CITY OF CUPERTINO

ADMINISTRATIVE SERVICES DEPARTMENT

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CITY COUNCIL STAFF REPORT
Meeting: December 3, 2024

Subject
Adopt the OPEB and Pension Trust Investment Policies

Recommended Action
A. Adopt Resolution No. 24-XXX for the OPEB Trust Investment Policy; and
B. Adopt Resolution No. 24-XXX for the Pension Trust Investment Policy

Discussion
Background
In Fiscal Year (FY) 2009-10, the City established a Section 115 Trust to help fund its retiree health obligations, also known as OPEB. In FY 2017-18, the City also established a Section 115 Trust to pre-fund its pension obligations and reduce the potential impact of pension cost volatility on the City's operating budget.

OPEB and Pension Trusts
Section 115 Trust Overview
A Section 115 Trust is a tax-exempt investment tool that allows local governments to pre-fund pension and retiree health costs. The benefits of a Section 115 Trust include the following:

- Local control over assets: The City controls the contributions, withdrawals, investment strategy, and risk level of assets in the Trust.
- Potential for higher investment returns than General Fund: Investment requirements that apply to the City's General Fund assets under Government Code 53601 are not applicable to Trust assets.
- Pension rate stabilization: Assets can be transferred to CalPERS at the City's discretion to pay for Normal Cost or Unfunded Accrued Liability (UAL) contributions and can be used to reduce or eliminate large fluctuations in the City's pension costs.
- Diversification: Trust assets will be diversified from CalPERS investments.

OPEB Trust Overview

In FY 2009-10, the City established a Section 115 Trust to help fund its retiree health obligations, also known as OPEB. Compared to a pay-as-you-go plan, the OPEB Trust allows the City to:

- Grow assets to pay future OPEB benefits.
- Earn higher returns than the General Fund.
- Reduce its total cost for providing post-employment benefits.
- Reduce its Net OPEB Liability.

In July 2010, the City contributed $7.0 million in initial funding. With additional contributions of $12.3 million, total contributions to date are $19.3 million.

As of June 30, 2024, the City's OPEB Trust had a market value of $38.0 million and had earned an annualized investment return of 6.71% gross of fees since inception.

Time Period	Annualized Investment Return
1 Year	13.85%
5 Year	6.54%
Since Inception	6.71%

1-Year investment returns were impacted by financial market volatility due to heightened geopolitical risk, supply chain bottlenecks and persistent inflation, and the Federal Reserve's pivot to a less accommodative monetary policy.

As of the June 30, 2024, measurement date, using a 6.5% discount rate, the City's OPEB plan had an accrued liability of $40.4 million and a market value of assets of $38.0 million, resulting in an unfunded accrued liability of $2.4 million and a funded ratio of 94.1%. Compared to June 30, 2023, the unfunded accrued liability continued to increase, and the funded ratio decreased, primarily due to changes in actuarial assumptions.

	June 30, 2022	June 30, 2023*	June 30, 2024*
Accrued Liability	29,871,000	35,290,000	40,389,000
Market Value of Assets	31,340,000	34,708,000	38,013,000
Unfunded Accrued Liability	(1,469,000)	582,000	2,376,000
Funded Ratio	104.9%	98.4%	94.1%

*Amounts provided from Actuarial Report, as opposed to PARS provided.

Pension Trust Overview

Since pension obligations are one of the City's largest financial obligations, the City has taken proactive steps to reduce the impacts of pension cost volatility. In March 2018, the City provided options to Council to address rising pension costs. In April 2018, the City presented a long-term pension funding strategy to the Fiscal Strategic Plan Committee. In May 2018, the City adopted a Section 115 Trust, also known as a Pension Rate Stabilization

Program (PRSP), to reduce pension rate volatility on the City's budget. The Pension Trust helps the City to:

- Grow assets for future pension contributions.
- Invest assets over appropriate time horizons.
- Earn higher investment returns than the General Fund.
- Reduce pension contribution volatility.
- Diversify funds from CalPERS investments.

As a fiscal sustainability measure, the City funds the Pension Trust using a more conservative discount rate of 6.25%. The City's pension funding goal is to accumulate sufficient funds in the Pension Trust to fund the difference between a 6.25% and a 7% discount rate and achieve a funded status of 80% by FY 2036-37, 20 years from the adoption of the Pension Trust. The City's projections indicated that it would need to accumulate over $42 million in the Pension Trust within 20 years to achieve its pension funding goal.

As a result, the funding strategy proposed $8.0 million in initial funding, along with additional funding of $10.0 million over the first five years. To date, the City has contributed $16.0 million, including:

- $8.0 million in FY 2018-19
- $4.0 million in FY 2019-20
- $2.0 million in FY 2020-21
- $2.0 million in FY 2021-22

As of June 30, 2024, the City's Pension Trust had a market value of $21.7 million and had earned an annualized investment return of 7.16% gross of fees since inception.

Time Period	Annualized Investment Return
1 Year	13.83%
5 Year	7.28%
Since Inception	5.62%

1-Year investment returns were impacted by financial market volatility due to heightened geopolitical risk, supply chain bottlenecks and persistent inflation, and the Federal Reserve’s pivot to a less accommodative monetary policy.

OPEB and Pension Trust Investment Policies

The Audit Committee is responsible for reviewing the OPEB and Pension Trust investment policies annually, appointing investment managers, and monitoring investment performance. The City Council is responsible for annually adopting the OPEB and Pension Trust investment policies.

It is not expected that the OPEB and Pension Trust investment policies will change frequently. Short-term changes in the financial markets should not require adjustments to the policies.

On October 31, 2024, the Audit Committee reviewed both proposed policies and recommended to remove the following language: "The international equity investments (including emerging markets) shall constitute no more than 20% of the total market value of the Portfolio". The Audit Committee unanimously (3-0-2) voted to accept the policies.

This section has been expanded to address supplemental questions and concerns that were received shortly before the City Council Meeting.

The rationale for removing the 20% cap on international equity investments was to better align the portfolio with its performance benchmark, the MSCI All Cap World Index, which consists of approximately 65% US stocks and 35% non-US stocks. This adjustment ensures that the portfolio's performance is more directly comparable to the benchmark and allows for greater diversification. If the restriction is removed, the current allocation to non-US equities would be approximately 25%, with the potential to increase at the portfolio manager's discretion, within the scope of the policy's overall investment objectives.

The Audit Committee reviewed and recommended this change, emphasizing the importance of alignment with the benchmark and maintaining the portfolio's "Balanced" investment objective. It is important to note that all investments, including international equities, must comply with the policy's stated principles of prudent investment, which prioritize diversification, risk management, and long-term returns.

While the removal of the cap provides additional flexibility, the City retains oversight through its investment policies and portfolio manager reporting requirements. Additionally, the City Council can provide further direction regarding specific criteria or restrictions for international equity investments in future policy reviews, ensuring that investments align with the City's broader goals and values.

An alternative to removing the cap would be to adjust the performance benchmark to align with a 20% international equity maximum allocation. However, this would limit the portfolio's ability to match the diversification and returns of the MSCI All Cap World Index.

Public Agency Retirement Services (PARS) is the City's Trust Administrator and US Bank is the City's Investment Manager for the Pension and OPEB Trusts. The Investment Manager manages the investments per the investment policies. Within the constraints imposed by these policies, Investment Managers are expected to comply with all applicable fiduciary and due diligence requirements under the "prudent investor" rules.

OPEB and Pension Trust Investment Objectives

The OPEB Trust has a "Balanced" investment objective with a target rate of return of 6.50%, and the Pension Trust has a "Balanced" investment objective with a target rate of return of 6.25%. The "Balanced" investment objective is designed to provide a moderate amount of current income with moderate growth of capital. Investors should have sufficient tolerance for price and return volatility and substantial periodic declines in investment value. This objective is recommended for investors with a long-term time horizon. The strategic asset allocation ranges and tactical targets for this objective are listed below:

Asset Class	Range	Target
Fixed Income	20-40%	29%
Equities	50-70%	63%
Real Estate	0-15%	5%
Commodities	0-10%	2%
Cash	0-10%	1%

The target rates of return are based on the long-term expected rate of return for assets in the trusts and the City's time horizon for the investments.

With strong reserves and a fully funded OPEB plan, the City can maintain a long-term investment horizon with a "balanced" investment objective. There may be periods of substantial decline in investment value, and the portfolio should expect periodic volatility. However, a 6.56% return on investment is expected over the long-term, based on the current investment objective. More conservative investment objectives such as "moderate" and "moderate-conservative" would expect less volatility and declines in investment value; however, over the long term, they would also expect lower returns. Many agencies anticipate needing to access the funds in their respective trusts sooner and invest with more emphasis on preserving capital in the near term.

The OPEB Trust has a higher discount rate than the Pension Trust because OPEB investments are expected to have a longer time horizon. OPEB obligations are generally longer in duration, and the City expects to withdraw Pension Trust funds earlier to fund CalPERS contributions. Given that changes to the CalPERS discount rate have larger effects on the City's operating budget and are farther out of the City's control, it is important that the City be able to use the Trust to pay CalPERS contributions as needed.

Next Steps

If the proposed investment policy changes are approved, the portfolio manager will strategically incorporate these changes into the investment strategy, aligning the portfolio allocations with the updated policy guidelines. This includes rebalancing investments as necessary to optimize performance while adhering to the revised policy framework.

If the proposed changes are not approved, the portfolio manager will continue to manage the portfolio based on the existing investment policy. However, maintaining the current policy may limit the portfolio's ability to align with performance benchmarks, such as the MSCI All Cap World Index, potentially impacting long-term returns and diversification opportunities.

Sustainability Impact
There is no sustainability impact.

Fiscal Impact
There is no direct fiscal impact at this time.

California Environmental Quality Act
Not applicable.

City Work Program (CWP) Item:
Not a CWP item.

CWP Item Description:
Not Applicable.

Council Goal:
Sustainability and Fiscal Strategy

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Reviewed by: Kristina Alfaro, Director of Administrative Services
Tina Kapoor, Interim Assistant City Manager
Approved for Submission by: Pamela Wu, City Manager
Attachments:
A – OPEB Trust Investment Policy (Redline)
B – OPEB Trust Investment Policy (Clean)
C – OPEB Investment Policy Draft Resolution
D – Pension Trust Investment Policy (Redline)
E – Pension Trust Investment Policy (Clean)
F – Pension Investment Policy Draft Resolution