Subject: Agenda Item #2 - Timing of an ADP

From: Phil Koen <pkoen@monteropartners.com>
Sent: Monday, June 8, 2020 10:13 AM
To: Rob Rennie; Marico Sayoc; Terry Duryea; Ron Dickel; Rick Tinsley
Cc: Laurel Prevetti; jak vannada; Lee Fagot
Subject: Agenda Item #2 - Timing of an ADP

Dear Finance Committee,

Staff has raised the question as to the "timing" of an ADP to minimize **downside risk** of incurring a loss base in the year the ADP is made. Staff hypothesizes that "the Town may wish to make an annual payment (I am assuming an ADP and not the annual minimum payment) at the beginning of each fiscal year to obtain the benefit of a full year of returns".

Staff is correct in their statement that CALPERS will attribute a "prorated proportional share" of whatever the investment return for that year to the ADP. The easiest way to think of this is that the ADP will earn the actual return for that investment year based on the "time weighted invested fund exposure" for the year. For instance, the $3.6m that was originally planned to be paid to CALPERS by May 1, would have a "time weighted invested fund exposure" of only 60 days. For CALPERS that means the $3.6m ADP would only have a $591,000 ($3.6m x (60/365)) exposure to the FY 20 actual returns. If we assumed that CALPERS has a 0% return for FY 20, the "base loss" for that year would be 7% (because 7% is the expected return for FY 20 but 0% was realized). Using a 7% "loss", the FY 20 loss base attributed to the $3.6m ADP would be $41,370 ($591,000 x 7%). That loss would be added to the schedule of prior year's gain/loss bases and amortized over a 20-year period. Based on the desire to avoid a "loss base" the Council decided to defer the $3.6m ADP payment until the start of the fiscal year 2021.

But was this really the right thing to do? I don't believe it was. When considering the timing of an ADP the only factor to consider is to insure the Town gets credit in the next fiscal year for extinguishing the target loss base prior to CALPERS cut-off date, which I believe is May 1. When making an ADP, debt is being paid down. The most important point is to remember that when a loss base is extinguished, the 7% interest charge associated with this loss base stops and the principal amount is removed from the calculation of next year's mandatory UAL payment. If ADP's are made prior to May 1, CALPERS will factor all payments into the next year's mandatory UAL.

Examining Council's decision to defer the $3.6m ADP until the next fiscal year, the Council failed to realize that by not making the payment by May 1, the Town would not capture the reduction in the next year's mandatory UAL payment. The trade off the Council made was in their desire to avoid an incremental $41,370 loss base associated with the $3.6m ADP, they gave up a $280,000 reduction in the FY 21 mandatory UAL payment, which was the amount of the benefit associated with paying off the targeted 2015 loss base. I believe it would have been better to realize a $280k reduction in the FY 21 UAL payment in exchange for incurring a $41k "base loss".

The point of revisiting the Council's decision is to reinforce that it is impossible to "time" the market and the Town should refrain from attempting to do so. It is best to simply make the ADP when the Town's cash flow can afford it, with an eye to making the payments prior to May 1. The Staff's recommendation of making ADP's at the beginning of the year does not provide any "protection" from the current year's investment return. What it does do is to maximize the "time weighted invested fund exposure".

This leads me to the notion of "unique market exposure". Since CALPERS invests in a diversified class of assets, the notion of a "market" exposure really doesn't exist. The return generated by CALPERS is the blended result of numerous

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investments across many different assets classes (publicly traded equites, debt, real estate, private equity, etc.), each having unique risk vs return profile and operating independently. It isn't apparent to me that the concept of a "unique market exposure" is really relevant when it comes to making an ADP which is really a "pay-off" of debt. The rule of thumb of paying off debt is, the sooner the better so you avoid the 7% compounding interest charge.

While admittedly it is a confusing concept, ADP's are addressing prior years losses that have occurred and are being charged interest. Once the loss base is extinguished, it is no longer an element of the UAL calculation and interest on that loss base stops. That is the "looking back" part of an ADP. As a result, the benefits of making an ADP are certain.

That doesn't mean that the ADP will be protected from future "losses". That is the "looking forward" part of the ADP. The entire concept of how pension liabilities are funded is based on the assumption that the assets managed by CALPERS will generate a 7% return over the long haul. The decision as to when to make an ADP should not be based on your guess as to the "look forward" performance in in any year. The CALPERS system is designed so that there will be fluctuations around the long-term investment return target of 7%. The years that experience a "loss" will be offset by the years that experience a "gain". The decision as to when to make an ADP should be based on the "looking back" benefit of making the payment to reduce the debt.

In closing, I do think that the Staff has made a good recommendation to use the CEPPT as a "holding tank" for future ADP's. The reason has nothing to do with the concept of "dollar cost averaging" which I do not believe is relevant when talking about funding a pension liability. Using the CEPPT will give the Town the flexibility to choose when to make ADP's while having funds invested in a trust which, while correlated to CALPERS investment returns, is still distinct.

At the end of the day, the Town still needs to make sizeable ADP's to pay down the unfunded pension liability as quickly as possible to minimize the 7% compounding interest charge.

Thank you.

Phil Koen