- Board of Directors
  Finance and Insurance Committee

8/20/2013 Board Meeting

8-2

Subject

Approve the selection of a third-party Other Post Employment Benefits (OPEB) trust provider; and authorize execution of an agreement(s) with the board-approved provider

Executive Summary

Staff is requesting board approval to contract with a third-party Other Post Employment Benefits (OPEB) trust provider to administer and invest monies contributed by Metropolitan to pre-fund OPEB for employees and retirees. The Office of the Chief Financial Officer will provide oversight and periodic reporting on the status of Metropolitan's OPEB trust.

Details

Background

Metropolitan has paid for its OPEB costs, representing medical premium costs for retirees of Metropolitan, on a pay-as-you-go basis, which is a common practice among public agencies. However, pay-as-you-go funding defers the payment of these costs until the employee retires instead of funding the cost of OPEB as the benefit is earned while the employee is working for Metropolitan.

Statement No. 45 of the Governmental Accounting Standards Board (GASB 45) requires that agencies account for and recognize OPEB costs over the active service of employees. This requires the payment of the present value of future benefits being earned by current employees, plus the amortization of the unfunded liability that represents benefits earned by current and retired employees not yet funded (the Annual Required Contribution, "ARC"). The ARC is calculated by Metropolitan's outside actuary, Bartel Associates, LLC.

Metropolitan's unfunded liability for OPEB is approximately $545 million based upon the most recent actuarial valuation. The current biennial budget provides for pre-funding OPEB payments of $5 million in FY 2012/13 and $10 million in FY 2013/14, and projects increasing the pre-funding payment annually by $5 million in future biennial budgets until the annual payments are equal to the ARC. In addition, at the June 11, 2013 Board meeting, the Board approved transfer of approximately $25 million of reserves into the Trust. Authorized pre-funding payments total approximately $40 million.

Establishing an Irrevocable Section 115 Trust

An irrevocable Section 115 Trust is a government- sponsored and -controlled trust that provides a tax-exempt base for funding retiree health benefits. Advantages of the trust include more predictable costs, tax exemption for interest earnings, and a higher discount rate in the calculation of the actuarially determined OPEB liability. The use of a higher discount rate is appropriate as pre-funding contributions may be invested in higher yielding securities, such as equities, than would otherwise be available if maintained and invested internally. The sole purpose of the trust will be to fund retiree health benefits.

Metropolitan has evaluated the options of establishing an irrevocable Section 115 Trust by hiring an administrator and investment manager(s), or utilizing an already established external Section 115 Trust, such as the California Employer's Retiree Benefit Trust (CERBT) managed by CalPERS. Staff has concluded that the time and costs associated with Metropolitan establishing its own independent Section 115 Trust would be more costly than utilizing an existing Trust.

Evaluation Process

Metropolitan developed evaluation criteria, and gathered and analyzed data on the following third-party OPEB trust providers:

California Employer's Retiree Benefit Trust. CERBT was established on January 1, 2008, and is managed by CalPERS. Its service offices are in Sacramento, and CERBT currently manages about $2.5 billion of assets. CERBT is a nonprofit, multiemployer trust (similar to the PERS pension fund.) Approximately 345 municipal agencies, including six of Metropolitan's member agencies and the Association of California Water Agencies, participate in the CERBT.

Public Agency Retirement Services (PARS). PARS has been managing OPEB trust funds since 1996. Its service offices are in Los Angeles, and PARS currently manages about $500 million in OPEB trust assets. PARS is a for-profit, private entity that manages both multiemployer and single employer trusts. PARS utilizes the services of U.S. Bank and Highmark Funds.

PFM Asset Management (PFMAM). PFMAM is the asset management company within the PFM Group. PFM has been managing OPEB trust funds since 2007 and currently has $1.8 billion of assets under management. Its service offices are in Los Angeles and San Francisco, while its investment management staff are in Harrisburg, Pennsylvania. PFMAM is a for-profit entity that provides single employer trusts.

Evaluation Criteria and Results

The three OPEB Trust providers were evaluated based on the following criteria:

Fees. Fees include both management fees and the cost of investment vehicles (e.g., mutual funds).

Structure. Structure involves the different parties to the agreement, such as the trustee and investment manager, as well as the legal structure of the trust (e.g., multiemployer or single employer).

Investment options. Investment options considered the spectrum of investment options available to Metropolitan (e.g., customized vs. model portfolios).

Returns/Performance. Returns measure the investment performance of the different providers over different periods of time.

Start-up cost and effort. Reflecting the level of staff, legal, and other efforts to establish the trust.

Ongoing administration. A measure of the estimated level of cost and effort to maintain the trust, ensure that the program is properly functioning, and monitor performance. The reporting and consulting support provided by the trust was included in this criterion.

Portability. Portability measures the ease in which Metropolitan would be able to move any monies deposited into the trust to another OPEB Trust provider.

Fiduciary risk. Fiduciary risk is a measure of the protection the trust provides to Metropolitan. Each of the providers takes on a different level of fiduciary responsibility for managing the trust.

Based on this review, all three firms are qualified to assist Metropolitan to establish a Section 115 Trust and to administer and invest the OPEB funding payments. CERBT utilizes PERS to manage investment and has the lowest overall administrative costs. PARS and PFMAM, while more expensive, allow for more customization of investment options and provides diversification in investment management as PERS currently manages the investments for the retirement system.

Recommendation

It is recommended that the committee select one of the three providers to work with Metropolitan to establish a Section 115 Trust and to administer and invest the OPEB funding payments. To assist the committee in making a selection, each of the providers will attend the August 19, 2013 committee meeting to provide a brief presentation on its qualifications. In addition, attached is a memorandum from Pacific Pension Advisors (**Attachment 1**), an independent pension investment consultant, that provides an independent assessment of the three firms. Pacific Pension Advisors will attend the committee meeting to provide an overview of the three providers and respond to questions.

Policy

Memoranda of Understanding with employee bargaining units

California Environmental Quality Act (CEQA)

CEQA determination for Options #1 and #2:

The proposed actions are not defined as a project under CEQA because they involve continuing administrative activities, such as general policy and procedure making (Section 15378(b)(2) of the State CEQA Guidelines). In addition, the proposed actions are not subject to CEQA because they involve other government fiscal activities which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment (Section 15378(b)(4) of the State CEQA Guidelines).

The CEQA determination is: Determine that the proposed actions are not subject to CEQA pursuant to Sections 15378(b)(2) and 15378(b)(4) of the State CEQA Guidelines.

Board Options

Option #1

Adopt the CEQA determination that the project is not subject to CEQA and authorize the General Manager, with approval of the General Counsel, to execute a contract with one of the recommended providers to administer and invest Metropolitan's pre-funding of OPEB benefits.
Fiscal Impact: Helps to reduce liability for OPEB by approximately $40 million for the current biennial budget. The liability will be reduced further in future years if the Board approves continued funding of these payments and increases the amounts over time up to the ARC.

Option #2

Adopt the CEQA determination that the project is not subject to CEQA and not select a provider to administer and invest Metropolitan's prefunding of OPEB benefits.
Fiscal Impact: No reduction in the liability of OPEB and the liability will continue to grow in the future.

Staff Recommendation

Option #1

Gary Breaux *Chief Financial Officer*	8/6/2013 *Date*
Jeffrey Kightlinger *General Manager*	8/6/2013 *Date*

Attachment 1 – Memorandum from Pacific Pension Advisors

Ref# cfo12623413

Pacific Pension Advisors

Memo

To: Board of Directors

The Metropolitan Water District of Southern California

Finance and Insurance Committee

From: Tom Lightvoet, President

CC: Gary Breaux, CFO

Date: 8/6/2013

Re: Third-party OPEB Trust Provider Finalists

First of all, we commend Metropolitan's Board members and staff for their decision to pre-fund this employee benefit liability. In so doing Metropolitan will alleviate future Board and staff members from having to make very difficult decisions that will arise at times when economic and market volatility are extreme.

For discussion purposes at the August 19, 2013 Finance and Insurance Committee meeting, this summary analysis of three OPEB trust provider finalists is intended to provide clarity for the Board during their selection process.

Third-Party OPEB Trust Provider Services

It is Metropolitan's intent to contract with an external Section 115 Trust provider for trust administration services and management of investments. Administration services to be provided include primarily the payment of retiree health care premiums to CALPERS and management of the investments held in the Trust.

Fees

This analysis is not as quantitative as one might expect. Fees may include both administrative and investment management fees but will not include the cost of trading securities. California Employer's Retiree Benefit Trust (CERBT) charges only an administrative fee. Public Agency Retirement Services (PARS) and PFM Asset Management (PFMAM) charge both administrative and mutual fund investment management fees. The total fee charged by each firm is as follows:

CERBT	.15%
PARS	.98%
PFMAM	.61%

As a non-profit organization, CERBT clearly has the lowest fees. PARS and PFMAM are both for-profit entities which accounts for their higher fees.

Structure

CERBT is set up as a multi-employer trust which provides investments under the CalPERS umbrella. OPEB assets under management in this trust are approximately $2.7 billion representing 345 municipal agencies. Their service office is in Sacramento.

PARS clients include both multi-employer and single employer trusts. Total assets under management for OPEB clients are $500 million. PARS uses US Bank for trust and custody services and HighMark mutual funds to invest the assets. Their fees tend to be higher because they have an additional layer of fees. They invest through HighMark mutual funds which in turn are made up of mutual funds. Therefore, you pay fees to the underlying mutual funds as well as paying fees to HighMark. Their service offices are in Los Angeles.

PFMAM is also a for-profit organization with $1.3 billion in OPEB discretionary assets under management and $500 million in non-discretionary assets for a total of $1.8 billion in OPEB assets. PFMAM's investment structure focuses on the selection of a variety of mutual funds. The strategy is quite similar to HighMark but eliminates the additional layer of fees. Their service offices are in Los Angeles and San Francisco.

Investment Options

California Employer's Retiree Benefit Trust (CERBT) has 3 investment strategies with allocations between stocks and bonds. Public Agency Retirement Services (PARS) and PFM Asset Management (PFMAM) have the most flexible investment programs stating that they have customized options available. PARS and PFMAM have similar investment strategies that invest in mutual funds rather than individual securities. PARS retains the services of HighMark mutual funds which in turn invest in mutual funds rather than separate securities. PFMAM has a more direct approach by researching and hiring mutual funds directly which reduces their fees.

Returns/Performance

Investment returns are normally calculated on a "time weighted total return" basis but there is a difference among the three firms. Assets invested with CERBT are unique. Their investments with CalPERS are in a "Separate account". Separate account returns are calculated on a "gross" basis. Mutual funds are reported on a "net" basis.

This creates a minor complication because in order to compare apples with apples, the CERBT returns would need to be reduced by the portion of their .15% fee that is investment related; which amounts to only .05%. Then the net CERBT performance would compare more accurately to the performance of PARS and PFMAM which use mutual funds. However, CERBT investment fees are only .05%, so the comparison is going to be very close even after the fee is subtracted from their performance numbers.

An even greater hurdle in comparing the returns of the three firms is the variation of investment strategies. Studies indicate that up to 90% of the performance of an investment strategy can be attributed to the asset allocation decisions being implemented. The asset allocations of the three firms may vary widely from one quarter to the next which makes it difficult to compare them.

Even if we ignore the differences in the asset allocation strategies, the investment strategies of the three firms are not synchronized, so comparing them is problematic. For example, ideally we would want to compare a fund's performance against a peer universe of funds that utilize similar strategies.

Analyzing the performance of three funds that all use a "growth" strategy to invest in US large-capitalization stocks would make it easy to compare them with one another. If one of the firms includes small-capitalization stocks in their portfolio, the performance of that firm may be higher over a full market cycle but it will also exhibit higher volatility. If another firm used a "value" strategy in their stock selection process, that firm may exhibit a lower volatility.

The bottom line is that comparing returns of these three firms indicates that less emphasis should be placed on performance analysis when considering which firm would best fit the needs of Metropolitan. It would be great to have a clear indication of one firm's investment strategy relative to the other two, but in this case it is unlikely to provide any direction on their future performance. In fact, it is well documented that "past performance is not a good indicator of future performance".

Administrative Responsiveness

This is the most subjective category to analyze.

CERBT was formed in 2008 and has unfortunately been cast in a negative light with CalPERS. The CERBT administration is a dedicated team, separate from the CalPERS administration, with much more flexibility. Interviewing several of Metropolitan's member agencies has not produced a single dissatisfied comment and in fact, received positive feedback. CERBT has also been the most responsive in the search process.

PARS has also been described as being responsive. However, having been in business managing OPEB trust assets since 1996, it begs the question as to why they have only $500 million under management. They do manage considerably more assets when including other types of plans but we are looking for OPEB specialization.

PFMAM has been in business for 33 years and has managed OPEB assets since 2007. OPEB assets under management stand at $1.5 billion in discretionary accounts and $500 million in non-discretionary accounts. PFM is well known for its client responsiveness and has also been very responsive to Metropolitan staff members.

Trust Flexibility

Staff has been in contact with each of the firms inquiring about their flexibility in making revisions to the trust. Staff did not have any questions or need for clarification from CERBT regarding the trust document. There were questions regarding the PARS trust, to which they responded with, “we do have leeway in the Adoption Agreement to modify or clarify certain provisions of the trust program without jeopardizing reliance on the Private Letter Ruling “. PFMAM responded quickly that, “as a general matter, the terms of the trust document have to be agreeable to all parties, not the least of which is Metropolitan”, implying that they are flexible.

Portability to another Provider

CERBT is the least liquid of the three firms. They require a three year lock in period and then a 90 day notice before Metropolitan could begin the transition to another firm. PARS has no lock in period but does require a 90 day notice. PFMAM has no lock in period and requires only a 30 day notice. However, given that it is unlikely that Metropolitan will want to undergo a transition in less than three years; this is not a significant consideration.

Conclusions

It would be expected that each of the categories analyzed will carry different weight depending on the perspective of each Board member. From an equal weighting approach, I would rank PFMAM and CERBT evenly and PARS next.

1. PFMAM:
    a. Very responsive
    b. Liquidity/portability is not an issue
    c. Their investment strategy is sound

d. Offices are located in Los Angeles and San Francisco
e. They are willing to make revisions to their standard trust document
f. PFMAM would provide investment management that is different than CalPERS that manages Metropolitan's pension investments. PFMAM invests in mutual funds which each invest in a portfolio of securities. CalPERS invests in individual securities. The amount of PFMAM investments in domestic small cap equities is diminimus when compared to CalPERS.

   For example, CalPERS' investment in small cap equities is so large that it tends to create an index like stream of performance which is impossible to add value to the index. PFMAM has an opportunity to outperform the CalPERS' investments by selecting a small cap equity mutual fund that has fewer assets under management so they can put their best ideas into a portfolio without driving up the price of the stocks.

2. CERBT:
   a. Very responsive
      i. Liquidity/portability is longer, however, it is highly unlikely that Metropolitan would want to undergo a transition in less than three years
   b. Investment through CalPERS is the least expensive of the three firms

      i. Although CalPERS Trustees sometimes micro manage investment decisions based on political views, the investment strategy is sound.
   c. Offices are in Sacramento

3. PARS:
   a. Response time is good
   b. Offices are in Los Angeles
   c. The liquidity/portability is not an issue (Note: keep order the same as PFMAM)
   d. A sound investment strategy but the most expensive of the three firms
   e. PARS would provide investment management that is different than CALPERS that manages Metropolitan's pension investments. However, PARS costs are higher than PFMAM.

      While PARS invests in mutual funds that have an opportunity to invest strategically in the equity market, they do so through the use of HighMark as a middle man. Since PARS pays HighMark an investment management fee to select mutual funds, who then charge an investment management fee, PARS' performance is reduced by the two levels of investment management fees. PFMAM pays a single investment management fee to select mutual funds.

Next Steps

Upon selection of a third-party OPEB trust provider, the following steps should be taken:

1. An Investment Policy Statement should be drafted which would include:
    a. Purpose
    b. Scope
    c. Responsibilities
    d. Policy – General Provisions, Allocation of Responsibilities, etc.
    e. Investment Objectives
        i. Investment Standards
        ii. Trading and Execution
        iii. Voting of Proxies
        iv. Evaluation of Investment Performance
        v. Watch List Guidelines
        vi. Placement Agents
    f. Definitions
    g. Appendices – Asset Allocation and Rebalancing Guidelines, Performance Goals and Objectives
2. Asset Liability Study
    a. Performed by the Actuary & Investment Consultant
    b. Optimizes expected returns versus acceptable level of risk
3. Performance Reporting
    a. should be reviewed at least semi-annually (preferably quarterly)
    b. Time weighted total returns
        i. Individual assets versus an appropriate Index and universe benchmark
        ii. Total Plan assets versus an appropriate Index and universe benchmark

Respectfully Submitted,

Tom Lightvoet

Thomas Lightvoet,
Pacific Pension Advisors