CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO:	Boards of Administration for the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan	FROM:	Daryn Miller
SUBJECT:	Staff perspective on the Stanford Institute for Economic Policy Research (SIEPR) Analysis of City of San Jose Retirement Plans Investment Portfolios	DATE:	December 21, 2017

Approved /Roberto Peña/ Date 12/18/17

The following memo was presented to the Investment Committee on 12/18/2017. The Investment Committee suggested a few modest changes, which have been reflected in the following.

Memorandum

TO:	Police and Fire Department Retirement Plan and Federated City Employees' Retirement System Investment Committees	**FROM:**	Daryn Miller, CFA
SUBJECT:	Staff perspective on the Stanford Institute for Economic Policy Research (SIEPR) Analysis of City of San Jose Retirement Plans Investment Portfolios	**DATE:**	December 18, 2017

Approved	/Roberto Peña/	**Date**	12/15/17

On November 20, 2017, the Stanford Institute for Economic Policy Research (SIEPR) published an analysis of the retirement plans' investment portfolios. This memo conveys ORS investment Staff perspective on the SIEPR analysis.

Summary

Staff appreciates the challenge in evaluating public pensions. The combination of cash flow, actuarial, and accounting concepts with large and complex investment portfolios creates a perplexing system for those not immersed in the theory and practice on a day-to-day basis. The SIEPR report calls attention to issues facing the San Jose plans, although a comprehensive picture remains elusive.

The San Jose pension plans have deliberately pursued an investment strategy of reducing portfolio risk through increased diversification, while also ensuring that actuarial assumptions are reasonable. An emphasis of the strategy is the mitigation of contribution volatility, and the execution of the strategy has required an increase in the scale and acumen of human capital at the Board, Staff, and advisor levels.

Background

On February 14, 2017, Mayor San Liccardo requested and the City Council approved that the City Auditor perform an audit of the administration of the Office of Retirement Services (ORS), and for an external review of the Police and Fire Department Retirement Plan and the Federated City Employees' Retirement System investment portfolios to be completed. The Stanford Institute for Economic Policy Research (SIEPR) was engaged for the external review of the investment portfolios. On November 20, 2017, SIEPR published their report titled Analysis of City of San Jose Retirement Plans Investment Portfolios.

Analysis

The SIEPR report lays out a financial statement-based methodology and peer analysis that considers:

- Funded status and the impact of discount rate assumptions,
- Asset allocation,
- Investment performance,
- The impact of demographics and employment,
- The impact of (and on) stakeholders (employees, retirees, and taxpayers), and
- The efficiency of investment office management.

The report concludes that the plans' deterioration in funded status is attributable to:

- Demographic factors such as a maturing and shrinking workforce,
- Relatively weak investment performance compared with a peer group,
- Relatively high investment expenses.

It further notes that the plans are particularly sensitive to weaker investment performance, implies that matching the duration of investments to duration of liabilities is appropriate, and questions whether alternative investments have been allocated optimally. Finally, the report suggests that subpar investment performance could require a downward adjustment to the discount rate.

Funded Status and Discount Rate

The SIEPR report provides data on the decline in funded status over the past decade (2006-2016) and notes that this has been a trend experienced by pensions broadly. In addition, the report documents a decline in the discount rate assumption at San Jose and in the industry in general. The report did not quantify the impact on funded status due to changes in actuarial assumptions, nor the impact from investment performance. ORS Staff, utilizing information from the plan's actuary, has shown that <u>a large portion of the decline in funded status has been due to a reduction in the discount rate</u>. While investment performance is a material factor in the decline in the funded status, it does not present a comprehensive picture. The San Jose pensions have been ahead-of-the-curve in ensuring that actuarial assumptions are reasonable, most notably in terms of reducing the discount rate. That said, the discount rate is not an isolated decision variable, but is an integral component of investment strategy, risk tolerance, asset allocation, and return expectation for the portfolio.

Asset Allocation and Investment Expense

The SIEPR report highlights an industry trend toward increased portfolio diversification and allocations to alternative investments. The report indicates that some alternative asset classes have not generated adequate returns to meet the pension's target return. The report does not recognize the potential value created from increased portfolio diversification.

The report comments on the increased level of investment expense over the past several years. <u>Higher investment expense is largely a function of the diversification strategy and asset allocation policy</u>. ORS is an industry leader in fee transparency and reporting, and publishes a comprehensive annual fee report. Given complexity in investment manager fee data collection, ORS analysis of industry fee reporting indicates that most public pension plans report only a portion of investment manager expense. Thus, peer comparisons are not apples-to-apples. That said, given that the San Jose portfolios are diversified and complex, ORS would anticipate a higher level of investment expense, the question is one of relative magnitude.

The report also points to the number of ORS investment staff as compared to peers. The report cites the ORS budgeted headcount number of 10—a level that the investment program has never been staffed at. The average annual vacancy rate of the ORS investment program over the past 7 years has been 40%. In addition, the ORS investment headcount includes operations and administration staff, while it is unclear what positions are included or excluded in investment headcount at other entities. The ORS annual fee report provides a comprehensive view of investment expense, including ORS investment staff. The annual expense for ORS investment staff is approximately 3 bps of average plan assets.

Investment Performance Analysis

The SIEPR report considered performance from several perspectives. Unfortunately, the potentially more insightful analysis was performed over a 1-year period, which is a short timeframe and in which the ability to accurately form conclusions is limited.

The report also evaluated peer performance under two lights, 1) a return-versus-return comparison, and 2) a risk-adjusted return comparison. Unfortunately, a return-versus-return comparison is a misguided exercise as it ignores numerous idiosyncratic factors of individual pension plans. Differences in investment strategy, risk profile, plan maturity, plan sponsor financial health, liability profile, benefit structure, and actuarial assumptions, are significant factors to consider, and are ignored in comparing returns of one plan verses another.

Risk-adjusted returns are much more informative, as it compares the return per unit of risk taken. <u>The SIEPR report did perform a risk-adjusted return comparison and found that the San Jose plans were in-line with peers on a risk-adjusted basis</u>. That said, the analysis was performed on a 1-year period, which again is an inadequate period to draw meaningful conclusions.

Expected Returns

The SIEPR report projected returns for the San Jose plans using the Board approved asset allocation and return forecasts from BlackRock Investment Institute. The projected returns were 4.8% for both plans, which is below the projected returns of 7.1% from the plan's investment consultant (Meketa). ORS staff compared the BlackRock return forecasts to Meketa's return forecasts, and found BlackRock's return forecasts lower across most asset classes.

ORS staff compared the BlackRock returns to an annual survey of return forecasts performed by Horizon Actuarial Services, and found that BlackRock's return forecasts generally at the lower-end of the return forecast range. While not questioning the BlackRock return forecast, we highlight where they tend to lie in the distribution.

Demographics

Pension plan demographics include factors such as the number of active and retiree members, the maturity of a plan, and the related characteristics around employee and employer contributions. The SIEPR report notes that the San Jose plans are mature, and that growth in annuitants exceeds growth in new members. This is a key factor to consider, and results in pension contributions and contribution sensitivity to changes in portfolio asset value having a notable impact on the plan sponsor's financial position. These are important factors, and have been a consideration in the Board's development of an appropriate investment strategy.

/Daryn Miller/

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