SAN JOSÉ - UNFUNDED PENSION LIABILITIES
A GROWING CONCERN

2018-2019 Civil Grand Jury
of Santa Clara County

June 19, 2019

Table of Contents

GLOSSARY AND ABBREVIATIONS

Benchmark	A set of data that is used as a measure of comparison against another set of data
BPS	Basis points - 100th of one percent (1/100 of 1%; 0.01%)
CAFR	Comprehensive Annual Financial Report
CEO	Chief Executive Office
CIO	Chief Investment Officer
City	City of San José
City Council	City of San José City Council
COLA	Cost of living adjustment
COLI	Cost of living index
Discount Rate	The assumed rate of return on pension plan assets that an actuary uses to determine employer and employee annual contribution to a plan in order to meet City's future obligations to its pensioners.
Federated	San José Federated City Employees' Retirement System
General Fund	The primary operating fund used to account for all the revenues and expenditures of the City that are not related to special or capital funds. Most day-to-day operations, including any shortfalls in the pension plans, are paid out of the General Fund.
K	Thousand (e.g., $5K is 5 thousand dollars)
LAFPP	Los Angeles Fire and Police Pensions
LACERS	Los Angeles City Employees' Retirement System
LACERA	Los Angeles County Employees Retirement Association
Mature	A mature pension plan is one in which there are an equal number or more retiree beneficiaries than active employees paying into the plan.
ORS	San José Office of Retirement Services

Pension plan/fund	Pension plans/funds are an employment benefit designed to provide employees with a source of income during their retirement years. The terms fund and plan are used inter-changeably in this report.
Percentile/Centile	A number that represents a percentage position in a list of data. For example, if the performance of an entity is at the 43rd percentile, then it performs better than 42 percent of all entities within its group.
Police and Fire	San José Police and Fire Department Retirement Plan
Plans	Both the Federated and Police and Fire Plans, collectively
Policy Benchmark	A standard designed to gauge the performance of a pension plan, investment manager, asset or other financial entity. It is calculated as the weighted average of returns of multiple indices selected to represent the asset classes and allocation percentages of, in the case of this report, a pension fund.
Quartile	One of the three points that divide a range of data or population into four equal parts. The first quartile (also called the lower quartile) is the number below which lies 25% of the bottom data. The second quartile (the median) divides the range in the middle and has 50% of the data below it. The third quartile (also called the upper quartile) has 75% of the data below it and the top 25% of the data above it.
Sharpe ratio	This is a measure that provides the average return of an asset minus the risk-free return of that asset divided by the standard deviation of the return on that asset. In other words, the ratio indicates how much excess return received for the extra volatility you experience for holding an asset with relatively higher risk.
SIEPR	Stanford Institute for Economic Policy Research
Standard Deviation	A measure of the historical volatility of an asset. For example, the higher the standard deviation the more volatile the asset.
Trailing returns	Returns for past specific periods
UAL	Unfunded accrued/actuarial liabilities are the calculated cost of promised benefits that is greater than the current value of a fund's assets.

SUMMARY

It has been recently reported that the City of San José's share of pension costs in fiscal year 2019 spiraled to nearly 28% of the General Fund, at approximately $335 million, and are estimated to continue to climb. This $335 million from the General Fund, which is the primary operating fund used to account for all the revenues and expenditures of the City of San José (City) that are not related to special or capital funds, would otherwise have been available for essential City services such as police and fire, street repairs, parks and libraries.

The City's two pension plans will need to distribute $4.3 billion to retirees between 2020 and 2029 according to the San José Office of Retirement Services (ORS). As originally conceived, these pension plans were supposed to be self-sufficient, without requiring annual cash infusions from the City's General Fund. The ORS estimates that the pension funds will pay out $1.3 billion between 2020 and 2029. This means that the City will have to provide at least $3 billion over the same timeframe.

The reasons for the pension plans' shortfalls include: (1) insufficient employer/employee contributions; (2) investment earnings that have fallen short of expectations; (3) annual mandatory retiree COLAs; and (4) high overhead. Verus Investments, a consultant to ORS, has estimated that for FY2020, the portion of the General Fund used for pension costs will increase to approximately 31%.

If changes are not made to the way in which the public pension plans are funded and managed, the City will likely be forced to continually increase its share of the required cash payouts and liabilities.

The City, Federated and the Police and Fire pension plans and the bargaining units are urged to find common ground on which to create strategies that will enable the City to reduce its annual cash obligations to cover the underfunding for the pension plans so that the City may deliver necessary services to its residents.

BACKGROUND

A pension plan is a benefit funded by an employer on behalf of its employees. Pension plans are designed to provide employees with a source of income for the remainder of their lives once they retire and meet certain criteria, such as length of time with that employer. Employees typically contribute a percentage of their pay into the plan as well. The San José Police and Fire Retirement Plan (Police and Fire) and the Federated City Employees' Retirement System (Federated) are examples of pension plans. These plans are "defined benefit plans" wherein the level of payments is set at the time of retirement and does not change based on the plan's investment performance. Almost all San José City employees are covered by one of these plans. In this report, the terms plan and fund are used inter-changeably, as in pension fund or pension plan.

As of June 30, 2018, among the 39 public pension plans in the state of California surveyed by Cheiron, the actuarial consultant contracted by each of the San José pension plans, Federated had the lowest funded status of all 39 plans. Its 50% unfunded actuarial liability (UAL) means it currently has half the assets necessary to meet the future obligations to its pensioners. Police and Fire, with stronger investment returns and higher City contributions, is better positioned for its future obligations, being funded at 74%. Table 1 below presents market value and actuarial liability for both Plans as of June 30, 2018.

Table 1 - Pension Fund Assets FY18

Plan/Fund	Market Value	Actuarial Liability
Federated Plan	$2.1 billion	$4.1 billion
Police and Fire Plan	$3.5 billion	$4.7 billion
Total	$5.6 billion	$8.8 billion

For fiscal year (FY) 2019, retirement costs will require a $334.7 million contribution from the General Fund, an increase of $15.6 million from the FY2018 contribution of $319.1 million. The FY2019 costs represent 27.8% of the total General Fund base expenditure budget with committed additions and reflect the Federated Retirement System and Police and Fire Department Retirement Boards' approved economic and demographic assumptions. The forecast for the City's FY2020 retirement contribution is $352 million, representing a 5% increase over its FY2019 contribution.

Many public and private organizations have changed from pension plans to 401(k) defined contribution plans. The primary reason for the change is that many of those pension plans have become increasingly burdensome to the organization due to underfunding. That is, the amount of funds paid into a plan and the amount of income generated by the assets are insufficient to cover the long-term costs. That shortfall necessitates the need for employers to cover those obligations through such mechanisms as borrowing, which also increases costs due to interest payments. In the case of San José, shortfalls are covered by using General Fund monies.

Police and Fire and Federated plans are governed by two separate boards of administration as authorized by Chapter 3 of the Santa Clara County Ordinance Code[1]. These two Boards are comprised of current employee plan members, plan member retirees and appointed members of the public from the financial and investment industry.

Police and Fire is a defined benefit retirement plan operating under the Municipal Code Chapter 3.32 and is managed and administered by the Police and Fire Board. The duties of the Board include administration and investment of funds, and retirement requests, membership and benefits. The Board has the authority to administer the Plans and to enter into agreements on behalf of the City for Plan administration. Board meetings are held monthly, except for July, at the San José City Hall.

The Police and Fire Board consists of nine members who serve four-year terms. Board members include one employee each from the Fire Department and Police Department and one each from their respective retired members. The active and retiree members are elected by their membership. In addition, four members of the public are appointed by the City of San José City Council (City Council) and one public member is selected by the Board. Public members must live within 50 miles of the San José City Hall and have a degree in finance, actuarial science, law, economics, business or other related field from an accredited university. Public members must also have at least twelve years of relevant experience.

Federated is a defined benefit retirement plan operating under the San José Municipal Code Chapter 3.28. Federated operates in much the same way as Police and Fire. The Federated Board consists of seven members, each of whom serves a four-year term. Board membership includes two employee members, who are members of two of the eleven labor unions, each of them from a different City department. One board member must be a retiree member of Federated. Three members are appointed from the general public by the City Council. One public member is selected by the Board.

Measure G amended the City Charter in regards to governance of the retirement Boards. The measure allowed the City Council to establish one or more retirement Boards, specified the hiring authority of the retirement services chief executive, excluded certain future retirement services employees from the classified civil service and established the process for setting stipends paid to non-employee retirement board members.[2]

[1] Chapter 3.28.100 - 1975 Federated Employees Retirement Plan
[2] ("City of San Jose Retirement Board Governance, Measure G," 2014)

The San José Office of Retirement Services (ORS) administers both the Police and Fire Plan (and fund) and the Federated Plan (and funds) on behalf of the two Boards. In November 2016, following the passage of Measure G, the Boards were given direct authority to hire and appoint a Chief Executive Officer (CEO) and a Chief Investment Officer (CIO) who report directly to the two Boards. There are approximately 13,400 active, vested-but-not-receiving-benefits, retired and survivor participants who are served by the ORS.

The 2011–2012 Santa Clara County Civil Grand Jury likewise concluded that mounting retirement obligations were a direct cause of the need to scale back government services. In a 2012 report on the pension systems of the county and all the cities and towns therein, the Grand Jury asserted:

> "The [2011-2012] Grand Jury concludes that until significant modifications are enacted, there is no doubt that the escalating cost of providing Benefits at the current level is interfering with the delivery of essential City services and the ultimate cost to the taxpayers is an unbearable burden. These costs are already impacting delivery of essential services such as demonstrated by San José reducing police and fire department staffing levels, closing libraries or not opening those newly built, curtailing hours of community centers, and not repairing pot-holed city streets."[3]

The 2018-2019 Civil Grand Jury (Grand Jury) finds this situation continues today.

[3] (2011-2012, 2012, p. 25)

METHODOLOGY

The Grand Jury began an investigation of the San José Police and Fire Retirement Plan and the Federated City Employees' Retirement System on November 6, 2018. The investigation focused on the structure of the two Boards and the ORS. The Grand Jury considered the efficiency and effectiveness of their administrative duties, investment profile of the underfunded pensions, along with the challenges these issues bring to members and taxpayers.

The Grand Jury also investigated public pension funding of other public entities' plans.

The Grand Jury conducted visits to San José City Hall, Stanford University Law School, Stanford University Institute for Economic Policy Research (SIEPR), the ORS, and San José Pension Fund workshops hosted by the City.

Fifteen interviews were conducted with twelve individuals. Interviewees included members of the San José City Council, employees of the ORS, Board members of the two San José pension funds, and an out of state pension fund manager. Interviews also included attorneys who advise on public policy and/or represent pension fund trustees and investors of a few of the largest national pension funds.

The Grand Jury attempted to obtain the perspective of the membership of the bargaining units and so invited representatives of the 11 unions whose members participate in the Plans to appear before the Grand Jury. The Grand Jury is disappointed that the bargaining units chose not to avail themselves of the opportunity. It was a missed opportunity for the membership of those units to provide valuable insight into how they view the serious issues confronting the pension funds and the City.

Reports specific to San José pensions were reviewed including the 2011-2012 Grand Jury reports and responses. The San José Municipal Code, Chapter 2, Parts 10 and 12, Section 2.08.1200 and Section 2.08.1000 were studied. Measure G of the City of San José was reviewed. A study of the San José public pension plans that was conducted by the SIEPR was reviewed and is referenced in this report. Other resources are listed in the Reference section of this report. Other sources of data include a significant amount of City and ORS information that was obtained from their websites.

The Grand Jury reviewed retirement plans and fund data for Los Angeles County, City of Los Angeles, Atlanta, Illinois Public Safety Officers, New York City, Palm Beach, Austin, Orange County Cities, New Jersey Public Safety Officers, the State of Nevada, among others, and a report from the California Policy Center by Robert Fellner of April 25, 2014.[4] The Grand Jury looked in-depth at the board structures of both the City and County of Los Angeles. Information from the California Policy Center was reviewed. Pension plan specifics for San José, the City of Los Angeles[5] and the County of Los Angeles[6] have in some cases been taken directly from their websites.

[4] Fellner, R. (2014). Evaluating Public Safety Pensions in California. Retrieved from California Policy Center website: https://californiapolicycenter.org/evaluating-public-safety-pensions-in-california/
[5] (LACERS, 2019)
[6] (LACERA, 2019)

DISCUSSION

San José ORS: Organization, Budget and Operations

The ORS currently reports to the two separate pension fund Boards. The ORS CEO oversees the general activities of all the services that the ORS provides including its budget for services that ranges from $10 to $12 million per year (see Table 2 below comparing FY19 and FY20 costs). The CEO and CIO are City employees and report to both Boards.

Table 2 - Office of Retirement Services Administrative Costs, 2018-2020

Expense Category	2018-2019 Adopted (A)	2018-2019 Forecast (B)	2019-2020 Proposed (C)	% Increase (Decrease) (A to C)	% Increase (Decrease) (B to C)
Personnel Services	$7,118,000	$6,201,733	$7,387,000	3.8%	19.1%
Non-personnel / Equipment	$2,624,000	$2,283,328	$2,816,000	7.3%	23.3%
Professional Services	$1,878,000	$1,413,270	$1,607,000	(14.4%)	13.7%
Medical Services	$438,000	$336,270	$355,000	(18.9%)	5.6%
TOTAL	**$12,058,000**	**$10,234,601**	**$12,165,000**	**0.9%**	**18.9%**

The CIO receives direction from both the CEO of ORS and the Board. The CIO is responsible for recommending investment policies and strategies to the Boards for both Police and Fire and Federated.

Both Plans earned negative returns in 2015 and 2016. Based in part on these poor returns, in March of 2017, the Mayor of San José requested and the City Council approved a review of the investment portfolios of the City's retirement plans by the City Auditor.[7] The City Auditor selected the SIEPR to conduct the analysis.

On October 12, 2017, the City Auditor (Auditor) published a report on the ORS' administrative and investment operations.[8] The Auditor found that the costs for administering these plans, from an operations standpoint, ranked in the middle and not significantly higher or lower than the peer benchmark jurisdictions assessed.

The SIEPR report[9], published on November 20, 2017, noted that using 2016 data, the San José Plans underperformed peer plans in net returns, although in terms of risk-adjusted return (Sharpe

[7] (Diamond, 2017)
[8] (Erickson, 2017a)
[9] (Nation, Tulloch, & Lipshitz, 2017)

Ratio), Police and Fire was ranked 5 and Federated was 8 out of 10 peers. The ORS later responded that 1-year data was inadequate to draw meaningful conclusions.

The SIEPR report also focused on the ineffectiveness of the prior investment management team, citing the investment funds selected and the generally high expenses associated with such management. Figures 13 and 14 on pages 22 and 23 of the report demonstrate that the total expenses of the San José Plans had increased from 2014 forward. The increased costs have placed San José among the costliest of managed plans among the peer group that SIEPR selected.[10] The report also cited the high number of investment staff for the San José Plans compared to peers.

The City of San José did not concur with those observations, arguing that circumstances warranted the costs. The City cited the pension portfolio's diversity of complex investments and the administrative effort required to manage that portfolio. In addition, the ORS took the position that San José pension administration overhead included staffing costs that peer groups did not report.

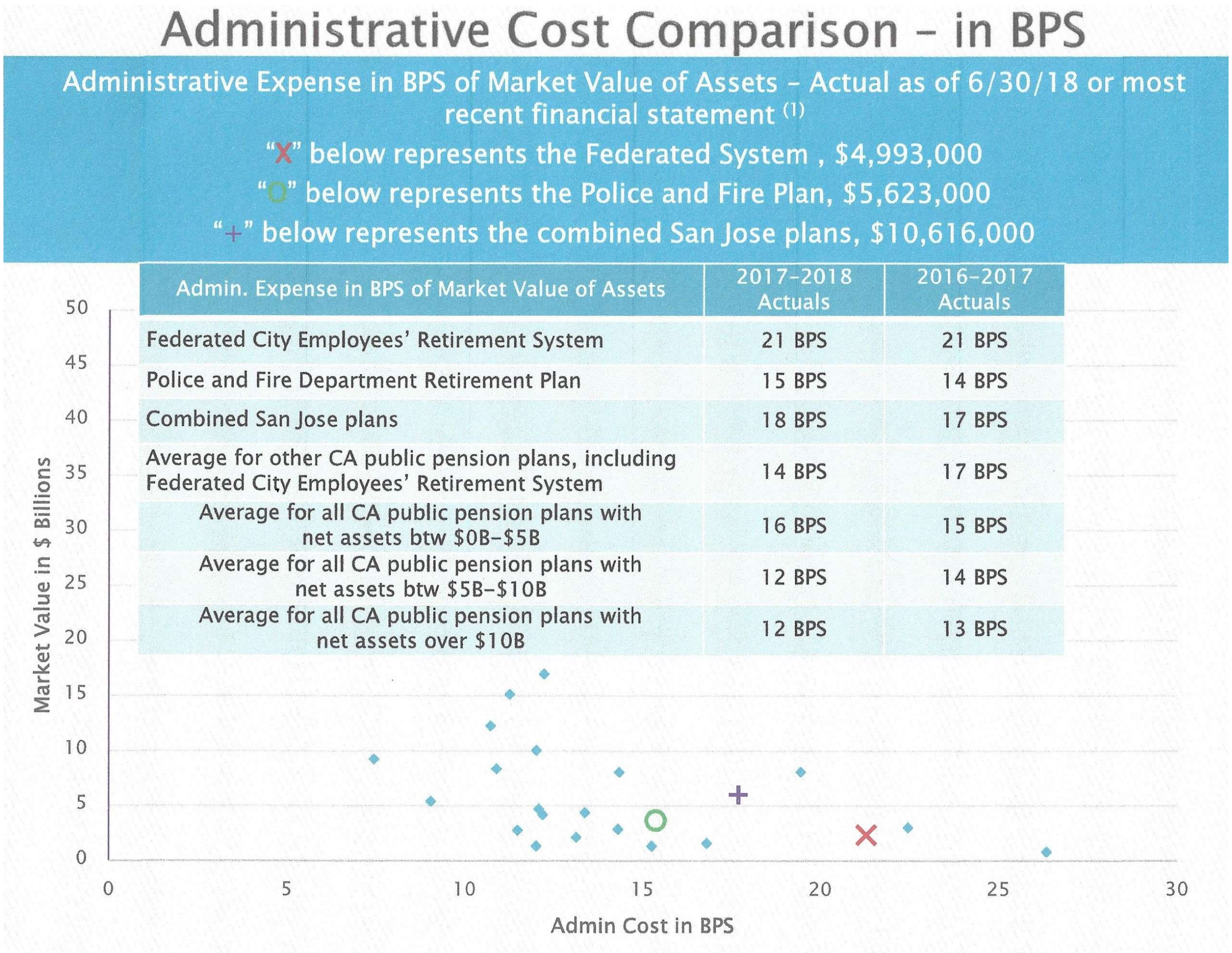
Board Structure and Expenses

Measure G, approved by the voters in November 2016, authorizes the establishment of one or more retirement boards to administer the retirement plans. A subsequent analysis by the City Attorney found that the City Council has the authority to establish "one" or "more" retirement boards.[11]

The Grand Jury reviewed the administration of the ORS in its relationship to the Boards in order to determine if there were improvements and/or cost benefits that could be achieved. The Grand Jury also reviewed the profiles of members of the Boards, and compared the member qualifications and experiences to other boards overseeing public pension funds in other jurisdictions.

In terms of administrative costs, Federated costs are the one of highest among all classes of public pension plans in California. California public pension plans, with net assets under $5 billion, had an average of $4.1 million in administrative costs. Both San José Plans have administrative costs in excess of this average.[12] Refer to Table 1 for the net asset values for the Plans and to Figure 1 that presents the San José funds' administrative costs in Basis Points (BPS) relative to other California public pension plans. Basis points (BPS) are used chiefly in expressing differences in interest rates and investment fees.

[10] (Nation et al., 2017, p. 24)
[11] (Erickson, 2017a)
[12] (Peña, 2019)



Admin. Expense in BPS of Market Value of Assets	2017-2018 Actuals	2016-2017 Actuals
Federated City Employees' Retirement System	21 BPS	21 BPS
Police and Fire Department Retirement Plan	15 BPS	14 BPS
Combined San Jose plans	18 BPS	17 BPS
Average for other CA public pension plans, including Federated City Employees' Retirement System	14 BPS	17 BPS
Average for all CA public pension plans with net assets btw $0B-$5B	16 BPS	15 BPS
Average for all CA public pension plans with net assets btw $5B-$10B	12 BPS	14 BPS
Average for all CA public pension plans with net assets over $10B	12 BPS	13 BPS

[1] *Retirement Services gathered and compiled most recent financial information from 23 public pension plans' CAFRs*

Figure 1 - Administrative Cost Comparison for Police and Fire, and Federated[13]

The Nevada Public Employees Retirement System presents an example of a pension fund that is managed cost efficiently with above-average returns. In an article in the Wall Street Journal titled, "What does Nevada's $35 Billion Fund Manager Do All Day? - Nothing", the author describes the Nevada pension fund as focused on minimizing investment fees and administrative overhead by investing pension assets into low cost passive index funds.[14] As of March 2019, the Nevada Public Employees Retirement System had assets with a market value of over $45 billion with 85% invested in low cost index funds managed by only 10 investment managers. By contrast, the City of San José's two pension plans with assets slightly above $6 billion utilize more than 70 investment managers and have less than 50% of assets in a passive index strategy. With investment fees about one-seventh the average public pension, the Nevada Public Employees Retirement System provides a compelling strategy of reducing investment costs to increase investment returns.

[13] (Peña, 2019)
[14] (Martin, 2016)

Examples of Board Structures, Member Profiles and Experience

In review of other board structures and profiles of board member experience, two relevant jurisdictions are discussed below. They were selected based on their complexity and diversified profiles.

The Los Angeles County Employees' Retirement Association (LACERA), for example, has safety and non-safety employees combined in one plan. The profile of the board is broad and diverse with the labor representatives including a public defender, retired sheriff, county assistant treasurer, deputy head of tax collection and assistant chief counsel. The public representatives include a real estate developer, two attorneys, an underwriter, the Chief Financial Officer of the Los Angeles County Department of Public Works Building and Safety, and a pension plan consultant. Safety and general employee members are represented together under one board of directors, however, there is a separate "Board of Retirement" and "Board of Investments" providing oversight for these plans.[15]

The LACERA "Board of Retirement" is responsible for the administration of the retirement system, the retiree healthcare program and review and processing of disability retirement applications. The board is composed of eleven members: six members are elected; two are active general members; two are retired members; and two are safety members. Four of its members are appointed by the Los Angeles County Board of Supervisors. The law requires the County Treasurer and Tax Collector to serve as ex-officio and alternate ex-officio members.

The LACERA "Board of Investments" is responsible for establishing the investment policy and objectives, as well as exercising authority and control over the investment management of the Plan. The Board is composed of nine members. Four members are elected: two are elected by active general members; retired members elect one member; and safety members elect one member. Four of its members are appointed by the Los Angeles County Board of Supervisors. The same law applies regarding the Tax Collector and Treasurer of the County. There is some overlap of individuals who serve on both boards.

The Los Angeles City Employees' Retirement System, (LACERS) [16] is a department of the City of Los Angeles, established by City Charter in 1937, to provide retirement benefits to the civilian employees of the City of Los Angeles, representing three-fifths of the city's workforce. The Los Angeles city profile is different than the county boards in that the City of Los Angeles has three separate groupings of labor members. In addition to the civilian employees noted above, the

[15] LACERA Los Angeles County Website: https://www.lacera.com/home/index.html
[16] LACERS website: https://lacers.org/aboutlacers/about-us.html

remaining two-fifths of the city workforce has retirement benefits through the Department of Water and Power Employees Retirement System, or the Los Angeles Police and Fire System.

Currently LACERS provides services to 24,000 active employees, and provides benefits to nearly 17,500 retirees and their beneficiaries. LACERS administers the benefits approved by the City of Los Angeles, the "plan sponsor", and includes pension benefits, administration of retiree health care premiums, and management of the pension fund portfolio to offset payment of these obligations.[17]

The Board of Fire and Police Pension Commissioners administers the Los Angeles Fire and Police Pensions (LAFPP) System in accordance with the City Charter, the City Administrative Code and the State Constitution. The Board consists of nine commissioners – five appointed by the Mayor of Los Angeles and confirmed by the City Council, and four elected by members. The five appointed members include a doctor of medicine, attorney, philanthropist and two investment managers. The diversity of the Public Board members for Los Angeles' three plans has a similar makeup to that of Los Angeles County, where it is not all comprised of investment financial professionals.

In reviewing the composition of each of the San José Boards of Administration the expertise of the members is heavily weighted toward investment professionals. Other more successful pension funds, such as LACERS, have boards that have a much wider range of expertise.

Oversight of the San José ORS' CEO and CIO

The Grand Jury discovered that the CEO and CIO of the ORS do not have an annual performance review that included predetermined measurable goals. The Grand Jury did not find evidence that the Boards evaluate performance based on metrics other than periodic evaluation of investment portfolios, although the Grand Jury learned that the need to determine metrics has been discussed.

Because the CEO and CIO of ORS report to two different boards, their efficiency and measurement of effectiveness is difficult to assess without established and measurable goals. For example, the complexity of Police and Fire benefit requirements and the financial difficulties of Federated may cause ORS to focus on varied priorities simultaneously.

The joint council personnel committee[18] of the Boards conducts performance evaluations. The Grand Jury found that there is currently no measurement of work effectiveness or performance of ORS personnel. A robust measurement of ORS staff might expose the inefficiencies caused by

[17] https://www.lacers.org/aboutlacers/about-us.html
[18] A committee consisting of members from each Board.

any duplication of efforts in serving two entities. Without such an analysis the City, Board and ORS are unable to address these management issues.

Consideration for Improving Effectiveness of the Boards

Both Boards appear to be strong and understand their fiduciary responsibilities. Members generally were found to be both engaged and comprehend the issues required to making informed decisions. The Grand Jury was advised that the Police and Fire Board tends to manage much more complex pension issues. As confirmation of this, on a statewide basis in California, Police and Fire employees make up 15% of California's total state and local government workforce but represent 25% of pension costs with different benefit needs.[19]

The Grand Jury discovered that the ORS administration and investment team members are subjected to unnecessary duplication of efforts. This duplication increases the amount of time spent on administration of activities, board meeting preparation and attendance, workshops and related work effort. The Grand Jury found that members of ORS participate in nearly three times the number of meetings than peer jurisdictions of similar size. In some instances, there are conflicts of priority that go along with a duplication of efforts resulting in less time being spent on value-added duties.

The Grand Jury learned that the City of San José has periodically considered the benefit of combining the two Boards partly for reasons described above, and there is currently a willingness from some interviewees to combine the Federated and Police and Fire Boards. The combining of the two boards would reduce redundancy and provide more time to focus on investment performance and serving the members.

There are already certain committees that report to both Boards, whose recommendations and actions are for both member populations, therefore suggesting that one board could serve all members of both Plans. Any such change should ensure that member representation on the Board not be diluted nor that they lose visibility.

Other pension plan boards have benefited from a broad range of backgrounds beyond an investment focus. San José should consider the benefits of this improvement in its public members.

[19] Fellner, R. (2014). Evaluating Public Safety Pensions in California. Retrieved from California Policy Center website: https://californiapolicycenter.org/evaluating-public-safety-pensions-in-california/(Fellner, 2014)

Other Areas of Possible Cost Reductions

Pension Plan Investment Management Fees

For calendar year 2017, the combined investment fees paid by Federated and Police and Fire exceeded $70 million.[20]

Management fees are fees charged by fund managers to invest and manage assets. Incentive fees are performance-based fees. That is, fees are based on the ability of the fund manager to meet or exceed an agreed upon level of return and are only applicable to certain types of investments. Operating expenses include overhead related to managing a fund; these expenses are indirectly borne by investors, and include professional, administration, research, tax, legal, custodial and audit expenses for a fund. Trading expenses such as broker commissions are not included in this discussion of fees. Other expenses excluded are institutional services such as custodial services (State Street Bank) and the cost of plan consultants who include the general investment consultant (Meketa Investment Group), the risk consultant (Verus Investments) and the absolute return consultant (Albourne America).

According to information received from ORS, for fiscal year 2017, the three plan consultants received total payments of approximately $1.5 million, broken down as follows: Meketa Investment Group Investment Group received $608K; Albourne America received $480K; and Verus Investments received $299K.

The Mayor and City Council have become more keenly focused on the impact of investment fees on investment performance. In the Mayor's budget message of March 9, 2019, he devoted a significant portion of his message to retirement contribution liabilities and the impact of underperforming assets in the pension funds.[21]

In this budget message, the Mayor stated, "Also troubling has been the tendency for the boards and Retirement Services staff to favor investment in high-fee, management-intensive alternative investments such as private equity, real assets, private debt, and hedge funds. Academics have long speculated about the likelihood of a widespread bias in the industry to prefer higher fee [these can include "carried interest" that is profit sharing between plans and managers] active investment approaches despite the evidence of inferior outcomes, perhaps because decision-makers tend to share the same education, career paths, and social circles as those directing actively managed funds. I've expressed concerns repeatedly in the past, however, that existing strategies maximize financial benefit to asset managers, at the cost to the City and our plan members."[21]

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[20] (Peña, 2017)
[21] (Liccardo, 2019)

Per the Plan's actuarial consultant, Cheiron, for every $1 million reduction in investment fees, the City contributions would decrease by approximately $20,000.

The Federated and Police and Fire Plans' overall expense ratio, sum of management, incentive and administrative fees, of 1.29% (129 basis points) is driven primarily by the higher fees associated with alternate investments. This fact is supported by the CEO's preliminary report on investment fee analysis dated March 12, 2019[22], that reveals multiple hedge investments in its global equity, private equity, real estate and absolute return allocations with expense ratios ranging from 3.29% to 5.35% (329 to 535 basis points).

The Impact of COLAs on Pension Liabilities

The growth in the City's unfunded liabilities has many causes, including the financial downturn after 2008. But the primary cause is a massive increase in retirement benefits. The 3% cost-of-living adjustments (COLA) awarded to all Tier 1 San José employees when they retire and all current Tier 1 retirees who retire after April 1, 2006 is one such generous benefit. Note that Tier 1 refers to retired and active plan members hired prior to the passage of Measure G. Tier 2 are all other employees.[23]

San José Tier 1 retiree plans include a mandated 3% COLA that compounds annually. Tier 2 employee plans support a COLA based on cost of living index values for the preceding year but cap at a maximum of 2%.

Based on estimated pension payouts and the mandated annual COLA increases, San José retirement plans in the next 10 years will need to payout approximately $4.3 billion, of which $1.8 billion is needed for Police and Fire retirees and the remainder for Federated retirees. ORS has estimated that the City will cover $3.0 billion of this expense and the retirement plans must cover the rest ($1.3 billion). To-date, the City has transferred over $30 million per year to cover retiree COLA expenses and will need to continue to do so; retiree COLA payouts are estimated to increase through at least year 2034. The Grand Jury has evaluated and annualized current City contributions including COLA payments, and determined the estimate of the City's contribution to be closer to $3.4 billion for the 10-year commitment.

A basic shortfall results as the City continues to contribute additional funds to cover costs and amortization of the unfunded liabilities. These sums are large and, as noted above, take funding away from other essential and desired services the City otherwise could provide its citizens.

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[22] "March Budget Message for Fiscal Year 2019-2020" memorandum from Mayor Liccardo to City Council, March 8, 2019, page 11

[23] Per San José Municipal Code sections 3.44.160 and 3.28.1910

To put part of the shortfall in context, a retiree's pension will double in 24 years when the guaranteed 3% COLA is applied (e.g., with an initial pension of $50K, payments in year 24 would equal $100K and in year 30, the same initial pension of $50K would payout $119.4K and so forth). See Table 2 below. These payout rates mean that the City and retirement plans must find increasing funds to cover the mandated pension obligations.

Table 2 - Pension Growth Based on COLAs

Pension at Retirement	COLA	Pension Pay Out at Year			Notes
		24	30	36	
$50,000	3%	$100,000	$119,400	$142,580	
$85,000	3%	$170,000	$202,990	$242,380	
$100,000	3%	$200,000	$238,810	$285,150	
$100,000	2%	-	-	$200,000	For comparison

Since 2009, at least 29 states have attempted to pare pension costs by reducing, suspending or eliminating post-employment COLAs, and some have implemented various mechanisms to help reduce the unfunded liability risk. Many of the COLA changes have taken place in states that had guaranteed a fixed percentage pension COLA, regardless of inflation. The financial pressures of the Great Recession of 2008, combined with a relatively low-inflation environment, made reducing or eliminating these guaranteed rates, or shifting to a different type of formula, attractive to states such as Colorado, Hawaii, Florida, Kansas, Illinois, Minnesota, Montana, New Mexico, Ohio and South Dakota.[24]

During this same period some states, including Kentucky, Minnesota, Montana, New Jersey and Wyoming, tied their COLAs to pension plan funding levels, while others, such as Colorado, tied COLAs to investment performance. Other types of cuts have involved skipping or delaying COLAs so that they apply only after a worker has been retired for a certain length of time or reached a certain age. Some states, including Rhode Island and Louisiana, have developed complex COLA arrangements that combine several of these features. Many state and local government pension COLA approaches fluctuate with inflation, based on consumer price indices (CPIs) published by the U.S. Bureau of Labor Statistics. These approaches are worthy of consideration. See also National Association of State Retirement Administrators (NASRA) 2018 papers on this subject with each state's current adjustments outlined in some detail.[25]

Illinois defined a 3-part pension solution of which an optional COLA buy-out was provided. In this program, Tier 1 members (that is, the older members who still have guaranteed 3% compounding cost-of-living adjustments) can accept a reduction in their COLA from 3% to 1.5%

[24] (Petrini, 2015)
[25] (NASRA, 2018)

in exchange for a lump sum benefit of 70% of the present value of the amount of future COLA reduction. This is projected to save the state $381.9 million of their $203 billion unfunded liability. Other states have delayed COLA payments for a time after retirement or until a certain age is achieved.

The Grand Jury acknowledges that reducing any part of an agreed upon pension benefit is complex, requires careful legal review and must thoroughly consider the impact on retirees, and active members who will retire in the future. However, there is room to develop creative and supportive solutions that address the ever-growing liability associated with pension costs.

An Example of How One County is Solving its Pension Liability Problems

Other public pension plans are continuing to address existing and growing unfunded liabilities. One example that bears consideration by San José is San Mateo County. San Mateo County pension plans support about 12,000 employees, retirees and vested-but-not-receiving-benefits members, which is comparable to San José's 10,600 members. San Mateo County has actively reduced its discount rate as has San José; San Mateo reduced those rates from 8.0% in 2004 to 6.75% in fiscal year 2018. Finally, San Mateo is an independently managed pension plan as is San José; neither is part of CalPERS.

Where San Mateo County and San José differ is in employee contribution rates and pension plan actual returns. San Mateo County employees contribute 13% (pro rata) to their pensions and the County's pension plan actual returns averaged 9.2% over the last five years, significantly higher than San José's. Although there are differences between San José and San Mateo County pension plan attributes, some of the County's approaches are worthy of consideration.

Among other solutions designed to address the growing UAL, San Mateo County in 2012-2013 decided to make payments over and above the annual required contribution, or supplemental payments, towards reducing the unfunded liability to zero within 10 years. They are on track to accomplish this goal. The benefits of these supplemental payments include:

a. Reducing current interest payments on the unfunded liability balance - San Mateo County expects to save almost 40% of its UAL in reduced interest costs over the 10-year time period; and
b. Reducing ongoing principal and interest costs in the years following when the UAL is fully paid off - San Mateo County estimates this to be about 14% of its costs.

San Mateo County and the Grand Jury acknowledge that this program is not without risk. Economic factors can lead to reduced revenues and hence limit the ability to make supplemental payments. Rates of return and asset allocations need to be managed to ensure effective returns.

However, an engaged and proactive administration and oversight team should be able to manage such challenges.

Pension Plans' Performance

The Grand Jury examined the investment performance of the San José Plans. The SIEPR report showed that the San José Plans were mature -- with more retirees and beneficiaries than the active members. To be self-sustaining pension plans generally need a ratio of active members to retirees of 2.0 or greater. The Grand Jury noted that at the end of FY18, the ratio of retiree/beneficiaries to active members in Federated was 1.19, and 1.37 in Police and Fire. This is a similar ratio to the 2016 numbers published in the SIEPR report. The ORS explained that maturity was the main reason for the San José Plans to take more risk-averse investment strategies and thus accept lower returns.

The Grand Jury used the annualized returns to examine the performance of the San José Plans. The data was obtained from the pension performance reports as of June 30, 2018.[26] The average annualized returns of the trailing 1-, 3-, 5-, and 10-year periods are presented in Appendix A together with the returns of the InvestorForce[27] Public defined benefit plan peers having assets of more than $1 billion.

The data shows that over the last 10 years, the San José Plans' returns were consistently lower than 99% of its peers. Police and Fire did slightly better in 2018, at 91% lower than its peers. Over the last 10 years, the investment policy benchmarks generally ranked in the lowest quartile, reflecting the risk-averse approach of plan investment. The data also show that the San José Plans consistently underperform their investment policy benchmarks. This indicates that the active management of funds did not serve its purpose of outperforming the market.

The Grand Jury found that the concern about actively managed portfolios to be a common issue. For example, the State of Pennsylvania Public Pension Management and Asset Investment Review Commission conducted a review of its two largest public pension plans, for public school employees and state employees. In 2018, the Commission made its final report[28], recommending "moving to fully index all public market investments in both equities and fixed income at both retirement systems". It stated that the Commission heard compelling evidence demonstrating that active management of public securities underperforms, net of costs, in all sectors over the long term when compared to the appropriate risk adjusted index benchmark, and that there is no

[26] Meketa. (2018). San José Federated City Employees' Retirement System Quarterly Review June 30, 2018. Retrieved from https://www.sjretirement.com/Uploads/Fed/2Q18%20SJFED%20Review_Revised%2006.30.2018.pdf

[27] InvestorForce is a company that does investment analytics and reporting solutions for the global investment industry. One data group is the public defined benefit plans, each of which has assets of more than $1B.

[28] (Tobash, 2018)

persistence of manager outperformance or reliable way to select outperforming managers in advance.

Because of the City's risk-averse approach, the Grand Jury also examined the investment performance using the risk-adjusted return (Sharpe Ratio) as a metric. The data are shown in Table 3 below.

Using the Sharpe Ratio, Police and Fire performance ranking improved, especially in the last five years, moving out of the last quartile of the peers. Federated performance ranking stayed in the bottom 10%. Both plans still underperform their policy benchmark. The benchmark selection appeared to have improved in the last 3 years, with benchmark performance ranking in the second and third quartiles among peers.

The effect of the lower than benchmark performance may be illustrated by looking at Federated's 2018 returns. At the 5.9% net return rate, the investment income paid for 60% of the Federated retirees' pension benefit. Had the investment return been at the policy benchmark level of 7.4%, it would have been able to pay for 75% of the retiree benefits. In addition, by following the public market index funds, the reduced investment manager fees further help the City reduce the unfunded liability, which Federated needs to be funded at 51% as of June 30, 2018.

Table 3 - Risk-Adjusted Return (Sharpe Ratio) Performance

Sharpe Ratio	Police and Fire Department Retirement Plan				Federated City Employees Retirement System			
	Trailing 1 year	Trailing 3-year	Trailing 5-year	Trailing 10-year	Trailing 1 year	Trailing 3-year	Trailing 5-year	Trailing 10-year
Total Fund % (percentile)	1.4 (63rd)	1.0 (54th)	1.1 (78th)	0.5 (96th)	1.2 (91st)	0.8 (94th)	1.0 (93rd)	0.4 (99th)
Policy Benchmark % (percentile)	1.4 (58th)	1.0 (40th)	1.2 (69th)	0.5 (75th)	1.5 (43rd)	0.9 (73rd)	1.0 (99th)	0.5 (91th)
Top 5% IFPDB Plans	2.3	1.5	1.7	0.8	2.3	1.5	1.7	0.8
25% IFPDB Plans	1.7	1.1	1.4	0.7	1.7	1.1	1.4	0.7
Median IFPDB Plans	1.5	1.0	1.2	0.6	1.5	1.0	1.2	0.6
75% IFPDB Plans	1.3	0.9	1.1	0.5	1.3	0.9	1.1	0.5
95% IFPDB Plans	1.1	0.8	1.0	0.5	1.1	0.8	1.0	0.5

The demographic maturity of the San José pension plans prompted the investment staff to take a more risk-averse approach to portfolio allocation and expected lower returns as a result. However, the lower investment return also requires the City and employees to contribute more to maintain unfunded liability. The Grand Jury appreciates the difficult situation the City is facing and wants to find ways to support the City. The following are observations from the Grand Jury's investigation that will hopefully trigger innovative ideas:

- CalPERS removed hedge funds from its portfolio in 2015 for its high fees and not having a significant material impact.[29]

- Over the last 10 years, Federated investment returns have always been lower than peer portfolios having similar or less standard deviation, as shown on pp. 48-49 of the pension performance report as of June 30, 2018 and reproduced in Table 3 of this report. Other

[29] Farmer, L. (2015). As Retirees Outnumber Employees, Pensions Seek Saviors. Retrieved from https://www.governing.com/topics/finance/gov-pension-hedge-funds-investments.html

city, county and state plans have achieved higher returns with lower risks; this should be investigated.[30]

- According to the Center for State and Local Government Excellence, most public pension plans have outperformed their blended portfolio benchmark over the long term.[31]

- Public pension plans that underperform their benchmarks more often pay higher fees across all major asset classes, particularly for such alternatives as private equity and hedge funds, as mentioned in reports from the Center for State and Local Government Excellence and the Boston College Center for Retirement Research.[32]

The Grand Jury suggests that the allocations to alternative asset classes should be reviewed to ensure that this is being done in the most optimal way.[33]

[30] (Meketa, 2018)
[31] (Aubry & Crawford, 2018)
[32] (Cypen, 2018)
[33] (Erickson, 2017b)

CONCLUSIONS

The ORS estimates that, over the period of 2020 through 2029, the City of San José will need to pay between $3 billion and $3.3 billion dollars from the General Fund to cover pension obligations. For 2020, the estimated cost amount is 31% of the City budget, monies that would otherwise be available for essential City services.

Some of the factors contributing to the underfunding of the pension plans are:

- Unrealistic projections of investment earnings (the funds have continually earned less than projected and have earned far less than comparable pension funds);
- Insufficient contributions by both the employer (the City) and the employee members of the 11 bargaining units (two for Police and Fire and nine for Federated). The insufficient contributions were largely based on unrealistically high earnings projections;
- The mandatory 3% annual COLA for Tier 1 retirees that doubles retiree pensions in 24 years as compared to the CalPERS COLA of the actual cost of living index with a 2% cap; and
- Two independent Boards of Administration (one board for Police and Fire and a second for Federated) result in duplication of management structures, redundant outside contractors and consultants fees and costs.

Among public pension plan peers, Federated has consistently been ranked at the bottom, while Police and Fire falls in the last 10th percentile. The demographic maturity of the plans appears to have been the primary reason why portfolio allocations changed to more risk-averse investment options. In recent years, even controlling for risk adjustment, Federated's return (Sharpe Ratio) still ranks in the lowest 10%, while Police and Fire ranks in the 50-75 percentile.

The Grand Jury recommends that the City, the 11 bargaining units, the two Boards of Administration and the ORS work collaboratively to address these issues.

FINDINGS AND RECOMMENDATIONS

Finding 1

Moving the City of San José mature pension plan to a more risk-averse investment portfolio has contributed, in part, to poor investment returns.

Recommendation 1

The two Boards of Administration should conduct a comprehensive review of the investment portfolios that should be made public by June 30, 2020. The review should consider investment strategies used by other state and government pension organizations, particularly assessing portfolios of other pension plans with similar risk profiles that had higher returns.

Finding 2

The City of San José pension plans are overburdened with a large number of investment managers and excessive investment management fees.

Recommendation 2

The two Boards of Administration should study ways in which to reduce the number and the cost of investment managers and make their findings public by June 2020.

Finding 3

The City of San José's mandatory required contributions to pension plans are putting an ever-increasing burden on the City's General Fund, which impedes the ability of the City to provide essential services to its residents.

Recommendation 3

The City of San José should work collaboratively with the 11 bargaining units to find ways to reduce this burden and make the findings public no later than June 2020.

Finding 4

Maintaining two separate pension Boards has resulted in inefficiencies including duplication of various tasks and responsibilities.

Recommendation 4a

The City of San José should examine the current Board models, consider opportunities for streamlining, and identify areas of administrative cost reduction. This investigation should include evaluating one board for both plans but structured to prevent the proportional dilution of members' representation. This recommendation does not include the combining or commingling of plans funds. The results of these actions should be made public by June 30, 2020.

Recommendation 4b

The Boards of Administration should implement employee reviews based on measurable goals and performance metrics for the CEO and CIO. The goals and performance metrics should be completed and made public by December 31, 2019.

Finding 5

The expertise of the public members of the Boards of Administration is heavily weighted toward investment professionals. Other more successful pension funds, such as LACERS, have boards that have a much wider range of expertise.

Recommendation 5

The City of San José should broaden the backgrounds of the public Board members beyond the present focus on investment strategy beginning with the next Board member appointment.

Finding 6

The 3% COLA for Tier 1 retirees has a major impact on the unfunded liability, increasing the burden on the City's General Fund and further impeding the ability of the City of San José to provide essential services to its residents.

Recommendation 6

The City of San José should examine ways in which the 3% COLA liability can be reduced fairly as many other public entities have done by considering options such as reducing COLAs in exchange for lump sum buyouts, etc. This examination should be completed and made public by June 2020.

REQUIRED RESPONSES

Pursuant to Penal Code sections 933 and 933.05, the Grand Gury requests responses as follows:

From the following governing bodies:

Responding Agency	Finding	Recommendation
The City of San José	3, 4, 5 and 6	3, 4a, 5 and 6
Police and Fire Board of Administration	1, 2, 3 and 4	1, 2, 3 and 4b
Federated Board of Administration	1, 2, 3 and 4	1, 2, 3 and 4b

APPENDIX A – Aggregate Annual Return Performance

This appendix presents trailing years performance returns and benchmarks.

Table A1 -- San José Plans Performance as of June 30, 2018

Annual Return (%)	Police and Fire Department Retirement Plan				Federated City Employees Retirement System			
	Trailing 1-year	Trailing 3-year	Trailing 5-year	Trailing 10-year	Trailing 1-year	Trailing 3-year	Trailing 5-year	Trailing 10-year
Total Fund Return % (percentile)	6.9 (91st)	5.2 (99th)	5.6 (99th)	4.6 (98th)	5.9 (99th)	4.2 (99th)	5.0 (99th)	4.1 (99th)
Policy Benchmark % (percentile)	7.6 (68th)	6.0 (86th)	6.2 (95th)	4.9 (96th)	7.4 (74th)	5.6 (99th)	5.9 (98th)	5.0 (95th)
Top 5% IFPDB Plans	10.5	8.1	9.3	7.5	10.5	8.1	9.3	7.5
25% IFPDB Plans	8.8	7.2	8.3	6.7	8.8	7.2	8.3	6.7
Median IFPDB Plans	8.0	6.7	7.5	6.1	8.0	6.7	7.5	6.1
75% IFPDB Plans	7.3	6.2	7.0	5.6	7.3	6.2	7.0	5.6
95% IFPDB Plans	6.5	5.8	6.2	4.9	6.5	5.8	6.2	4.9

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Note: All links verified June 10, 2019

This report was **ADOPTED** by the 2018-2019 Santa Clara County Civil Grand Jury on this 19th day of June 2019.

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Foreperson