MEMORANDUM

CITY OF NOVI
cityofnovi.org

TO: VICTOR CARDENAS, INTERIM CITY MANAGER
FROM: CARL JOHNSON, FINANCE DIRECTOR
SUBJECT: RETIREE HEALTH CARE PLAN – INVESTMENT OVERVIEW
DATE: JANUARY 10, 2023

Mayor and Council -
A follow-up on the request by Council from the Audit presentation in December.
- Victor

The purpose of this memorandum is to provide an overview of the investment philosophy for the *City of Novi Retiree Health Care Plan.*

Overview

The City of Novi provides healthcare benefits to eligible full-time employees upon retirement. These healthcare benefits, which are referred to as *other post-employment benefits* (OPEB), are earned by employees during their working years but paid to (or used by) individuals after they retire. The decision to begin pre-funding OPEB began in the early 1990's when the City established the ***Retiree Health Care Benefits Fund.***

The OPEB liability, as determined by the actuary, is funded by contributions from the various funds of the city. Contributions by the city are required annually until the funding level is in the 130-140% funded range (not 100% due to the ever-changing assumptions of the actuaries). The contributions are invested similarly to pension funds on a long-term basis and are governed by a formal investment policy. The investment policy is updated periodically with the last amendments to it approved by City Council on December 9, 2019. The general investment strategy for long-term assets, like OPEB funds, is to aggressively invest them when the plan is in its infancy (70% equity/30% other) and more conservative as the liability gets closer to being fully funded, which is why the approved investment policy suggests ranges rather than absolute percentages. The $32.4 million of OPEB assets are allocated between three investment managers.

Funding Status and key Actuary Assumptions

The June 30, 2022, audit report shows the following:

Actuarial Accrued OPEB Liability	28,782,154
OPEB Plan Assets	32,361,913
Unfunded Actuarial Accrued Liability	(3,579,759)
Funded Ratio	112.4%

Historical Funded ratio:

- 2022 112.4%,
- 2021 131.9%,
- 2020 108.7%,
- 2019 104.4%,
- 2018 105.0%
- 2017 94.9%.

The two key assumptions in the annual reports include:

- A 7.0% annual investment rate for return.
- The health care cost trend (increases) range from 3.5% to 7.5%.

A decrease in the investment rate of return would increase the OPEB liability by approximately $3.840 million per 1% reduction.

Investment Strategy 2019-2022

During each of our quarterly meetings with the OPEB investment managers the city discussed the asset allocation percentages and the fact that the overall funding level was starting to exceed the 100% level. As noted in the attached email from UBS (one of the investment managers) the issue has been that if we were to immediately move a substantial amount of our investments from equities to fixed income or cash the interest rates have been at or near zero for the past 14 years and the result would have been little or no return. The overall direction was to continue to reduce the exposure in equities as the opportunities presented themselves with the goal of getting to the bottom of the existing investment policy which is 50% in equities. It is important to remember the actuary assumptions assume a 7% return annually, to the extent that is not reached, the funding level decreases. During this period the overall funding level began at 105% in 2019 and ended at 112.4% in 2022.

Investment Strategy 2023-2026

As noted in the attached email from UBS, the Fed has made aggressive interest rate hikes over the past nine months of over 4.25%, driving the yields up on fixed-income securities and cash from near zero to the 4-6% range. The investment managers agree now is the ideal time to begin a more significant shift from our current equity position into longer-term fixed-income securities. This shift is not something you do overnight as it should be timed with the maturity of investments and other factors but is moving forward currently. Two other items associated with this shift in investments include the amendment of the OPEB investment policy and change in actuarial assumptions. During the next few months, finance will be proposing an amendment to the OPEB investment policy which will update the new asset allocation targets (by 2026) of this mature plan of 30-50% equities and 50-70% fixed income. Coupled with the change in allocation will be the realization that the annual rate of return will fall to the 5-6% range and will need to be reflected in the actuarial assumptions. The actuarial change will be phased in over the next few years to try and ensure the city will continue no annual OPEB contributions. Furthermore, as part of the revised policy, staff will propose a game plan to reduce equity exposure as the OPEB fund sees a further increase to its funding level.

Summary

Overall, the investment plan for the OPEB assets has been very successful since my arrival at the city in 2014, increasing the OPEB funding level from 83% to its current level of 112.4%. The noted changes in investment allocations which began in 2019 and continue to date, should help reduce the volitivity of the assets and ensure overall excellent funding levels into the future.

Johnson, Carl

From: LaBruzzy, Jeffrey <jeffrey.labruzzy@ubs.com>
Sent: Tuesday, December 13, 2022 4:19 PM
To: Johnson, Carl; Glenn, Tina
Subject: Novi - Retiree Healthcare Fund
Attachments: Legal Disclaimer.txt

Carl and Tina,

Please review this summary of our discussions from our most recent quarterly review meeting on the allocation, risk and performance of the investments we manage on behalf of the Retiree Healthcare Fund. As you know we have comprehensive reviews on a quarterly basis which include a review of compliance with the IPS, current asset allocation, recent performance, long term performance and fund balance relative to overall anticipated liability. Additionally, we spend a significant amount of time on managing risk, incorporating economic outlooks, market valuations, interest rates and make allocation adjustments accordingly.

It can be easy to forget that the Fed was holding interest rates at almost 0% as recently as the Q1 2022. For the last 14 years the Fed has been holding interest rates at or near 0% for 11 of those 14 years. We experienced one period of rising interest rates from December of 2015 to December of 2018 during this 3 year tightening the Fed raised rates 25 basis points steadily 9 times for a totals increase of 2.25%. Ten months later from October 2019 to March of 2020 the Fed quickly cut rates 2.25% back to near 0%. This March almost exactly 2 years from the beginning of the last rate cuts the Fed began raising rates to combat inflation and cool the hot economy. The fed has aggressively raised rates 7 times this year from March 2022 through December 2022. The speed and rate of these recent increases is unprecedented, a 425 basis point increase in less than 9 months. These increases have resulted in significant negative returns in both bonds and equities.

We believe the recent rate increases have provided a potential opportunity to rebalance the portfolio. Our direction is to consider reducing equity exposure and increase fixed income exposure. Fixed income yields are now at a more attractive level. Yields have not been at current levels in the last 14 years. Equity valuations are more normalized and if earnings continue to meet expectation are fairly valued. We believe a fundamental shift will occur away from growth equities that have been using inexpensive debt to fund growth to equities with consistent earnings and cash flow.

As you may recall we have consciously reduced our equity exposure, we have liquidated equities to cover 100% of the requested distributions. The portfolio has weathered the "Great Recession" and "Covid 19" by maintaining a disciplined, unemotional investment approach guided by the IPS. Our allocation remains near the upper range of equity exposure. We anticipate the equity market will stabilize and recover as the significant rate increases are digested and inflation is corralled. .

Our long term performance has exceeded the Benchmark as defined by the IPS and the return used by the Actuary. Our goal is to continue this outperformance.

The portfolio only exists to cover future anticipated Retiree Healthcare expenses. Actuarial calculations are the tool we have to anticipate this future liability. These calculations assume a consistent rate of return. My understanding is the actuaries are using a return estimate of 7% and a 17 year time horizon to determine the level of funding necessary to meet the obligations of the Retiree Healthcare Fund. We are working with a finite pool of covered individuals; the actual expenses and timing remains uncertain. Current bond yields range from 4-6%, increasing our allocation to 100% bonds may result in a guaranteed shortfall of future liabilities. I suggest it would be helpful to request the actuary calculate funding levels based on 4, 5 and 6 percent returns. (I have done some Present Value and Future Value calculations and believe reducing the 7% return assumption/goal would result in an underfunded plan ranging from 61%-86% funded. I am unable to model any out flows for benefit payments which are important so you must rely on actuary calculations).

We discussed reviewing the IPS, and if it was appropriate, revisit overall investment guidelines. I believe the current document provides enough flexibility to accomplish the stated goals and modifications are not necessary.

We discussed the idea of systematically reducing equity exposure by dollar cost averaging and dollar into an increased bond exposure. No specifics were proposed but the logic of not timing the rebalancing all at one point and time was the emphasis.

I hope you find this useful. Let me know if you need any additional information or clarification.

Regards,

Jeffrey J. LaBruzzy
Senior Vice President
Wealth Management

UBS Financial Services, Inc.
2301 W. Big Beaver Rd., Suite #800
Troy, MI 48084

(248) 760-6182 *mobile*
(248) 649-7576 *Linda*
(855) 820-3981 *fax*
jeffrey.labruzzy@ubs.com

www.ubs.com/team/joneslabruzzygroup