Report to the Special Joint Meeting of the Committee on Budget and Finance and City Council Committee of the Whole

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Introduction

Since becoming SDCERS’ Administrator/CEO in May 2006, I have been committed to improving communications with all three of our plan sponsors. Consistent with this commitment, and given the seriousness of the current situation facing the City resulting from today’s unprecedented turmoil in the world’s financial markets, I wanted to provide you with: (1) the historical context of current investment markets, (2) SDCERS’ fiscal year 2009 year-to-date investment performance, and (3) the impact of SDCERS’ investment returns on the City’s Annual Required Contribution (ARC).

Historical Context

SDCERS has been in the investment business since 1927 and has never missed a benefit payment. Even with the recent market downturn, as of October 31, 2008, SDCERS has approximately $3.7 billion dollars of assets, more than enough to pay retiree benefits when they come due.

SDCERS invests its money for the very long term. For an employee hired today, we invest for their 30-year career, a 30-year retirement and a spousal continuance that might extend for another ten years. As a result of this 70-year time horizon, SDCERS’ investment philosophy and strategy is geared to long-term results. Short-term market declines, even those as severe as what we are experiencing today, are, in relation to SDCERS’ time horizon, just that: short-term.

Because of this long-term focus, SDCERS has never, and should never, manage its portfolio for the short term. Our disciplined strategy of a well-balanced portfolio has and will continue to work over the long haul.

Indeed, Warren Buffett recently wrote in The New York Times (“Buy American. I Am.”, N.Y.Times, 10/17/08) that, “fears regarding the long-term prosperity of the nation’s many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now.” He also said:

    Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497.

I am confident in SDCERS’ ability to manage through investment downturns, and our long-term investment track record supports that confidence: For the 10 years ended June 30, 2008, SDCERS ranked ahead of 96 percent of other public pension funds.

Finally, during the past 30 months, SDCERS has accomplished more administratively than any other pension plan in the country. We have implemented more conservative
actuarial methods, completed an actuarial experience study, established an independent Audit Committee, issued four CAFRs with audited financial statements, strengthened Board governance, established a Group Trust, increased our internal investment resources, completed the IRS’ Voluntary Correction Program and received a favorable IRS tax determination letter confirming SDCERS’ status as a tax-qualified plan. Very few governmental pension plans have a current determination letter, and SDCERS now is recognized as a leader among governmental plans in tax compliance.

SDCERS’ FY 2009 Year-To-Date Investment Performance

But even with this historical context, there is no debate about the current turmoil in the global financial markets. To quote Mr. Buffett’s *Times* article again:

> The financial world is a mess, both in the United States and abroad. Its problems, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near term, unemployment will rise, business activity will falter and headlines will continue to be scary.

Clearly, unlike San Diego’s prior pension problems, what we are experiencing today is not unique to San Diego. This is a national problem that every level of government, every business, and every pension plan is dealing with. The CalPERS trust fund lost more than 20% of its value between July 1 and October 10, and it is undoubtedly lower today. CalPERS also is notifying its local government participants that if current investment market losses are sustained, their contribution payments for FY 2011 may rise. Corporate pension plans have suffered significant investment losses, too.

Because SDCERS invests in the global markets, it is no surprise that SDCERS’ performance has suffered. SDCERS’ FY 2009 first quarter ended September 30, 2008 return was -10.1% (excluding private real estate, whose valuations are lagged one quarter). October was a terrible month for stocks. The Dow was down 14.1%, its worst drop since August 1998. All 30 of the companies in the index had price declines. The S&P and NASDAQ indices were down 16.8% and 17.7%, respectively. (SDCERS’ long-standing practice is to measure the trust fund’s performance quarterly, not monthly.)

However, it is important to keep in mind, the market downturn we have experienced since July 1, bad as it is, reflects just over one quarter of SDCERS’ four-quarter fiscal 2009 year. And, as always, the Board of Administration’s Investment Committee and SDCERS’ investment staff closely monitor the activities of our 30 professional money managers and custodial bank.

Impact of SDCERS’ Investment Returns on the City’s ARC

**Fiscal Year 2009.** Today’s investment environment and SDCERS’ current investment assets have no impact on the City’s FY 2009 budget. As I wrote to Ms. Tevlin on November 10, the City paid its FY 2009 Annual Required Contribution (ARC) of $161.7 million in full on July 1, 2008. In addition to this payment, the City also will pay
approximately $1.2 million to fund the City’s Preservation of Benefit Plan (POB) for FY 2009.

**Fiscal Year 2010.** SDCERS’ investment performance for the fiscal year ended June 30, 2008 was -4.66%. This performance will be, in part, reflected in our actuary’s calculations in preparing the City’s June 30, 2008 Actuarial Valuation. That Valuation will include the City’s FY 2010 ARC that will be due on July 1, 2009. SDCERS’ actuary, Gene Kalwarski of Cheiron, will be in San Diego on Friday, December 19, 2008 to present the City’s June 30, 2008 Actuarial Valuation in public session to the SDCERS Board of Administration. Each of you will be provided with a copy of the Valuation when we receive it, and I invite you to attend the Board meeting to hear Mr. Kalwarski’s presentation in person. I have asked Mr. Kalwarski to return to San Diego after that meeting to present the Valuation to the Council and to answer any questions you might have.

Unfortunately, prompted by the City Attorney, Joseph Esuchanko stated during his Council appearance last week that “approximately $85 million” would need to be added to the forecasted $166 million FY 2010 ARC payment contained in the City’s “Five-Year Financial Outlook” for 2010-2014. The accurate FY 2010 ARC payment won’t be known until Cheiron publicly discloses it on December 19. However, based on preliminary estimates by Cheiron that have not been certified, Mr. Esuchanko’s prediction is materially off the mark. (Unfortunately, Mr. Esuchanko’s prediction was picked up in the press and reported as fact. See, Gene Cubbison, “Pension Deficit Saps City Budget,” NBC 11/13/08, and Don Bauder, San Diego Reader, “City Pension Fund Only…,” 11/11/08.)

**Fiscal Year 2011.** The City’s FY 2011 ARC will be based, in part, on SDCERS’ investment returns from July 1, 2008 through June 30, 2009. Only when all four fiscal quarters have been concluded, on June 30, 2009, and the ARC payment calculated by Cheiron, will the impact of the current market condition on the City be known for sure. That calculation will be completed just over one year from now, and the corresponding ARC will be payable by the City on July 1, 2010.

Since 1990, of the 18 periods from October 31 through the following June 30, 14 periods showed market gains. We hope this historical trend continues. If it doesn’t, and as reflected in the City’s FY 2011 Forecast in Scenario 2 of the Five-Year Financial Outlook (Table V), the City’s FY 2011 ARC payment will reflect a significant increase over whatever the City’s FY 2010 payment is.

**Investment Returns and the ARC.** It is critical to understand that the market value of assets is just one aspect of a complex actuarial picture. Public pension plan actuaries do not base their calculations on the current market value of assets; rather, they calculate an actuarial value of assets in order to dampen fluctuations, up or down, in investment returns. Other actuarial variables also can offset negative investment returns, including
favorable experience in the inflation, disability, termination, active mortality or salary increase rates.

Any attempt to estimate an accurate actuarial valuation that is based only on the change in one variable, like the market value of assets, and that fails to consider the possible offsetting impact of other variables, will be misleading. Because of the interrelationship of so many actuarial factors, the only actuarial numbers that can be relied on for accuracy are those contained in SDCERS’ June 30 actuarial valuation.

The Elements of an ARC. Given the focus on ARCs, I want to explain the elements of the City’s ARC.

In 2006, based on Cheiron’s recommendation, the SDCERS Board agreed that the $1.2 billion 2007 unfunded actuarial liability (UAL) would be amortized over 20 years with no negative amortization. That shortened the amortization period for this UAL from its then 27 years. Because of the shorter time frame for paying it off, it had the effect of increasing the annual amount of the City’s future ARC payments. In addition to this change, the Board also voted to amortize any future gains and losses over 15 years. Gains and losses are calculated on experience factors that include investment returns, inflation and member behaviors (e.g., pay, retirement, mortality, turnover and disability).

The City’s FY 2009 ARC (paid on July 1, 2008) was $161.7 million, and it was made up of two amounts: (1) the normal cost, $68.6 million (the present value of benefits allocated to the current year), and (2) an amortization payment, $93.1 million, to pay off the $1.2 billion UAL as of June 30, 2007.

The City’s FY 2010 ARC (payable on July 1, 2009) will be made up of: (1) the normal cost, (2) an amortization payment to pay off the 2007 UAL, and (3) the amortization of any June 30, 2008 gain or loss. We will know these numbers when Cheiron presents the City’s June 30, 2008 Valuation on December 19, 2008.

The City’s FY 2011 ARC (payable on July 1, 2010) will reflect results of SDCERS’ current fiscal year that concludes on June 30, 2009. It will be made up of: (1) the normal cost, (2) another amortization payment to pay off the 2007 UAL, (3) an amortization payment based on June 30, 2008 gains or losses, and (4) an amortization payment based on June 30, 2009 gains or losses.

This amortization process continues into the future with, I hope, more gains than losses.

Disclosure of Pension Issues. As has been well-documented, the City’s pension problems first came to light in 2003 because of disclosures – or the lack thereof – in City bond offering documents. Fortunately, lessons were learned: the City and SDCERS have worked together to ensure comprehensive and accurate disclosure of SDCERS’ information in all financial documents. As an example, the City’s financial staff asked SDCERS to review disclosures in its water bond preliminary official statement (POS)
that relate to SDCERS. We did, and Mark Hovey, SDCERS’ Chief Financial Officer, has signed a certification concerning their accuracy. This is a best practice.

Jay Goldstone, the City’s Chief Operating Officer, also has asked about the impact of the current financial markets and the impact of a significant investment loss on the City’s future ARCs. Again, SDCERS responded by providing our best estimate of the impact. That input is reflected in the “Retirement” section and Table V of the City’s Five-Year Financial Outlook. I am proud of the positive and professional relationship SDCERS’ staff has with the City’s management team and the Office of the Independent Budget Analyst.

**Conclusion**

San Diego, like every other governmental entity in the United States, is in a very difficult financial situation because of the current economy. The economy’s impact on your retirement plan is just one of the many budget components you have to manage.

In finding solutions to these issues, our community cannot continue to see them as “us” versus “them.” We must recognize that these issues are “ours” not “theirs.” We also need a return to civil dialogue and civility in dealing with one another. Serious issues require serious discussions, and they must occur in a thoughtful and respectful manner. Finally, we can all better respond to these difficult economic issues if policy makers rely on calculations and forecasts that are based on accurate data. SDCERS will continue to communicate and cooperate with the City during these exceptionally difficult times to assist you in making sound policy decisions while ensuring SDCERS’ future security.