**TOWN OF LOS GATOS**

**FINANCE COMMITTEE REPORT**

MEETING DATE: 06/17/2019

ITEM NO: 3

DATE: JUNE 10, 2019

TO: COUNCIL FINANCE COMMITTEE

FROM: LAUREL PREVETTI, TOWN MANAGER

SUBJECT: REVIEW AND PROVIDE DIRECTION ON ADDITIONAL DISCRETIONARY PAYMENT STRATEGIES

RECOMMENDATION:

Review and provide direction on additional discretionary payment strategies.

BACKGROUND:

Based on direction from the Town Council and Town Pension and Other Post-Employment Benefits (OPEB) Trusts Oversight Committee (Pension/OPEB Committee), staff presented a report to the Town Pension and OPEB Trusts Oversight Committee on March 5, 2019 entitled "Review and Provide Direction on Additional Discretionary Payment (ADP) Strategies" (Attachment 1). The ADP strategies are intended to reduce unfunded Pension and OPEB obligations. The staff report provided high level informational material about the three primary types of ADP strategies available: (1) long-term capital accumulation and appreciation, (2) pension contribution management, and (3) direct payments to CalPERS. The report concluded that to date, the primary strategies utilized by the Town have been the prefunding of OPEB obligations and ADPs provided to PARS for long-term capital accumulation and appreciation of the Town's pension assets.

On June 4, 2019 the Town Council adopted the FY 2019/20 Operating Budget which among other items identified an additional $3.2 million allocation to reducing either outstanding OPEB or pension unfunded obligations. Also on June 4, 2019, the Town Pension and OPEB Trusts Oversight Committee held its quarterly meeting. As with past meetings, both bodies expressed

PREPARED BY: ARN ANDREWS
ASSISTANT TOWN MANAGER

Reviewed by: Town Manager, Finance Director, and Town Attorney



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BACKGROUND (Continued):

an interest in the Town Finance Committee reviewing previous guidance for the exclusive allocation of ADPs to the PARS 115 Pension Trust and analyzing alternative allocation approaches. In addition, there have been recent discussions regarding the appropriateness of the current asset allocations for both the OPEB and Pension Trusts. The Town Council and the Pension/OPEB Committee would also like the Finance Committee to review previous asset allocation decisions and report back to both bodies.

DISCUSSION:

The following report is intended to be informational and summarize previous data, analysis, and Committee decisions regarding the allocation of ADPs and pension/OPEB plan asset allocations. Based on the Finance Committee's deliberations, staff will return at the August Committee meeting with more detailed analysis based on the Committee's direction. If in August the Committee is ready to make a recommendation to the Town Council, the topic would be scheduled in coordination with the Mayor as is the Town's practice. Assuming a September Town Council discussion, this would align well with the anticipated availability of the actuarial valuations update and year end performance reports for both the pension and OPEB plans.

The Town has four primary vessels for receiving additional discretionary payments which include: Town OPEB 115 Trust, CalPERS Town Miscellaneous Plan and Safety Plan, and Town Pension 115 Trust. The following summaries will outline the advantages and disadvantages associated with each one of those vehicles.

**Town OPEB 115 Trust**

The Town's retiree healthcare plan is an Internal Revenue Code Section 115 Trust which is administered by the Town Pension and OPEB Trusts Oversight Committee. The Oversight Committee is responsible for the management and control of the healthcare assets. In 2009, the Town Council approved a Finance Department recommendation to initiate a ten-year phase in of pre-funding future OPEB obligations. Prior to 2009, the Town like most other cities, followed the generally accepted government accounting principle of paying OPEB benefits on a "pay as you go" basis. The Finance Department recommendation also included participating in the CalPERS managed California Employers' Retiree Benefit Trust (CERBT) Fund. As the table below illustrates, as of July 31, 2018 the Town pre-funded $12,360,000 since the Trust Fund was established. In addition, the Town's investment in CERBT Strategy 1 has earned approximately $4.2 million in investment earnings with an average annualized rate of return of 8.33%.

DISCUSSION (Continued):

| Account summary as of July 31, 2018 (Source: CalPERS Annual Review) | |
|---|---|
| Initial contribution (6/29/2009) | $400,000 |
| Additional contributions | $11,960,000 |
| Disbursements | ($0) |
| CERBT expenses | ($53,431) |
| Investment earnings | $4,212,256 |
| Total market value of assets | $16,518,825 |
| Average annualized internal rate of return (6/29/2009-7/31/2018) | 8.33% |

*CalPERS CERBT Asset Allocation Strategies*

The California Employers' Retiree Benefit Trust (CERBT) provides multiple options for investment of the Town's retiree healthcare assets. The CalPERS managed CERBT provides three distinct asset allocations. Each asset allocation has varying degrees of exposure to equity, fixed income, Treasury Inflation Protected Securities (TIPS), Real Estate Investment Trusts (REITs), and commodities. Following are the three asset allocations:

| 2018 Asset Allocation Targets | Strategy 1 | Strategy 2 | Strategy 3 |
|---|---|---|---|
| | 2018 | 2018 | 2018 |
| Global Equity | 59% | 40% | 22% |
| Fixed Income | 25% | 43% | 50% |
| Global Real Estate (REITs) | 8% | 8% | 8% |
| Treasury Inflation Protected Securities (TIPS) | 5% | 5% | 16% |
| Commodities | 3% | 4% | 5% |

DISCUSSION (Continued):

The three investment options represent varying degrees of investment risk/return profiles. As the table below illustrates, a reduction in equity exposure correlates to a reduction in long-term expected returns and a reduction in the variability of those returns as expressed by standard deviation.

| 2018 Asset Allocation Strategies | Strategy 1 | Strategy 2 | Strategy 3 |
|---|---|---|---|
| | 2018 | 2018 | 2018 |
| Expected Long Term Annualized Rate of Investment Return | 7.59% | 7.01% | 6.22% |
| Discount Rate | Determined by Actuary (Currently 6.75%) | Determined by Actuary (Currently 6.75%) | Determined by Actuary (Currently 6.75%) |
| Standard Deviation of Expected Investment Returns | 11.83% | 9.24% | 7.28% |

*OPEB Funding Status*

Since the initial $400,000 prefunding in 2009, the OPEB funded status has grown steadily due to the additional contributions and investment earnings. Based on the June 30, 2017 Retiree Healthcare Plan Actuarial Valuation performed by Bartel Associates, the funded status of the plan has grown to 55%.

| Valuation Date | Total OPEB Liability | Actuarial Value of Assets | Funded Status |
|---|---|---|---|
| 6/30/2013 | $19,211,000 | $4,866,000 | 25% |
| 6/30/2015 | $20,977,000 | $8,238,000 | 39% |
| 6/30/2017 | $24,773,000 | $13,605,000 | 55% |
| Projected 6/30/2018 | $26,390,000 | $16,148,000 | 61.2% |

Source: Bartel Associates Actuarial Valuations

DISCUSSION (Continued):

It is important to note that during the development of the 2017 actuarial valuation, the Oversight Committee elected to lower the discount rate from 7.25% to 6.75%. In addition, since the development of the 2017 actuarial valuation, the Town's bargaining groups and Management and Confidential employees agreed to eliminate the current retiree healthcare benefit prospectively for new employees. During labor negotiations, staff asked Bartel Associates to perform a preliminary review of what the implications may be for the funding status and potential funded status if ADPs were allocated to the OPEB plan. Provided below is a summary of the preliminary data:

| 2018 Asset Allocation Strategies & Discount Rates (Amounts in 000's) | CERBT Strategy1 | CERBT Strategy 2 | CERBT Strategy 3 |
|---|---|---|---|
| | 6.75% | 6.25% | 5.50% |
| Actuarial Accrued Liability (AAL) | $26,390 | $28,020 | $30,785 |
| Market Value of Assets (MVA) | 16,277 | 16,277 | 16,277 |
| Unfunded AAL (UAAL) | 10,113 | 11,743 | 14,508 |
| Funded Percentage | 61.7% | 58.1% | 52.9% |
| $ Amount Needed for 80% Funded % | $4,835 | $6,139 | $8,351 |

*OPEB Trust ADP Advantages*

- Multiple asset allocation options
- Control over asset allocation
- Control over discount rate/assumed rate of return
- Control over amortization period
- Immediate unfunded actuarial accrued liability (UAAL) and contribution impact
- Less UAAL interest cost
- Reduces accounting net pension liability

*OPEB Trust ADP Disadvantages*

- Market timing risk
- Assets restricted to OPEB benefits

DISCUSSION (Continued):

**CalPERS Town Miscellaneous and Safety Plans**

The Town's pension plans are administered by the Board of Administration of the California Public Employees' Retirement System (CalPERS). In addition, the Board has exclusive control of the administration and investment of funds. The Miscellaneous Plan is administered by CalPERS and invested in the Public Employees' Retirement Fund (PERF A). Sworn employees are covered under the Safety Plan which is a pooled cost-sharing plan and invested in PERF C. According to the 2017 Annual Valuations provided by CalPERS, the Miscellaneous Plan and Safety Plan had $69.5 million and $62.5 million calculated Market Value of Assets, respectively. According to CalPERS, 59 cents of every dollar paid out of the PERF fund has historically been from investment returns.

*CalPERS Public Employees Retirement Fund (PERF) Asset Allocation*

The PERF was established by statute in 1931 and provides retirement, death and disability benefits to members of its participating employers, which include the State of California, non-teaching, non-certified employees in schools, and various other public agencies. The benefits options for the public agencies are established by statute and voluntarily selected by contract with the system in accordance with the provisions of the Public Employees' Retirement Law.

In December 2017, the CalPERS Board voted on the asset allocation of the PERF's investment portfolio for the next four years. The Board examined four potential portfolios and their impact on the PERF. Each portfolio represented different distributions of assets based on varying rates of expected return and risk of volatility. The Board selected the portfolio with expected volatility of 11.4 percent and a return of 7.0 percent, which aligns with the December 2016 decision to lower the discount rate to 7.0 percent over three years. The following tables provide the PERF investment returns for the 12-month period that ended June 30, 2018, as well as five-year, ten-year, and twenty-year periods since inception.

| CalPERS Investment Return | 2018 | 5 Years | 10 Years | 20 Years | PERF Since Inception (1988) |
|---|---|---|---|---|---|
| | 8.6% | 8.1% | 5.6% | 6.1% | 8.4% |

The current asset allocation is provided in the next table.

DISCUSSION (Continued):

| 2018 PERF Asset Allocation Targets | PERF A | PERF C |
|---|---|---|
| | 2018 | 2018 |
| Global Equity | 49% | 49% |
| Private Equity | 8% | 8% |
| Global Debt Securities | 22% | 22% |
| Real Assets | 12% | 12% |
| Liquidity | 3% | 4% |
| Inflation | 6% | 6% |

*Miscellaneous and Safety Pension Plan Funding Status*

As of June 30, 2017, the funded status of the PERF was 70.1 percent. The funded status as of June 30, 2018, is estimated to be approximately 71.0 percent. PERF funded status values were calculated using a 7.00 percent discount rate. In December 2016, the CalPERS board voted to lower the discount rate from 7.5 percent to 7.0 percent. Also in February 2018, the CalPERS Board voted to shorten the period over which actuarial gains and losses are amortized from 30 to 20 years. The table below illustrates the funding history for both the Town's Miscellaneous and Safety Plans.

| Pension Plan | Valuation Date 6/30/11 | Valuation Date 6/3014 | Valuation Date 6/30/17 |
|---|---|---|---|
| Miscellaneous | 72.6% | 76.2% | 69.6% |
| Safety | 71.7% | 82.2% | 73.9% |

DISCUSSION (Continued):

Provided below is the schedule of amortization bases for the Miscellaneous Plan as of June 30, 2017. Similar to the early analysis performed on the OPEB Plan by Bartel Associates, if the Finance Committee were interested, staff could ask Bartel Associates to run scenarios which illustrate the effects on contribution rates and funding status for paying down/off varying amortization bases.

| Reason for Base | Date Established | Ramp Up/Down 2019-20 | Amorti-zation Period | Balance 6/30/17 | Expected Payment 2017-18 | Balance 6/30/18 | Expected Payment 2018-19 | Balance 6/30/19 | Scheduled Payment for 2019-20 |
|---|---|---|---|---|---|---|---|---|---|
| ASSUMPTION CHANGE | 06/30/03 | No Ramp | 6 | $1,780,035 | $266,995 | $1,632,584 | $273,196 | $1,468,020 | $280,479 |
| METHOD CHANGE | 06/30/04 | No Ramp | 7 | $(166,052) | $(22,588) | $(154,698) | $(23,102) | $(141,989) | $(23,720) |
| BENEFIT CHANGE | 06/30/07 | No Ramp | 9 | $1,646,511 | $190,679 | $1,568,412 | $194,828 | $1,480,355 | $200,062 |
| ASSUMPTION CHANGE | 06/30/09 | No Ramp | 12 | $2,566,712 | $247,607 | $2,496,373 | $252,637 | $2,415,725 | $259,458 |
| SPECIAL (GAIN)/LOSS | 06/30/09 | No Ramp | 22 | $2,100,631 | $142,257 | $2,105,604 | $144,524 | $2,108,588 | $148,467 |
| SPECIAL (GAIN)/LOSS | 06/30/10 | No Ramp | 23 | $1,755,770 | $116,186 | $1,762,739 | $117,992 | $1,768,343 | $121,214 |
| ASSUMPTION CHANGE | 06/30/11 | No Ramp | 14 | $1,710,594 | $150,016 | $1,679,253 | $152,924 | $1,642,629 | $157,063 |
| SPECIAL (GAIN)/LOSS | 06/30/11 | No Ramp | 24 | $809,430 | $52,416 | $813,831 | $53,210 | $817,729 | $54,664 |
| PAYMENT (GAIN)/LOSS | 06/30/12 | No Ramp | 25 | $199,878 | $12,683 | $201,234 | $12,870 | $202,495 | $13,222 |
| (GAIN)/LOSS | 06/30/12 | No Ramp | 25 | $1,791,787 | $113,697 | $1,803,946 | $115,376 | $1,815,246 | $118,531 |
| (GAIN)/LOSS | 06/30/13 | 100% → | 26 | $10,388,059 | $419,466 | $10,706,787 | $567,711 | $10,895,099 | $729,061 |
| ASSUMPTION CHANGE | 06/30/14 | 80% ↗ | 17 | $4,484,869 | $166,960 | $4,637,116 | $255,108 | $4,709,113 | $349,398 |
| (GAIN)/LOSS | 06/30/14 | 80% ↗ | 27 | $(7,403,556) | $(202,526) | $(7,730,575) | $(308,168) | $(7,971,898) | $(422,159) |
| (GAIN)/LOSS | 06/30/15 | 60% ↗ | 28 | $3,320,211 | $46,754 | $3,512,507 | $94,780 | $3,669,008 | $146,078 |
| ASSUMPTION CHANGE | 06/30/16 | 40% ↗ | 19 | $1,502,722 | $(42,200) | $1,655,372 | $31,238 | $1,743,036 | $64,186 |
| (GAIN)/LOSS | 06/30/16 | 40% ↗ | 29 | $4,225,172 | $0 | $4,531,497 | $62,882 | $4,794,909 | $129,230 |
| ASSUMPTION CHANGE | 06/30/17 | 20% ↗ | 20 | $1,176,961 | $(50,144) | $1,314,221 | $(51,586) | $1,462,925 | $27,570 |
| (GAIN)/LOSS | 06/30/17 | 20% ↗ | 30 | $(1,513,779) | $0 | $(1,623,528) | $0 | $(1,741,234) | $(24,135) |
| **TOTAL** | | | | **$30,375,955** | **$1,608,258** | **$30,912,675** | **$1,946,420** | **$31,138,099** | **$2,328,669** |

*Miscellaneous and Safety Pension Plan ADP Advantages*

- Immediate UAL and contribution impact
- Can elect shorter amortization (Fresh Start)
- Can elect to pay specific amortization bases
- Less UAL interest cost

*Miscellaneous and Safety Pension Plan ADP Disadvantages*

- Single asset allocation option
- No control over discount rate/assumed rate of return
- Market timing risk
- Assets restricted to pension benefits
- No current benefit to accounting net pension liability
- Pooled liability risk with Safety Plan

**Town Pension 115 Trust**

On August 15, 2017, Town Council approved Public Agency Retirement Services (PARS) as the administrator of the Town's Section 115 Pension Trust. The 115 Pension Trust acts as an additional investment vehicle for the overall funding of pension liabilities associated with the

DISCUSSION (Continued):

Town's Miscellaneous and Safety Pension Plans (the "Pension Plans"). The 115 Pension Trust provides the Town with flexibility in a variety of ways, including making lump sum payments directly to CalPERS and augmenting budget stability by using trust assets to defray pension costs in future years. In addition, the 115 Pension Trust can be utilized to either mimic or alter the risk/reward profile of assets currently invested with CalPERS.

On December 4, 2017, the Council Finance Committee recommended to invest in the PARS Capital Appreciation Index Plus. PARS utilizes the services of Highmark Capital for the management of the 115 assets. In addition, the Committee recommended that assets placed in the 115 Pension Trust be dollar cost averaged over the next year to mitigate risks associated with a single market entry point. On December 19, 2017, the Town Pension and OPEB Trusts Oversight Committee affirmed the Committee recommendations.

*Asset Allocation Strategies*

Highmark Capital Management currently provides the 115 Pension Trust with five different asset allocation options. Each asset allocation has varying degrees of exposure to equity, fixed income, and cash. The five asset allocations are intended to provide the Pension Plans with five distinct risk/reward profiles. The following are the equity exposures and investment objectives for the asset allocations provided by PARS:

| PARS Strategy | Investment Objective | Equity Allocation | Fixed Income | Cash |
|---|---|---|---|---|
| Capital Appreciation | Provide growth of principal and income | 65-85% | 10-30% | 0-20% |
| Balanced | Provide growth of principal and income | 50-70% | 30-50% | 0-20% |
| Moderate | Provide growth of principal and income | 40-60% | 40-60% | 0-20% |
| Moderately Conservative | Provide current income and moderate capital appreciation | 20-40% | 50-80% | 0-20% |
| Conservative | Provide a consistent level of inflation-protected income over the long-term | 5-20% | 60-95% | 0-20% |

DISCUSSION (Continued):

The asset allocation for the PARS Capital Appreciation Index Plus portfolio as of April 30, 2019 is provided below.

| PARS Strategy | Equity Allocation | Fixed Income | Cash |
|---|---|---|---|
| Capital Appreciation | 76% | 22% | 2% |

For the period ending April 30, 2019 the investment returns for the PARS Capital Appreciation Index Plus portfolio are provided below with an expected standard deviation of 11.85%.

| PARS Strategy | 1 Month | 3 Month | 1 Year* |
|---|---|---|---|
| Capital Appreciation | 2.37%% | 5.99% | 6.79% |

*Plans Inception Date 3/20/2018

*PARS Funding Status*

In March 2018 the initial $300,000 was deposited into the PARS account with additional $300,000 deposits programmed monthly for a current total of $4.4 million in assets as of April 30, 2019.

*PARS Pension Trust ADP Advantages*

- Actuarial equivalence with CalPERS for interest savings if assumed rate of return achieved
- Multiple asset allocation options
- Control over asset allocation
- Assets can be used to pay CalPERS directly or reimburse the Town for CalPERS contributions

*PARS Pension ADP Disadvantages*

- Market Timing Risk
- Assets Restricted to Pension Benefits
- No Current Benefit to Accounting Net Pension Liability

CONCLUSION:

Staff looks forward to the discussion with the Committee and its direction on next steps

ATTACHMENT:

1. Public Comment

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