CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: Honorable Mayor and City Council Members

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

DATE: September 1, 2020

SUBJECT: RESULTS OF ACTIONS OF PENSION BOARDS IN LIGHT OF COVID -19 PANDEMIC - RELATED MARKET VOLATILITY

SUMMARY

The Federated and Police & Fire pension plans returned a healthy 3.6% and 3.1% respectively for FY 2019-20, owing to a dramatic comeback by financial markets in Q2 2020 and swift actions by both pension boards.

INTRODUCTION

This information memorandum highlights the results of actions taken by our pension boards in light of Covid-related market volatility.

The pandemic had a profound negative effect on financial markets across the world in Q1 2020, exacerbated by a swiftness in decline that took everyone by surprise. It took only 12 days to enter bear market territory (defined as a 20% decline in equity markets) which was the steepest decline ever recorded. After reaching a high of 3,393 on February 19th 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.

Since then, the economic crisis has been met with unmatched monetary and fiscal stimulus. In addition to the immediate interest rate cuts enacted by the Fed, central banks around the world have undertaken extraordinary actions to support the flow of credit, keep institutions afloat, and in conjunction with fiscal stimulus, have greatly supported individuals, corporations, and state and local governments. Such was the confidence boost to market participants that financial markets rebounded in dramatic fashion in Q2

2020, all but erasing the declines of the first quarter. Since July 1st, 2020, US and global financial markets have continued to register strong gains.

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.

EFFECT OF RECENT ACTIONS ON OUR PENSION PORTFOLIOS

Our pension boards had 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. This defensive stance greatly helped minimize losses during Q1 2020. While the Federated and Police & Fire pension plans lost 10.7% and 10.5% for the quarter respectively, our performance ranked in the 23rd and 20th percentile of our peers. In comparison, the MSCI ACWI (All Country World Index), an index of global stocks, had lost 22.4% for the quarter.

While our boards decided to increase growth assets at the end of Q1 2020 taking into account the increased return expectations of growth assets over the long term, the coincident market rally following unprecedented monetary and fiscal stimulus once again immensely benefitted the performance of our plans. The Federated and Police & Fire pension plans returned 11.1% and 9.6% respectively for Q2 2020, boosting FY 2019-20 returns to 3.6% (14th percentile) and 3.1% (17th percentile) respectively. For CYTD through June 30th, 2020, the plans finished in the 1st and 12th percentiles of their public pension plan peers. In July 2020, the two plans continued their strong run, returning +3.96% and +3.91% respectively.

While we have been somewhat fortuitous in how quickly our recent actions have helped boost plan returns, and while it is gratifying to note our peer-relative performance, your boards are fully aware of, and focused on, the unique circumstances surrounding our pension plans. Both boards are aware of the potential for increased volatility in coming months as a result of both the devastating effect of the pandemic on the economy as well as the uncertainty that accompanies a presidential election year. The increased allocation to growth assets has the potential to exacerbate that volatility. Your boards, investment team, and consultants constantly monitor market risks associated with the plans against the backdrop of greater return potential over the long-term, keeping in mind both the requirement of meeting our actuarial return assumptions while balancing the risks to our sponsor.

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

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