



Council Meeting: July 20, 2010

SUBJECT: Investment Advisory Agreement with PFM Asset Management LLC to Serve as Investment Manager for the City's Retiree Medical Trust

BACKGROUND

The City of Sunnyvale provides healthcare benefits to eligible retirees and their dependents through the California Public Employees' Retirement System (CalPERS) healthcare program (PEMHCA). Benefit levels are established through agreements and memorandums of understanding between the City and employees or labor unions. At June 30, 2009 there were 624 retired plan participants.

Governmental Accounting Standards Board (GASB) Statement No. 45 required the City to begin disclosing our liability for other post-employment benefits (OPEB) such as retiree medical costs beginning with the year ended June 30, 2008. In preparation for this requirement, an actuarial valuation of our retiree medical liability was completed in 2003, updated in 2006, and updated again in 2009. The 2009 valuation showed Sunnyvale's total liability for retiree medical costs to be \$92.8 million.

Since 2007, the City has set aside funds in the Employee Benefits Internal Service Fund to begin to address the OPEB liabilities. In August 2008, staff recommended and City Council approved a resolution for the City to participate in the California Employers' Retiree Benefit Trust (CERBT), an irrevocable trust administered by CalPERS and organized under Internal Revenue Service Code Section 115 to pre-fund retiree healthcare benefits.

In FY 2008/2009, the City budgeted \$28.1 million for its initial investment into the CERBT. The 2008 Council action authorized staff to transfer the available balance to the CERBT when prudent. Because of staff's concerns about unstable market conditions and the vulnerability of the CalPERS portfolio, no transfer has been made to date and the funds have remained in the City's Employee Benefits and Insurance Fund earning interest at the City's current portfolio rate. Had a transfer been made in 2008, a considerable portion of the \$28.1 million would have been lost due to the unprecedented negative earnings in the CERBT investment portfolio.

Staff continues to have concerns about investing the City's OPEB Trust funds into the CERBT for a number of reasons. First there has been a significant amount of actuarial and investment staff personnel turnover recently at CalPERS and negative information regarding their investment practices. Second, the City's bias toward conservative investment does not fit well with the more aggressive, and therefore more volatile, investment strategy currently in place at CalPERS. Finally, investing in the CERBT involves a three year period where the funds cannot be transferred to another trust. For these reasons, staff retained Milliman, Inc., an employee benefits and investment consulting firm, to evaluate the options available to the City for managing our OPEB Trust and to make a recommendation as to whether to go forward with the CERBT or select another qualified trust.

EXISTING POLICY

Fiscal Sub-Element E.2.6: An Actuarial Retiree Medical Reserve will be maintained at a level that is deemed adequate to meet projected liabilities as determined by an actuarial evaluation. This Reserve should meet the GASB reporting requirements for these future costs.

DISCUSSION

As indicated earlier, staff engaged Milliman, Inc. to determine whether to move forward with the California Employers' Retiree Medical Trust as previously approved or select an alternative provider of OPEB trust administrative services. Milliman identified a number of possible providers of these services in addition to the CERBT and reviewed each of them for the following services:

- Implementation plan
- Establishment of a GASB qualified irrevocable trust for retiree medical benefits
- Preparation of an appropriate investment policy
- Development of an asset allocation strategy
- Retention and monitoring of investment managers, including benchmarking
- Quarterly and annual reporting

In addition to reviewing the services provided, Milliman also evaluated the firms for knowledge of and experience with public sector OPEB trusts, the flexibility afforded by the trust to meet Sunnyvale's long-term funding strategy, and the ease of administration of the trust.

The analysis performed by Milliman identified a number of disadvantages to going with CERBT for our retiree medical trust at this time:

- It's a "one-size fits all" program. If a jurisdiction goes with CERBT, the asset allocation is decided by CalPERS on a pool-wide basis. There is no

opportunity for a particular jurisdiction to develop individual investment preferences. If plan characteristics and/or client risk tolerance dictates a different selection of asset mix or investment managers, this would not be possible.

- Going with CERBT cedes responsibility for its investments to a group over which it has virtually no influence.
- CalPERS is currently and historically has been on the aggressive side with its investments. Staff believes that a more conservative approach is appropriate at this time because of volatility in the market.
- There has been a fair amount of actuarial and investment staff personnel turnover recently at CalPERS, which could be a concern.
- Investing in CERBT involves a three year lock-up period where the assets cannot be moved to another provider. Other alternatives provide the opportunity to change trust administrators if desired.

The Milliman analysis identified two providers of retiree medical trusts that the City should consider. These were the trusts provided by Public Agency Retirement Services (PARS) and PFM Asset Management LLC. Both firms are qualified to provide these services to the City of Sunnyvale. Both offer flexibility in investment choices, both serve a number of clients similar to Sunnyvale and offer services we require, both have experienced and capable personnel, and both received excellent references.

Staff received proposals from each of the two firms, and after review of the proposals and in depth interviews with the principals of each is recommending that the City contract with PFM Asset Management LLC for the purpose of developing an irrevocable retiree health trust and managing the assets of the trust on behalf of the City. The decision to recommend PFM was based on several factors: their expertise and knowledge of OPEB issues and retiree trusts; their experience with public sector clients nationwide; their unique ability to match the trust's investments with the cash flow requirements of the City's retiree health benefits; and the ease of administration of the trust. In addition, PFM's fees were slightly lower than those of PARS.

PFM Asset Management has been providing investment management solutions exclusively to the public sector for more than 28 years. The firm has a team of consultants with experience in providing service to California governments, investment consulting and management services, general benefits and retirement services, and deferred compensation plan consulting. PFM Asset Management provides investment consulting services to more than 100 defined benefit pension and OPEB plans. Currently, PFM advises OPEB clients representing more than \$950 million in retiree medical plans. As an independent investment advisor, PFM does not accept any remuneration from

investment managers, mutual funds, or other services providers and therefore the firm can focus exclusively on the plan's needs with no conflict of interest.

PFM has teamed up with U.S. Bank National Association, the nation's sixth largest bank, to provide the trustee/administrator services needed by the plan. U.S. Bank provides first class technology and systems and offers the flexibility to customize their services to meet a client's unique needs.

Based on the facts discussed above, staff is recommending that the City Council authorize the City Manager to enter into the attached Investment Advisory Agreement with PFM Asset Management LLC and take all necessary steps to establish and administer the City's retiree medical trust.

FISCAL IMPACT

The City's OPEB liability as of June 30, 2009 was \$92.8 million. The City currently has \$29.7 million set aside in the Employee Benefits Fund for its initial investment into the trust. The 20-year Long Term Financial Plan includes additional contributions to the trust through FY 2023/2024. Following this point, the OPEB liability will be funded and the City's costs for retiree medical benefits are expected to slow to a rate that is less than the current "pay as you go" obligations. This is the result of the interest earnings from the initial contributions offsetting the total cost of retiree medical benefits and reducing the annual amount the City needs to contribute. As a result, pre-funding the City's future retiree health benefits costs via the trust will produce a significant savings over the "pay as you go" method over the long term. These savings have been included in the adopted FY 2010/2011 Budget.

Assuming an initial \$30 million deposit into the OPEB trust, total fees and costs for PFM Asset Management Services will be .49% of the trust portfolio. This amounts to \$144,000 annually, which will be paid from interest earnings on the trust. These fees include all services to be provided by PFM and U.S. Bank, including implementation, investment management, and reporting.

PUBLIC CONTACT

Public contact was made by posting the Council agenda on the City's official-notice bulletin board outside City Hall, at the Sunnyvale Senior Center, Community Center and Department of Public Safety; and by making the agenda and report available at the Sunnyvale Public Library, the Office of the City Clerk and on the City's Web site.

ALTERNATIVES

1. Authorize the City Manager to approve the attached Investment Advisory Agreement with PFM Asset Management LLC and take all necessary steps to establish and administer the City's retiree medical trust.

2. Authorize the City Manager to enter into an agreement with an alternate firm to establish and administer the City's retiree medical trust.
3. Direct the City Manager to continue with the CalPERS California Employer's Retiree Benefits Trust for the City's retiree medical liabilities.

RECOMMENDATION

Staff recommends alternative 1, to authorize the City Manager to approve the attached Investment Advisory Agreement with PFM Asset Management LLC and take all necessary steps to establish and administer the City's retiree medical trust.

Prepared by:

Grace Leung, Interim Director of Finance

Approved by:

Gary M. Luebbers
City Manager

Attachments

- A. Investment Advisory Agreement with PFM Asset Management LLC

INVESTMENT ADVISORY AGREEMENT

THIS AGREEMENT, entered into as of the 20th day of July, 2010 (the "Agreement"), by and between City of Sunnyvale, Santa Clara County, California (hereinafter the "Client") and PFM ASSET MANAGEMENT LLC, a Delaware limited liability company with an office in San Francisco, California (hereinafter the "Advisor").

W I T N E S S E T H

WHEREAS, the Client maintains the Sunnyvale Retiree Medical Trust (the "Fund") in order to satisfy the City's long-term liability for retiree medical costs; and

WHEREAS, the Fund has funds available for investment purposes; and

WHEREAS, the Client desires to avail itself of the experience, sources of information, advice, assistance and facilities available to the Advisor; to have the Advisor undertake certain duties and responsibilities; and to perform certain services as investment advisor on behalf of the Fund, as provided herein; and

WHEREAS, the Advisor is willing to provide such services on the terms and conditions hereinafter set forth.

NOW, THEREFORE, in consideration of the premises and mutual covenants herein contained, the parties hereto, intending to be legally bound, agree as follows:

1. SERVICES OF ADVISOR.

The Client hereby engages the Advisor to serve as investment advisor with respect to the Fund under the terms of this Agreement, and the Advisor accepts such engagement. The Advisor will determine the asset allocation of investments for the Fund (the "Investment Strategy" of the Fund) on the basis of information provided by the Client or other service providers, including the anticipated amounts of cash required by the Fund for distributions and other

expenses, and the appropriate risk tolerance for the Fund based upon the cash needs of the Fund and the Client's resources. The Advisor will then execute the Investment Strategy of the Fund by buying and selling shares of the investment funds. Initially the Fund shall be invested in investment funds in specified proportions as set forth in a separate schedule delivered to the Client by the Advisor at or prior to the time the Fund is initially funded (as the same may be revised by the Advisor from time to time, the "Schedule").

The Advisor will reassess and may alter the Investment Strategy asset allocation at least annually and "rebalance" the investment funds as reflected in the Schedule at least annually to maintain the ratios of the Investment Strategy, and will consult with the Client at least annually to determine whether there are reasons to revise the Investment Strategy. The Advisor will conduct a review at least annually of the performance of the investment funds held by the Fund and, in its judgment, will add to or reduce allocations to each investment fund and will add or delete investment funds (within the parameters of the Investment Strategy). The Advisor will promptly advise the Client in writing of any revision of the Fund's Investment Strategy and any additions to or deletions from the investment funds held by the Fund. In addition, the Advisor will provide to the Client a quarterly analysis of the performance of the investment funds in which the Fund is invested together with notice of any reallocation of assets among investment funds; the asset balances and market values for such analysis shall be as supplied to the Advisor by the Custodian (as hereinafter defined). In connection with all of the foregoing, the Advisor will promptly give the Client written notice of any changes to the Schedule.

The Client agrees to legally appoint a custodian (the "Custodian") to take and have custody of cash, assets and securities of the Fund. The Custodian shall not be the Advisor and shall be independent of the Advisor. The Client agrees to enter, or that it has entered, into a custodian agreement with the Custodian. The Advisor is authorized to give instructions to the Custodian with respect to the Fund as to deliveries of securities and payments of cash for the payment of securities and as otherwise provided in Section 2(b) of this Agreement. The Advisor shall not take possession of or act as custodian for the cash, securities or other assets of the Fund and shall have no responsibility in connection therewith. The Advisor agrees to recommend and to monitor the Custodian so that the Client's custodial and transaction costs are appropriate

for the level and nature of services rendered by the Custodian to the Fund, the Client and the Advisor.

Authorized investments shall include only those investments which are permissible under applicable statutes and regulations and the Fund's written investment policy, if any, as provided by the Client to the Advisor. The Custodian or an affiliate of the Custodian may be the investment advisor of investment funds selected by the Advisor.

2. COMPENSATION.

(a) For all services provided by the Advisor to the Fund pursuant to this Agreement, the Fund shall incur an annual fee based on net assets under management in the Fund determined on a monthly basis as defined in the Investment Advisory Fee Schedule below. For purposes of this section, "net assets" means the net market value of all cash and investments assets as of the end of the most recent month.

Investment Advisory Fee Schedule:

With a minimum investment of \$25 million within first six months:

First \$50 million in net assets.....	0.29%
Thereafter for assets above \$50 million.....	0.20%

With a minimum investment of less than \$25 million within first six months:

Net assets.....	0.36%
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until such time as investments exceed \$25 million, after which time the preceding fee schedule applies.

Included in this fee is PFM's direct payment of expenses associated with obtaining a federal IRS private letter ruling on its OPEB trust. Alternatively the Client may elect to pay one-half of those expenses directly and the above fee on the first \$50 million of assets invested will be reduced by one basis point (0.01%) to 28 basis points (0.28%).

(b) At the end of each calendar month, the Advisor will prepare and submit to the Client for approval a monthly invoice for its fee. Such invoice will

include a statement of the basis upon which the fee was calculated. Unless instructed otherwise within 15 calendar days of the postmark on the invoices, the Client authorizes the Advisor to charge such invoices to the Fund's account and authorizes and instructs the Custodian to disburse funds from such account for the payment of the fees and costs to the Advisor. If sufficient funds are not available, the Client agrees to compensate the Advisor from other sources within 30 calendar days of the postmark date. If the Advisor shall serve for less than the whole month, the compensation shall be pro-rated.

(c) If and to the extent that the Client shall request the Advisor to render services other than those to be rendered by the Advisor hereunder, such additional services shall be compensated separately on terms to be agreed upon between the Advisor and the Client.

(d) Assets invested by the Advisor under the terms of this agreement may from time to time be invested in a money market mutual fund or local government investment pool managed by the Advisor (either, a "Pool"), or in individual securities. Average daily net assets subject to the fees described in this section shall not take into account any funds invested in the Pool. Expenses of the Pool, including compensation for the Advisor and the Pool custodian, are described in the relevant prospectus or information statement and are paid from the Pool.

3. EXPENSES.

(a) The Advisor shall furnish at its own expense all necessary administrative services, office space, equipment, clerical personnel, telephone and other communication facilities, investment advisory facilities, and executive and supervisory personnel for managing the investments, inclusive of reasonable costs required to attend meetings with the Client.

(b) Except as expressly provided otherwise herein, the Fund shall pay all of its expenses including, without limitation, taxes, expenses (including front- or back-end charges) of an investment fund, fees and expenses of the Fund's independent auditors and legal counsel, if any, insurance premiums, fees and expenses of the Custodian appointed by the Client, as provided in Section 1, and the keeping of books and accounts.

4. REGISTERED ADVISOR; DUTY OF CARE.

The Advisor hereby represents it is a registered investment advisor under the Investment Advisers Act of 1940. The Advisor shall immediately notify the Client if at any time during the term of this Agreement it is not so registered or if its registration is suspended. The Advisor agrees to perform its duties and responsibilities under this Agreement with reasonable care. The federal securities laws impose liabilities under certain circumstances on persons who are required to act in good faith. Nothing herein shall in any way constitute a waiver or limitation of any rights which the Client, the Fund, or the Advisor may have under any federal securities laws. The Client hereby authorizes the Advisor to sign an Internal Revenue Service Form W-9 on behalf of the Client and to deliver such form to broker-dealers or others from time to time as required in connection with securities transactions pursuant to this Agreement.

5. ADVISOR'S OTHER CLIENTS.

The Client understands that the Advisor performs investment advisory services for various other clients which may include investment companies, commingled trust funds and/or individual portfolios. The Client agrees that the Advisor, in the exercise of its professional judgment, may give advice or take action with respect to any of its other clients which may differ from advice given or the timing or nature of action taken with respect to the Fund. The Advisor shall not have any obligation to purchase, sell or exchange any security for the Client solely by reason of the fact that the Advisor, its principals, affiliates, or employees may purchase, sell or exchange such security for the account of any other client or for itself or its own accounts.

6. TERM.

This Agreement may be terminated by the Client in the event of any material breach of its terms immediately upon notice by certified mail, return receipt requested. This Agreement may be terminated by the Client at any time, on not less than thirty (30) days' written notice to the Advisor. The Advisor may terminate this Agreement immediately upon any material breach of its terms by the Client, or at any time after one year upon thirty (30) days' written notice.

7. FORCE MAJEURE.

The Advisor shall have no liability for any losses arising out of the delays in performing or inability to perform the services which it renders under this Agreement which result from events beyond its control, including interruption of the business activities of the Advisor or other financial institutions due to acts of God, acts of governmental authority, acts of war, terrorism, civil insurrection, riots, labor difficulties, or any action or inaction of any carrier or utility, or mechanical or other malfunction.

8. DISCIPLINARY ACTIONS.

The Advisor shall promptly give notice to the Client if the Advisor shall have been found to have violated any state or federal securities law or regulation in any criminal action or civil suit in any state or federal court or in any disciplinary proceeding before the Securities and Exchange Commission or any other agency or department of the United States, any registered securities exchange, the Financial Industry Regulatory Authority, or any regulatory authority of any State based upon the performance of services as an investment advisor.

9. INDEPENDENT CONTRACTOR.

The Advisor, its employees, officers and representatives, shall not be deemed to be employees, agents (except as to the purchase or sale of securities described in Section 1), partners, servants, and/or joint ventures of the Client or the Fund by virtue of this Agreement or any actions or services rendered under this Agreement.

10. BOOKS.

The Advisor shall maintain appropriate records of all its activities hereunder. The Advisor shall use its best efforts to cause the Custodian to provide the Client with a statement, no less frequently than quarterly, showing deposits, withdrawals, purchases and sales (or maturities) of investments, earnings received, and the value of assets held on the last business day of the month all as provided for in the Custodian agreement between the Client and the Custodian.

11. ADVISOR'S DISCLOSURE STATEMENT.

The Advisor warrants that it has delivered to the Client, at least 48 hours prior to the execution of this Agreement, the Advisor's current Securities and Exchange Commission Form ADV, Part II, including, without limitation, Schedule H thereto (disclosure statement). The Client acknowledges receipt of such disclosure statement at least 48 hours prior to the execution of this Agreement.

12. MODIFICATION.

This Agreement shall not be changed, modified, terminated or discharged in whole or in part, except by an instrument in writing signed by both parties hereto, or their respective successors or assigns.

13. SUCCESSORS AND ASSIGNS.

The provisions of this Agreement shall be binding on the Advisor and its respective successors and assigns, provided, however, that the rights and obligations of the Advisor may not be assigned without the consent of the Client.

14. NOTICE.

Written notices required under this Agreement shall be sent by regular mail, certified mail, overnight delivery or courier, and shall be deemed given when received at the parties' respective addresses shown below. Either party must notify the other party in writing of a change in address.

Client's Address

City of Sunnyvale
650 W. Olive Ave.
Sunnyvale, CA 94086
Attn: Grace Leung, Director of Finance

Advisor's Address

PFM Asset Management LLC
50 California Street
Suite 2300
San Francisco, CA 94111
Attn: Girard Miller, Senior Strategist

With a Copy to:

PFM Asset Management LLC
Two Logan Square, Suite 1600
18th & Arch Streets
Philadelphia, PA 19103-2770
Attn: Controller

15. APPLICABLE LAW.

This Agreement shall be construed, enforced, and administered according to the laws of the State of California. The Advisor and the Client agree that, should a disagreement arise as to the terms or enforcement of any provision of this Agreement, each party will in good faith attempt to resolve said disagreement prior to filing a lawsuit.

16. APPROVAL; EXECUTION; SEVERABILITY.

(a) This Agreement has been approved by the City Council (the “Governing Body”) of the Client. The Governing Body hereby authorizes each designated person (a “Designated Person”) identified on Annex I hereto, acting on behalf of the Client, to interact with the Advisor regarding the Fund, and the Advisor may rely on any instructions received from such Designated Person; provided however, that this Agreement may not be amended without the prior approval of the Governing Body. The City Manager may designate additional Designated Persons or remove Designated Persons from time to time by written notice to the Advisor.

(b) Each party to this Agreement represents and warrants that the person or persons signing this Agreement on behalf of such party is authorized and empowered to sign and deliver this Agreement for such party.

(c) The invalidity in whole or in part of any provision of this Agreement shall not void or affect the validity of any other provision.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed by their authorized representatives as of the date set forth in the first paragraph of this Agreement.

PFM ASSET MANAGEMENT LLC

By: _____

Name: _____

Title: _____

CLIENT

By: _____

Name: Gary Luebbers_____

Title: City Manager_____

ANNEX I

DESIGNATED PERSONS

The following are Designated Persons pursuant to Section 16 of the foregoing Investment Advisory Agreement, and each such person's signature is set forth below.

<u>Name of Designated Person</u>	<u>Title</u>	<u>Signature</u>
<u>Grace Leung</u>	<u>Director of Finance</u>	_____
<u>Gary Luebbers</u>	<u>City Manager</u>	_____
_____	_____	_____
_____	_____	_____