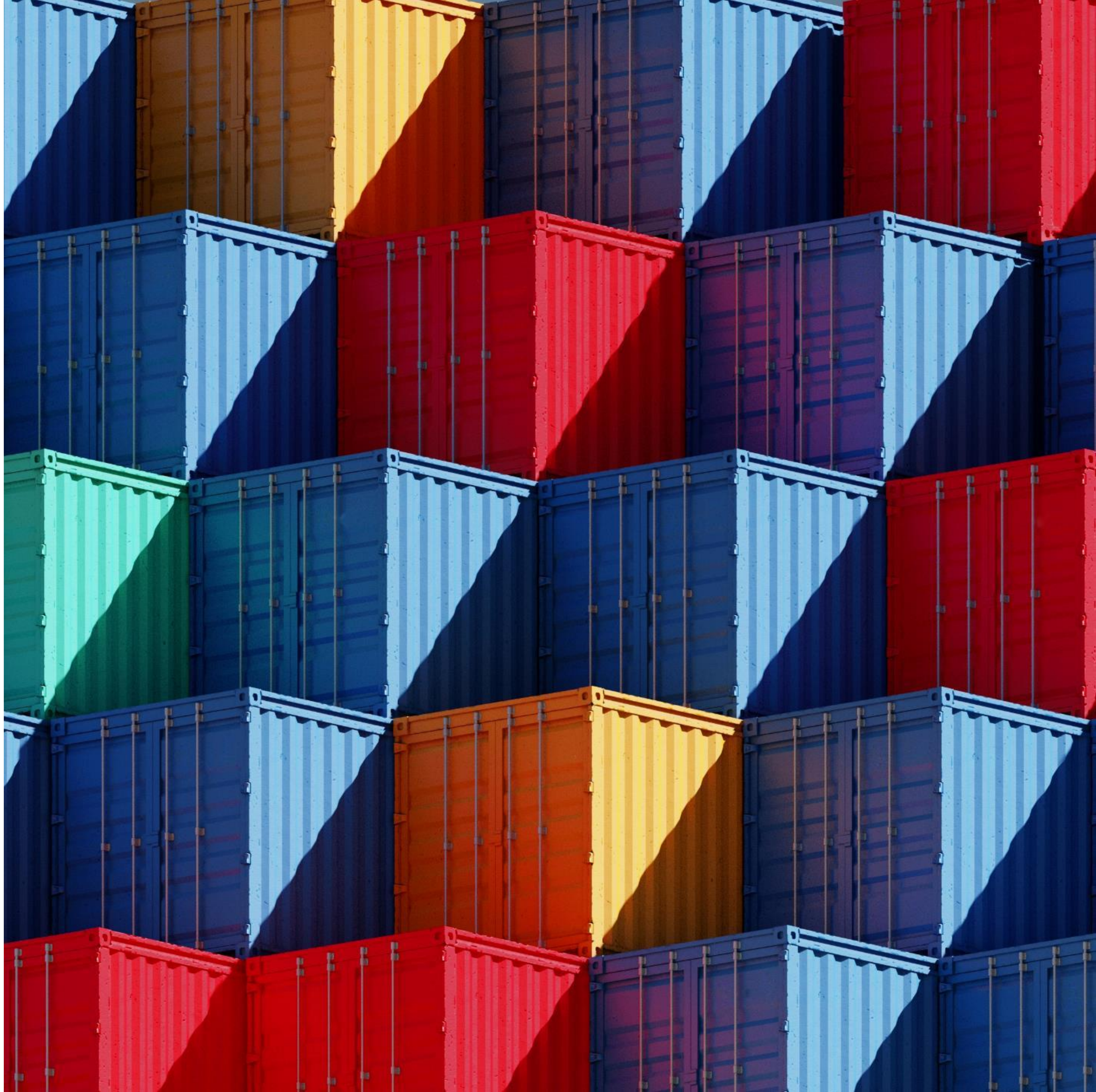
Key Recommendations from OPEB Asset-Liability Study (DRAFT)

City of Novi, Michigan Retiree Health Care Plan (Novi)

March 2025



Novi's Collective Goals/Objectives of the OPEB Asset-Liability Study

The consensus goals/objectives of the OPEB plan were described as follows:

- Remain overfunded
  - There is utility to the existing surplus and the goal is to preserve and maintain it

- Minimize contributions
  - Consider adjustments to the contribution policy to avoid tail-risk scenarios

- Reduce portfolio volatility
  - Either by reducing risk and/or added diversification

Key Findings from the OPEB Asset-Liability Study

Current State Overview

- The City of Novi's Retiree Health Care Plan is overfunded as of 9/30/2024
  - Estimated to 134.3% funded based on a market value of plan assets

- Due to the overfunding, no contributions are expected in the coming years
  - While contributions are zero today, there are elements of the funding policy that can cause risk in adverse economic scenarios

- The following recommendations from the asset-liability study are expected to strengthen Novi's current position

Recommendations

1. Risk Tolerance
   - Currently 58% return-seeking (R-S) assets
   - 20-40% R-S assets is the zone of solutions that is expected to keep the Plan overfunded while minimizing contributions
     - 40% R-S is selected from that range as a potential solution due to its alignment with the expected long-term actuarial assumed rate of return (6.00%)

2. Portfolio Diversification
   - Public equities make up the current R-S portfolio
   - Additional diversification – via return-seeking fixed income and open-end real assets – is expected to smooth the pattern of future returns and further reduce volatility

3. Contribution Policy
   - Current policy is to amortize (gains)/losses over a declining period, eventually reaching immediate recognition
   - Recommendation is to decrease the period down to 5 years and then create laddered amortization bases to reduce contribution volatility

Risk Tolerance

Novi's allocation as of 9/30/2024 is expected to result in an ever-increasing funded ratio

- Taking some risk off the table is expected to increase the likelihood of remaining overfunded, reduce the portfolio's volatility, and reduce the probability of any future contributions

A 40% return-seeking portfolio aligns with the expected long-term actuarial rate of return (6.00%)

- The current expected return is 7.00% but feedback from Novi is that it will be decreasing to 6.00%
- Portfolios below 40% return-seeking assets can provide narrower ranges of outcomes, but will start to erode the funded status

	9/30/2024 Allocation	40% Return-Seeking Assets
Return-Seeking (R-S) %	58%	40%
New Asset Classes	N/A	No
Expected Return[1]	6.45%	5.96%
Portfolio Volatility	11.26%	8.25%
Probability of 100% Funded after 15 Years	80.7%	81.1%
Probability of Contributions During 15 Years	38.0%	34.3%

[1] Expected returns are using Aon's 30-Year Capital Market Assumptions as of 9/30/2024. CMAs contain projections about future returns on asset classes. Our CMA projections are designed to reflect the typical cost of implementing an investment program. Expected returns are calculated using weighted allocations of the underlying CMAs. Expected Returns are geometric (long-term compounded; rounded to the nearest decimal) assuming portfolio weights are rebalanced annually. Expected returns presented are models and do not represent the returns of an actual client account. Your actual returns will be reduced by your advisory fees and other expenses you may incur as a client. Aon's advisory fees are described in Part 2A of Aon's Form ADV. Not a guarantee of future results.
Totals may not sum to 100% due to rounding.

Portfolio Diversification

Novi's return-seeking allocation as of 9/30/2024 is primarily public equity

- Diversifying into additional asset classes is expected to further reduce the portfolio's volatility, increase the probability of staying overfunded, and decrease the probability of any future contributions

Additional diversification is recommended in the following asset classes:

- **Return-Seeking Fixed Income**
  - Diversifies public equities and core fixed income
  - Rotates among credit sub-strategies including, but not limited to: high yield, emerging markets debt, bank loans, and securitized
- **Open-Ended Real Assets**
  - Diversifies public equities
  - Income and inflation protection
  - Modeled as 50% core real estate / 50% core infrastructure

	9/30/2024 Allocation	40% Return-Seeking Assets	40% Return-Seeking Assets with Diversification
Return-Seeking %	58%	40%	40%
New Asset Classes	N/A	No	Yes
Expected Return[1]	6.45%	5.96%	5.91%
Portfolio Volatility	11.26%	8.25%	7.03%
Probability of 100% Funded after 15 Years	80.7%	81.1%	82.2%
Probability of Contributions During 15 Years	38.0%	34.3%	30.1%

[1] Expected returns are using Aon's 30-Year Capital Market Assumptions as of 9/30/2024. CMAs contain projections about future returns on asset classes. Our CMA projections are designed to reflect the typical cost of implementing an investment program. Expected returns are calculated using weighted allocations of the underlying CMAs. Expected Returns are geometric (long-term compounded; rounded to the nearest decimal) assuming portfolio weights are rebalanced annually. Expected returns presented are models and do not represent the returns of an actual client account. Your actual returns will be reduced by your advisory fees and other expenses you may incur as a client. Aon's advisory fees are described in Part 2A of Aon's Form ADV. Not a guarantee of future results.

Totals may not sum to 100% due to rounding.

Contribution Policy

Novi's current contribution policy amortizes gains/loses over a declining period

- This period will decrease until it reaches one year, or immediate recognition
- Contributions could be volatile under immediate recognition, especially in pessimistic outcomes

Recommend continue decreasing the period down to 5 years, then create a laddered amortization

- This will smooth contributions in volatile scenarios compared to the current funding policy

	Current Funding Policy	Recommended Funding Policy
Policy	Amortize (gains)/losses over period declining from 14 years to 1 year	Continue declining period until 5 years, then laddered 5-year amortization bases
Pessimistic Outcome Annual Contribution in 2037[1] (1-in-20 likelihood downside event)	$4.3 million	$1.7 million
Pessimistic Outcome – Present Value of Total Contributions over next 15 Years[1,2] (1-in-20 likelihood downside event)	$4.6 million	$3.7 million
Expected Contributions Over Next 15 Years[1]	$0	$0

[1] Projections assumes Projections assume a discount rate of 7.00% for FYE 2023-24 and 6.00% for FYE 2025+ for OPEB liabilities for all investment policies studied. Projections include estimated expenses paid from plan assets, assumed to start at $14,000 annually increased with inflation, which is assumed to be inclusive of investment management fees. Actual fees and expenses may differ from those presented. See Asset-Liability Study: Results presentation for more information.
[2] Present value measured at 7.00%
Figures shown are based on the 40% Return-Seeking Assets with Diversification portfolio

Summary of Results

Given Novi's strong funding position, there can be a range of appropriate solutions that balances Novi's desire to (1) remain fully funded, (2) minimize contributions, and (3) minimize portfolio

Our analysis highlights that a range from 20% to 40% return-seeking assets balances these objectives

The 40% return-seeking portfolio (shown to the right) was selected from that range due to its alignment with the projected long-term actuarial rate of return (6.00%), which is expected to keep the funded ratio steady over time

Aon recommends revisiting the asset allocation with another asset-liability in 3-5 years, or sooner if circumstances warrant

Asset Class	Target Allocation
Return-Seeking Assets	
- Public Equity	30%
- Liquid Return-Seeking Fixed Income	4%
- Open-End Real Assets	6%
Risk-Reducing Assets	
- Risk-Reducing Fixed Income	60%
Total	100%

Next Steps

Following the decision on the target asset allocation, the next steps would be as follows:

1. Document in Investment Policy Statement (IPS)
2. Update rebalancing policy
3. Define benchmarks
4. Other – including manager selection and transition plan

An example for inclusion in the IPS could be the following:

Asset Class	Minimum[1]	Target Allocation	Maximum[1]	Recommended Benchmark
Return-Seeking Assets				
- Public Equity	27%	30%	33%	Public Equity Benchmark[2]
- Liquid Return-Seeking Fixed Income	1%	4%	7%	Return-Seeking Fixed Income Benchmark[3]
- Open-End Real Assets	1%	6%	11%	NCREIF ODCE Index
Risk-Reducing Assets				
- Risk-Reducing Fixed Income	57%	60%	63%	Bloomberg Barclays Aggregate Bond Index
Total		100%		Weighted average of asset class benchmarks[4]

[1] The portfolio may be outside of allowable ranges during the transition to the new target allocation
[2] Benchmarked as 85% ACWI / 15% Russell 3000
[3] Benchmarked as 1/3 High Yield Bonds, 1/3 Bank Loans, 1/3 Emerging Market Debt
[4] During transition period, the Total Fund benchmark would be weighted at actual portfolio weights until long term targets are reached

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