# The State of the Pension Fund

OFFICE OF THE CITY CONTROLLER

The Board of Pensions and Retirement is charged with the creation and maintenance of the City of Philadelphia's Retirement System that provides benefits for all City employees. As of July 1, 2017, the Pension Fund is 45.3% funded, with an unfunded liability of $6.2 billion. Pension-related costs currently take up 15% of the City's General Fund budget. With limited budgetary resources and competing priorities, as well as growing pension costs, the need to stabilize and improve the fiscal health of the Pension Fund to ensure benefits are available for current and future pensioners is great.

## RECENT CHANGES HAVE IMPROVED THE HEALTH OF THE PENSION FUND

Over the last few years, the Pension Board and the City have taken several important steps to improve the Pension Fund's funded status and better meet its obligations:

- adopted the Revenue Recognition Policy, which uses sales tax revenue and increased employee contributions to pay down the unfunded liability;
- implemented a stacked hybrid pension plan and obtained higher contributions from union members;
- moved toward more passive management, from 36.7% of all assets in 2015 to 53.6% in 2018;
- negotiated lower management fees, decreasing fees from 0.62% in 2015 to 0.35% in 2018;
- incrementally lowered the assumed rate of return to the current 7.6%.

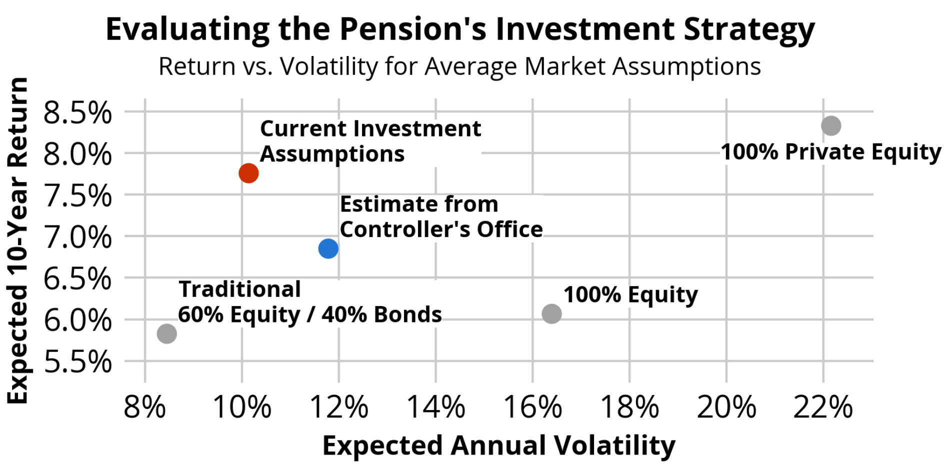
As a result, the Pension Fund's net cash flow is projected to be positive in 2018 for the first time in decades, meaning that total contributions to the Pension Fund will exceed its benefit payments and expenses. This net positive cash flow is projected to continue over the next few years, and reflects the Pension's decreased dependence on investment returns to fill the gap between contributions and disbursements.

## FINDINGS AND RECOMMENDATIONS

As part of her due diligence as a trustee of the Pension Board, Controller Rebecca Rhynhart, with support from her staff, analyzed the Pension Fund's stability and its capacity to meet future obligations, evaluating the current investment strategy and the reasonableness of the assumed rate of return.

### THE PENSION'S INVESTMENT STRATEGY

The Board assumes its current investment strategy, enacted in 2016, will yield an annual return of 7.76%. To determine how reasonable the 7.76% return assumption is, the Controller's Office simulated portfolio returns thousands of times using the Horizon Survey, an annual average of industry professionals' capital market assumptions. We found the current return assumption too optimistic and a return of 6.8% to be more reasonable.




Note: Analysis relies on average capital market assumptions from the 2018 Horizon Survey (10-year)

The chart to the left shows the Controller's return estimate as compared to the current return assumption and other investment strategies.

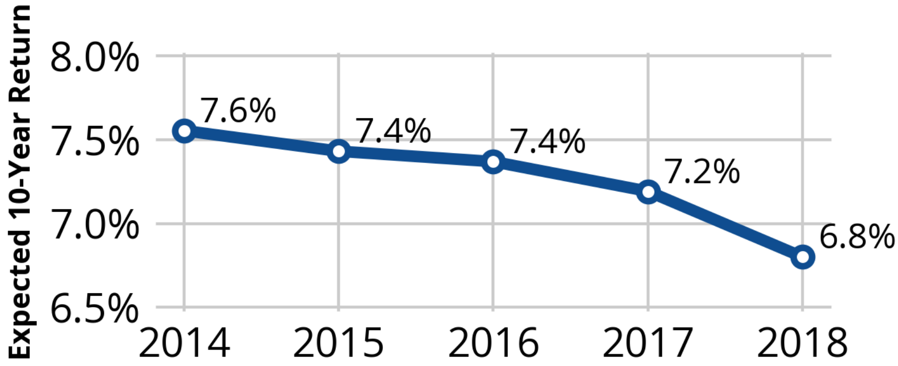
## ASSUMED RATE OF RETURN

Despite recent reductions to the assumed rate of return, our analysis shows that the assumed rate of return (7.6%) remains too high. Pensions are not expected to perform as well as they have in the past and in response, public pensions have implemented declines in their assumed rates of returns. As a result, we recommend the Pension Board set a goal to reduce the assumed rate of return to reflect current market assumptions and re-evaluate the return assumption annually.

The figure to the right shows the Pension Fund's expected market returns using Horizon Survey assumptions for previous years. Expected returns have declined and so should our return assumptions.

**The Impact of Changes in Market Assumptions on Returns**

Expected returns have diminished over the past five years




Note: Analysis uses average market assumptions from each year's Horizon survey and the Pension's target allocation strategy

## PRIVATE EQUITY

Private equity makes up a substantial portion of the Pension Fund's overall assets. It's considered an asset that offers high rewards, but at considerable risk, and it's notorious for a lack of transparency. It requires constant monitoring. The Board has already taken steps to reduce fees, and they should continue to monitor them in the future. But, the Board should also formalize in the Investment Policy Statement clawback procedures and a public market equivalent as the primary performance benchmark.

## ANNUAL STRESS TESTS

Because future investment returns are unpredictable, annual stress testing is a best practice for assessing a pension plan's ability to meet future obligations. We recommend that the Pension Board conduct annual stress testing in compliance with best practices, including testing better and worse than expected returns, market shock scenarios and a liquidity analysis. The liquidity analysis is particularly important given the Pension Fund's increased allocation to private equity and real estate. These tests show how the Pension responds to worst-case scenarios, as well as provide insight into the plan's potential vulnerabilities.

## TRANSPARENCY

While most of the recommendations aim to preserve and improve the Pension, we also wanted to encourage the Pension Board to consider how it presents information to taxpayers and pensioners. The Government Finance Officers of America recommends the publishing of a comprehensive annual financial report (CAFR) for pension plans. Other cities, like Chicago, Houston and Baltimore, publish a pension CAFR. The Controller's Office recommends that the Pension Board release a CAFR to help the public understand how the pension is investing public money.