



ADMINISTRATIVE SERVICES DEPARTMENT

CITY HALL
10300 TORRE AVENUE • CUPERTINO, CA 95014-3255
TELEPHONE: (408) 777-3220 • FAX: (408) 777-3109
CUPERTINO.ORG

AUDIT COMMITTEE STAFF REPORT

Meeting: November 15, 2021

Subject

OPEB & Pension Trust Investment Policy Review

Recommended Action

Accept staff report and provide recommendations.

Discussion

Background

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). 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.

The Audit Committee is responsible for reviewing the investment policies for the Section 115 Trusts. On October 22, 2019, the Audit Committee reviewed the investment policies. It adopted an OPEB Trust Investment Policy with a target rate of return of 6.5% and a Pension Trust Investment Policy with a target rate of return of 6.25%. The Investment Manager, US Bank, manages security selection and asset allocation in accordance with the investment policy.

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 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; and
- reduce its net OPEB liability.

As of June 30, 2021, the City's OPEB Trust has a market value of \$38.0 million and has earned an annualized investment return of 8.16% gross of fees since inception.

OPEB Trust Investment Objective

The OPEB Trust has a 'Balanced' investment objective with a target rate of return of 6.5%. The investment objective is designed to provide a moderate amount of current income with moderate growth of capital. 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%

CalPERS Overview

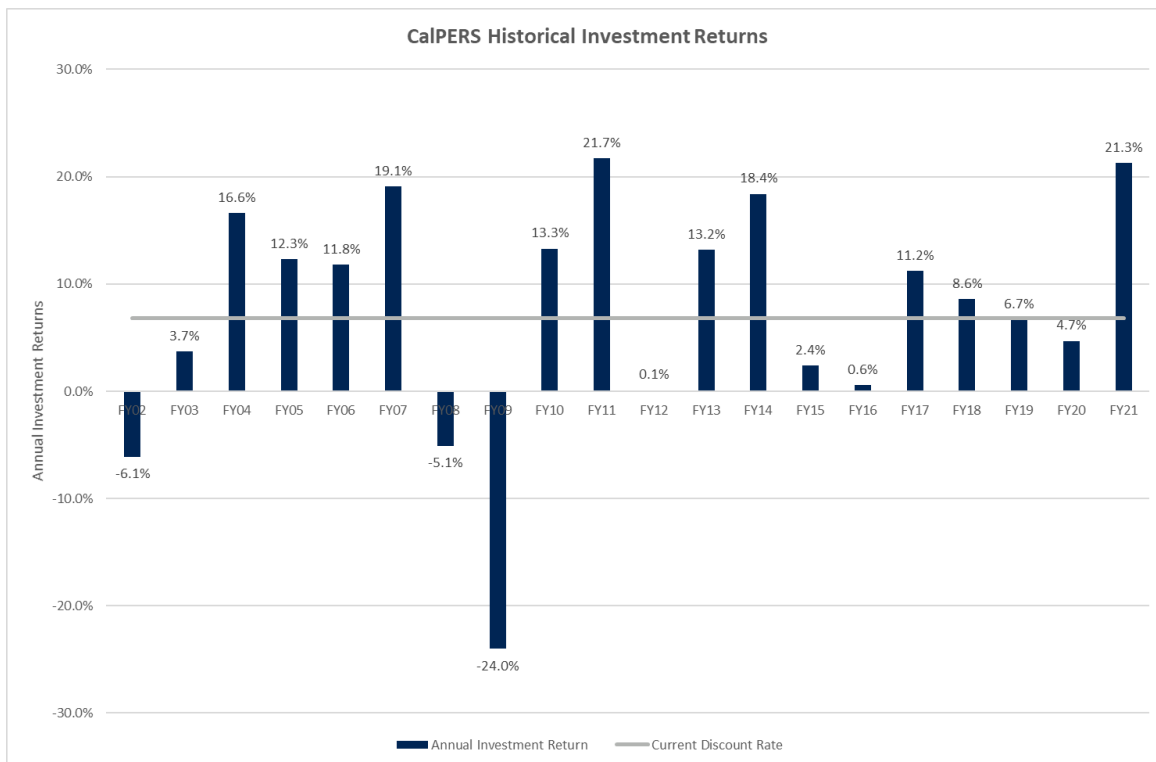
The City provides a defined benefit pension to its employees through the California Public Employees' Retirement System (CalPERS). Retiree pensions are calculated using a formula based on an employee's age, earnings, and years of service, and are funded by a combination of employer contributions, employee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

As of the June 30, 2019 actuarial valuation, the City's CalPERS plan has an actuarial liability of \$148.5 million, an unfunded liability of \$49.2 million, and a funded ratio of 66.9%. The unfunded liability is the difference between pension assets and liabilities while the funded ratio is the ratio of pension 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.



For FY 2020-21, CalPERS reported a preliminary investment return of 21.3%, bringing the average investment return to 10.3% for a 5-year period, 8.5% for a 10-year period, 6.9% for

a 20-year period, and 8.4% 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 Total Investment Return	
1 Year	21.3%
5 Year	10.3%
10 Year	8.5%
20 Year	6.9%
30 Year	8.4%

Under the "Funding Risk Mitigation Policy," approved by the CalPERS Board of Administration in 2015, the double-digit return in FY 2020-21 will trigger a reduction in the discount rate used to calculate employer and Public Employees' Pension Reform Act (PEPRA) member contributions. The discount rate, or assumed rate of return, will drop to 6.8% from its current level of 7%. The impact of the Risk Mitigation Policy will affect contributions starting in FY 2023-24.

Currently, CalPERS is conducting its Asset Liability Management (ALM) process. The ALM process, which runs on a four-year cycle, reviews the current investment strategies and actuarial assumptions. The ALM process can result in changes to the asset allocation of the investment portfolio, new actuarial assumptions, and changes to the discount rate. As a result, the CalPERS Board of Administration may elect to lower the discount rate even further. The positive returns experienced in FY 2020-21 would mitigate a potential lowering of the discount rate.

Pension Trust Overview

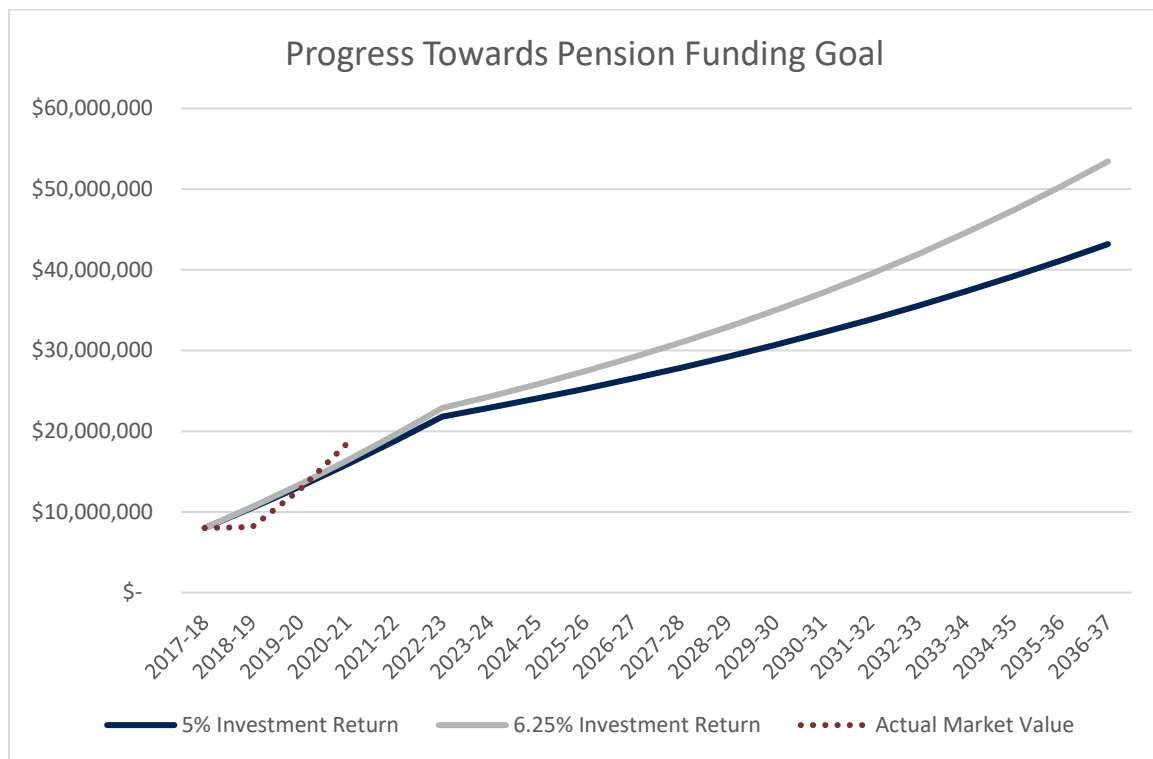
Given that pension obligations are one of the City's largest financial obligations, the City has taken proactive steps to reduce the impacts of pension cost volatility. In March 2018, the City provided options to Council on addressing rising pension costs. In April 2018, the City presented a long-term pension funding strategy to the Fiscal Strategic Plan Committee. In May 2018, the City implemented a Pension Rate Stabilization Program (PRSP), also known as a Section 115 Trust, to reduce pension rate volatility on the City's budget. The City contributed \$8.0 million in FY 2018-19 and \$4.0 million in FY 2019-20, bringing total contributions to \$12.0 million. 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; and
- 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 ratio of 80% over 20 years. The City's projections

indicated that the City would need to accumulate over \$42 million in the Pension Trust within 20 years to achieve its pension funding goal.

To achieve this goal, the funding strategy proposed \$8.0 million in initial funding, along with additional funding of \$10.0 million over the first five years. The following chart illustrates the City's progress towards 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. The Pension Trust was funded with an initial contribution of \$8.0 million and subsequent contributions of \$4.0 million in FY 2019-20 and \$2.0 million in FY 2020-21. As of June 30, 2021, the City's Pension Trust has a market value of \$18.5 million and has earned an annualized investment return of 15.44% gross of fees since inception. This chart illustrates that the City is on track towards its pension funding goal.



Note: The 5% Investment Return and 6.25% Investment Return projections are for illustrative purposes only. Actual returns will be different.

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 required by CalPERS. If CalPERS investment returns fall short of assumptions, the City will be better prepared for future pension cost increases. If the discount rate is lowered below the recent triggered reduction to 6.8%, which is a distinct possibility, the City will be better prepared to absorb these costs.

Pension Trust Investment Objective

The Pension Trust has a 'Balanced' investment objective with a target rate of return of 6.25%. This investment objective is designed to provide a moderate amount of current income with moderate growth of capital. 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%

Discount Rate

Defined benefit plans are highly sensitive to the discount rate assumption. The discount rate is the expected rate of return of 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. The duration of the defined benefit obligation for a retiree health plan is often longer than that for a pension plan. As a result, the choice of discount rate for OPEB plans can be higher than for pension plans.

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. The discount rate must be realistic to allow the City to foresee funding issues that may impact future operating budgets and future generations of retirees and plan members. 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.

OPEB Discount Rate Analysis

The discount rate of the OPEB Trust is currently 6.5%. Under GASB 75, if an OPEB plan holds investments in a trust specifically to pay for future benefit payments and those assets are projected to be sufficient to make the projected benefit payments, the discount rate is based on the long-term expected rate of return for those investments.

The City's OPEB contributions are primarily driven by investment returns and changes in medical costs. A 1 percentage point decrease in the discount rate is expected to increase OPEB contributions by up to \$565,000 per year.

CalPERS Discount Rate Analysis

While CalPERS currently uses a discount rate of 7% and although the rate was recently triggered to be reduced to 6.8%, market experts project lower returns for the next several decades due to lower-than-historical interest rates and economic growth. The Pew Research Center forecasts a long-term investment return of 6.4% while J.P. Morgan, and Wilshire Associates forecast 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 6.8% assumption, the City's CalPERS contributions will increase. If CalPERS lowers the discount rate by 1 percentage point, the City's contributions will increase by up to \$2.4 million per year.

This analysis shows the potential contribution impacts if CalPERS were to lower the discount rate based on lower expected investment returns.

Recommendation

The City recommends maintaining the discount rates of 6.50% for the OPEB Trust and 6.25% for the Pension Trust. The discount rates are based on the long-term expected rate of return for assets in the trusts and the City's time horizon for the investments.

US Bank, the Investment Manager, and PARS, the Trust Administrator, have estimated a long-term expected return of 6.56% based on the current asset allocation (60%-80% equities).

The City recommends a higher discount rate for the OPEB Trust 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. A lower discount rate can reduce investment return volatility and reduce the probability of losses to assets, allowing the City to preserve its capital better.

The Audit Committee has reviewed these policies at the September 27, 2021 and October 25, 2021 Audit Committee meetings and most recently, provided the following input and requests:

- volatility study
- cryptocurrencies to be a prohibited asset class and transaction
- leveraged assets to be a prohibited asset class and transaction

The City's investment trusts follow a "balanced" investment objective which is designed to provide moderate current income with moderate growth of capital. Investors should

have sufficient tolerance for price and return volatility and substantial period declines in investment value. This objective is recommended for investors with the long-term time horizon. Because future economic and market conditions are unknown, volatility studies are difficult to generate while providing accurate and meaningful information from which decisions may be based. Please refer to attachment "C" for a detailing of U.S. Bank's Research and Due Diligence Process.

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

In reviewing the city's investments reports, it's important for a governing body to maintain a wholistic approach as policy makers. Responding to performance or current market conditions and making regular changes to a policy or portfolio that has a long-term time horizon (20 years) may compromise the work that has been completed in past years and also hinder the portfolio's ability to respond to ever changing market conditions. Understanding the purpose and goals of the investment trusts is essential in analyzing investment performance and considering policy and/or portfolio changes.

Direct or indirect exposure to cryptocurrencies, despite its extreme unlikelihood of appearing in the portfolio, has been added as a prohibited asset class and transaction for both policies.

The Committee's request to include leveraged assets as a prohibited asset class and transaction was duly noted and staff worked with U.S. Bank on this request. Leverage is a tool to manage risk and return. The use of leverage allows an investor to meet their return target without decreasing the risk-reward ratio of their portfolio. That is, leverage leads to an increase in risk, but the increase in risk is actually lower compared to an attempt to meet the return target without the use of leverage.

Staff is recommending that unregistered Hedged Equity and Hedged Fixed Income positions be included as prohibited asset classes; however, it is also recommended to have registered Hedged Equity and Fixed Income positions remain as an allowable asset class. Additionally, staff recommends establishing bounds for use of leverage at no more than 10% of the total market value of the Portfolio at any given time.

Lastly, on page 4 of each policy, the term “physical” has been added when referring to prohibited commodities. This is for purposes of distinguishing between physical commodities, a prohibited asset class, and commodity mutual funds, an allowable asset class.

Sustainability Impact

There is no sustainability impact.

Fiscal Impact

There is no direct fiscal impact at this time. The discount rate assumptions will affect the City's contributions to the plan, the plan's assets, and the plan's liabilities.

Prepared by: Thomas Leung, Senior Management Analyst

Reviewed by: Zach Korach, Finance Manager

Approved for Submission by: Greg Larson, Interim City Manager

Attachments:

A – OPEB Trust Investment Policy

B – Pension Trust Investment Policy

C – U.S. Bank Research and Due Diligence Process