CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Prabhu Palani

CC: Board of Trustees, Federated City Employees' Retirement System
Board of Trustees, Police and Fire Department Retirement Plan
Roberto Pena, CEO, ORS

SUBJECT: **ACTIONS OF PENSION BOARDS IN LIGHT OF COVID-19 PANDEMIC**

DATE: April 07, 2020

INTRODUCTION

We are in the midst of another historic meltdown in global markets. What started as a health care issue has very quickly morphed into an economic calamity of enormous proportion. Economies at every level – global, national, state, and local – have been hit hard by an unprecedented seizure of economic activity not seen in modern times. This information memorandum highlights actions taken by our pension boards in light of recent developments.

As can be expected, the pandemic has had a profound negative effect on financial markets across the world, exacerbated by a swiftness in decline that has taken everyone by surprise. It took only 12 days to enter bear market territory (defined as a 20% decline in equity markets) which is the steepest decline ever recorded. After reaching a high of 3,393 on February 19^{th} the S&P500 reached a low of 2,191 on March 23rd, registering a fall of 35%. During that time, both developed markets and emerging markets equity indices registered similar or greater declines, as did the Russell 2000, the index of small capitalization US stocks.

EFFECT OF THE CURRENT MARKET MELTDOWN ON OUR PENSION PORTFOLIO

Our pension boards have followed a deliberate policy of designing defensive portfolios, taking into account both the maturity of our plans as well as the relatively high valuations of the past few years in growth-oriented assets. Our portfolio construction is built around the concept of resilient growth – maintaining an immunized cash flow portfolio to meet near-term pension payments, investing in low beta strategies that offer diversification and downside protection, and a growth portfolio that produces sufficient risk-adjusted returns to meet our funding needs.

However, no portfolio that follows a growth mandate can be completely insulated from a market downturn. While we do not know the exact effect of the current market meltdown on our portfolios, since some portion of the portfolios are invested in assets such as private equity and absolute return strategies that are not marked-to-market on a daily basis, a very rough estimate by our general consultant shows that our pension portfolios did considerably better than the major equity indices and also outperformed a passively managed global 60/40 portfolio. Our immunized cash flow and low beta strategies produced positive returns during the severe market correction, and we estimate that both our absolute return strategies (hedge funds) and private equity investments performed considerably better than public equity indices. However, unless there is a big market rally between now and June 30th, our portfolios' returns will be in the red, shrinking our funding ratios on a market value basis to levels not seen since the Great Recession of 2008-09.

MONETARY AND FISCAL STIMULUS

The current economic crisis has been met with monetary and fiscal stimulus unmatched in history. The US Federal Reserve cut its benchmark interest rate by 50 basis points in an emergency meeting on March 3rd and a further 100 basis points on March 15th, bringing its target federal funds rate to near zero. In addition to coordinated action with central banks of major economies, the Federal Reserve has announced unlimited bond buying support, taken several measures to support the flow of credit to households and businesses, enhance the provision of US dollar and money market liquidity, and support state and municipal money markets. On March 27th, Congress passed the CARES Act, a massive $2.2 trillion stimulus bill which provides direct relief to individuals, corporations, and state and local governments. The House of Representatives is now contemplating "CARES 2" legislation, to further extend support to an economy in recession.

ACTIONS TAKEN BY OUR BOARDS

The Federated and Police & Fire pension plan investment committees met multiple times in March and also held two special board meetings (Police & Fire on March 18th and Federated on March 27th) to consider the economic ramifications of the COVID-19 pandemic as well as its effect on our pension portfolios. During those deliberations, trustees paid close attention to the effect of the meltdown on plan portfolios, potential impact on the sponsor, the effects of monetary and fiscal stimulus, as well as opportunities to position the portfolio for long-term success. Following these deliberations, both pension boards, with input from the boards' investment consultants as well as the investment team, decided to increase the level of growth assets in the portfolio, balancing increased return expectations going forward with the risk tolerance of the City, and instructed the investment team to implement the revised strategic asset allocation as efficiently and expeditiously as possible. The increased exposure to growth assets may cause greater short-term volatility but we expect to reap the benefits of taking more risk in the longer term while we continue to have liquidity to meet near-term obligations.

The tables below show the prior and current strategic asset allocation weights as approved by the boards for both pension plans.

Federated City Employees Retirement Plan – Asset Allocation Change

	Fed Prior (%)	Fed Current (%)
Growth	**61**	**75**
US Equity	13	25
Dev. Market Equity (non-US)	10	12
Emerging Market Equity	12	12
Global Equity	NA	NA
Buyouts	8	8
Venture Capital	5	4
Private Debt	4	3
Private Real Estate	3	3
Private Real Assets	3	3
Emerging Market Bonds	3	3
High Yield Bonds	0	2
Low Beta	**27**	**8**
Absolute Return	7	3
Short-Term Investment Grade Bonds	15	0
Cash Equivalents (Immunized CFs)	5	5
Other	**12**	**17**
Core Real Estate	5	5
Commodities	2	0
TIPS	2	2
Investment Grade Bonds	3	8
Long-term Govt Bonds	0	2

Police & Fire Department Retirement Plan – Asset Allocation Change

	P&F Prior (%)	P&F Current (%)
Growth	**64**	**70**
US Equity	14	23
Dev. Market Equity (non-US)	12	11
Emerging Market Equity	13	12
Buyouts	8	6
Venture Capital	4	4
Private Debt	4	3
Private Real Estate	3	3
Private Real Assets	3	3
Emerging Market Bonds	3	3
High Yield Bonds	0	2
Low Beta	**24**	**8**
Absolute Return	5	3
Short-Term Investment Grade Bonds	14	0
Cash Equivalents (Immunized CFs)	5	5
Other	**12**	**22**
Core Real Estate	5	5
Commodities	2	0
TIPS	2	2
Investment Grade Bonds	3	12
Long-term Govt Bonds	0	3

Please do not hesitate to reach out to us for further information.

Digitally signed by Prabhu Palani
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