



Railroad Retirement Board: Trust Fund Investment Practices

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Summary

Beginning in 2002, a significant portion of the assets of the Railroad Retirement Board (RRB) have been invested in private stocks, bonds, and other investments. Prior to the Railroad Retirement and Survivors' Improvement Act of 2001, P.L. 107-90, surplus railroad retirement assets could only be invested in U.S. government securities—just as the Social Security trust funds must be invested. The 2001 act established the National Railroad Retirement Investment Trust (NRRIT; hereafter, the Trust) to manage and invest part of the RRB's assets in the same way that the assets of private-sector and most state and local government pension plans are invested. The remainder of RRB's assets continue to be invested solely in U.S. government securities.

Congress structured the Trust to assure independence of investment decisions and limit political interference. It also aimed to increase railroad retirement system funding, add enhanced benefits, potentially reduce taxes, and protect system financing in case of market downturns. The Trust's assets are invested in a diversified portfolio, both to minimize investment risk and to avoid disproportionate influence over an industry or firm. Since the Trust is a nongovernmental agency, it is not subject to the same oversight as federal agencies. However, the act requires an annual management report to Congress.

The Trust's investments have generally followed the markets' recent performance. From FY2003 to FY2011, the Trust's annual returns averaged 7.2%. This is slightly below the expectations of the bill's drafters, who assumed nominal annual returns of 8.0%. The recent economic downturn did not spare the Trust, which lost 19.1% in FY2008 and 0.7% in FY2009. However, the trust rebounded with a 11.2% rate of return in FY2010 and had slight loss of 0.1% in FY2011. As the Trust's investment portfolio has diversified over time, its administrative expenses have steadily increased, to 36 basis points in FY2011, but remain low compared with industry standards.

The Trust is designed to maintain four to six years' worth of benefits in case of lower-than-expected returns. To maintain this balance, the tier II tax is set to automatically adjust to maintain the fund balance at four to six years. This tax adjustment would not require congressional action. No tax increase is scheduled at the time of this writing.

The goal of this report is to inform readers about the Trust, which is of particular interest to policymakers exploring the option of collective investment of the Social Security trust funds or establishing other private investment funds within the federal government.

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Background

The Railroad Retirement Act authorizes retirement, survivor, and disability benefits for railroad workers and their families.¹ The Railroad Retirement Board (RRB), an independent federal agency, administers these benefits. Workers covered by the RRB include those employed by railroads engaged in interstate commerce and related subsidiaries, railroad associations, and railroad labor organizations. These benefits are earned by railroad workers and their families in lieu of Social Security.

Railroad retirement benefits are divided into two tiers. Tier I benefits are generally computed using the Social Security benefit formula, on the basis of earnings covered by either program. In some cases, RRB tier I benefits can be higher than comparable Social Security benefits. For example, RRB beneficiaries may receive unreduced tier I retirement benefits as early as 60 years old if they have at least 30 years of railroad service; Social Security beneficiaries may receive unreduced retirement benefits only when they reach their full retirement ages, currently rising from age 65 to 67. RRB tier II benefits are similar to private pension benefits and are based only on railroad work.²

History of the Trust

Beginning in 2002, a significant portion of railroad retirement assets have been invested in private stocks, bonds, and other investments. Prior to the Railroad Retirement and Survivors' Improvement Act of 2001, P.L. 107-90, surplus railroad retirement assets could only be invested in U.S. government securities—just as the Social Security trust funds must be invested.³ The 2001 act established the National Railroad Retirement Investment Trust (NRRIT; hereafter, the Trust) to manage and invest assets in the Railroad Retirement Account in the same way that the assets of private-sector retirement plans are invested. The Railroad Retirement Account is used to fund RRB tier II benefits and supplemental annuities. This account is also used to pay for tier I benefits that are higher than equivalent Social Security benefits, such as early retirement benefits for railroad employees with at least 30 years of railroad service. Assets in the Social Security Equivalent Benefits Account, which is used for RRB tier I benefits that are equivalent to Social Security benefits, continue to be invested solely in U.S. government bonds, as required by law.

¹ 45 U.S.C. §231 *et seq.* For additional information on the RRB, see CRS Report RS22350, *Railroad Retirement Board: Retirement, Survivor, Disability, Unemployment, and Sickness Benefits*, by Alison M. Shelton.

² Railroad employers also finance a supplemental annuity program for certain railroad employees hired before October 1981. General revenues finance a vested dual benefit for certain railroad employees who were eligible for benefits before 1975.

³ The Social Security trust funds may not be invested in private markets. For additional information on current practices, see CRS Report RS20607, *Social Security: Trust Fund Investment Practices*, by Dawn Nuschler.

Structure of the Trust

Independence

Congress structured the Trust to be independent and to resist political interference and the Trust is independent of the RRB and is not part of the federal government. It has no responsibilities for administering RRB benefits. The Trustees of the Trust are required to act solely in the interest of the RRB and the participants in the railroad retirement system. The fiduciary rules governing the Trustees are similar to those required by the law that governs the private pension system, the Employee Retirement Income Security Act (ERISA).⁴

The board of the Trust is made up of seven Trustees who have expertise in managing financial investments and pension plans. Three of the Trustees are selected by railroad labor unions, three by railroad management, and one by the other six Trustees. Each of the Trustees' terms is three years. The Trustees hire a professional staff to handle day-to-day operations of the Trust and independent investment managers to invest the assets of the Trust according to the investment guidelines established by the Trustees.

Each investment manager may control no more than 10% of the Trust's assets. Each manager must vote all proxies he or she holds in the Trust's portfolio in the sole interest of railroad retirement participants and beneficiaries, in accordance with written guidelines provided by the Trust. Votes must also be recorded and provided to the Trust upon request. Finally, all investment managers must certify each year that all proxies have been voted in the sole interest of railroad retirement participants and beneficiaries.⁵

Goals

Congress designed the Trust to increase RRB funding. Investing railroad retirement funds in private markets was expected to yield higher average annual returns than investing solely in government securities. The higher returns were intended to pay for the enhanced benefits that were established in the act and to potentially reduce future tax rates for railroad employers and employees.⁶

Impact on Tier II Tax Rates

The Trust is also designed to maintain four to six years' worth of benefits in case of lower-than-expected returns. To maintain this balance, the tier II tax is set to automatically adjust to maintain the fund balance at four to six years without congressional action. Since the inception of the

⁴ For additional information on ERISA, see CRS Report 95-926, *Regulating Private Pensions: A Brief Summary of ERISA*, by Patrick Purcell.

⁵ National Railroad Retirement Investment Trust, *Annual Management Report for Fiscal Year 2011*, January 2012, Appendix F, <http://www.rrb.gov/pdf/nrrit/reportFY2011.pdf>. Hereafter cited as NRRIT, *Annual Management Report for Fiscal Year 2011*.

⁶ U.S. Congress, House Committee on Transportation and Infrastructure, *Railroad Retirement and Survivors Improvement Act of 2001*, Report to accompany H.R. 1140, 107th Cong., 1st sess., May 24, 2001, H.Rept. 107-82, part 1 (Washington: GPO, 2001), pp. 14-15. Hereafter cited as H.Rept. 107-82, part 1.

Trust, the tier II tax rates have never increased and have been lowered twice. In 2005, the tier II tax rate on employers was automatically lowered from 13.1% to 12.6% and the tax rate on employees was lowered from 4.9% to 4.4%. Tier II tax rates were lowered again in 2007 to their current levels of 12.1% on employers and 3.9% on employees. The statute requires that the tier II tax rate on employers range between 8.2% and 22.1% caps the tax rate on employees at 4.9%.

Investment Guidelines

The assets in the Trust are invested in a diversified portfolio, both to minimize investment risk and also to avoid disproportionate influence over a particular industry or firm. The investment guidelines adopted by the Trustees include target asset allocations developed by the Trust's investment staff in consultation with an independent investment advisory firm. Outside investment managers hired by the Trust invest the assets according to these guidelines. The resulting investment performance is monitored by the Trustees and the Trust's Chief Investment Officer.

The Trust's target asset allocations change over time. For example, from FY2006 to FY2008, the Trust began to move away from fixed income investments (from 35% of total investments in FY2006 to 27% in FY2008) and toward private equity (from 5% to 10%) and real estate (from 5% to 10%). The Trust's adoption of a more aggressive investment strategy coincided with market downturns. In 2009, the Trust adjusted its target allocation ranges, but not its individual target allocations, to provide for greater flexibility during periods of market volatility.⁷

The investment guidelines were changed again in September 2011 to reflect current market expectations. These changes included continued movement away from fixed income investments (from 27% of total investments in 2009 to 22% in 2011); the elimination of the opportunistic investments category, which had a target allocation range of between 5% and 20% in 2009; and the adoption of a cash category with a target allocation range of between 0% and 3%.⁸ The Trust's current investment guidelines are shown in detail in **Table 1**.

Oversight

Because the Trust is an independent nongovernmental agency, it is not subject to the same oversight as federal agencies. The act outlines specific reporting requirements including an annual management report to Congress. The report must include a statement of financial position, a statement of cash flows, a statement on internal accounting and administrative control systems, and any other information necessary to inform Congress about the operations and financial condition of the Trust. The financial statements must be audited by independent public accountants. A copy of the annual report and audit must be submitted to the President, the RRB, and the Director of the Office of Management and Budget (OMB). The RRB has the authority to bring a civil action to enforce provisions of the act.

However, the RRB Office of Inspector General (OIG) has expressed concern about the effectiveness of the oversight of the Trust. The OIG argues that the annual financial audit required

⁷ National Railroad Retirement Trust, *Annual Management Report for Fiscal Year 2009*, January 2010, p. 15, <http://www.rrb.gov/pdf/nrrit/reportFY2009.pdf>.

⁸ NRRIT, *Annual Management Report for Fiscal Year 2011*, Appendix B.

“is not adequate to support the RRB’s enforcement responsibility because such audits are not intended to provide information about all areas of risk that could indicate the need for enforcement action.”⁹ There are fewer safeguards protecting the Trust than there are for the retirement investments of federal government and private-sector workers. For example, there is no requirement for performance audits of the Trust, which would assess program effectiveness, economy and efficiency, internal control, and compliance with the law.

Table 1. Trust Target Asset Allocations and Ranges

as of September 20, 2011

Asset Class	Target Allocation (%)	Target Allocation Range (%)
Equity	54	45-61
Domestic	23	18-28
International	21	16-26
Private	10	2-15
Fixed Income	22	18-28
Domestic	13.5	9-18
International	8.5	5-15
Real Assets	15	2-22
Commodities	5	2-8
Real Estate	10	2-15
Other	9	5-20
Absolute Return	8	2-10
Cash	1	0-3

Source: National Railroad Retirement Investment Trust, *Annual Management Report for Fiscal Year 2011*, January 2012, p. 17.

Accounting in the Federal Budget

As required in the 2001 act, purchases and sales by the Trust initially produce no direct budgetary cost or income.¹⁰ The law did not prescribe the treatment of unrealized capital gains and losses on the Trust’s investments. The Congressional Budget Office (CBO) and OMB agreed that any capital loss or gain resulting from changes in market prices would be recognized in the year in which the price change occurs, and interest payments and dividends would be recorded as offsetting receipts.¹¹ As a result, income and capital gains reduce outlays and the deficit, and

⁹ Railroad Retirement Board, Office of Inspector General, *Statement of Concern: National Railroad Retirement Investment Trust Lack of Provision for Performance Audits*, March 31, 2008, <http://www.rrb.gov/pdf/oig/REPORTS/nrritStatement.pdf>.

¹⁰ For budgetary purposes, purchases by the Trust are not considered outlays, but as an exchange of assets of equal value; redemptions are not considered offsetting receipts. This differs from long-standing budgetary rules, which usually treat an investment in nonfederal securities as the purchase of an asset, recording both an obligation and an outlay equal to the purchase price during the year of the purchase.

¹¹ For more information on accounting for government investment in private markets, see Congressional Budget Office, *Evaluating and Accounting for Federal Investment in Corporate Stocks and Other Private Securities*, January 2003, (continued...)

losses increase them. This reflects the change in real economic resources available to the government as the value of the Trust changes. As for future performance, both CBO and OMB use risk-adjusted rate of return assumptions—that is, they assume that the Trust’s investments will earn the Treasury bond rate.

Performance of the Trust

To date, the Trust’s average annual performance has fallen slightly short of the expectations of the bill’s drafters. It was assumed that investments by the Trust would earn an average annual return of 8.0%.¹² From FY2003 to FY2011, the Trust’s annual returns have averaged 7.2%. However, for the first half of the Trust’s existence, the Trust’s returns exceeded expectations. Prior to FY2008, the average rate of return on Trust investments was 14.7% and the average rate of return exceeded the expected rate of 8.0% through FY2010. The Trust had negative rates of return in FY2008 and FY2009 but rebounded with an 11.2% rate of return in FY2010 followed by a slightly negative rate of return of -0.1% in FY2011.¹³

Since railroad retirement funds were first invested through the Trust in September 2002, a total of \$21.3 billion has been transferred to the Trust, with no transfers taking place after the end of FY2004.¹⁴ The Trust earned a total of \$12.4 billion from its inception to the end of FY2011.¹⁵ As of March 31, 2012, the Trust held \$24.2 billion, and since inception \$12.5 billion in earnings have been used to pay RRB benefits.¹⁶

Total RRB Assets

At the inception of the Trust in February 2002, the value of the total assets of the RRB, including assets in the Trust and assets held in reserve in accounts at the Department of the Treasury was \$20.7 billion. As of March 31, 2012, the value of total RRB assets was \$25.5 billion, with \$24.2 billion held by the Trust and \$1.3 billion held in reserve accounts at the Treasury Department. The net increase in total RRB assets since the inception of the Trust is \$4.8 billion.¹⁷

Comparison to Benchmarks

The Trust’s rates of return have generally compared favorably to its benchmarks. A benchmark is a standard used for comparison when measuring investment performance and the NRRIT strategic policy benchmark is based on a series of benchmarks corresponding to each of the nine

(...continued)

<http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/40xx/doc4023/01-08-03-stocks.pdf>

¹² H.Rept. 107-82 Part 1, p. 14.

¹³ NRRIT, *Annual Management Report for Fiscal Year 2011*, p. 7.

¹⁴ Ibid., p. 13.

¹⁵ Ibid.

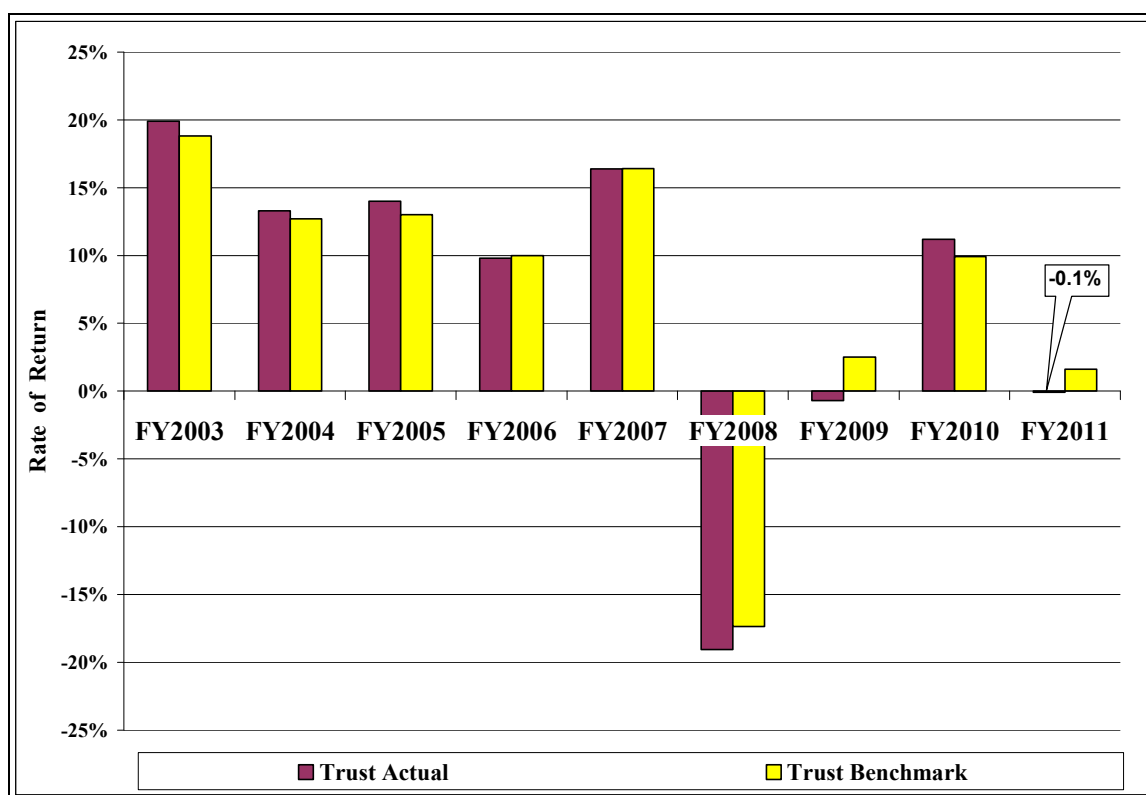
¹⁶ National Railroad Retirement Investment Trust, *Quarterly Update for the Period Ending March 31, 2012*, April 2012, <http://www.rrb.gov/pdf/nrrit/qrtlyupd033112.pdf>.

¹⁷ Ibid.

major asset classes in the Trust.¹⁸ For example, the current benchmark for the Trust's investments in domestic equities is the Russell 3000 Index.¹⁹

As shown in **Figure 1**, in FY2003 through FY2005, the performance of the Trust exceeded its strategic policy benchmarks. In FY2006 and FY2007, the Trust's performance was roughly equal to its benchmarks, whereas in FY2008, FY2009, and FY2011, the Trust's investments had lower returns than its strategic policy benchmarks. In FY2010, the strategic policy benchmark rate of return of 9.9% was exceeded by the Trust's rate of return of 11.2% and in FY2011 the benchmark of 1.6% exceeded the Trust's rate of return of -0.1%.

Figure 1. Trust Rates of Return Compared with Strategic Policy Benchmarks
FY2003 to FY2011



Source: National Railroad Retirement Investment Trust, *Annual Management Report for Fiscal Year 2011*, January 2012, p. 7; and previous editions.

¹⁸ Benchmarks for each of the Trust's asset classes are provided in NRRIT, *Annual Management Report For Fiscal Year 2011*, Appendix B, <http://www.rrb.gov/pdf/nrrit/appendicesFY2011.pdf>.

¹⁹ Additional information on the Russell 3000 Index is available on the website of Russell Investments at http://www.russell.com/Indexes/data/fact_sheets/us/Russell_3000_Index.asp.

Administrative Expenses

The Trust's administrative expenses have steadily increased as its investment portfolio has diversified over time, as shown in **Table 2**. However, administrative expenses remain low compared with industry standards. In FY2012, the Trust's expense ratio was 36 basis points (expenses were 0.36% of average net assets).²⁰ In comparison, in 2011, the average expense ratio for all investors was 79 basis points for equity funds, 62 basis points for bond funds, 80 basis points for hybrid funds, and 21 basis points for money market funds.²¹

Table 2. Trust Expense Ratios
FY2003 to FY2010

Fiscal Year	Basis Points
2003	2
2004	4
2005	9
2006	15
2007	24
2008	25
2009	26
2010	33
2011	36

Source: National Railroad Retirement Investment Trust, *Annual Management Report for Fiscal Year 2011*, January 2012, p. 19; and previous editions.

Acknowledgments

An earlier version of this report was prepared by Kathleen Romig.

²⁰ NRRIT, *Annual Management Report For Fiscal Year 2011*, Independent Auditors' Report, p.19.

²¹ Investment Company Institute, *Trends in the Fees and Expenses of Mutual Funds, 2010* April 2012, <http://www.ici.org/pdf/per18-02.pdf>.