MEETING DATE: 08/04/2020

ITEM NO: 4

ADDENDUM

TOWN OF LOS GATOS

TOWN PENSION AND OPEB TRUSTS OVERSIGHT COMMITTEE REPORT

DATE: August 3, 2020

TO: Town Pension and OPEB Trusts Oversight Committee

FROM: Laurel Prevetti, Town Manager

SUBJECT: Review and Approve the Town of Los Gatos Retiree Healthcare Plan June 30, 2019 Actuarial Valuation and its Assumptions as Prepared and Recommended by Bartel Associates, LLC.

REMARKS:

Attachment 2 contains public comment received since the issuance of the staff report on Thursday, July 30, 2020, and before 11:00 a.m. Monday, August 3, 2020.

Attachments previously received with the Staff Report:

1. June 30, 2019 OPEB Actuarial Valuation Final Results

Attachment distributed with this Addendum:

2. Public Comments received 11:01 a.m. Thursday, July 30, 2020 and 11:00 a.m. Monday, August 3, 2020.

PREPARED BY: Arn Andrews
Assistant Town Manager

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

From: Phil Koen
Sent: Monday, August 3, 2020 9:07 AM
To: Marcia Jensen <MJensen@losgatosca.gov>; Marico Sayoc <MSayoc@losgatosca.gov>; BSpector <BSpector@losgatosca.gov>; Rob Rennie <RRennie@losgatosca.gov>
Cc: Laurel Prevetti <LPrevetti@losgatosca.gov>; Arn Andrews <aandrews@losgatosca.gov>
Subject: Pension and OPEB Trust meeting - August 4, 2020

Agenda item #4

The Staff report states that the OPEB liabilities are currently 67.9% funded and that the unfunded actuarial accrued liability is $8.7m as of June 30, 2019 based on the actuarial valuation report prepared by Bartels. The report also points out that this is an increase in the funded status since the last valuation report as of June 30, 2017. **But is this really so?** The answer to that question is that it depends on the assumptions used in preparing the valuation report.

If you refer to Exhibit A, you will see under the Actual June 30, 2019 column the funded percentage of 67.9% and the 6.75% discount rate which was used in computing the valuation. The funded percentage is substantially determined by the discount rate. **The higher the discount rate, the higher the funded percentage. The lower the discount rate, the lower the funded percentage.**

If you look at Exhibit C, you will see that the discount rate represents the "expected long-term NET RATE OF RETURN on assets projected to be paid from the OPEB Trust". A question that this Oversight Committee should address is why you are comfortable with a 6.75% discount rate when the CERBT Strategy #1 performance from inception has only produced a 4.74% return? What objective evidence do you have that informs you that the discount rate of 6.75% is the appropriate "expected long-term net rate of return"? As Trustees, wouldn't it be more prudent to use a more conservative rate for purposes of the valuation analysis?

This is a very important question and is clearly highlighted in Exhibit B. Here Bartels is presenting **the ALTERNATIVE funding percentages** achieve if different discount rates are used in the valuation analysis. Specifically, if this Committee had selected more conservative net rate of returns of 6.25%and 5.5% (by selecting Strategy #2 or Strategy #3), the funding percentages would be 64% and 58.4% respectively. Please note that even these target rates are still materially greater than the actual returns achieved, which would strongly suggest the prudent approach is to use more conservative discount rates and investing strategies.

Here is the most troubling piece of all of this – namely by using the most aggressive and risky discount rate, the Town is able to show the **LOWEST** actuarially determined contribution which is the minimum amount required to be paid into the benefit plan. Again, referring to Exhibit B, under Strategy #1 the Town's ADC (actuarially determined contribution) is $1.9m for FY 21. If the Committee had selected Strategy #3 which is the most conservative and least risky investment strategy, the ADC would be $2.6m or 32% higher! Simply put, by selecting Strategy #1, the Town is able to contribute less money on an annual basis into the OPEB based on the "hope" that the investment returns will be substantially higher and therefore higher levels of contributions are not required. This is the bet the Committee is making if they accept this valuation report and continue with Strategy #1 .

This is hardly consistent with the message that has been put forth that the Town uses conservative budgeting practices. It is my recommendation that the Committee direct Staff to adopt more realistic net rate of return assumptions (i.e. 4.74%) to determine the required ADC. Why set the Town up “for failure” by adopting an unrealistic expected long-term net rate of return which is highly unlikely to be achieved which then results in the ADC being understated?

I would like to make one last point which hopefully convinces you of the risk in the current approach. Again, referring to Exhibit A, under the column Projected June 30, 2020 you can see that the valuation analysis projects that as of June 30, 2020 the value of the assets in the trust fund is $20.3m and a year later grows to $21.9m. This reflects the assumption that every year Strategy 1 will generate net returns of 6.75%. And it is because of that assumption, the valuation analysis shows the funded percentage every year improving. Ask yourself, is this a reasonable and prudent assumption given that the quarter ending March 30, 2020 generated a fiscal year to date decline of 9.3% and that inception to date the net return has been 4.74%?

Phil Koen

A

CERBT #1

Actuarial Obligations

4.74%

Actuarial Obligations (Amounts in 000's)	6/30/17 Valuation Actual 6/30/17	Projected 6/30/19	6/30/19 Valuation Actual 6/30/19	Projected 6/30/20	Projected 6/30/21
■ **Discount Rate**	6.75%	6.75%	6.75%	6.75%	6.75%
■ **Present Value of Benefits**					
• Actives	$19,569	n/a	$19,848	n/a	n/a
• Retirees	15,436	n/a	16,952	n/a	n/a
• Total	35,005	$37,106	36,800	$37,794	$38,814
■ **Actuarial Accrued Liability**					
• Actives	9,337	n/a	10,065	n/a	n/a
• Retirees	15,436	n/a	16,952	n/a	n/a
• Total	24,773	28,061	27,017	28,568	30,155
■ **Actuarial Value of Assets**	13,605	17,084	18,341	20,259	21,949 ?
■ **Unfunded AAL**	11,168	10,977	8,676	8,309	8,206
■ **Funded Percentage**	54.9%	60.9%	67.9%	70.9%	72.8%
■ **Annual Cost for Following Year**					
• Normal Cost	1,247	1,323	1,217	1,191	1,171
• PEMHCA Administrative Fees	4	4	2	2	2
• CERBT Administrative Expenses	8	10	9	10	11
• Annual Cost	1,259	1,337	1,228	1,203	1,184

Actuarial Obligations
June 30, 2019

Actuarial Obligations (Amounts in 000's)	Cash Subsidy	Implicit Subsidy	Total Subsidy
■ **Discount Rate**	6.75%	6.75%	6.75%
■ **Present Value of Benefits**			
• Actives	$16,486	$3,362	$19,848
• Retirees	15,694	1,258	16,952
• Total	32,180	4,620	36,800
■ **Actuarial Accrued Liability**			
• Actives	8,358	1,707	10,065
• Retirees	15,694	1,258	16,952
• Total	24,052	2,965	27,017
■ **Actuarial Value of Assets**[8]	16,328	2,013	18,341
■ **Unfunded AAL**	7,724	952	8,676
■ **Annual Cost 2020/21**			
• Normal Cost	993	197	1,191
• PEMHCA Administrative Fee	2	n/a	2
• CERBT Administrative Expenses	10	n/a	10
• Annual Cost	1,005	197	1,203

[8] Actuarial Value of Assets allocated to cash subsidy and implicit subsidy in proportion to Actuarial Accrued Liability.

CERBT Prefunding[19]

CERBT Target Investment Allocation

■ CERBT Investment Strategy	CERBT #1	CERBT #2	CERBT #3
■ Global Equity	59%	40%	22%
■ Fixed Income	25%	43%	49%
■ TIPS	5%	5%	16%
■ REITs	8%	8%	8%
■ Commodities	3%	4%	5%
■ Total	100%	100%	100%
■ Long-Term Expected Real Return[20]	4.14%	3.54%	2.83%
■ Long-Term Inflation Assumption	2.75%	2.75%	2.75%
■ Assumed Investment Expenses	(0.05%)	(0.05%)	(0.05%)
■ Long-Term Expected Net Nominal Return	6.84%	6.24%	5.53%
■ Recommended Discount Rate	6.75%	6.25%	5.50%

[19] Bartel Associates is not an investment advisor and cannot recommend specific OPEB trusts. CERBT funds are shown for illustrative purposes only. Other OPEB trust options are available.

[20] Using Bartel Associates' 2017 capital market assumptions which are based on a survey of various investment advisors' expected asset class returns.

B

CERBT Prefunding

(Amounts in 000's)

■ Investment Strategy ■ Discount Rate	CERBT #1 6.75%	CERBT #2 6.25%	CERBT #3 5.50%
■ **Present Value of Benefits**	$36,800	$39,792	$45,057
■ **Funded Status - 6/30/19**			
• Actuarial Accrued Liability	27,017	28,649	31,414
• Actuarial Value of Assets	18,341	18,341	18,341
• Unfunded AAL	8,676	10,308	13,073
• Funded Percentage	67.9%	64.0%	58.4%
■ **ADC 2020/21**			
• Annual Cost	1,203	1,322	1,528
• UAAL Amortization[21]	656	761	922
• Total ADC	1,859	2,082	2,451
■ **ADC% 2020/21**	11.0%	12.4%	14.5%

Δ 32%

[21] Amortized as a level percentage of payroll over a 18-year period.

Actuarial Methods

Method	June 30, 2017 Valuation	June 30, 2019 Valuation
■ Implicit Subsidy	• Implicit subsidy estimate included for non-Medicare eligible retirees	• Same
■ Projections	• Valuation Results - closed group, no new hires • Projections: ➢ Simplified open group projection ➢ Total active pay increased in accordance with aggregate payroll assumption ➢ Normal cost percentage of 8.7% for new hires ➢ No additional retirees from new hires over the 10-year projection period	• Valuation Results - closed group, no new hires • Projections: ➢ Simplified open group projection ➢ Total active pay increased in accordance with aggregate payroll assumption ➢ Normal cost percentage of 1.6% for new hires[25] ➢ No additional retirees from new hires over the 10-year projection period

[25] Normal cost percentage of pay if all actives hired in the past 3 years received Tier 2 benefit.

C

Definitions

6.75% vs 4.74%

■ Actuarial Obligations	• The Present Value of Benefits (PVB) is calculated as follows: ➢ Project future employer-provided retiree benefits for current retirees and current active employees (future retirees) ➢ Discount projected benefits to valuation date using the discount rate ➢ Discount rate is the expected long-term net rate of return on assets for benefits projected to be paid from the OPEB trust and the expected long-term net rate of return on Town investments for benefits projected to be paid from Town assets ➢ Allocate the PVB to past, current, and future working periods using the Entry Age Normal Cost Method • Normal Cost (NC) is portion of the PVB allocated to one fiscal year • Actuarial Accrued Liability (AAL) is the portion of the PVB allocated to prior Town service, that is, the accumulation of prior years' NCs • Unfunded AAL (UAAL) is AAL less the Actuarial Value of Assets • Actuarial Value of Assets (AVA) smooths market value of assets (MVA) volatility by spreading investment gains and losses over 5 years