcomes, including shorter life expectancy, higher infant mortality rates, and higher death rates for the 14 leading causes of death.” (3) Investing in AI and Technology-enabled Healthcare can significantly change this landscape, with the promise of personalized treatment and reduced access costs.

According to the Pennsylvania cancer registry, the five year survival rate for cancer is under 50% for cancers in the pancreas, liver and intrahepatic bile duct, esophagus, lung and bronchus, brain and other nervous system, stomach, and ovary.



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Healthy Returns = Healthy Lives: The Perfect Storm

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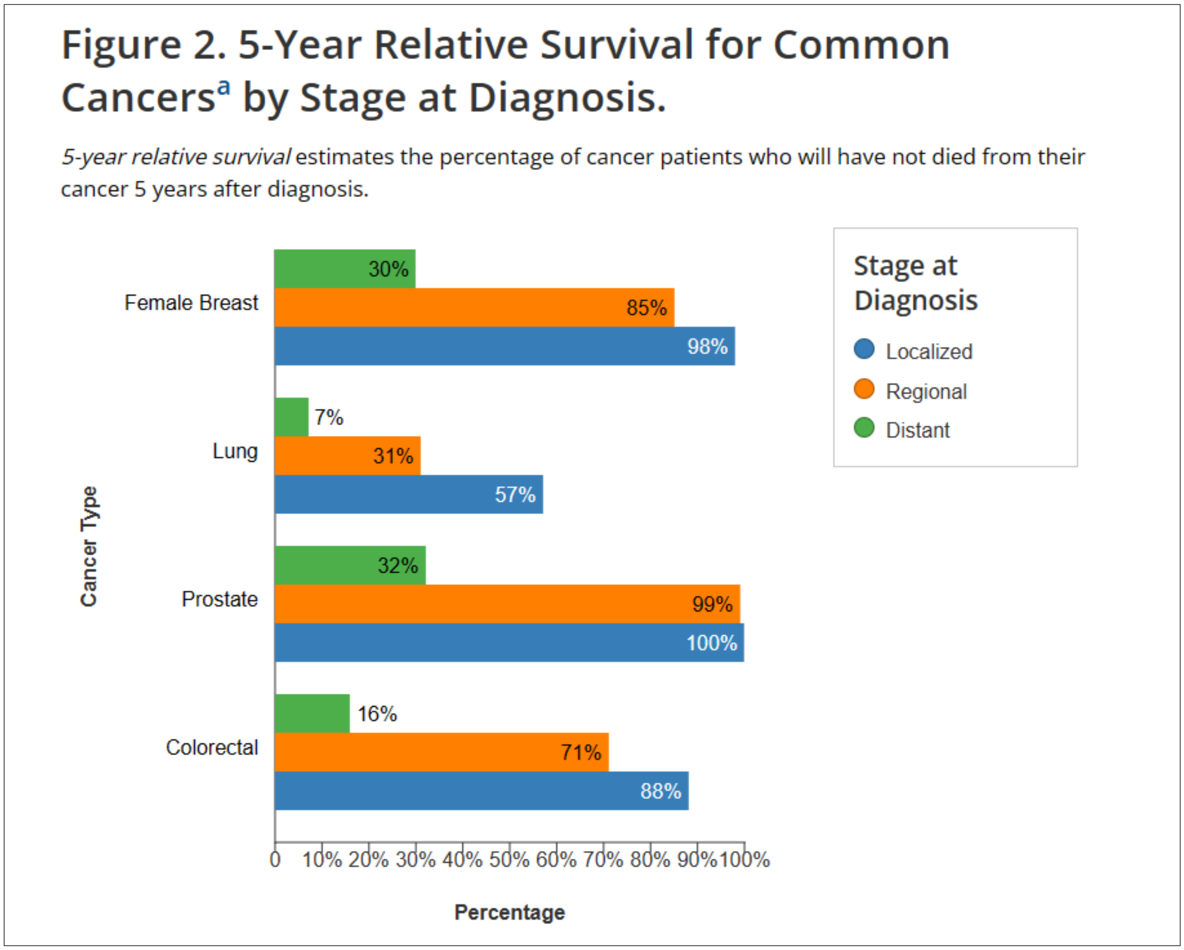
Researchers classify cancer in screening tests as “early stage” when the cancer is still localized in its original organ/location, or “late stage” when it has spread to nearby organs, structures or regional lymph nodes, or other parts of the body far from where it started. Identifying illness early with testing significantly improves life expectancy. Breast cancer survival goes from 98% to 30%; lung cancer from 57% to 7%; prostate cancer drops from 100% to 32%; and colorectal plummets from 88% to 16%.



[aBased on cancers diagnosed during 2011 to 2017 and follow-up of patients through December 31, 2017. (4)

Clearly, investing in innovation that helps people identify illness earlier saves our lives and reduces the costs of the healthcare system.

But is it also a good investment?

According to Deloitte’s Investment View of Healthcare, they predicted – “with interoperability and real time data coupled with the full range of new technologies – the greatest returns will accrue to organizations that successfully mine data to deliver personalized solutions that keep people healthy and functioning at their highest potential.” (5)

In fact, the AI in Healthcare market is now projected to grow at a 37.1% CAGR through 2030. (6)

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Healthy Returns = Healthy Lives: The Perfect Storm

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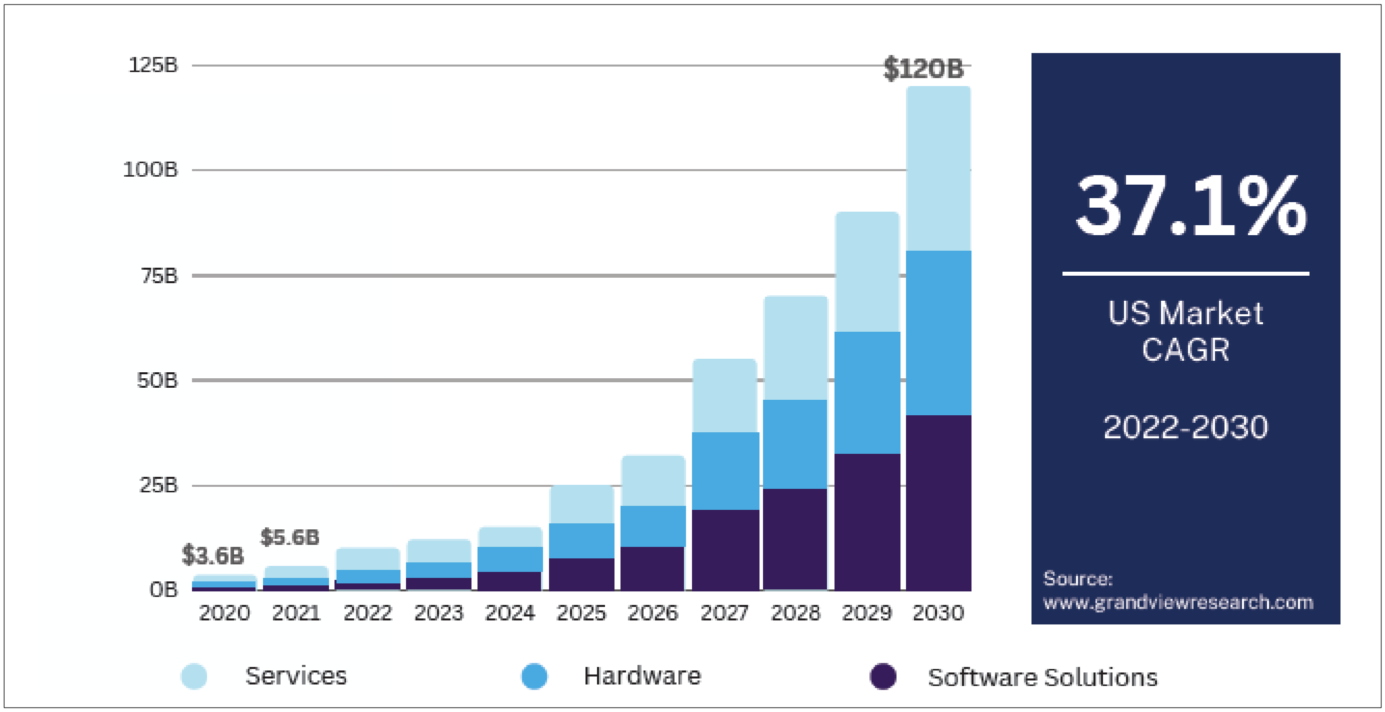

Healthcare provides a great investment opportunity because it will always be needed, and returns are uncorrelated to the ebbs and flows of the public markets. The US Healthcare sector is growing faster than the rest of the economy, powered by advances in tech and AI, an aging population and improved treatments for chronic diseases and conditions. Healthcare spending is projected to grow at an annual rate of 5.4% through 2028, reaching $6.2 trillion and 19.7% of US GDP (7)

And when these holdings go public, the numbers hold. According to the McKinsey Life Sciences report in 2021, over the past three decades, the Medtech industry has outpaced the S&P index by almost 15 percentage points, with stellar periods in the early 1990s, mid-2000s, and late 2010s. "(8) As of January 1, 2022, companies projected to grow by more than 10 percent CAGR traded at a multiple of almost 11 times revenue. During the past ten to 15 years, much of the improvement has come from small- and midcap companies." (9) In 2016, analysts' consensus growth estimate for these companies was 11 percent CAGR; by 2022, it had topped 17 percent (10)

Even Hedge Funds are getting into early stage private equity. Traditionally hedge funds did not play in early stage venture but that is changing as they seek opportunities for greater returns not available in the hedge fund industry right now..

According to Jacob Wolinsky in his article in Forbes, the Goldman Sachs report indicated that over the past 10 years ending in 2020, PE and VC strategies have enjoyed an annualized return of 14.2%, marking a 3.7% premium over equities. Private equity and venture capital have outperformed hedge funds by about two to one, as hedge funds returned 7.1% annualized over the last decade. (11)

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Healthy Returns = Healthy Lives: The Perfect Storm

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Venture capital returns follow the Pareto principle — 80% of the wins come from 20% of the deals. The average time to hold a venture investment is now about ten years. So early stage venture investing is only for those with long term investment horizons and with an understanding that many investments do not succeed. Mitigating the risk by focusing on the noncorrelated healthcare industry with active, knowledgeable field expert managers who can navigate their portfolio company investments through the many hurdles encountered in the early stage, at a time when venture investors expect current vintage years to be some of the best they've seen, is a strategy worth exploring. Now is the perfect time to *"do well by doing good!"*

Citations:

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5. Doug Beaudoin, "An industry on the brink of exponential change: Health in 2040," Health Care Current, Deloitte, November 6, 2018.; DI_Investment-view-of-health-care-market.pdf (deloitte.com)
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8. McKinsey Life Science Report
9. Corporate Financial Institute = (CFI) "Return on capital employed (ROCE)," accessed April 2, 2019.
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11. Goldman Report- as quote d in Forbes "Why Hedge Funds Are Increasingly Turning To The Private Markets For Returns" (forbes.com) By Jacob Wolinsky

Potholes remain, but bonds headed in right direction

By: Don Ellenberger, Federated Hermes

Don Ellenberger *is head of the Multi-Sector Strategies Group. He manages Federated Hermes Total Return Bond Fund and co-manages Federated Hermes Strategic Income Fund. He also manages several multi-sector fixed-income institutional separate accounts. He serves as the chairman of the Yield Curve Committee. Don joined Federated Hermes in 1996 and has more than 35 years of investment experience. He was previously a derivatives trader and portfolio manager with Bank of New York Mellon. Don earned his bachelor's degree from the Pennsylvania State University and an MBA from Stanford University.*

Three things to watch in 2023

Rocky road ahead With apologies to the beloved ice cream, we don't see a way in which the Federal Reserve can pull off a soft landing. Not if it truly is committed to slaying inflation and retaining credibility it is capable of guiding the economy. Policymakers are reasonably confident they can achieve the former, but have deep concerns about the latter. There should be little doubt they are willing to risk a recession to accomplish both. That is probably unavoidable at this point, anyway. Whenever inflation has been above 4% and the unemployment rate has been below 5%, as both are now, a recession has followed within two years *every single time*. The same goes for every period in the past in which the unemployment rate has risen at least five-tenths of a percent. And the fact that the job market is refusing to turn over likely will push the Fed to keep a high terminal rate until it suppresses aggregate demand enough to weaken labor and regain price stability.

A yield curve you could ski down The inverted curve has already anticipated a slowdown. Unfortunately, the slope might transform from a green circle to a black diamond. We don't think the bond market has priced in the magnitude of the coming contraction. Spreads are nowhere near the peak typical of recessions. At the very least, they should rise because Treasury yields historically drop in this type of economic environment.

Delay the credit play? We think so. Investors should resist the temptation to pounce on cheap bonds. Any sustained rally in stocks and corporate bonds likely is doomed because the Fed is apt to see it as a sign financial conditions are not tight enough, providing another reason to hold rates higher for longer. High-quality bonds and Treasuries are the best bets for the near future. But it's not all bad news for fixed-income investors. We are headed in the right direction. The time to buy bonds and add back to the credit sectors is approaching.

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

A Peak That Persists

By: Neuberger Berman

Brad Tank, *CIO and Global Head – Fixed Income, joined Neuberger Berman in 2002 and is a member of the Operating, Investment Risk, Asset Allocation, and Fixed Income Investment Strategy Committees, and leads the Fixed Income Multi-Sector Group. From 2008-2015, Brad was also CIO of the Multi-Asset Class Investment business. From 1990-2002, Brad was director of fixed income for Strong Capital Management, a member of the OCEO, and headed institutional and intermediary distribution. From 1982-1990, he was a VP at Salomon Brothers in the government, mortgage and financial institutions areas. Brad earned a BBA and MBA from the University of Wisconsin.*

December's U.S. Consumer Price Index data was welcomed by financial markets after it showed another reassuring month of steady declines. However, the underlying mix of inflation was perhaps less encouraging.

The November data appeared to show inflation easing quite broadly. In December, we continued to see month-over-month cooling, and even some accelerating deflation, in most food, energy and goods prices. But services inflation picked up again, reminding everyone that these price hikes have tended to be the stickiest in past inflationary cycles.

Still, an initial, sharp tightening of financial conditions was quickly reversed as investors chalked this up as another relatively benign set of numbers. Many point to the broader economic outlook to support this interpretation.

On January 10, the World Bank almost halved its 2023 global growth estimate to just 1.7%. It slashed its estimate for the advanced economies from 2.2% to 0.5%. Manufacturing Purchasing Managers' Indices (PMIs) suggest a contraction in the U.S., Europe and Japan. And why worry about services inflation when the U.S. services PMI has just plummeted into contraction?

With a slowdown like this in the cards, won't central banks be forced to cut rates again in the second half of 2023? Rates markets continue to price for that outcome.

Nonetheless, while some Fed officials have started to talk about tapering rate hikes to 25 basis points, they seem determined to sustain them until inflation is back to target. We take the Fed at its word, as we think inflation will continue to prove awkwardly sticky.

Energy is subject to numerous complex factors and is difficult to call, but we do think goods inflation has turned a corner and we expect shelter costs to ease slowly despite the uptick in December.

It's in the other services sectors where we see stickier inflation, driven by wages in a tight, services-oriented labor market. U.S. jobless claims have been declining again and U.S. unemployment is near a 50-year low. We see growing evidence of big wage settlements in Japan, Europe and the U.S.—such as the 19% hike that ended the recent strike by New York nurses. We think that could leave us with headline inflation still above target at 3.0– 3.5% by the end of this year.

From our perspective, it's not difficult to imagine a 2023 in which that sticky, above-target services inflation is paired with a moderate slowdown that enables central banks to maintain rates at a peak that persists.

On the plus side, we think that means substantially lower rates volatility than in 2022, with enough carry now available in the market to compensate for duration risk and provide a buffer for total returns. As we've seen in recent years, economic data and events can always surprise us—but for fixed income investors, we think 2023 offers more opportunity and much less risk than 2022.

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A Peak That Persists

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The Uniquely Powerful Role of Private Securities Law Enforcement

By: Laura S. Stein, Esq., Robbins Geller Rudman & Dowd LLP

Laura Stein *is Of Counsel in Robbins Geller Rudman & Dowd LLP's Philadelphia office. Since 1995, she has practiced in the areas of securities class action litigation, complex litigation, and legislative law. Ms. Stein has served as one of the Firm's and the nation's top asset recovery experts with a focus on minimizing losses suffered by shareholders due to corporate fraud and breaches of fiduciary duty. She also seeks to deter future violations of federal and state securities laws by reinforcing the standards of good corporate governance. Ms. Stein works with over 500 institutional investors across the nation and abroad, and her clients have served as lead plaintiff in successful cases where billions of dollars were recovered for defrauded investors against such companies as: AOL Time Warner, TYCO, Cardinal Health, AT&T, Hanover Compressor, 1st Bancorp, Enron, Dynegy, Inc., Honeywell International, Bridgestone, LendingClub, Orbital ATK, and Walmart, to name a few. Many of the cases led by Ms. Stein's clients have accomplished groundbreaking corporate governance achievements, including obtaining shareholder-nominated directors. She is a frequent presenter and educator on securities fraud monitoring, litigation, and corporate governance.*

In 2013, prominent social scientists from the University of Toronto, UC Berkeley, and the University of Chicago estimated that less than one-third of corporate fraud is detected and that 11% of the largest, publicly traded companies likely commit securities fraud each year. They estimated that investors lost $744 billion in equity to securities fraud in 2020 alone.

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The Uniquely Powerful Role of Private Securities Law Enforcement

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That is more than the GDP of Sweden and more than the GDP of Belgium, Norway, and 100 other countries, respectively.

With this magnitude of economic impact at stake, one might expect securities fraud to be a top government policy priority. But the truth is that *institutional investors* – especially public pension funds – are the leaders in the most significant securities fraud cases and obtain the largest fraud-related recoveries. Public funds, including Pennsylvania funds, have secured recoveries in national litigation that have had great impact on injured investors, equaling or in some cases exceeding the recoveries in government enforcement actions.

Bucks County Retirement System, assisted by Bucks County Solicitor Joe Khan and First Assistant Solicitor Amy Fitzpatrick, recently prosecuted two nationwide securities fraud class actions that are instructive examples. The first was a complex securities fraud case against pharmaceutical company Endo International. The suit alleged that the company misled investors concerning the company's strategy of massive generic drug price increases based on unsustainable, noncompetitive market conditions, which caused substantial investor losses when the truth was revealed. After years of hard-fought litigation, Bucks County settled the class action last year and recovered $64 million for investors worldwide, including its own retirees.

The second case involved fraud claims against REV Group, a specialty vehicle manufacturer, which allegedly misrepresented the market opportunity for its most profitable business segments in connection with public offerings of its stock to investors at artificially inflated prices. The suit alleged that, shortly after REV Group's public stock offerings, the company reported a series of deeply disappointing financial results that contradicted representations the company made in connection with the offerings. Bucks County recovered over $13 million for investors in this class action case.

Both cases are significant, not just monetarily, but because the injured investors in these cases attracted relatively little attention from enforcement or regulatory agencies. Endo faced significant enforcement scrutiny for its underlying price-fixing conduct, but the harm to investors was largely unaddressed. Likewise, REV Group's misrepresentations in connection with its IPO fell beneath the radar of government enforcers. Public funds stepped in to protect investors in both cases.

Recent scholarship suggests that this is perhaps the right policy. In his study "Wearing Out the Watchdog," Professor Samuel Bonsall analyzed recent SEC enforcement actions and found that "busy SEC offices are less likely to pursue cases with the largest shareholder losses — likely because large-loss cases take longer to close." He found that the most serious securities fraud cases remain "uninvestigated." This is the case because pension funds and other institutional investors, rather than the government, tend to prosecute complex frauds that involve larger losses and larger potential recoveries, often against large corporations. They also tend to lead *class action* litigation, which, if the class is certified by the court, can bring benefit to all impacted investors throughout the market.

At some level, this division of labor makes some sense based on the differing mandates that apply to pension funds and the SEC. The SEC's mandate is broader than our institutional clients' fiduciary duties to maximize returns. The SEC focuses on *all* forms of securities markets. But institutional investors have a strong, duty-driven interest in treating potential claims in litigation as plan assets and prosecuting appropriate cases to maximize those assets. They may be less likely to prosecute a securities fraud case that lacks significant shareholder losses or does not present an opportunity to advance the fund's mission-critical goals. Such cases are more appropriate for government action.

The rub is that pension funds cannot rely on government enforcement alone to secure their portfolios from fraud. As illustrated by the recent cases in Pennsylvania, the government enforcement mandate is broad, and loss recovery and recovery maximization are often within the remit of private enforcement.

It remains imperative for all public pension funds to maintain a vigilant effort to monitor their investments for fraud-related losses and to have experienced counsel at the ready to carefully evaluate the costs and benefits of recovery litigation. If scholars are correct, and investors have lost $744 billion in equity to securities fraud in a single year, then we have a lot of important work ahead of us.

Factors Shaping Private Credit in 2023

By: Randy Schwimmer & Jessica Nels,
Nuveen/Churchill Asset Management

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Jessica Nels *is a Managing Director in the Capital Markets team for Churchill Asset Management where she is responsible for middle market club transactions, syndication and lender relationship management. Prior to Churchill, Jessica was a Director on the Capital Markets team for Twin Brook Capital Partners where she structured, underwrote, and syndicated senior debt and unitranche credit facilities for middle-market private equity sponsors. Prior to that, she held various roles at BMO Harris Bank, Antares Capital and GE Capital. Jessica earned a B.S. in finance and accounting from the University of Wisconsin-Madison and an M.B.A. in finance and economics from the University of Chicago Booth School of Business.*

For over a decade, including through COVID-19, the tide of capital has flowed mostly in one direction: into markets. That's because since the Great Recession of 2008, central banks across the world have kept interest rates low. Public credit, both loans and bonds, benefitted from this support, but as we look ahead to 2023, it is important to shift our gaze and examine the impact of rate hikes and quantitative tightening on capital markets and private credit.

Some seasoned credit investors are on the side-lines, waiting for more direction from markets and the economy. Our reappraisal of current conditions, however, suggests there may be a lot for investors to cheer about, particularly in private credit. In fact, we believe that capital scarcity is ultimately beneficial for illiquid loans.

Risk vs opportunity in private credit

Direct lenders built up record levels of dry powder over the past five years, but they have also been busy putting it to work. Now, experienced managers are becoming more judicious about deploying the capacity they have left for these three reasons:

1. Continued public market volatility and concerns around a slowing economy
2. The dislocation in broadly syndicated loans has compelled issuers to pivot to private markets for credit solutions
3. While recession worries may slow M&A, pent-up demand from private equity (PE) sponsors flush with LP cash will drive flow once conditions allow

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Factors Shaping Private Credit in 2023

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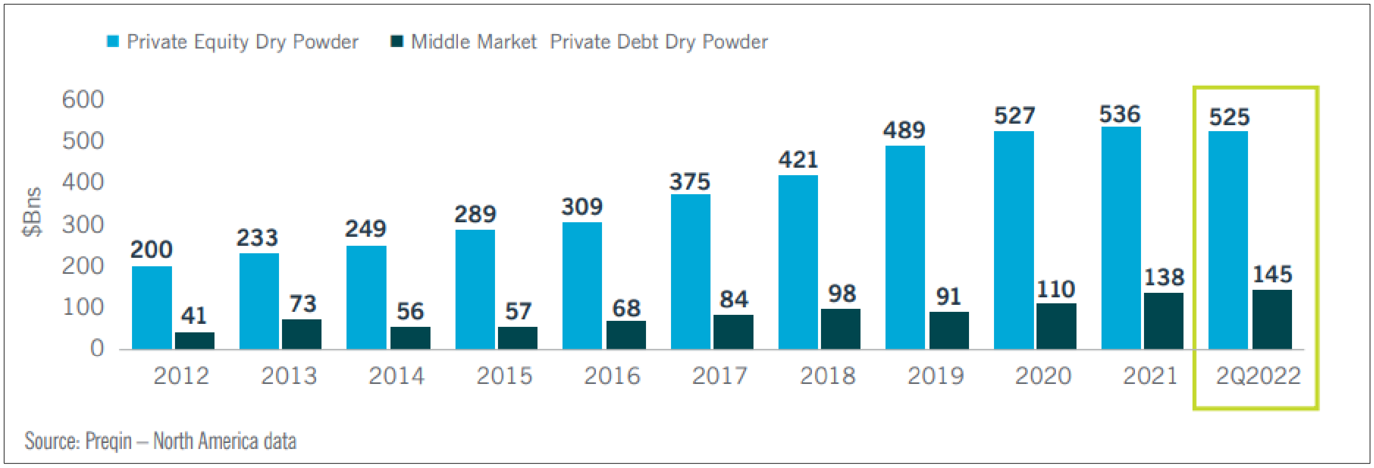
Top private credit managers are increasingly weighing risk versus opportunity in allocating capital to deals. The opportunities are seen through the lens of a possible recession that could upend earnings and valuations of companies that have performed well, even during the pandemic.

Meanwhile, the amount of private credit dry powder is greater than ever, but it remains dwarfed by the money raised by PE sponsors, as shown in figure I. However, 2022 data would suggest that sponsors may find a more challenging fundraising environment over the next several years.

Figure 1: Dry Powder

There's an almost $400 billion gap between private equity and credit dry powder as of 2Q 2022.



So, in this period of uncertainty, with managers carefully weighing up risks versus opportunity, does it make sense to wait for more direction from the economy? At Churchill, we believe the answer lies in the role of the manager in an illiquid asset class.

With illiquid assets, selection is key

For private equity and credit, portfolio construction is key. The importance of picking the right assets from the start largely determines returns and, since you can't trade the assets, you can't easily unload a problem into a ready secondary market.

Asset and sector selection also matter across business cycles. Timing is a part of every public market portfolio manager's tool kit to seek undervalued loans or out-of-favour industries. Liquidity allows them to pick exit and entrance points, but if a consumer-facing borrower or a heavy cyclical stumbles when the economy softens, a buy-and-hold lender may find themselves with a long-term problem.

Nevertheless, the next several quarters will be constructive for private credit investors. Scarce assets are more highly valued, so the question is, as the era of greater selectivity unfolds, will there be enough to go around? For lenders with strong sponsor relationships and unique sourcing models, we believe so.