MEMORANDUM
OFFICE OF THE
COUNTY EXECUTIVE
COUNTY OF PLACER

TO:	Honorable Board of Supervisors
FROM:	Thomas Miller, County Executive Officer
DATE:	September 13, 2011
Subject:	Other Post Employment Benefits, Asset Allocation Strategy & Discount Rate Selection

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REQUEST

That the Board of Supervisors approves:

1. The California Employers' Retiree Benefit Trust Asset Allocation Strategy #1 for the County's Other Post Employment Benefit funds investment option; and
2. Using a 7.61% discount rate for the preparation of actuarial OPEB reports dated June 30, 2011 and later.

BACKGROUND

Employers promise benefits, including pension and retiree health benefits, in order to attract and retain qualified personnel. Fulfillment of retiree benefit obligations has become a major concern in government and private sectors as retirees are living longer and the retirement age is declining. The financial reporting standard, Government Accounting Standards Board (GASB) Statement 45, requires governments to include Other Post Employment Benefit (OPEB) costs in their financial statements. GASB 45 relates to payments and services provided for retirees other than pensions, primarily for retiree health insurance.

On December 27, 2007 Placer County joined the California Employers' Retiree Benefit Trust (CERBT) Fund which administers the county's OPEB obligations. The CERBT is managed by the CalPERS Board of Directors who approve to which asset classes all Trust investment dollars are allocated. The plan currently is designed to achieve a moderately-aggressive balance between stocks and bonds, within a prudent level of risk and liquidity. The CERBTs investment objective has been to seek favorable returns that reflect the broad investment performance of the financial markets through moderate capital appreciation and investment income. The diversified portfolio carries a lower level of risk than a portfolio consisting entirely of stock. Asset class target allocations are as follows: 35% U.S. Equity, 29% International Equity, 20% U.S. Fixed Income, 10% Real Estate Investment Trusts (REITs), and 6% High Yield Bond / Fixed Income.

In March 2011 the CalPERS Board approved changes to the CERBT's asset allocation strategy and reduced the current discount rate of 7.75%, used in the actuarial reports, to 7.61%. At the same time Effective August 2011 existing CERBT employers were offered a choice of three separate asset allocation strategies to provide more approaches to financial and budget management. The three CERBT asset allocation strategies share the same public market asset classes as follows: Global Equity, US Bonds, Global Real Estate, Inflation Linked Bonds (TIPS), and Commodities. Each of the Portfolios will be managed to accomplish the following:

1. Offer to employers a distinct investment alternative.
2. Invest in an asset allocation mix with targets and ranges based on periodic asset liability management review.
3. Maintain significant diversification to temper losses from market volatility.
4. Ensure that the asset class policy ranges approved are adhered to, and that any rebalancing is performed efficiently and prudently.
5. Maintain adequate liquidity to meet cash needs.

The Fund is structured to allow multiple CERBT employers to participate using individual asset allocation strategies. The Fund employs a *unitized fund structure* to maintain separate and distinct historical records and to produce individual net asset values for each asset class.

The amount of risk in the portfolio depends, in part, on the asset class allocations. As identified in Table 1, each investment strategy allocation mix is unique; levels of expected return and risk vary among the Portfolios. The objective of stocks is to help build the value of a portfolio over the long term while the objective of bonds is to provide income and stability of principal. In keeping with this premise, investment returns using Strategy #1 are more volatile (66% invested in Global Equity / 18% Bonds) with a higher long term return, and using Strategy 3 are less volatile (31.6% Global Equity / 42.4% Bonds) with a lower long term return. Several other types of "risk" apply to investments that affect the actual results of the investment strategy. For this reason investment strategies should be reviewed from time to time to evaluate if investment goals are being met.

TABLE 1

	STRATEGY 1	**STRATEGY 2**	**STRATEGY 3**
Discount Rate	**7.61%**	**7.06%**	**6.39%**
Asset Allocation Mix			
Global Equity	66.0%	50.1%	31.6%
U.S. Nominal Bonds	18.0%	23.9%	42.4%
Global Real Estate	8.0%	8.0%	8.0%
Inflation Linked Bonds	5.0%	15.0%	15.0%
Commodities	3.0%	3.0%	3.0%
Expected Return	**7.10%**	**6.5%**	**5.75%**
Expected Risk	**11.73%**	**9.46%**	**7.27%**
Return / Risk	**.61%**	**.69%**	**.79%**

FINANCE COMMITTEE REVIEW AND RECOMMENDATION

In March 2011, prior to the CalPERS Board action noted previously, your Board received an OPEB report for June 2011 that used the now obsolete discount rate of 7.75%. Since that time, upon receiving word of the CalPERS Board action, the Finance Committee reviewed several OPEB scenarios that utilized different discount rates in the analysis. This was done in an effort to evaluate the impact that a discount rate change would have on the County's finances.[1] As demonstrated in the following Table, when a lower discount rate was used in the analysis, the unfunded liability amount increased. When the unfunded liability increased, then the annual required contribution amount also increased. Finance Committee members recommended that using a 7.61% discount rate would be most appropriate given the long term nature of the investments in the CERBT and the associated lower annual funding requirements. This decision

[1] Updated actuarial information also included the actual asset values at 6/30/11 as this information is now available, in lieu of the projected figures noted in the earlier report.

can, and should be, revisited at the next required report date in two years, upon review of the funded status of the CERBT and in accordance with the County's needs

TABLE II

Actuarial Accrued Liability	7.75% Discount Rate	7.61% Discount Rate	7.25% Discount Rate
Actives	$148,050	$151,225	$159,816
Retirees	+ 159,827	+ 162,098	+ 168,200
Total Liability:	**$307,877**	**$313,323**	**$328,016**
Actuarial Value of Assets	- 117,502	- 117,502	- 117,502
Total Unfunded Liability:	**$190,375**	**$195,821**	**$210,514**
% FUNDED	38.2%	37.5%	35.8%
ARC	$26,261*	$27,013	$28,457
Pay-as-you-go Cost	- 11,661	- 11,661	- 11,661
CERBT PAYMENT	**$14,600**	**$15,352**	**$16,796**

Note: 000's omitted
* Estimate using the updated actuarial value of assets.

The preliminary Final Budget for FY 2011-12 includes $18.5 million to fund OPEB obligations: $16.5 million to pay the annual required contribution and $2 million set aside to fund increased obligations related to new employees that are hired during the fiscal year. In keeping with previous Board policy the County contributes, at a minimum, 100% of the annual required contribution (ARC) each year to the CERBT (calculated as ARC less Pay-as-you-go retiree health costs). With the current, depressed economic climate the County's ability to continue to contribute additional funds, as has been the practice in previous years, is minimal. With the Trust currently 35-38% funded (depending on the discount rate used), the County's payments for retiree health premiums are made directly from the County's treasury, not from the CERBT. The OPEB plan assumes the liability will be fully funded in about 30 years, so that retiree health premium payments can be deducted directly from the CERBT, predominantly paid for from investment earnings. This action would free-up ongoing revenues to fund county services and Board priorities.

The size of the discount rate has a significant impact on the actuarial findings. In addition to picking an Asset Allocation Strategy and Discount Rate Selection, CalPERS suggests agencies consider the use of a Margin for Adverse Deviation (MFAD). Electing to utilize MFAD would reduce the discount rate which, in turn, increases the liabilities and annual contribution amount. The positive impact of MFAD is that actuarial asset gains would be more likely in the long run. John Bartel, the County's actuary, recommends the use of a 36 basis point margin for adverse deviation for the most aggressive CERBT investment mix (Strategy 1) if the County were to use a MFAD. Doing so would reduce the discount rate to 7.25%. John Bartel clarified this recommendation as follows: a 7.61% discount rate represents a 50% confidence level, meaning that half the time the county should expect the actual return to be higher and half the time lower. In addition, the 7.61% rate is based on a lower investment return expectation for the next 10 years and a higher expectation beyond that.

According to Rand Anderson, CERBT, CalPERS doesn't make recommendations for or against using a MFAD and both 7.25% and 7.61% discount rates meet the standard of best actuarial practice. In Strategy 1 statistically the employer has a 2 of 3 chance of earning a return between 19% and -4% in any given year so, in terms of volatility, a large MFAD could be justified. The 7.61% is at the upper end (50th percentile) of the range of expected returns. Since a second strategy option with lower return volatility is available (CERBT Strategy 2) agencies could switch to Strategy 2 rather than increase the MFAD. The actuarial valuation process is self-correcting whereby plan results are fed back into the model each time it is run and future estimates are adjusted to recognize their impact. That self-correction will occur irrespective of the discount rate that is chosen.

The Finance Committee did not recommend the use of a MFAD. The Finance Committee recommended Strategy 1 for the Asset Allocation Mix utilizing 7.61% for the discount rate for actuarial reports. The County's objective is to build the value of a portfolio over the long term, so the strategy that includes more equities in the mix is appropriate. When the agency gets closer to achieving its funding goal, a change in the investment strategy to a less volatile platform might be more appropriate. Essentially, under different circumstances different applications will apply. As a result, the County's OPEB investment strategy should be evaluated periodically to determine if the then current allocation mix is appropriate. Strategy 1's asset allocation most closely resembles the current structure used by the CERBT whose objective is building the value of the portfolio over the long term.

FISCAL IMPACT

If the Board accepts the recommendation to use a 7.61% discount rate, there will be no additional fiscal impact in excess of the current recommended final budget. A discount rate of 7.25% requires about $600,000 additional dollars be collected to fund OPEB than is currently budgeted ($17.1 million ARC - $16.5 budget).

The unfunded liability was "point-in-time", meaning that it was based upon a number of assumptions regarding the County's workforce as of a specific date (June 30, 2011). Given this fact, the figures do not include costs related to hiring future employees. However, the Board's policy of prefunding OPEB for new employees at the time of hire should mitigate impacts to the OPEB liability from new hires. Absent such direction from the Board, the County's 2011 unfunded liability would undoubtedly grow.

In the future, continued good management of the County's OPEB liability remains critical to the County's maintaining a stable credit profile as these unfunded actuarial retiree healthcare obligations are viewed as debt-like in nature. Credit quality could suffer if changes resulting from OPEB adversely affect the County's financial position or flexibility. Steady contributions mark progress toward funding the current unfunded liability and support sound financial management practices and quality credit ratings.