CalPERS
P.O. Box 942709
Sacramento, CA 94229-2709
888 CalPERS (or **888**-225-7377)
Telecommunications Device for the Deaf
No Voice (916) 795-3240
www.calpers.ca.gov

Date: November 18, 2008
Reference No.:
Circular Letter No.: 200-056-08
Distribution: I, IA, VI
Special:

Circular Letter

TO: **ALL PUBLIC AGENCIES**

SUBJECT: **INVESTMENT RETURN IMPACT ON EMPLOYER RATES**

ATTENTION: **FINANCE DIRECTORS, HUMAN RESOURCE DIRECTORS, PUBLIC AGENCY DECISION MAKERS**

CalPERS is sending this circular as a result of our commitment to periodically provide information regarding the current financial market volatility impact to the CalPERS trust fund, to our employers and to our members. CalPERS continues to manage a well diversified portfolio and maintain a prudent, long term investment strategy in order to ensure the financial security for those we serve.

RECENT EMPLOYER OUTREACH

CalPERS issued Circular Letter 310-050-08 on October 6, 2008 in order to inform public agencies of the CalPERS investment policy and strategy during the market decline. That Circular Letter also addressed the impact of financial market volatility on employer contribution rates and on the security of retiree benefits. On October 21, 2008, CalPERS staff presented an agenda item to the Board of Administration that assessed the impact to the System’s funding status and employer contribution rates under various 2008/2009 fiscal year investment return scenarios. In addition, CalPERS Board Members and Executive staff addressed these same issues extensively during the 2008 CalPERS Educational Forum that was held in southern California from October 27 through October 29. This Circular Letter updates the information shared in October and includes the impact of a revision to the fiscal year 2007/2008 investment return and more recent asset return information during fiscal year 2008/2009.

FINAL 2007/2008 INVESTMENT RESULTS

In July 2008, CalPERS released preliminary net of fees investment returns for the 2007/2008 fiscal year of about negative 2.5 percent. Consistent with previous years, this announced return was labeled <u>preliminary</u> because the market value figures for the real estate and Alternate Investment Management (AIM) programs were as of March 31, 2008 and December 31, 2007, respectively.

The one to two quarter lag is a normal consequence of the time private market partners take to complete their financial reporting to CalPERS. This lag is consistent with industry reporting standards. CalPERS has now obtained final figures for these investments. The official 2007/2008 investment return net of expenses is negative 5.1 percent. More information about the official investment return is available on the CalPERS web site at www.calpers.ca.gov.

IMPACT ON 2010/2011 PUBLIC AGENCY EMPLOYER RATES

Local public agency contribution rates are affected by the investment return of a given fiscal year in the third fiscal year that follows. For example, CalPERS recently set the employer contribution rates for fiscal year 2009/2010 based on the investment return of the fiscal year ending June 30, 2007. The negative 5.1 percent return for fiscal year 2007/2008 will first be reflected in the public agency employer contribution rates applicable for the 2010/2011 fiscal year.

CalPERS achieved double digit gains in each of the four years leading up to the 2007/2008 fiscal year. Through CalPERS 15 year smoothing of investment returns, these previous positive returns will cushion the impact the 2007/2008 investment losses will have on employer contribution rates in 2010/2011. In fact as of June 30, 2007, the asset smoothing method set aside about 14 percent of the CalPERS fund as a “rainy day” fund. The negative 5.1 percent return for fiscal year 2007/2008, about 12.9 percent less than the 7.75 percent expected rate of return, uses up most of the 14 percent of the “rainy day” fund. The good news is that employer contribution rates in 2010/2011 are not expected to increase as a result of the 2007/2008 negative 5.1 percent return. In fact, with the rate smoothing policies at CalPERS, the estimated impact of the negative 5.1 percent investment return is a decrease up to 0.1 percent of payroll in expected 2010/2011 employer rates. This assumes that all other actuarial assumptions are realized in aggregate. **It is important to note that in recent years, the demographic experience of most plans translated to increases in employer rates.**

By now, you should have received your actuarial valuation report as of June 30, 2007, which set employer contribution rates for fiscal year 2009/2010. That actuarial valuation also contained an estimated employer contribution rate for fiscal year 2010/2011. However, due to timing and availability of data, that report projected the 2010/2011 employer rate using the preliminary estimated negative 2.5 percent rate of return rather than the actual negative 5.1 percent investment for fiscal 2007/2008. The projected employer contribution rate for 2010/2011 shown in the annual valuation report should be about 0.1 percent of payroll higher than the figure contained in this most recent report.

IMPACT ON 2011/2012 PUBLIC AGENCY EMPLOYER RATES

The investment return for fiscal year 2008/2009 will first impact public agency employer contribution rates in the 2011/2012 fiscal year. As a result of the rate stabilization method adopted by the Board, the impact on employer rates will be greatly mitigated. However, the smoothing method adopted by CalPERS imposes a corridor of 80 percent to 120 percent of the market value of assets when determining the smoothed actuarial value of assets. Stated another way, the 15 year smoothing method stops when the actuarial value of assets hits 120 percent of the market value of assets or 80 percent of the market value assets.

The corridor limit will be hit if the 2008/2009 investment return reaches about negative 13 percent. Investment return lower than negative 13 percent will produce a significantly greater impact on employer rates. Note that the impact on employer rates will vary from plan to plan based on the assets of your plan compared to the payroll of active members of your plan. The higher the ratio of assets to payroll, the greater the change in employer rate.

The table below shows the estimated impact of various 2008-2009 investment returns on the employer rate for fiscal 2011/2012.

ESTIMATED Change in Employer Contribution Rates in Fiscal 2011/2012

	Hypothetical Investment Return for 2008-2009						
	-20% Return	**-15% Return**	**-10% Return**	**0% Return**	**7.75% Return**	**10% Return**	**20% Return**
Range of Estimated Changes in Rates in Fiscal Year 2011/2012	Increase of about 2% to 5% of Payroll	Increase of about 1% to 2% of Payroll	Increase of about 0.2% to 0.5% of Payroll	Increase of about 0.1% to 0.2% of Payroll	Decrease of less than 0.1% of Payroll	Decrease of about 0.1% to 0.2% of Payroll	Decrease of about 0.2% to 0.5% of Payroll

If CalPERS does experience a negative return in 2008-2009 as illustrated above, and then returns to its anticipated 7.75 percent investment return, employer rates would likely continue to rise slowly over time. Returns in excess of 7.75 percent in subsequent years would be necessary to prevent a steady rise in employer rates.

For example, if the 2008/2009 fiscal year ends with an investment return of negative 20 percent, investment returns of 7.75 percent in the next few years would result in increases in employer rates of about 0.2 percent to 0.6 percent of payroll each year.

IMPACT ON FUNDED STATUS

CalPERS determines a plan's funded status by comparing the market value of assets to the accrued liability.

The table below displays the average funded status of CalPERS public agency plans as of June 30, 2007. The table also shows the estimated funded status as of June 30, 2008 based on the negative 5.1 percent return during 2007/2008.

	Funded Status on a Market Value of Assets Basis as of June 30, 2007	**ESTIMATED Funded Status on a Market Value of Assets Basis as of June 30, 2008**
Average Public Agency Miscellaneous Plan	103%	89%
Average Public Agency Safety Plan	99%	85%

The table below provides estimated average funded status for CalPERS public agency plans as of June 30, 2009 under various possible investment return scenarios.

ESTIMATED Funded Status on a Market Value of Assets Basis as of June 30, 2009 Based on Hypothetical Investment Returns

	Hypothetical Investment Return for 2008-2009						
	-20% Return	**-15% Return**	**-10% Return**	**0% Return**	**7.75% Return**	**10% Return**	**20% Return**
PA (Misc)	66%	70%	74%	82%	89%	91%	99%
PA (Safety)	63%	67%	71%	79%	85%	87%	95%

CalPERS cannot predict what the rest of the fiscal year will bring in the way of investment return; therefore, we are providing these scenarios to employers in order to build awareness of the potential impacts due to the global market downturn and to assist administrators with long term planning. CalPERS will continue to utilize our full range of resources and talents to protect our employer and member financial interests today and into the future.

If you wish to discuss these issues further, please contact your CalPERS actuary at **888 CalPERS** or (**888**-225-7377).

Ronald L. Seeling, Chief Actuary
Actuarial & Employer Services Branch