FINANCE COMMITTEE SUMMARY MINUTES

Special Meeting
October 18, 2022

The Finance Committee of the City of Palo Alto met on this date in the Community Meeting Room and by virtual teleconference at 5:33 P.M.

Present In-Person: Filseth, Kou

Present Virtually: DuBois (Chair)

Absent:

Oral Communications

Agenda Items

1. Review Pension and Other Post-Employment Benefits (OPEB)/Retiree Healthcare Trust Funds

MOTION: Council Member Filseth moved, seconded by Council Member DuBois to accept the Pension and Other Post-Employment Benefits/Retiree Healthcare Trust Funds report.

MOTION PASSED: 3-0

Assistant City Manager Kiely Nose explained that this is the second step of a multistep process looking at long-term liabilities and strategies to address those.

Budget Manager Jessie Deschamps discussed the City Council-adopted pension policy with a goal to reach 90% funded status by fiscal year 2036 and discussed funding components and reporting requirements. There will be an upcoming review of comprehensive actuarial analysis, tentatively scheduled for November 29, 2022. Areas for Finance Committee feedback included items on investment diversification, rate stabilization, and liability payments. The action was to review and accept a status update of the City's pension and CERBT funds, discuss variables governing these plans, and provide feedback and potential policy changes moving forward.

CalPERS Manager Matt Goss discussed OPEB liability mitigation strategies. He reviewed the OPEB plan's short-term future for the next 1 to 5 years and the 2 most recent OPEB actuarial evaluation reports. The liability goes up from one report to the next currently and the contributions recommended by the actuary are going down because of paying the debt down quickly.

Council Member Eric Filseth questioned what discount rate was used to calculate the normal cost of 7.099 million.

Manager Goss stated that the actuaries who did the work, Bartel Associates, used a 6.75% discount rate for that in 2019, which was reduced to 6.25% in the 2021 report. The normal cost still went down, which could be because of the age of the active employee population.

Assistant City Manager Nose stated that the cost of healthcare impacted normal cost. The actuaries had said in the last OPEB report that the lower assumption for the cost of healthcare was equally if not more important than the additional earnings in the portfolio from an asset perspective. The City pays the actuarial-determined contribution at a more conservative discount and contributes both in OPEB and pension additional costs to account for the margin for adverse deviation. There was further discussion about this. The risk-mitigating strategies have kept the payment flat. There was additional funding because of the added head count, which will not be realized from 2 to 4 years from a reporting standpoint.

Manager Goss reviewed the CERBT account summary, including contributions and disbursements. The main goal was to improve funded status and start to subsidize the costs each year by reimbursing additional assets from the trust. He discussed the CERBT projected returns over various time periods for different investment strategies, including time-weighted returns. The costs of the program are charged through an all-inclusive fee rate, and the participating employers pay the costs. The fee rate is very consistent from one year to the next. CERBT was honored to be able to serve the City of Palo Alto.

Council Member Tom DuBois questioned why there was $1 into OPEB one year.

Assistant City Manager Nose clarified that it was an administrative error and the next year the amount was double what it was annually.

Council Member DuBois questioned where the City's OPEB contribution comes from.

Manager Goss stated in OPEB, it is the City who makes the contributions to the trust to prefund the portion of the benefit they choose to subsidize. It was Manager Goss's understanding that it was currently funded entirely by the City.

Assistant City Manager Nose stated there are also multiple retiree health benefit levels. The City has amended he retiree medical program a few times, so each program is a little bit different. The City is funding the City-side of the contributions of those programs and if there is an employee side, the retiree would contribute the remainder. It depends on the plan.

Council Member DuBois asked if Strategy 1 is the most aggressive strategy.

Manager Goss agreed that Strategy 1 is the most aggressive strategy and Strategies 2 and 3 are more conservative. That is manifested through differing levels of exposure o the same asset classes. It is possible to utilize more than one strategy simultaneously or move to a new strategy at any time with no additional fees.

Assistant City Manager Nose stated this was included in the staff report on packet pages 9 and 10. The OPEB and pension trusts were started with small amounts of funding with the goal to accumulate and grow assets to offset liabilities. There is a marked change in the position today compared to when they were established. Once a certain level is reached, the position may change from wanting to aggressively grow assets to preserving assets and using some of them to pay costs, which will require a change in investment strategies. The experts were present to discuss some of these things, like why or when to invest in different strategies.

Council Member Filseth questioned the statement that the City Strategy 1 fund has experienced a cumulative net gain of 5.7% since its inception in 2007 and whether the normal costs should be calculated at that 5.7% as opposed to 6.75% or 6.25%.

Manager Goss felt that would be more accurate for a 10-year time horizon compared to 30 years. OPEB is a long-term benefit, for which it is more applicable to use long-term expected rates of return.

Assistant City Manager Nose stated the organization has chosen with the Council's leadership not to assume those higher rates. On the OPEB side, they have chosen the lower rate and a shorter amortization period.

Council Member Filseth felt it would be helpful for laymen on the City Council to track the actuarially determined normal cost plus the MAD and what percent expected asset return rate that represented. He felt it was helpful to think of this as two buckets, existing liabilities in which the assets and liabilities do not match and liabilities put on right now. Keeping those separate would make it simpler in terms of what kind of investments to make.

Council Member DuBois wanted to clarify if a blended strategy was to have a mix of aggressive investment and a shift to preservation in order to preserve being funded at the 80% level.

Manager Goss stated that for reimbursing from the trust at a time like now, it would be better to pull the assets from Strategy 3 where their projected volatility is 8.4 and the probable real volatility is less. Moving 5 years down the road, it might be better to reimburse that money from Strategy 3 as opposed to cementing unrealized losses out of Strategy 1. By placing a year or two of reimbursable assets into Strategy 3, there would not be a lot of drag on total performance but there would be much more functional liquidity.

Council Member DuBois stated the money in the 115 for pension is normal cost money and is committed to paying the normal the future pensions of the people whose normal cost contribution it went toward. He questioned why money would be pulled out of the 115 to pay down the UAL and believed they should be treated separately. The inviolable law is not to dig the hole any deeper than it already is.

Executive Vice President of PARS Mitch Baker described the 3 companies working together on this program: PARS is the trust administrators, US Bank is the trustee and holds the assets, and High Mark Capital is the investment management partner. PARS is an IRS-approved trust with $39.3 million in assets to date. Money can only be used for pension-related expenses, either to reimburse the agency for pension costs or to pay CalPERS when deemed appropriate. He reviewed a historical summary of the agency's pension plan and the current pension status.

Director of High Mark Capital Management Andrew Brown discussed the economic forecast with the assumptions for 2022 and 2023, the performance in the past 12 months with net around -14% rate of return, and the positioning for the pension plan as of the most recent quarter end. He discussed the potential for changing the investment objective in the next 1 to 5 years and explained the 5 strategies offered, from more conservative to more aggressive.

Council Member Filseth stated that Section 115 is $40 million right now, a small fraction of net pension assets, most of which are not invested as conservatively. He questioned the expected return of the moderately conservative strategy and wanted to ensure it matched the asset return rate calculated for normal costs.

Director Brown stated time horizon is important. The two reasons cities use the 115 are pension rate stabilization or a pool of funds that augments the effort to get to 90% while giving budget flexibility. There was discussion about the percentage rates of various strategies.

Council Member DuBois felt a more aggressive investment strategy might be considered because the pension fund is less funded. The Section 115 is a pretty small portion of the assets.

Director Brown agreed with Manager Goss that considering volatility is important. His recommendation would be staying the course with a moderately conservative strategy.

Council Member DuBois questioned comparing this to CalPERS' performance.

Director Brown stated it is difficult to do an apples-to-apples comparison. There was further discussion about this, with Manager Goss stating he did not believe an accurate comparison was possible.

Council Member Filseth stated there are all kinds of assets and money as a municipality, some which need to be more conservative because they may be needed short term. The question is where the right place is for the 115 and for the majority.

Assistant City Manager Nose restated the 2 primary functions cities use their 115 for, as a rate stabilization fund and working to build the asset pool to meet funded status. Each argues for a different investment strategy. The policy question is honing in on the intended use of these trusts, and now is the point to start thinking about being more intentional to use them as effectively as possible.

Council Member Filseth believed that the top priority is building the asset as opposed to rate stabilization. Saving more than the actuarially determined payment every year also gives some cushion for rate stabilization issues. There was further discussion about this. This decision does not need to be made this week or even this year.

Director Brown questioned the probability that these funds will be needed in 5 or 7 years.

Assistant City Manager Nose stated the Council has a history of strong fiduciary discipline. Part of the reason for the policy is to guide the Council and staff in the work and investments on this.

Vice Mayor Lydia Kou asked if one strategy is used for different assets, like equity, fixed income, and cash, or if it could be different.

Director Brown stated there is flexibility to combine different strategies or to do an individual fixed income portfolio. There was further discussion on ways to do this, when it would be appropriate, and what other cities are doing. The main determining factor on the risk tolerance level choice is when the money is needed.

Vice Mayor Kou asked when the money is needed.

Assistant City Manager Nose stated any uses of these funds would be identified as part of the annual budget process. It is a policy question for the Council on how to use the trust fund. There was more discussion.

Council Member Filseth stated that in theory it does not matter how much money is with each fund. If there was a bill from CalPERS that was for more than was in the fund, the money would come from the High Mark Capital fund. The money is still being saved. The present value of the debt does not matter; it is the future value that is important.

Council Member DuBois questioned if staff needed to investigate the likelihood of needing the money within 10 years, to factor into the decision.

Assistant City Manager Nose stated that tonight's agenda was to get the Committee thinking about the uses of these tools. The policy work is important to continue to ensure the right trajectory, but it will not be 10 years before revisiting this. She felt 10 years was a long period of time that does not include the factors that would trigger a need to use these trust funds, unforeseen scenarios such as a fire, earthquake, change in staffing levels. Those things could not be modeled.

Council Member DuBois was interested in bringing a policy to Council in which the 115 trust is for asset growth with a more aggressive investment strategy, with other reserves and emergency funds available.

Council Member Filseth agreed and wanted to make sure that assumptions for expected asset return rate match the expected return for where the pension asset investment is on the curve. He would like to see an update on the trajectory of the UAL. There was discussion on what decisions needed to be made and when this would to the committee. Council Member Filseth questioned how the assets are invested currently, equities versus fixed income, etc.

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Manager Goss stated there is a vast array because of the additional utilization of asset classes, like private equity or real assets. There was more discussion about this.

Council Member Filseth felt it was important to look at the whole portfolio.

Future Meetings and Agendas

Assistant City Manager Kiely Nose discussed that this would be brought back to the committee before the end of the year.

Adjournment: The meeting was adjourned at 7:35 P.M.