CITY OF CUPERTINO

ADMINISTRATIVE SERVICES DEPARTMENT

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CITY COUNCIL STAFF REPORT

Meeting: December 6, 2022

Subject

Consider the OPEB and Pension Trust Investment Policies

Recommended Action

Adopt Resolution No. 22-XXX and No. 22-XXX accepting the OPEB and Pension Trust Investment Policies

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 other post-employment benefits (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.

On an annual basis, the Audit Committee reviews the City's investment policies before they are presented to City Council. The City's Audit Committee reviewed and accepted the attached OPEB Trust and Pension Trust investment policies on October 24, 2022.

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 other post-employment benefits (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, 2022, the City's OPEB Trust had a market value of $31.3 million and had earned an annualized investment return of 5.77% gross of fees since inception.

Time Period	Annualized Investment Return
1 Year	-17.28%
5 Year	4.34%
Since Inception	5.77%

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.

The FY 2021-22 investment return also impacted the unfunded accrued liability and funded ratio. As of the June 30, 2022 measurement date, using a 6.5% discount rate, the City’s OPEB plan had an accrued liability of $29.9 million and a market value of assets of $31.3 million, resulting in an unfunded accrued liability of $(1.5) million and a funded ratio of 104.9%. Compared to June 30, 2021, the unfunded accrued liability increased, and the funded ratio decreased due to the FY 2021-22 investment loss.

	June 30, 2021	June 30, 2022
Accrued Liability	28,626,000	29,871,000
Market Value of Assets	38,025,000	31,340,000
Unfunded Accrued Liability	(9,399,000)	(1,469,000)
Funded Ratio	132.8%	104.9%

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 for addressing 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:

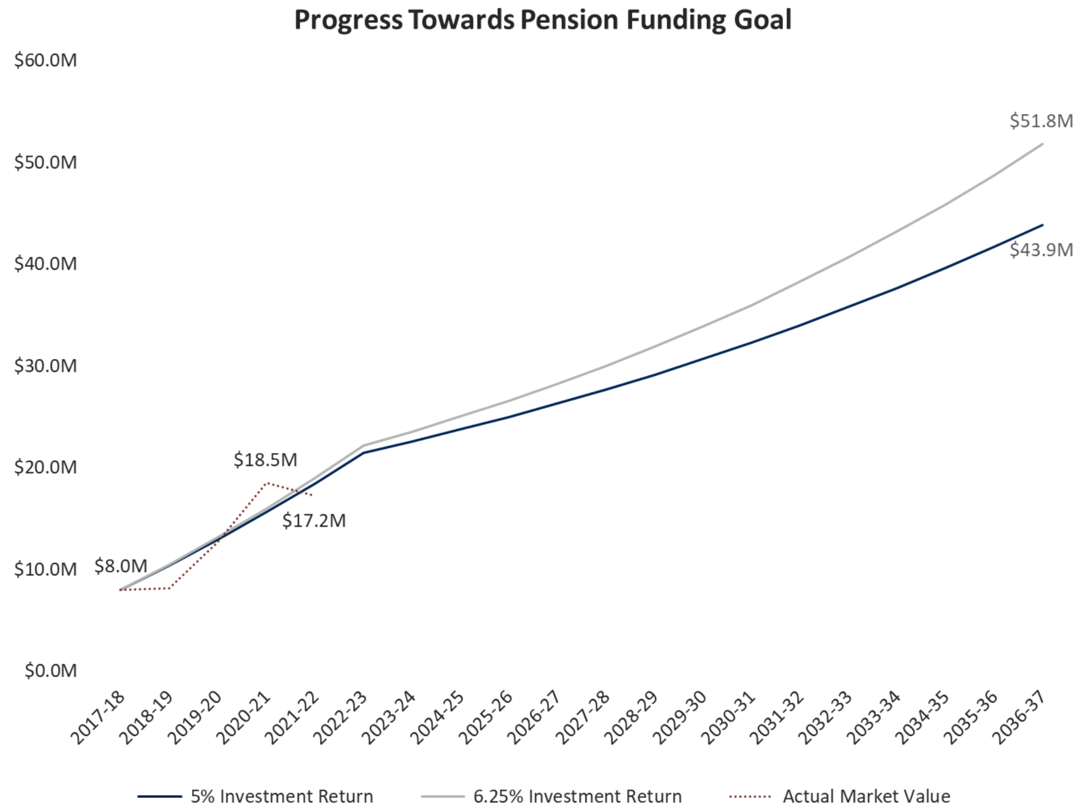
- $8.0 million in FY 2018-19
- $4.0 million in FY 2019-20
- $2.0 million in FY 2020-21
- $2.0 million in FY 2021-22

As of June 30, 2022, the City's Pension Trust had a market value of $17.2 million and had earned an annualized investment return of 3.94% gross of fees since inception.

Time Period	Annualized Investment Return
1 Year	-17.19%
Since Inception	3.94%

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.

The following chart illustrates the City's progress toward its pension funding goal. The 5% investment return represents the lowest investment return that would allow the City to achieve its goal. A 6.25% investment return is the current target rate of return of the Pension Trust. The dotted line represents the actual market value of the City's Pension Trust.



Note: The 5% Investment Return and 6.25% Investment Return projections are for illustrative purposes only. Actual returns will be different. Past performance is no guarantee of future results.

Given this strategy and the City's current progress, the City is in a strong position to withstand the effects of pension cost increases. By using a more conservative discount rate than CalPERS, the City can allocate more towards pension funding each year than CalPERS requires. If CalPERS investment returns fall short of assumptions, the City will be better prepared for future pension cost increases. If CalPERS lowers the discount rate, the City will be better prepared to absorb the costs.

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.

The Audit Committee reviewed the policies on September 27, 2021, October 25, 2021, and November 15, 2021. The Audit Committee accepted the policies with recommended additions to the prohibited asset classes. The changes included:

- Prohibiting direct or indirect exposure to cryptocurrencies
- Prohibiting leveraged securities, other than registered hedged equity and hedged fixed income positions
- Limiting registered hedged equity and fixed income positions to 10% of the portfolio

On December 7, 2021, the City Council adopted the investment policies with the Audit Committee's recommendations.

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.

CalPERS

CalPERS Overview

The City provides a defined benefit pension to its employees through the California Public Employees' Retirement System (CalPERS). Retiree pensions are calculated using a formula based on an employee's age, earnings, and years of service. The retirement benefits are funded by:

- Investment earnings (60%)
- Employer contributions (29%)
- Employee contributions (11%)

Each year, CalPERS determines an employer's contributions based on actual investment returns and actuarial assumptions, including:

- Expected investment returns (discount rates)
- Inflation rates
- Salaries
- Retirement ages
- Life expectancies

Contributions to fund the pension plan are comprised of two components:

- The Normal Cost (NC), which is the cost of the benefits earned in a respective year.
- The Unfunded Accrued Liability (UAL) payment, which is the amortization of the unfunded accrued liability.

CalPERS Discount Rate
Defined benefit plans are highly sensitive to the discount rate assumption. The discount rate is the expected rate of return on the plan's assets over the long term. The discount rate will depend on the plan's size, asset allocation, time horizon, and other considerations.

From the City's perspective, the discount rate is important as it is used to determine the City's annual contributions to the plan, the plan's unfunded liability, and the plan's funded status. In other words, the discount rate is used to determine whether a plan has enough assets to meet its future obligations. If the discount rate assumption is too high and investments earn less than expected, a funding shortfall may result, requiring the City or CalPERS members to make greater contributions than expected.

CalPERS Update
As of the June 30, 2021 actuarial valuation, the City's CalPERS plan had an accrued liability of $168.4 million and market value of assets of $127.1 million, resulting in an unfunded accrued liability of $41.3 million and a funded ratio of 75.5%. Compared to the June 30, 2020 actuarial valuation, the unfunded liability decreased, and the funded ratio increased due to the FY 2020-21 investment gain. The June 30, 2022 actuarial valuation will reflect the FY 2021-22 investment returns.

	June 30, 2020	June 30, 2021
Accrued Liability	157,610,543	168,421,875
Market Value of Assets	103,788,993	127,113,891
Unfunded Accrued Liability	53,821,550	41,307,984
Funded Ratio	65.9%	75.5%

The unfunded liability is the difference between assets and liabilities, while the funded ratio is the ratio of assets to liabilities.

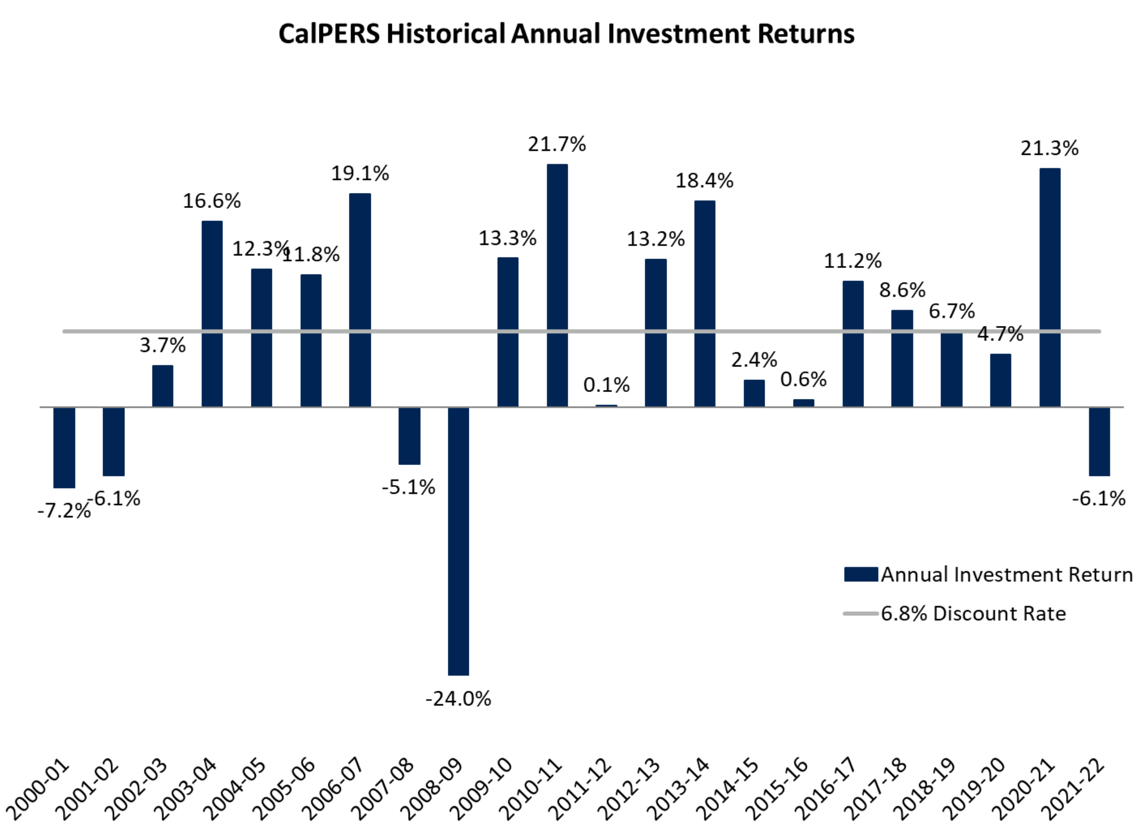
A defined-benefit plan is considered adequately funded if its assets equal or exceed the value of its future liabilities. When the funded ratio is lower than 100%, the plan has insufficient assets to pay all future liabilities. Poor investment returns during the Great Recession significantly decreased the plan's assets. In addition, enhanced benefits and actuarial assumption changes due to increased life expectancies increased the plan's liabilities. These two factors significantly decreased the funded status of the system.

Over the past few years, CalPERS has taken steps to improve the long-term financial sustainability of the system. In December 2016, the CalPERS board voted to reduce the discount rate, also known as the assumed rate of return for investments, from 7.5% to 7.0% over three years from FY 2018-19 to FY 2020-21. In February 2018, the CalPERS board also voted to decrease the amortization period for new pension liabilities from 30 years to 20 years, effective July 1, 2019. While these changes will provide long-term benefits to the pension plan, they will also increase the City's pension contributions.

Funding Risk Mitigation Policy
Under the "Funding Risk Mitigation Policy," the 21.3% return in FY 2020-21 triggered a reduction in the discount rate, or assumed rate of return, from 7% to 6.8%. The Funding Risk Mitigation Policy, approved by the CalPERS board in 2005, lowers the discount rate in years of good investment returns to reduce risk in the portfolio. The Risk Mitigation Policy will affect contributions starting in FY 2023-24.

Asset Liability Management Process
In November 2021, CalPERS completed its Asset Liability Management (ALM) process, which follows a four-year cycle. The ALM process reviewed investment strategies and actuarial assumptions. At the November 15-17, 2021, meetings, the CalPERS Board approved a 6.8% discount rate, selected a new asset allocation for the fund's investment portfolio, and adopted new actuarial assumptions.

CalPERS Investment Returns



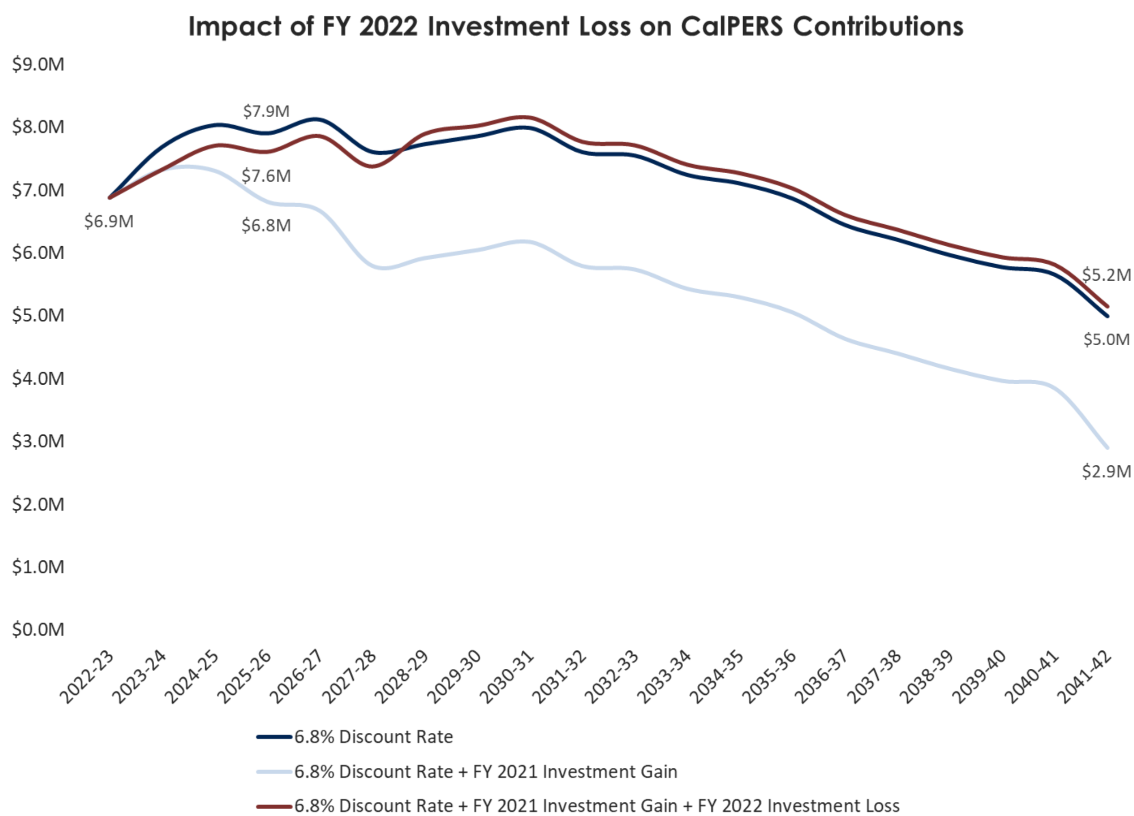
Note: Beginning in 2002, investment returns are reported gross of fees.

Challenging and volatile financial markets impacted FY 2021-22 investment returns. For FY 2021-22, CalPERS reported a preliminary investment return of -6.1%. The average investment return is 6.7% for a 5-year period, 7.7% for a 10-year period, 6.9% for a 20-year period, and 7.7% for a 30-year period. Given that returns in a given year are volatile, it can be more instructive to look at returns over longer time horizons.

Time Period	Annualized Investment Return
1 Year	-6.1%
5 Year	6.7%
10 Year	7.7%
20 Year	6.9%
30 Year	7.7%

CalPERS assumes it will earn investment returns of 6.8% each year. If investment returns are higher than 6.8%, the City's contributions decrease. On the other hand, if investment returns are lower than 6.8%, the City's contributions increase.

The FY 2021-22 investment loss is expected to affect the City's pension contributions starting in FY 2024-25.

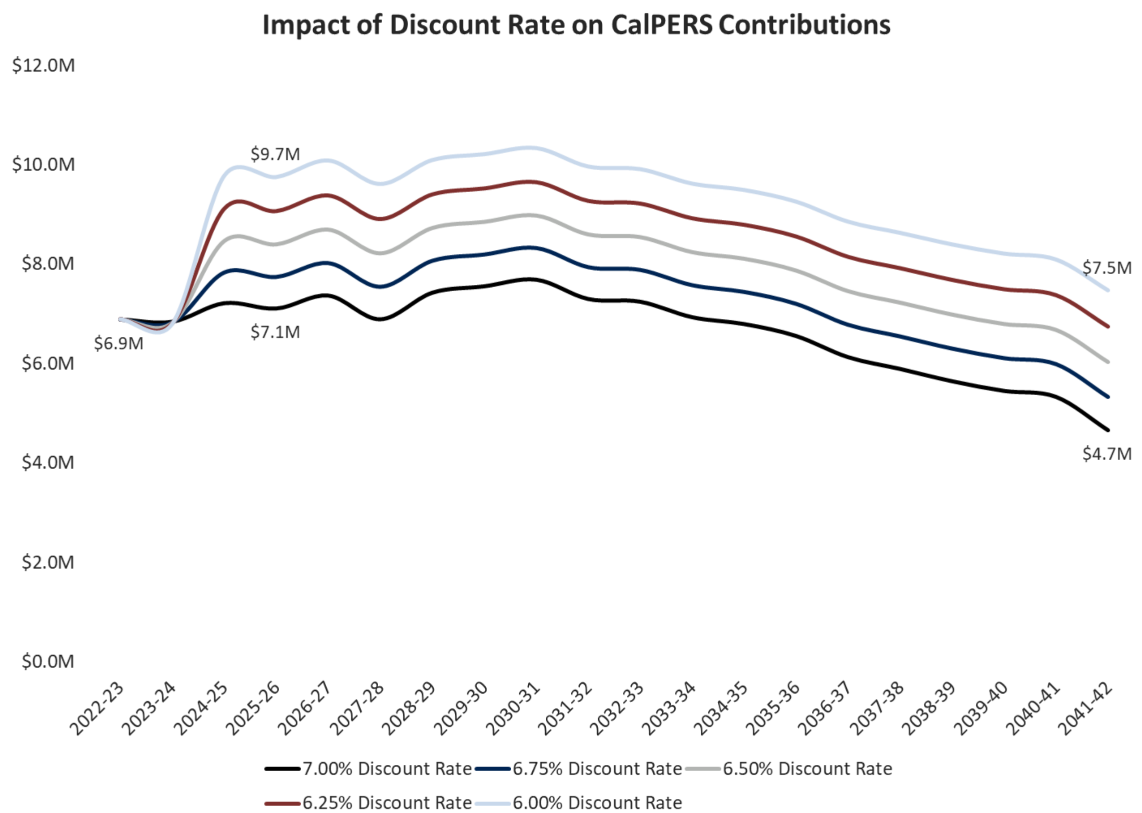


In FY 2028-29, when the FY 2021-22 investment loss is fully phased in, the City's annual costs are expected to be $2.0 million higher than previously projected. The $2.0 million increase in contributions due to the -6.1% investment loss in FY 2021-22 is partially offset by the $1.8 million decrease in contributions due to the 21.3% investment gain in FY 2020-21.

CalPERS Discount Rate Analysis
Due to lower-than-historical interest rates and economic growth, market experts project lower returns for the next several decades. The Pew Research Center forecasts a long-term investment return of 6.5% for typical pension fund portfolios.

The discount rate has a significant effect on the City's CalPERS contributions. If the discount rate is less than the discount rate assumption, the City's CalPERS contributions will increase. If CalPERS lowers the discount rate by one percentage point, the City's contributions will increase by up to $2.9 million annually.

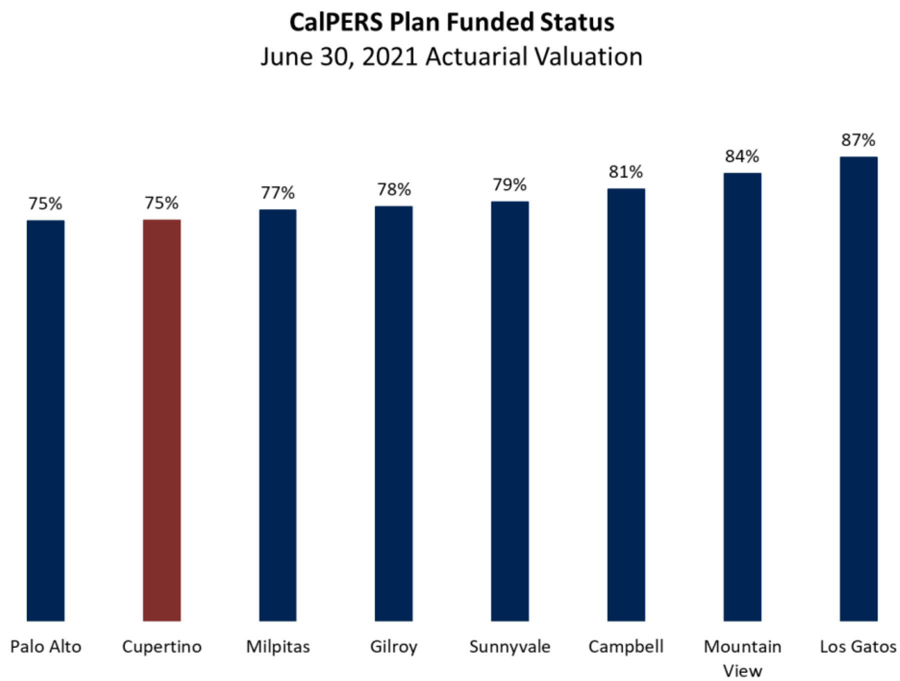
The chart below shows the impact on pension contributions if CalPERS were to lower the discount rate.



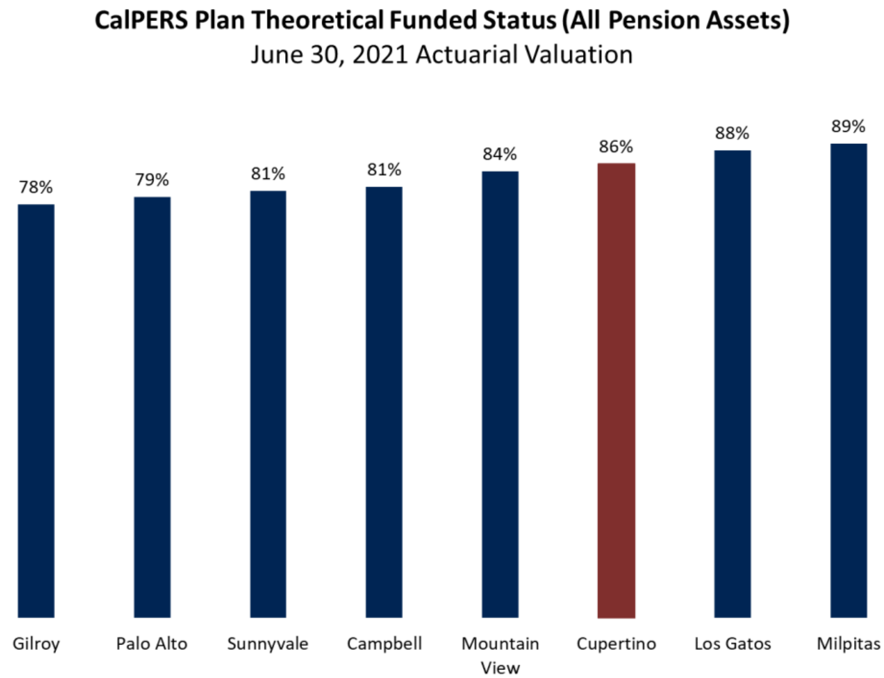
Note: Projections include FY 2021-22 investment loss of -6.1%.

Comparison of Pension Funding with Neighboring Cities
The following chart compares the funded status of the City's CalPERS plan with other cities in the County of Santa Clara. As of the June 30, 2021 actuarial valuation, Cupertino's funded status was 75.5%, lower than most cities in the County, because the City has not made additional contributions, also known as Additional Discretionary Payments (ADPs), to CalPERS beyond the required employer contributions. Instead, the City has placed funds in a Section 115 Trust, which allows for more diversification and local control.

The Pension Trust may be used to pay down liabilities through Additional Discretionary Payments to CalPERS. The City may elect to make additional contributions, above and beyond the required employer contributions, at any time and in any amount. However, payments made to CalPERS are permanent and cannot be returned.



The funded status reported by CalPERS only includes assets that cities have contributed to CalPERS. It does not include assets in a Section 115 Pension Trust or pension reserve. After factoring in Section 115 Pension Trusts and pension reserves, the theoretical funded status of the City's pension plan is 85.7%, slightly above the average of other cities in the County.



While the funded status of a pension plan is a helpful measure of fiscal sustainability, it does not provide a complete picture. First, the funded status is a snapshot in time. It doesn't consider future pension contributions. While Cupertino plans to contribute an additional $2.0 million in FY 2022-23, other cities have different funding strategies. Second, the funded status is sensitive to the discount rate. The funded status is based on CalPERS' current discount rate of 6.8%; however, if CalPERS lowers the discount rate, the funded status will be lower.

Sustainability Impact
There is no sustainability impact.

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

Prepared by: Thomas Leung, Budget Manager
Reviewed by: Kristina Alfaro, Director of Administrative Services
Approved for Submission by: Pamela Wu, City Manager
Attachments:
A – OPEB Trust Investment Policy
B – OPEB Trust Investment Policy Draft Resolution
C – Pension Trust Investment Policy
D – Pension Trust Investment Policy Draft Resolution