AC Transit
Employees' Retirement System

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AC Transit Retirement System

To: AC Transit Board of Directors September 2021

From: Jeffrey Lewis - Chair, AC Transit Retirement Board

Jeffrey Lewis

Re: 2021 Semi-Annual Report (#2)

When I wrote the following paragraph last year, I was hoping that it would not be relevant a year later, unfortunately it is:

> Like the rest of the world and at the rest of the District, the Retirement Board and staff have spent a lot of time and effort reacting to the pandemic. Our thoughts are with the many District employees, and their families, who are working on the frontlines during these times.

This report will focus on:

- The recently completed Actuarial Valuation.
- Investment performance for year to date 2021.
- The response of the Retirement System to the pandemic.
- PEPRA Implementation

Recently Approved Actuarial Valuation

At its August 18th meeting, the Retirement Board approved the 2021 Actuarial Valuation, completing a process that began in March. As in prior years, the General Manager, CFO, and Finance staff were involved in providing feedback to the Retirement Board. The Retirement Board approved a projected District contribution of $63.3 million for the District's 2021/22 fiscal year, an increase of $2.5 million from last year.

This contribution is based on the assumption that the District's pensionable payroll will be $190 million during the current fiscal year. The District's contribution can be broken down into two components: 1) the normal cost (plus expenses); and 2) the amortization of the unfunded liability. The normal cost is the cost allocated to fund the benefits earned for the current year of service for the current workforce; the amortization of the unfunded liability is the payment required to close the gap between the current funding level and the funding target over a specific period of years. For the current fiscal year, the normal cost, plus expenses, is projected at $28.2 million (14.19% of pensionable payroll for classic members and 6.48% for PEPRA as the employee pays 6.25%), while the amortization of the unfunded liability will be $35.0 million. Roughly 55% of the District's contribution is a result of amortizing the unfunded liability. The projected District contribution in the current valuation was $63.3 million, while in last year's valuation it was $60.7 million.

The Retirement Board reviews the actuarial assumptions on an annual basis. This year, based on consultations with our actuary, our investment consultant and the District, the Retirement Board decided to reduce the assumed rate of return on Plan assets from 7.0% to 6.75%. Most other California pension plans have either reduced their assumed rate of return in recent years or will soon be doing so. Moving to 6.75% was a result of the changing investment environment, particularly the low interest rates available for fixed income investments. Decreasing the assumed rate of return, all other things being equal, results in the District contribution increasing and the funded ratio decreasing.

The Retirement Board decided to phase-in the cost impact of the decrease in the assumed rate of return on the unfunded liability payment over a three-year period. This was done in consultation with the District. The reduction in the assumed rate of return phased in over three-years increased the projected contribution by the District by roughly $1.66 million for the current fiscal year.

At its August meeting, the Retirement Board, along with the General Manager, reviewed the projected District contribution and the projected funded ratio of the Plan for the next 20 years. These are discussed below. As always, we welcome the opportunity to answer any questions from District Board members pertaining to the Actuarial Valuation.

This year is the fourth year in which the actuary computed the District's contribution on the PEPRA plan for unrepresented employees hired after 12/31/15. The estimated savings for the District's current fiscal year, as a result of the implementation of PEPRA, is roughly $28,000.

Funded Ratio

The funded ratio of the Plan increased on the Actuarial Value of Assets, from 70.9% to 72.7%, while it increased substantially on the Market Value of Assets from 73.1% to 77.2%. The dramatic increase in the funded ratio on a Market Value of Assets basis was a result of the strong investment performance in 2020 (see below). The more moderate increase in the funded ratio on the Actuarial Value of Assets was a result of the smoothing methodology employed by the Plan, which limited the impact of the current year's investment gains. As you recall, smoothing spreads over five years each year's gains or losses, compared to our assumptions, and minimizes changes to the District's contributions for the following year. The significant contributions being made by the District also increased the funded ratio on both a Market and Actuarial Value of Assets basis.

Projections

The 2021 Actuarial Valuation includes projections for the District's expected contributions and the funded ratio of the Plan over the next 20 years. These projections assume that all the assumptions made by our actuary are met. We all know that not all assumptions will be met; however, the projections on pages 9 and 10 of the Actuarial Valuation are the best forecast of where the District contribution and the Funded Ratio of the Plan are headed. (These pages are attached to this report.)

The Retirement Board is happy to provide the District with projected results under any scenario requested. If you would like to discuss these projections, please contact Hugo Wildmann.

Investment Results

To say that investment performance in 2020 was volatile would be an understatement. In 2020, equity markets started the year off with gains and then, with the onset of the COVID-19 pandemic, markets plunged dramatically, only to recover very quickly with U.S. equity markets returning over 20% for the year. These strong gains have continued in 2021 with U.S. equity markets up over 19% as of the writing of this report. The Plan ended 2020 with $837.8 in assets compared to $746.9 million at the end of 2019. As of the writing of this report, Plan assets are slightly over $900 million.

When writing about investment results in these reports, I have consistently mentioned that the focus of the Retirement Board is on the long-term. We all know that in the short-term markets will go up and down, but over the long-term, we expect equity markets, in which over half of the Plan's assets are invested, to go up. At the same time, however, our investments are diversified among various types of equity, fixed income, and other investments, so as to protect the Plan from drastic losses to the extent possible.

Through the end of August, the investment return for calendar year 2021 for the Plan is over 8.0%. As I have mentioned often, it is reasonable to expect that roughly one year out of every three or four years will produce a negative return for the Plan, and that close to 40% of years will produce a return below our actuarially assumed rate. The fact that the Plan will have a year (or several years in a row) of returns below the actuarially assumed rate is not a reason for alarm or a time to implement changes to the investment portfolio. It is usually a time to take a long-term view and wait out the cyclical nature of the markets.

As part of our long-term asset allocation strategy, the Board has instructed our managers to sell $40 million in equities in recent months, and we have moved these funds to our fixed income managers to keep our asset allocation near our target of 51% equities. In order to keep our equity allocation close to our 51% long-term target, the Board needs to sell equities after a period of strong performance and purchase equities when they have performed poorly.

Department Activity

Like many other departments at AC Transit, the Retirement Department has successfully transitioned to working from home with occasional trips to the office. With technology – Zoom, Facetime and email -- the department has been able to meet the requests of employees and retirees. As productive as the department has been in working from home, I look forward to them safely returning to the office in the near future.

PEPRA

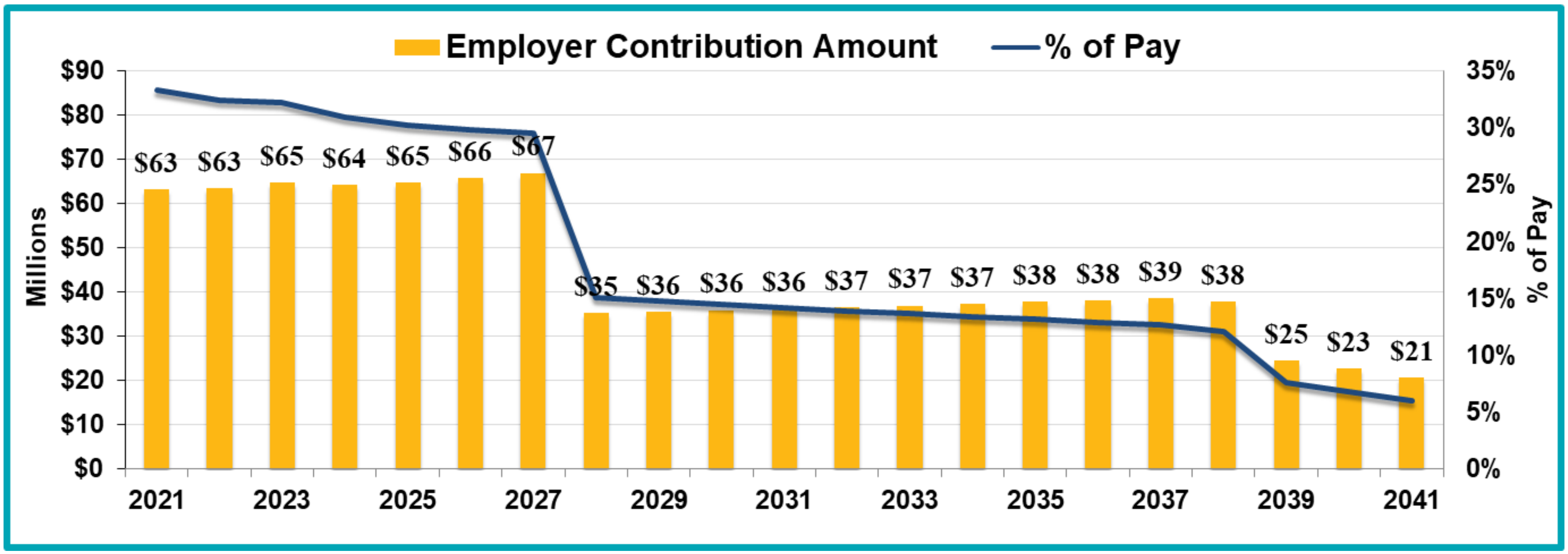
The Retirement System continues to work with the District on the implementation of PEPRA. Currently, the primary focus is on the Plan Amendment for Represented employees. As I have previously mentioned, implementing the employee contribution will take considerable staffing resources from both the District and Retirement System. Our respective staffs have been working on this project together.

Please feel free to call me, Jeffrey Lewis (510-463-3900), or Hugo Wildmann (510-891-4889), if you would like to discuss this report or request additional information.

F. Future Expected Financial Trends

The analysis of projected financial trends is perhaps the most important component of this valuation. In this section, we present our assessment of the implications of the January 1, 2021 valuation results in terms of benefit security (assets over liabilities) and contribution levels. The following graph shows the projection of contributions assuming that assets will earn the long-term 6.75% assumption each year during the projection period, which is clearly unlikely. Future total payroll increases are assumed to be 3.00% per year.

Projection of Employer Contributions, 6.75% return each year



The contribution rate graph shows that the Plan's contribution rate is expected to decline moderately through 2027, as a result of the recognition of deferred investment gains and a reduction in the employer normal cost rate, due to the PEPRA members becoming a larger portion of the active population. A significant reduction in contribution rate and amount is projected in 2028 as the bulk of the

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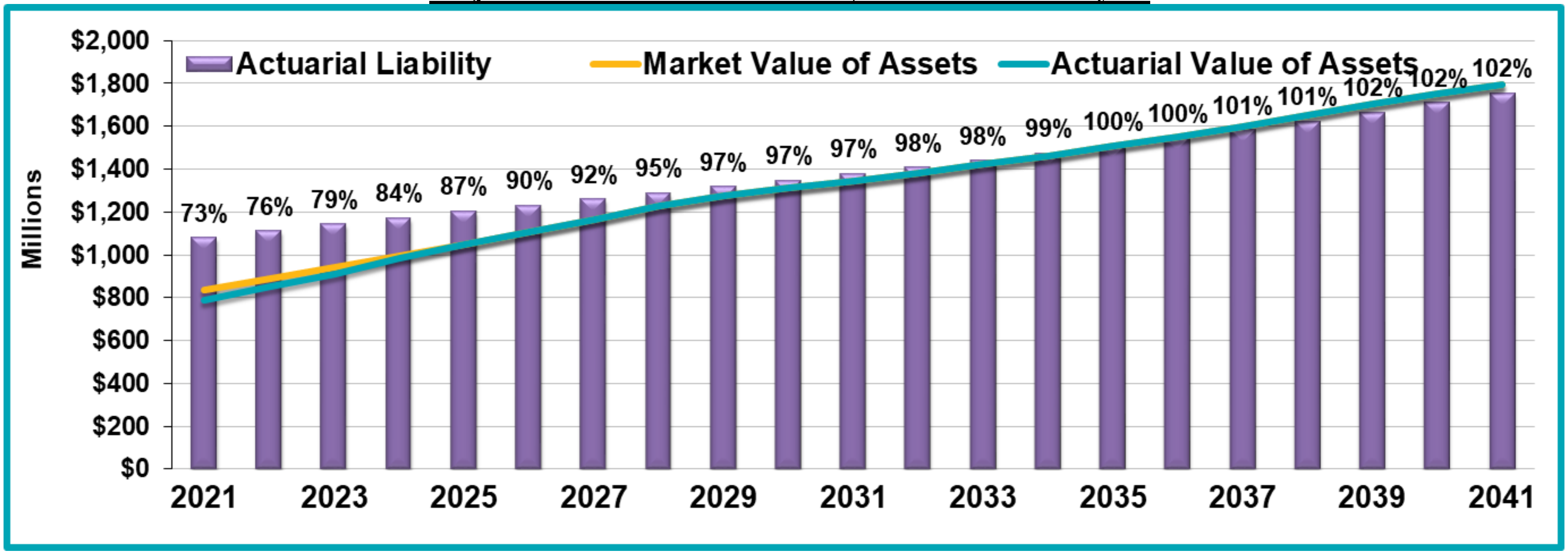
current unfunded liability is fully paid for by 2028. Note that this graph does not forecast any actuarial gains or losses or future changes to the funding policy, aside from deferred gains on the Actuarial Value of Assets in the next few years.

Asset and Liability Projections:

The following graph shows the projection of assets and liabilities assuming that assets will earn the long-term 6.75% assumption each year during the projection period. The percentage shown at the top of each bar is the ratio of the Actuarial Value of Assets to the Actuarial Liability (the funded ratio on a smoothed basis).

Projection of Assets and Liabilities, 7.00% return each year



The graph shows that the projected funded status increases over the next 20 years to reach 102%, assuming the actuarial assumptions are achieved. **However, it is the actual return on Plan assets that will determine the future funding status and contribution rate to the Plan.**