



Financial and Strategic Analysis to the Department of Defense (DoD) Investment Board

Report FY10-07

- **Recommendations for Defense Finance and Accounting Service investment decisions for the Military Retirement Fund and the Medicare-Eligible Retiree Health Care Fund**

April 2010

Financial and Strategic Analysis to the Department of Defense (DoD) Investment Board

TASK

The Chairman, Defense Business Board (DBB) formed a Task Group, at the behest of the Undersecretary of Defense (Comptroller), to review the Defense Finance and Accounting Service (DFAS) Military Retirement Fund (MRF) and the Medicare-Eligible Retiree Health Care Fund (MERHCF) with an approximate combined value of \$500 billion. The Task Group was asked to provide recommendations to the Department on the Funds' Investment Board's current and proposed investment strategies. A copy of the official Terms of Reference (TOR) outlining the scope and deliverables for the Task Group can be found at **Appendix A**.

The Task Group was chaired by William Phillips. Other Task Group members included: Owsley Brown, Bonnie Cohen, and Robert Stein. The Task Group Executive Secretary was Captain Michael Bohn, USN.

PROCESS

The Task Group conducted interviews and elicited comments from all levels of DFAS Management, representatives of the DoD Office of the Actuary, and industry treasury securities investment professionals, related to the management of the two funds.

Additionally, the Task Group reviewed public laws, Department of the Treasury Operating Circular "Responsibilities Relating to Government Investment Accounts and Investment in Government Account Series (GAS) Treasury Securities", the draft January 2010 Investment Policy Statement from DFAS Trust Fund Accounting Division for the Department of Defense Investment Board, and the last three meeting minutes of the most recent investment board meetings.

The Task Group presented their findings and recommendations to the full Board on April 22, 2010 (**see Appendix B**).

FINDINGS

Detailed information on each of the funds was provided by meetings and discussions with DFAS representatives and through reviewing the references listed in the above “PROCESS” section.

Furthermore, legal requirements were reviewed and the current fund oversight was analyzed. The current investment strategy is based strictly on US Treasury non-marketable instruments utilizing a buy and hold to maturity approach and the use of Treasury Inflation Protection Securities (TIPS) in a laddering investment profile. The use of TIPS and laddering is intended to spread the inflation risk and uncertainty over multiple years. The long-term objective is to have fully funded the obligations these funds support. This current investment strategy is consistent with US Treasury guidance provided in the Operating Circular.

It was also found that The Treasury Department provides no investment recommendations or advice. The assumption is that the buyer, in this case the Department of Defense, is in the best position to determine their requirements and financial needs with these funds and therefore is solely responsible for the investment strategy employed.

Specific details of the findings are provided in **Appendix B**.

PROCESS OBSERVATIONS

The Trust Fund Accounting Division (TFAD) has a strong focus on diversifying the maturity of the portfolio through laddering and using TIPS to provide inflation protection.

There is also good discipline around the investment management process utilized today and the TFAD is making progress towards the full funding of both funds' long term obligations. The TIPS instrument had accumulated cumulative inflation gains of \$61B as of December 31, 2009. These gains are only recognized when the instruments mature.

In 2009, DFAS attempted to obtain outside investment expertise to provide a review and recommendations for the investment strategy. The request for proposal was issued soliciting this assistance but it received no response.

Defense Business Board

In addition to the TFAD, DoD has established an Investment Board that provides oversight and approval of the investment strategy developed and implemented by the TFAD. The Investment Board is chaired by the Director of DFAS and includes a military representative (currently vacant) and the DoD Deputy Chief Financial Officer. The DoD Inspector General participates as an observer. The current membership of the Investment Board does not include anyone with specialized expertise pertaining to public debt securities investing.

The Task Group also observed there is no modeling of performance projections or alternative investment strategies and no comparative benchmarks or metrics with other portfolios currently being utilized. While metrics and analysis is used in some areas, a robust set of modeling tools that are common in commercial investment activities are lacking.

It is also important to note that the risk to these funds is limited to the earning opportunity associated with the portfolio mix. The treasury funds have the full backing of the US Government for the value of the securities themselves.

Overall,

1. The ongoing administration of the MRP and MERHCF funds appears sound and consistent with the guidelines contained within the Treasury Circular that governs these funds.
2. The current investment strategy addresses inflation protection, aligning payment requirements with instrument maturities, and is focused on achieving full funding of future fund obligations.
3. The strategy appears to be somewhat static and should be revisited with the assistance of outside expertise. This would enable the potential for a more dynamic strategy that could provide better financial results and the use of appropriate metrics to manage this strategy and facilitate implementation.

Specific details of the findings are provided in **Appendix B**.

RECOMMENDATIONS

Based on the Task Group's research, findings, and analysis the following four overarching recommendations are provided:

Defense Business Board

1. Review the current investment strategy and alternatives with external experts
 - Just as DFAS recognized in 2009, the market is dynamic and the need for specialized investment advice is important
2. Establish an Investment Advisory Board
 - A small group of experts in public debt securities that would interact with DFAS and the Investment Board on a regular basis to provide an outside perspective and help inform the investment decisions of the Trust Fund Division
3. Utilize modeling techniques to assess investment alternatives
 - These techniques will provide analytical support to the development and implementation of the approved investment strategies
4. Re-name the current Investment Board to better describe what they do
 - This board is really providing oversight to the investment process and the Task Group suggests re-naming it to an Oversight Board, to be more in line with its focus and expertise

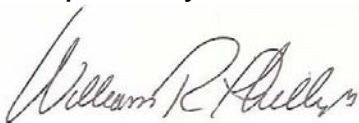
Specific details of the recommendations are provided in **Appendix B**.

CONCLUSION

The Department's management of the MRF and MEHCRF is critical to fully funding these funds and ensuring the future, ongoing payments of their respective eligible recipients.

The Board urges DoD to consider the Task Group's findings and implement its recommendations.

Respectfully submitted,



Mr. William Phillips
Task Group Chair

Defense Business Board

APPENDIX A

TERMS OF REFERENCE

Defense Business Board

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DEFENSE
BUSINESS
BOARD

DEFENSE BUSINESS BOARD
1155 DEFENSE PENTAGON
WASHINGTON, DC 20301-1155

14 January 2010

MEMORANDUM FOR BILL PHILLIPS, DEFENSE BUSINESS BOARD (DBB)

SUBJECT: Terms of Reference – “Financial and Strategic Analysis to the Department of Defense (DoD) Investment Board”

The Defense Finance and Accounting Service (DFAS), the world’s largest finance and accounting office, provides services to the military and other members of DoD. DFAS manages the Military Retirement Fund (MRF) and the Medicare-Eligible Retiree Health Care Fund (MERHCF) with an approximate combined value of \$500 billion.

The DoD Investment Board, established in 2003, oversees DFAS investment decisions regarding these funds to ensure compliance with policy and public laws. Members of the Investment Board are the Director, DFAS, the DoD Deputy Chief Financial Officer, and a senior military member, currently the Vice Chief of Naval Operations. The Investment Board meets twice a year to establish investment objectives, policies, and performance strategies with the goal of maximizing investment income.

I request you chair a DBB Task Group to review the Investment Board’s current and proposed investment strategies to aid in their management of the MRF and MERHCF funds. Consider future investing proposals and the basis for such proposals as input for the Investment Board, if different from the current or proposed strategies. Please include a discussion of risk associated with any recommendations from the Task Group.

Owsley Brown, Bonnie Cohen, and Robert Stein will assist you in this effort. DFAS will provide technical support as needed. CAPT Michael Bohn, USN, will serve as the Task Group Secretariat Representative. Please plan to present your findings and draft recommendations at the April 2010 DBB meeting.

As a subcommittee of the DBB, and pursuant to the Federal Advisory Committee Act of 1972 and the Government in the Sunshine Act of 1976, this Task Group shall not work independently of the DBB’s charter, and shall report its recommendations to the full Board for public deliberation. The Task Group does not have the authority to make decisions on behalf of the chartered Board, nor can they report directly to any federal officer or employee who is not also a Board member. This Task Group will avoid discussing “particular matters” within the meaning of Section 208 of Title 18, U.S. Code.

Michael J. Bayer
Chairman, Defense Business Board



Defense Business Board

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Defense Business Board

APPENDIX B

**FINDINGS AND RECOMMENDATIONS PRESENTED
TO THE FULL BOARD ON APRIL 22, 2010**

Defense Business Board

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DEFENSE BUSINESS BOARD



“Financial and Strategic Analysis to the Department
of Defense (DoD) Investment Board”

Task Group

April 22, 2010

Task Group Overview

Terms of Reference

The DoD Investment Board oversees Defense Finance and Accounting Service (DFAS) investment decisions for the Military Retirement Fund (MRF) and the Medicare-Eligible Retiree Health Care Fund (MERHCF). Review the DoD Investment Board's current and proposed investment strategies to aid in their management of these funds.

Deliverables

Recommend future investing processes and the basis for such processes as input for the Investment Board, if different from the current or proposed methods. The Task Group should include a discussion of risk with the current, proposed, and recommended investment strategies of these funds.

Task Group

Mr. Bill Phillips (Chair)

Mr. Owsley Brown

Ms. Bonnie Cohen

Mr. Robert Stein

Military Assistant

Captain Michael Bohn, USN

Task Process

- DoD Interviews
 - The Honorable Robert F. Hale, Under Secretary of Defense (Comptroller)
 - Ms. Teresa McKay, Director, Defense Finance and Accounting Service
 - Mr. David McDermott, Director, Standards & Compliance
 - Mr. Greg Schmalfeldt, Deputy Director, Standards
 - Mr. Rick Davis, Deputy Director, Compliance
 - Mr. Bill Bergmeyer, Director, Corporate Reporting
 - Ms. Donna Cox, Director, DoD Audited Financial Statements Reporting and Analysis
 - Ms. Elizabeth Ridge, Division Chief, DoD Trust Funds
 - Ms. Lori Haines, Lead Accountant, DoD Trust Funds
 - Mr. Brad Ryder, DoD Office of the Actuary
 - Mr. Peter Rossi, DoD Office of the Actuary

- Interviews with Industry Treasury securities investment professionals

Task Process

- Reviewed governing documents
 - Public Law 98-94. Title 10 USC A-II-74 1461 through 1467 (MRF)
 - Public Law 106-398. Title 10 USC A-II-56 1111 through 1117 (MERHCF)
 - Department of the Treasury Operating Circular “Responsibilities Relating to Government Investment Accounts and Investment in Government Account Series (GAS) Treasury Securities” with effective date October 1, 2008
 - Draft January 2010 Investment Policy Statement from DFAS Trust Fund Accounting Division for the Department of Defense Investment Board
 - Minutes of most recent investment board meetings
 - March 19, 2010
 - September 29, 2009
 - February 27, 2009

Findings

■ Fund Descriptions

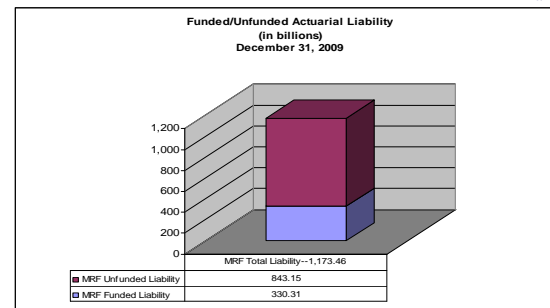
– Military Retirement Fund, 97X8097

- Established as a pension program in FY1984 by public law
- Pays retired Army, Navy, Marine Corps and Air Force members and their survivors
 - Non-disability retired pay, disability retired pay, retired pay for reserve service and survivor annuity programs

– Medicare-Eligible Retiree Health Care Fund, 97X5472

- Established in FY2001 by public law
- Provides funds to pay health benefits for Medicare eligible
 - DoD military retirees, retiree family members, survivors

MILITARY RETIREMENT FUND



Funded liability includes inflation compensation, short term bills and overights not included in previous slides.

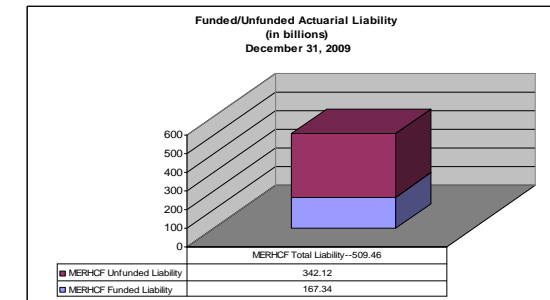
2/26/2010

Integrity - Innovation - Service

5

- Charts in Appendix
 - Blue is funded
 - Red is unfunded

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND



Funded liability includes inflation compensation, short term bills and overights not included in previous slides.

2/26/2010

Integrity - Innovation - Service

11

Findings

- Legal Requirements
 - Funds established by public laws 98-94 and 106-398
 - Investment decisions limited to US Treasury public debt securities
 - DoD actuarial team provides funding recommendations to Congress for appropriations actions
 - Investment process and limitations governed by Treasury Circular, effective date of October 1, 2008

- Current Funds Oversight
 - Provided by Investment Board
 - Established in September 2003 by DoD
 - Meets semi-annually in February and September and on an as-needed basis
 - Membership
 - Director, DFAS (Chair)
 - Deputy CFO, OUSD(C)
 - Senior military service member appointed by the USD(C)
 - Observer - DoDIG

Findings

- Current Investment Strategy is consistent with US Treasury Guidance
 - Strategy based on US treasury based instruments
 - Hold investments until maturity
 - Carry investments at book values, though market values are calculated monthly
 - Implementation of a six year ladder investment profile
 - Currently holding treasury inflation protection securities (TIPS) in years 2025-2029 and 2032
 - Expanding laddering process over time
 - Match maturities to disbursements
 - Investment allocation
 - 90% in TIPS
 - 10% in conventional instruments
 - Historical decision for 90/10 split - from DFAS statements:
 - “The [previous] split was generally that funds needed for the upcoming year would be invested in conventional securities and funds needed later would be invested in long term TIPS. This generally meant a 90/10 split.”
 - “In September 2008 my office recommended the strategy be changed from investing primarily in securities maturing in one year to investing in a ladder approach starting with 6 years and extending as funds were available. At that time we recommended 90% of the FY09 funding be invested in laddered TIPS and 10% be invested in conventionals. The Board approved this strategy and kept this strategy for FY10 investing”
 - Intent is to fully fund the obligations over time
 - MRF is expected to be fully funded in 2034
 - MERHCF is expected to be fully funded in 2051

Findings

- Treasury Guidance
 - Operating Circular from October 1, 2008 on process and responsibilities
 - “Responsibilities Relating to Government Investment Accounts and Investment in Government Account Series (GAS) Treasury Securities”
 - Section 4010 ...Treasury specials offered to government investment accounts are special-issue non-marketable Treasury securities
 - Section 4030
 - It is the responsibility of the program agency for a government investment account to develop a strategy for investing moneys
 - This responsibility is the program agency’s because the program agency for a government investment account is generally in the best position to estimate the disbursement needs of the federal program being financed through the account
 - In developing the investment strategy, the program agency should practice a “buy and hold” policy

- Treasury Department provides no investment recommendations or advice

Process Observations

- Strong focus on diversifying the maturity of the portfolio through laddering
- Good discipline around the investment management process utilized today
 - Consistent with established strategy
 - Critical goal is to match short-term funds with short-term obligations
 - Investment strategy discourages selling securities before maturity
- DoD making progress toward the full funding of long term obligations
- TIPS instruments are providing inflation protection
 - The cumulative gains of these funds are calculated on a quarterly basis and the amount may increase or decrease based on inflation and when the instruments are sold
 - TIPS instruments provide inflation protection but not a guarantee of increased returns over face value. As of 31 December 2009, the funds have generated \$61B of inflation protection
 - \$40B for MRF
 - \$21B for MERHCF

Process Observations

- No outside expertise currently supporting investment strategy
 - DFAS attempt in 2009 resulted in no bidders
- Current Investment Board lacks specialized expertise pertaining to public debt securities investing
- No modeling of performance projections or alternative investment strategies
- No comparative benchmarks or metrics with other portfolios utilized
- Risk to these funds is limited to the earning opportunity associated with the portfolio mix

Process Observations: The Bottom Line

- On-going administration of the MRP and MERHCF funds appears sound and consistent with the guidelines contained within the Treasury Circular that governs these funds.
- Current investment strategy addresses inflation protection, aligning payment requirements with instrument maturities and is focused on achieving full funding of future fund obligations.
- However, that strategy appears to be somewhat static and should be revisited, with the assistance of outside expertise, to determine if a more dynamic strategy would provide better financial results and the use of appropriate metrics to manage this strategy and facilitate.

Recommendations

- Review current investment strategy and alternatives with external experts

- Establish an Investment Advisory Board
 - Top experts in the field of public debt securities
 - 5-7 members, provide annual recommendations for DFAS consideration
 - Provide guidance and advice to the Investment Committee around the investment strategy and implementation issues
 - Focus on questions like:
 - What's the best balance of instruments (e.g. TIPS, Conventional, Separate Trading of Registered Interest and Principal of Securities (STRIPS))?
 - What is the appropriate average maturity of the portfolio?
 - Are there better alternatives to holding securities to maturity?
 - Is the current laddering plan appropriate for fund objectives?
 - Recommend benchmarks or metrics to facilitate performance evaluation

- Utilize modeling techniques to assess investment alternatives

- Re-name current Investment Board to better describe what they do
 - “Oversight Committee” seems more appropriate

Outbriefs

- Mr. Robert F. Hale, Under Secretary of Defense (Comptroller)
- Ms. Teresa McKay, Director of Defense Finance and Accounting Service
 - And other members of the DFAS Team

DEFENSE BUSINESS BOARD



Questions?

DEFENSE BUSINESS BOARD

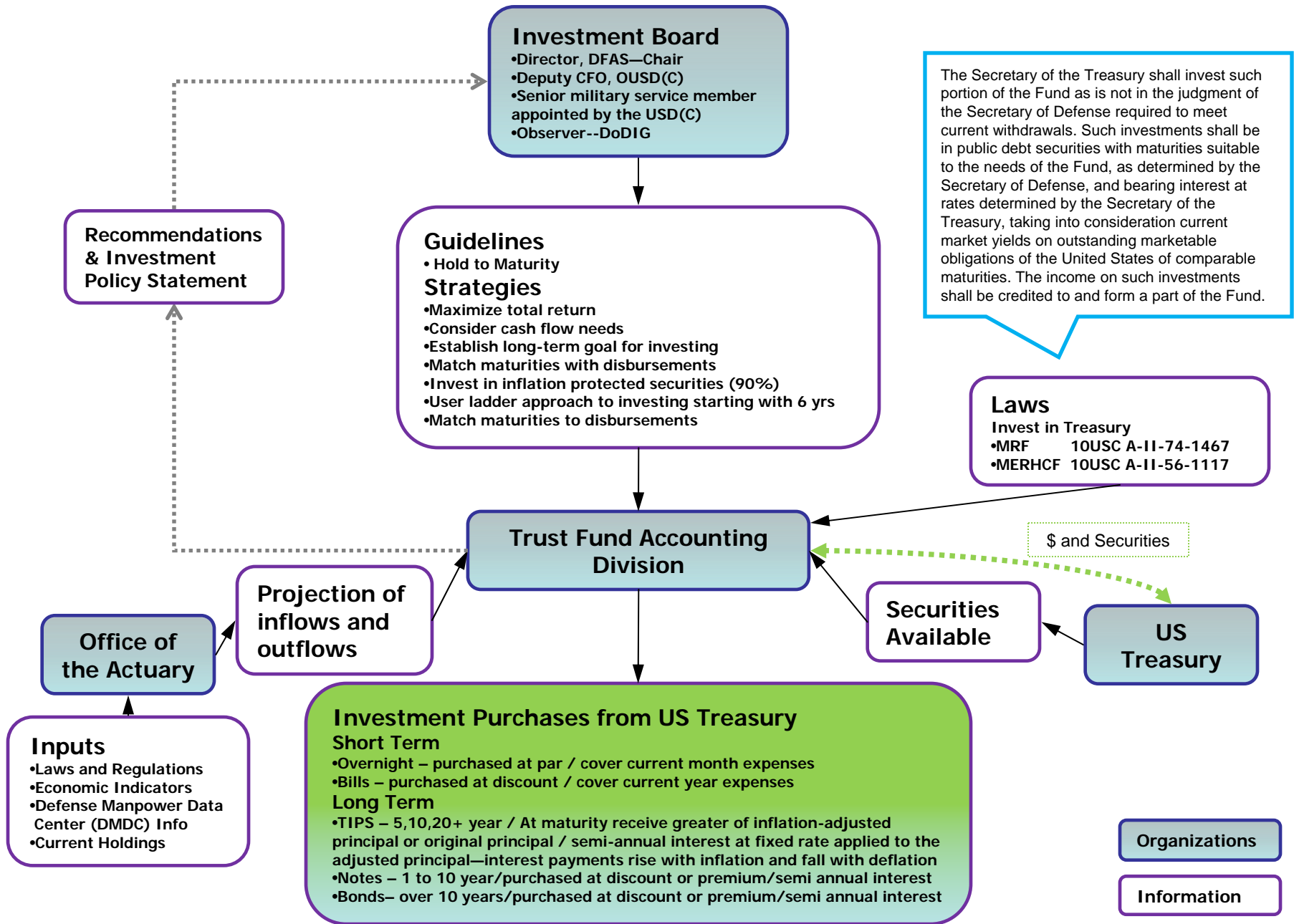
Business Excellence In Defense of the Nation

DEFENSE BUSINESS BOARD

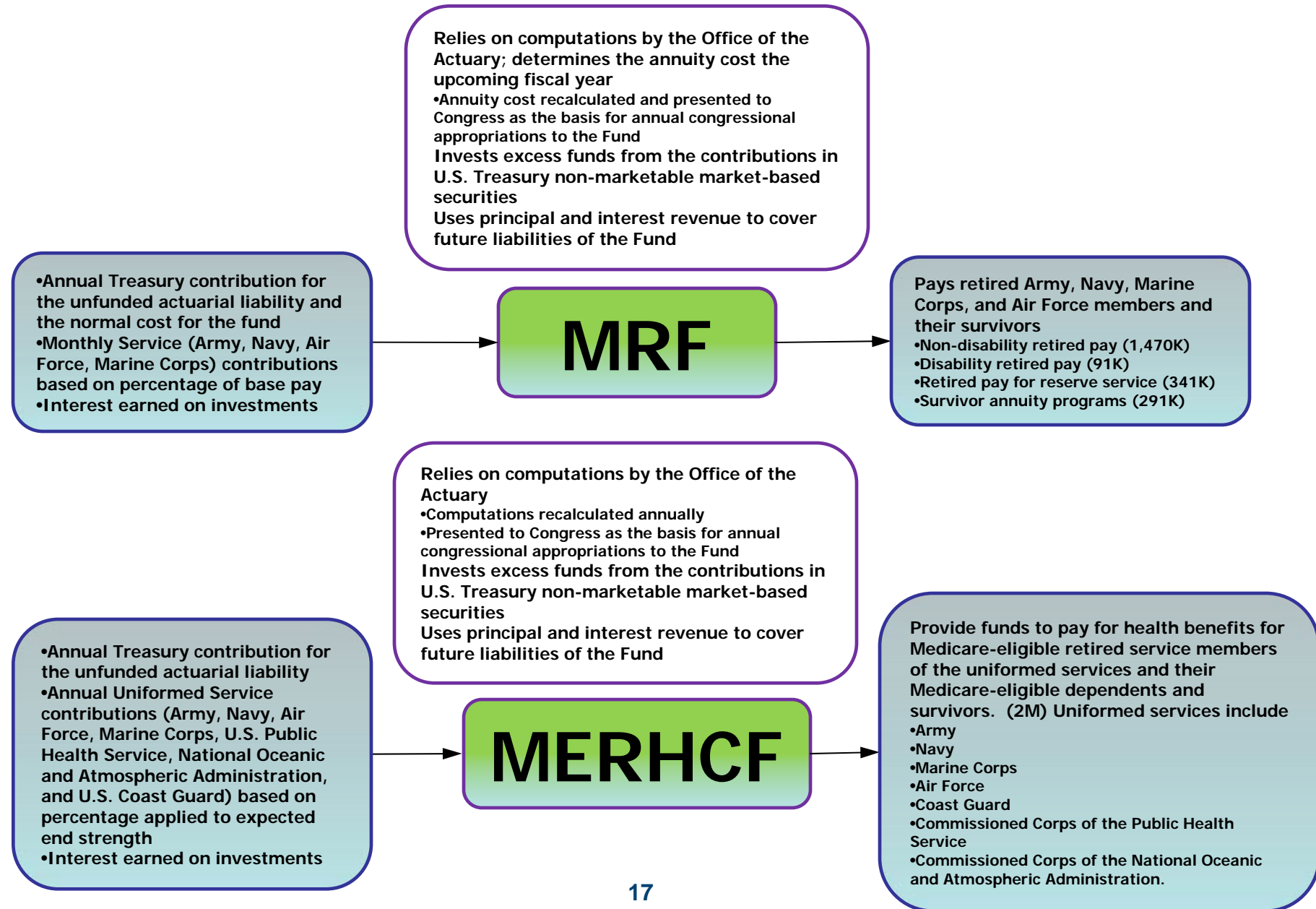


Appendix

DoD MRF and MERHCF Information Overview

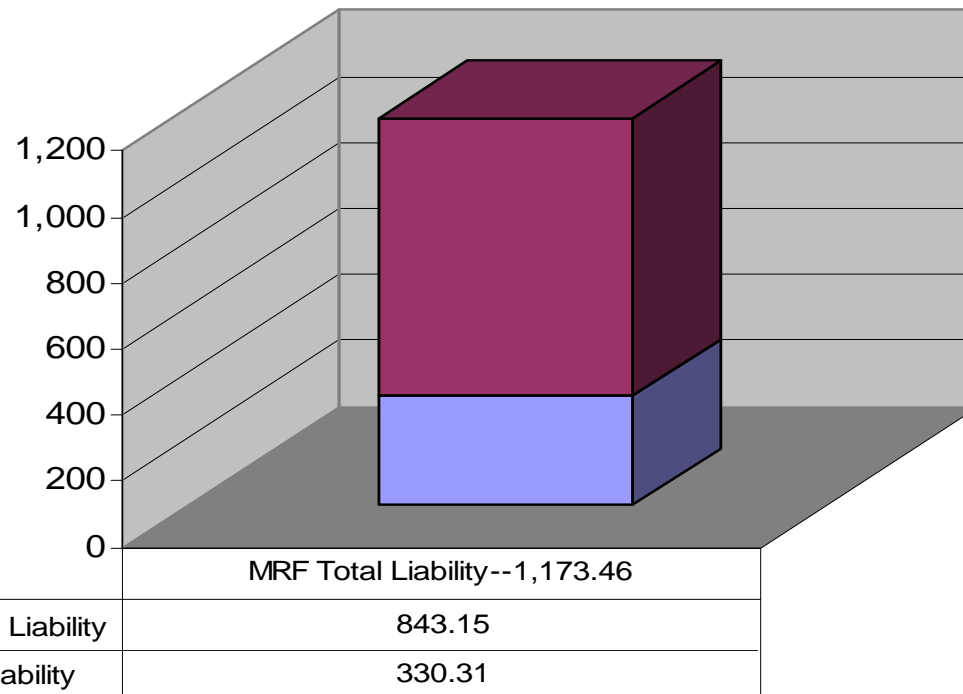


DoD MRF and MERHCF Information Overview



MILITARY RETIREMENT FUND

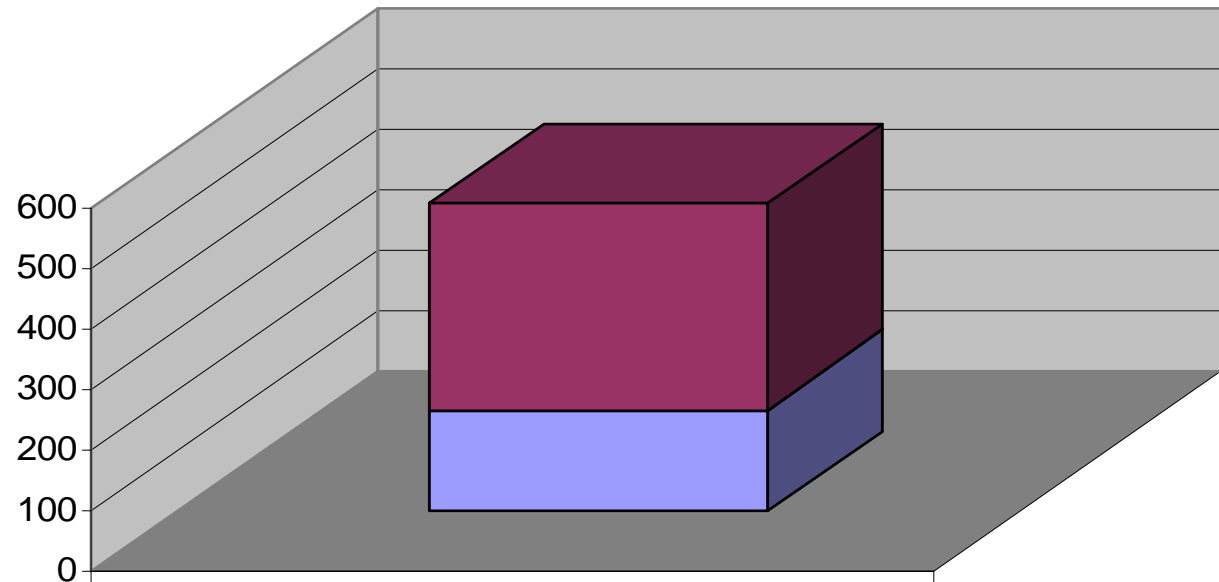
Funded/Unfunded Actuarial Liability
(in billions)
December 31, 2009



Funded liability includes inflation compensation, short-term bills and overnights not included in previous slides. Current inflation gain is \$40B.

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND

**Funded/Unfunded Actuarial Liability
(in billions)
December 31, 2009**

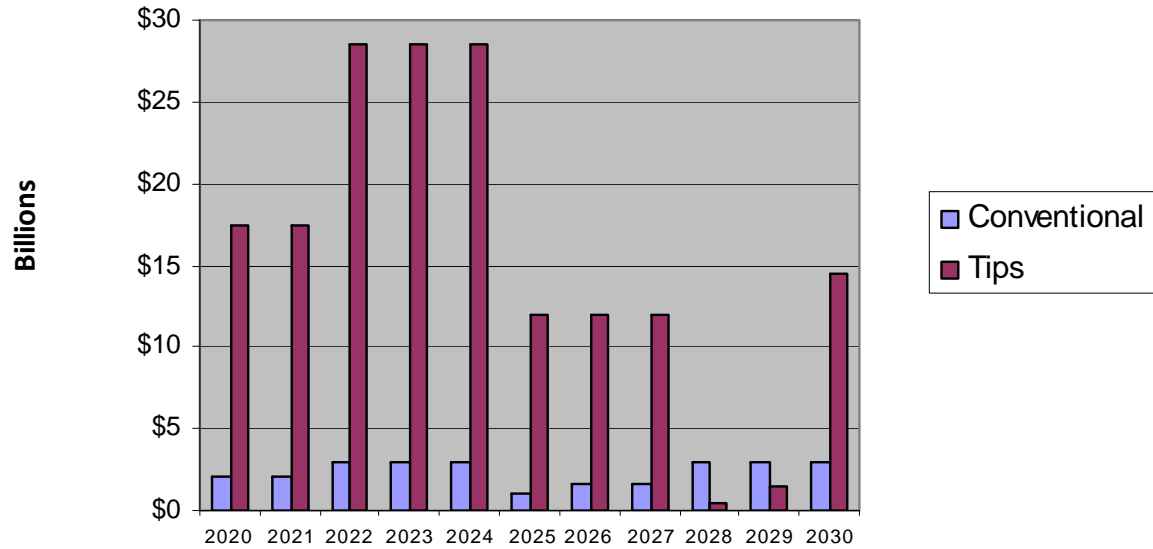


	MERHCF Total Liability--509.46
■ MERHCF Unfunded Liability	342.12
■ MERHCF Funded Liability	167.34

Funded liability includes inflation compensation, short-term bills and overnights not included in previous slides. Current inflation gain is \$21B.

MILITARY RETIREMENT FUND

MRF PROPOSED PURCHASING

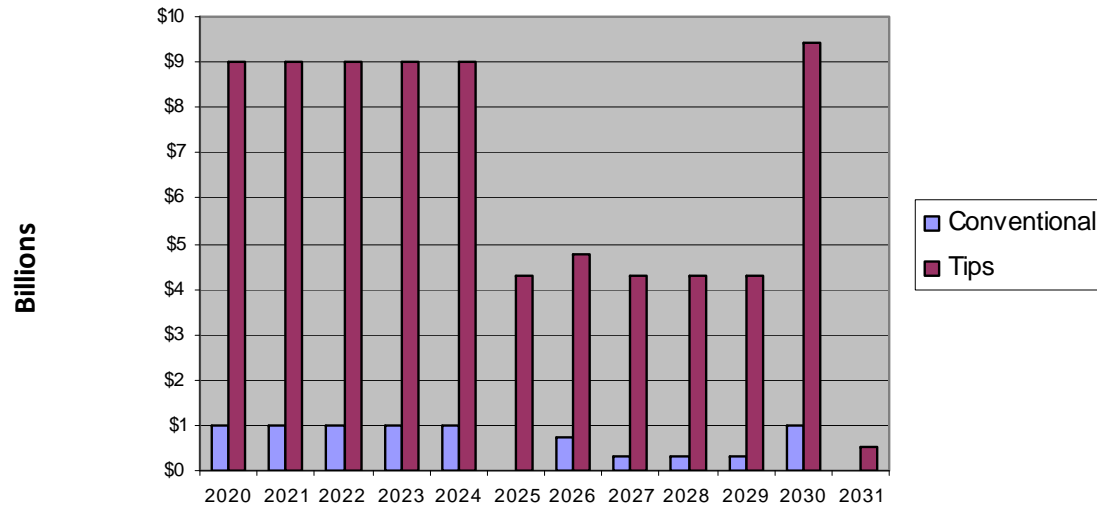


2015 Tips					28.5					0.95
2015 Conventional					3					1.55
2014 Tips				28.5						13.5
2014 Conventional				3						1.45
2013 Tips			28.5			3.5	3.5	3.5	0.5	0.5
2013 Conventional			3							1.7
2012 Tips		17.5				0.5	0.5	8.2		1
2012 Conventional		2							3	1.3
2011 Tips	17.5					8	8	0.3		
2011 Conventional	2					1	1.6	1.6		

Maturity FY

MILITARY RETIREMENT FUND

MERCHF PROPOSED PURCHASING



2015 Tips				9					4.95	0.5
2015 Conventional				1					0.55	
2014 Tips			9						2.95	4.5
2014 Conventional			1						0.15	0.45
2013 Tips			9					4.3	1.35	
2013 Conventional			1					0.2	0.15	
2012 Tips		9				2.5	4.3			
2012 Conventional		1				0.5	0.3	0.1		
2011 Tips	9				4.3	2.25				

Maturity FY