



City of Austin, Texas

Review of Austin Firefighters Relief and Retirement Fund

March 7, 2019

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Mr. Art Alfaro
City of Austin
621 Capital Mall Suite 1200
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Dear Mr. Alfaro,

This report addresses our review of the Austin Firefighters Relief and Retirement Fund's (AFRS) annual Actuarial Valuation Reports for the five-year period ending December 31, 2017. We concluded that:

- The 2017 AFRS Actuarial Valuation Report (valuation report) generally complies with the requirements of the Texas State Pension Review Board Guidelines for Actuarial Soundness (State Board).
- The valuation report is generally in compliance with the Actuarial Standards of Practice (ASOPs), including ASOPs 4, 23, 27, 35, 41 and 44.
- The actuarial assumptions were mainly selected from the 2015 Experience Study and appear to provide an accurate profile of the participant demographics and the plan's liabilities.
- The inflation assumption is high and inconsistent with the general wage inflation assumption used in the valuation. We recommend that the general inflation assumption be reduced to no more than the general wage assumption.
- We recommend that Foster & Foster, the Plan's actuary, consider reducing the payroll growth assumption based on the last six years of payroll growth.
- We recommend that Foster & Foster reconsider the investment return assumption, in light of any revisions to the general inflation assumption.
- We recommend that Foster & Foster consider reviewing the mortality assumption in light of the recently published Public Sector Public Safety mortality table.
- We recommend that some margin for mortality improvement be included in the disability mortality assumption.
- We recommend that the Cost of Living Adjustment (COLA) assumption be disclosed. We also recommend that Foster & Foster consider adding a COLA assumption given the COLAs granted in recent years.
- We recommend that the actuary consider adding some measures of risk to the valuation report to give the trustees a better understanding of the factors that affect the "riskiness" of the AFRS.
- We recommend that Foster & Foster consider adding some projections of the funded status and amortization levels covered by the current contribution rate to give the trustees a better understanding of the adequacy of the current contribution levels.
- We recommend that Foster & Foster add to the valuation report a participant reconciliation from the prior valuation to the current valuation and some statistical metrics, such as average age and average benefits, for the inactive population.

The undersigned actuaries are available to answer any questions on the material in this report or to provide explanations or further details as appropriate. We meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinions contained in this report. We are not aware of any direct or material indirect financial interest or relationship, including investments or other services that could create a conflict of interest that would impair the objectivity of our work.

Sincerely,

BOLTON



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EXECUTIVE SUMMARY

The City of Austin requested a review of the actuarial reports for the Austin Firefighters Relief and Retirement Fund (AFRS) for the 5 years ending December 31, 2017. Bolton was hired to (1) review the reports for compliance with Texas Government Code, relevant Actuarial Standards of Practice (ASOPs), and any other statutory requirements, (2) provide commentary on the completeness of the reports, and (3) provide any recommendations or enhancements for best practices.

We note the following recommendations for possible improvements or areas where further review may be warranted:

- We recommend that the inflation assumption be reduced to be consistent with the decrease in the general wage inflation assumption that was made in 2015. Generally, the price inflation assumption is lower than the general wage inflation assumption by 25 to 100 basis points. The 2015 Experience Study stated that the general wage inflation assumption was reduced from 3.5% to 3.0% based on the historical increases in the CPI-U. The CPI-U is a better measure of price inflation than of general wage inflation. If, as was recommended in the Experience Study, the general wage inflation was reduced to 3.0% because of the historical increases in the CPI-U, then the price inflation assumption should have been reduced to no more than 3.0%.
- Consider lowering the investment return (also referred to as the discount rate) based on using a lower assumed future inflation rate as discussed immediately above.
- The experience study should consider using geometric returns instead of arithmetic returns when determining the investment return assumption, as geometric returns better reflect the long-term expected investment returns.
- The payroll growth assumptions should also be revised to be consistent with the price inflation assumption.
- The 2017 actuarial report does not disclose an assumption for future COLAs. We assume the assumption is 0%. Since the benefit guide allows for COLAs and five COLAs have been granted in the last six years, a COLA assumption above 0% should be considered and a COLA assumption, even if equal to 0%, should be disclosed.
- The actuary should consider adding a mortality improvement scale to the disability mortality table.
- The actuary should consider reviewing the mortality table in light of the new Public Safety mortality tables published by the Society of Actuaries in 2018.
- The actuary should consider adding some risk measures, especially in light of the requirements of ASOP 51 which will be effective as of the next valuation. We note that the 2015 experience study provides the impact of various changes to the payroll growth and investment return assumption on the amortization period.
- The actuary should consider adding some projections to the valuation report to give the trustees a better understanding of the adequacy of the current contribution rate.

- We also suggest some minor changes to the actuarial report, shown in the *Completeness and Best Practices* section of this report.

We reviewed the annual actuarial valuation reports for the past five years, the 2015 Experience Study prepared by Foster & Foster, and the benefit provisions described in the City code. We also reviewed the appropriate ASOPs, the State Board provisions and the Conference of Consulting Actuaries (CCA) Public Plans Community's publication *Actuarial Funding Policies and Practices for Public Pension Plans*.

We received a response from Foster & Foster, the actuary for AFRS, to our initial draft report in a letter dated February 8, 2019. Their response is included in Appendix D of the report. We have no issues with their comments to our recommendations but provide further commentary below on Audit Suggestions #4 and #5. For Audit Suggestion #4, we note that Foster & Foster is considering recommending that the plan use the public safety mortality tables just released by the Society of Actuaries (SOA) for next year's valuation. We recommend that if the plan uses a public safety mortality table that a projection scale be included with the adoption of the new table as recommended by the SOA public plan mortality study. For Audit Suggestion #5, we continue to recommend that the Board consider adding a future COLA assumption based on the fact that the plan has granted several COLAs in the last few years or based on the premise that ad hoc COLA's should be funded over a short period of time. While there may be a rigorous process for approving a COLA, the fact that elaborate 10-year projections of the funded status and amortization periods for the plan, approval by the Board, and a recommendation from the actuary is required for a COLA to be approved may not significantly reduce or eliminate the possibility of a COLA being granted on a routine basis. We note that the plan does not have the ability to fund an ad hoc COLA over a one- or two-year period because of the fixed rate funding approach. Because of the inability to fund ad hoc COLAs over a short period, we recommend that the actuary adopt an assumption regarding future ad hoc COLAs, so that the plan's liability accounts for the likely future ad hoc COLAs.

PURPOSE & PROCESS

Purpose of the Audit

The City of Austin retained Bolton to conduct an independent review of the Austin Firefighters Relief and Retirement Fund (AFRS) annual actuarial valuations in light of ASOPs 27 and 35 in order to satisfy the requirements of Texas Government Code Section 802.1012. At a minimum, the audit should address the following:

- Appropriateness of the actuarial cost method used to calculate the normal cost and actuarial accrued liability;
- Appropriateness of the method used to develop the actuarial value of assets;
- Appropriateness of the assumptions used in the actuarial valuation;
- Completeness of the valuation report and any additional items which the reviewing actuary believes should be included in future valuation reports and also items which could be omitted from future reports;
- Whether the valuation meets all statutory requirements, the requirements of the Texas State Pension Review Board Guidelines for Actuarial Soundness, and relevant Actuarial Standards Board Standards of Practice; and
- Other items or issues which the Actuary believes should be addressed.

Our assistance could be considered similar to a Level 3 Actuarial Audit (as defined by the Government Finance Officers Association (GFOA)), as we reviewed the plan provisions and actuarial valuation reports, including the methods and assumptions, but did not replicate the liability and cost calculations (Level 1) or review sample lives (Level 2) to confirm the normal cost and accrued liability calculations.

Scope of the Audit

For this actuarial audit, we focused first on the application of the plan's benefit provisions, methods and assumptions, and Foster & Foster's model reflecting these factors. We evaluated whether the assumptions and methods are appropriate, given prior experience as reflected in the experience studies, ASOPs, and the State Board's legislative provisions regarding plan funding. Then we focused on whether the most recent actuarial report fairly represented the financial condition of the AFRS and made suggestions for possible enhancements.

This audit provides the following:

1. A measurement of economic actuarial assumptions against those used by other public plans and an assessment of their reasonableness;
2. A review of the demographic actuarial assumptions for consistency with generally accepted

actuarial practices and the specific experience of the AFRS, as documented in the last experience study;

3. Recommendations for changes in procedures, methods, assumptions and forecasts of expectations;
4. Commentary on whether the current contribution rate corresponds to a reasonable funding level;
5. An analysis of the reasonableness of the current fixed contribution rate.

The scope of this study did not include:

1. Assurance that appropriate benefits are being valued;
2. Confirmation that the valuation system is accurately calculating present value of benefits and appropriately dividing these present values into accrued liabilities and normal cost, by testing sample lives as representative of the normal cost and actuarial liability of the entire system;
3. Confirmation that the valuation system is valuing benefits as described in the valuation report and consistent with applicable statutes;
4. Any analysis regarding the tax qualification of the AFRS, or of the taxation of any employee contributions to the AFRS;
5. Any analysis of the GASB accounting results;
6. Any analysis of the 2015 experience study other than a review of the recommendations made in the 2015 experience study.

Methodology of the Audit for the 2017 Actuarial Valuation

The purpose of this audit is to express an opinion regarding the reasonableness of the actuarial assumptions, methods, and valuation results and whether the 2017 actuarial valuation report adequately documents the results of the valuation so that the reader may understand the funding issues facing the AFRS.

Assumptions Analysis

One of the most critical components in assessing the reasonableness of the funding levels is the selection and application of the actuarial assumptions. With respect to the assumptions, we;

1. Compared the economic assumptions to market data and assumptions used by other plans to determine the reasonableness of these assumptions.
2. Compared the demographic assumptions to the current distribution of the participant population, published studies, and other similarly-situated public pension plans.
3. Reviewed the results of the 2015 Experience Study conducted by Foster & Foster.

Methods Analysis

The second component in assessing funding levels is the selection and application of the actuarial cost method (including the method for amortizing the unfunded actuarial accrued liability) and the asset valuation method (including smoothing techniques).

Completeness and Best Practice

Finally, we reviewed the actuarial valuation report for compliance with Texas Government Code and best practices. We used the *Actuarial Funding Policies and Practices for Public Pension Plans* published by the CCA as a source for some of the best practices. We compared the results of the actuarial valuation report to the requirements of the Texas Government Code and provided commentary on how well the report conveys the financial condition of the AFRS and the adequacy of the current contribution rates.

This report also includes a review of the documentation of the valuation results as provided in the 2017 actuarial valuation report for compliance with the ASOPs (particularly ASOP 41, Actuarial Communications).

ASSUMPTION REVIEW

Introduction

The Actuarial Standards of Practice (ASOPs) provide guidance on the measurement of pension obligations. The relevant ASOP for measuring pension obligations is ASOP 4 (Measuring Pension Obligations and Determining Pension Plan Costs or Contributions). ASOP 4 also references ASOP Nos. 27 (Economic Assumptions), 35 (Demographic Assumptions) and 44 (Asset Valuation Methods).

ASOP 27 (Selection of Economic Assumptions for Measuring Pension Obligations) and ASOP 35 (Selection of Demographic and Other Noneconomic Assumptions for Measuring Pension Obligations) provide guidance concerning actuarial assumptions. ASOP 44 (Selection and Use of Asset Valuation Methods for Pension Valuations) provides guidance concerning asset valuation methods. ASOP 4 addresses broader measurement issues including cost allocation procedures and contribution allocation procedures and provides guidance for coordinating and integrating all of these elements of an actuarial valuation of a pension plan.

Links to the ASOPs are provided in Appendix A.

Economic Assumptions

Section 3.6 of ASOP 27 states that each economic assumption selected by the actuary should be reasonable. For this purpose, an assumption is reasonable if it has the following characteristics:

1. It is appropriate for the purpose of the measurement;
2. It reflects the actuary's professional judgment;
3. It takes into account historical and current economic data that is relevant as of the measurement date;
4. It reflects the actuary's estimate of future experience, the actuary's observation of the estimates inherent in market data, or a combination thereof; and
5. It has no significant bias (i.e., it is not significantly optimistic or pessimistic), except when provisions for adverse deviation or plan provisions that are difficult to measure are included and disclosed, or when alternative assumptions are used for the assessment of risk.

Section 4.1 (Communications) of ASOP 27 states that any actuarial report communicating work subject to this standard should contain the following disclosures:

1. Assumptions Used: The actuary should describe each significant assumption used in the measurement of the obligations.
2. Rationale for Assumptions: The actuary should disclose the information and analysis used in selecting each economic assumption that has a significant effect on the measurement.

The *Actuarial Assumptions and Methods* section of the 2017 actuarial report provides some level of rationale for each major assumption used in the valuation. In most cases, the actuarial experience study dated June 15, 2015 is cited as the rationale for the assumption used. We believe that this approach satisfies the requirements of the ASOPs unless a specific exception is noted.

Price Inflation

The 2017 actuarial valuation report discloses the core inflation assumption to be 3.5% based upon long-term historical experience. When setting this assumption, the actuary should review appropriate inflation data, which may include consumer price indices, the implicit price deflator, forecasts of inflation, yields on government securities of various maturities, and yields on nominal and inflation-indexed debt.

We reviewed this assumption against the 20-, 30-, and 40- year historical averages of CPI-U. The averages were 2.15%, 2.57%, and 3.54%, respectively. We also reviewed the inflation assumption against the spread of 10-, 20- and 30-year treasury bonds to the corresponding maturity of Treasury Inflation-Indexed Bond as of December 31, 2017. The spreads were 1.97%, 1.98%, and 2.01% respectively. The spread between TIPS and Treasuries gives an expectation of future inflation while historical returns provide what inflation has been in the past. Neither is a perfect measure of future inflation and both should be considered when setting an inflation assumption. The past is not always the best prediction of the future as economic conditions may be different now and into the future than in the past. Additionally, the spread between TIPS and Treasuries are not just impacted by the expectation of future inflation. TIPS' trading volume is much lower than that of Treasuries, so the yield differential can often change due to technical factors not having to do with inflation expectations. Therefore, the difference in yield can be used as a guide but not as an absolute measure of current inflation expectations. In the past 20 years, the TIPS spread has underestimated inflation levels about two-thirds of the time. Therefore, using an expected inflation rate higher than the TIPS and Treasuries spread is reasonable.

We believe that the 3.5% is higher than historical averages. While the 40-year average was 3.54%, the 30-year and 20-year averages are significantly lower and the spread between Treasuries and TIPS, which provide more of a forward-looking projection of inflation, suggest a rate much lower than 3.5%. In addition, the actuary assumes a wage inflation growth of 3.0%. We almost always see wage inflation growth assumptions that are higher than price inflation, as wages are expected to grow faster than inflation due to productivity improvement. Of the plans that we have audited, we rarely, if ever, have encountered a general inflation assumption that is higher than the wage growth assumption. Such a scenario is theoretically possible in a rapidly declining economy, which is inconsistent with our understanding of the Austin economy.

We measured general wage inflation by reviewing the historical increases in the National Average Wage Index (NAWI) published by Social Security. The NAWI measures the year-to-year increase in average wages subject to Federal income taxes. It is a good measure of general wage inflation in the U.S. The increase in the NAWI for 10, 20, 30, and 40 years ranged from 60 to 95 basis points higher than general inflation as measured by CPI. As such, we typically recommend a general wage inflation that is higher than

general inflation by 50 to 100 basis points. The 2017 actuarial report assumes that general wage inflation is 50 basis points *less* than core inflation, which is very unusual.

In addition, the 2015 Experience Study recommended a reduction in the general wage inflation assumption based on historical increases of the CPI-U. The CPI-U measures the increase in the consumer price index for all urban consumers. It is a better indicator of price inflation than general wage inflation and price inflation is generally less than wage inflation. If the actuary believed that general wage inflation should be decreased to 3.0% based on the historical increases in the CPI-U, then we would have expected a recommendation to similarly reduce the price inflation assumption.

We recommend that the actuary review both of these assumptions and make any adjustment to other assumptions that may be based on either of these assumptions (e.g. investment return and payroll growth).

Investment Rate of Return (Discount Rate)

Historically, most sponsors of public sector defined benefit pension plans have set the investment return or discount rate assumption by considering the expected rate of return on the plan's investments.

Section 3.8 of ASOP 27 states that the actuary may consider a broad range of data and other inputs, including the judgment of investment professionals. Some of the factors that the standard recommends that the actuary consider are historical and current investment data including real and nominal returns, inflation, historical performance, investment policy, forecasts of GDP growth, investment volatility, investment and other administrative expenses, cash flow timing, and benefit volatility. Many of these considerations can be reviewed through an analysis of the return and volatility expectations of the plan's portfolio based on a target allocation of investments, which is often stated in the plan's investment policy.

The 2017 actuarial report discloses an investment return assumption of 7.7% per year, net of all expenses. The actuarial report discloses that this rate is supported by the target asset allocation of the trust and the expected long-term return by asset class.

To test the reasonableness of the 7.70% assumption, we used the Capital Market Assumptions (CMAs) contained in Horizon Actuarial Services' 2018 Edition of their *Survey of Capital Market Assumptions*. The Horizon report (included as Appendix B) blends the CMAs from 34 different investment firms and presents both 10-year return assumptions and 20-year return assumptions. The returns reported are net of investment fees, but not of any administrative fees. We note that this survey was developed for multiemployer pension plans, but the generally long-term investment approach and size of these funds is consistent with that of the AFRS. While it is prudent to evaluate both short term and long-term return assumptions, public sector pension plans generally have a long investment horizon. As such, we calculated a 20-year expected geometric return assumption based on the target allocation and the Horizon 20-year CMAs and compared the resulting rate to the investment return assumption of 7.70%. The table below shows our approximate mapping of the asset classes to those used in the Horizon report and the subsequent expected geometric return calculation. Note that the investment mix shown below differs from the investment mix used in the

Experience Study to determine the 7.7% investment return assumption. The investment mix shown below was developed based on the investment mix shown in the 2017 annual report.

Mapped to Horizon Asset Classes	Target Allocation	Real Return (Net of Infl)		Inflation Assumption		Arithmetic Return		Geometric Return		Weighted	
		10 Year	20 Year	10 Year	20 Year	10 Year	20 Year	10 Year	20 Year	St. Dev	St. Dev
Horizon CMAs (all respondents)											
US Equity - Large Cap	12.78%	5.10%	6.26%	2.24%	2.47%	7.34%	8.73%	6.07%	7.42%	16.39%	2.09%
US Equity - Small/Mid Cap	6.39%	6.25%	7.66%	2.24%	2.47%	8.49%	10.13%	6.57%	8.18%	20.20%	1.29%
Non-US Equity - Developed	10.97%	6.12%	6.99%	2.24%	2.47%	8.36%	9.46%	6.71%	7.71%	18.67%	2.05%
Non-US Equity - Emerging	10.97%	8.28%	9.47%	2.24%	2.47%	10.52%	11.94%	7.64%	8.82%	24.89%	2.73%
US Corp Bonds - Core	20.50%	1.30%	2.16%	2.24%	2.47%	3.54%	4.63%	3.37%	4.46%	5.71%	1.17%
US Corp Bonds - Long Dur.	0.00%	1.66%	2.67%	2.24%	2.47%	3.90%	5.14%	3.32%	4.44%	10.83%	0.00%
US Corp Bonds - High Yield	0.00%	3.05%	3.97%	2.24%	2.47%	5.29%	6.44%	4.78%	5.82%	10.24%	0.00%
Non-US Debt - Developed	10.25%	0.13%	1.09%	2.24%	2.47%	2.37%	3.56%	2.18%	3.22%	6.86%	0.70%
Non-US Debt - Emerging	0.00%	3.39%	4.38%	2.24%	2.47%	5.63%	6.85%	5.00%	6.13%	11.43%	0.00%
US Treasuries (Cash Equiv)	0.00%	0.31%	0.63%	2.24%	2.47%	2.55%	3.10%	2.48%	3.05%	2.74%	0.00%
TIPS (Inflation-Protected)	0.00%	0.84%	1.79%	2.24%	2.47%	3.08%	4.26%	2.88%	4.04%	6.25%	0.00%
Real Estate	8.30%	4.65%	5.20%	2.24%	2.47%	6.89%	7.67%	5.90%	6.66%	13.86%	1.15%
Hedge Funds	0.00%	3.05%	4.14%	2.24%	2.47%	5.29%	6.61%	4.96%	6.19%	7.87%	0.00%
Commodities	2.47%	3.22%	4.00%	2.24%	2.47%	5.46%	6.47%	3.97%	4.92%	17.60%	0.44%
Infrastructure	0.00%	5.37%	5.77%	2.24%	2.47%	7.61%	8.24%	6.56%	7.14%	14.74%	0.00%
Private Equity	17.37%	8.48%	9.70%	2.24%	2.47%	10.72%	12.17%	8.33%	9.52%	22.16%	3.85%
	100.00%										
Portfolio Arithmetic Return						7.09%	8.33%				
Portfolio Variance										1.38%	
Standard Deviation										11.7%	
Portfolio Geometric Return (net of inv expenses)								6.40%	7.64%		
Administrative Expenses								0.07%	0.07%		
Return net of Admin Expenses								6.33%	7.57%		

We calculated an expected geometric return of 7.64% from the asset allocation at December 31, 2017 as reported in the 2017 annual report and adjusted 7 basis points for administration expenses to get a net expected return of 7.57%. The actuary appears to have calculated their assumed return based on arithmetic returns. While arithmetic returns should be used to calculate a weighted average return of various asset classes, often it is converted to a geometric return to reflect the compounding effect of returns over a multi-year period. The arithmetic return can never be less than the geometric return, and thus, a geometric return assumption is generally considered more conservative than an arithmetic return assumption. The assumed return of 7.70% is less than the 55th percentile expected geometric return of the portfolio (7.97%) over a 20-year investment horizon, and we generally find a return assumption to be reasonable if it lies between the 35th and 65th percentiles of the expected portfolio return over a 20-year period. In addition, the 7.57% expected return developed using the return and volatility expectations from the Horizon survey is based on an assumed inflation rate of 2.47%, which is 103 basis points lower than the 3.50% assumed in the 2017 actuarial report. The real rate of return calculated using the return and volatility expectations from the Horizon Survey is 5.1% compared to the real rate of return of 4.41% determined in the 2015 Experience Study. If we used a 3.50% inflation assumption along with the real rates of return expectations from the Horizon Survey, the calculated expected geometric return would be approximately 8.60%, well above the 7.70% assumed rate. However, as discussed earlier, we believe that a 3.50% inflation return assumption used to determine the investment return assumption is too high.

We also reviewed the investment return assumption in light of the National Association of State Retirement Administrators' (NASRA) annual survey of investment return assumptions (included as Appendix C.) The 2018 edition reflects a median investment return assumption of 7.5%, lower than the rate currently used by

Foster & Foster for valuing the liabilities in the AFRS. The February 2019 edition reflects a median investment return assumption of 7.25%.

We conclude that the assumption of 7.70% is reasonable. However, we recommend that the investment assumption should be reviewed using a lower inflation rate. If a 2.75% or 3.00% inflation rate is used with the real rate of return of 4.41% determined from the 2015 Experience Study, a reasonable investment rate of return assumption would fall into the range of 7.00% to 7.50%.

Administrative Expenses

The actuary assumes that the majority of administration expenses are netted out of the investment return assumption (also known as the discount rate). Most actuaries assume only investment expenses are netted from the investment return and provide an explicit assumption for administrative expenses. In order to review the assumption as a reduction to the assumed investment return, we looked at the amount of administration expenses paid over the last 6 years as a percentage of beginning of year assets. Administrative expenses were consistently 0.06% to 0.17% of beginning of year assets, with only the most recent year being above 0.08%. Therefore, when we tested the return on investment assumption, we reduced the calculated expected geometric returns using the Horizon survey assumptions by the median expenses as a percentage of beginning of year assets (7 basis points) over the last 6 years.

Salary Increase

The salary increase assumption assumes a general wage increase of 3.00% plus merit and longevity increases based on service. The general wage increase should generally be based on the average wage increases in the region or the country. We tested the wage increase assumption by looking at the Social Security Wage Index average annual increase over the last 10, 20 and 30 years. The averages were 2.23%, 3.1%, and 3.42%, respectively. Also, the real wage increase assumption is generally slightly higher than the assumed rate of inflation to reflect productivity gains. The assumed rate of inflation used in the 2017 valuation is 3.50%, thus the wage increase assumption is 50 basis points *lower*. We generally see spreads of 25 to 100 basis points *higher* with 50 basis points *higher* being the most common spread used between the real wage increase and inflation assumptions. Given the 20- and 30-year historical increases, we believe a 3.00% wage increase is reasonable and complies with ASOP 27. However, as stated above, we believe that the price inflation assumption is too high, especially when compared to the general wage increase assumption.

Finally, we compared the expected salary increases in excess of the general wage increase to the current Austin Firefighters pay scale published on the City of Austin website as of December 20, 2018 and the 2015 Experience Study. The pay increases are generally aligned with the current pay scale but include some small increases in years for which the pay scale is 0%, presumably to account for promotions. The 2017 salary scale assumption is also consistent with the actual observed results presented in the 2015 Experience Study. The salary increase assumption seems reasonable and in line with the requirements of ASOP 27.

Payroll Growth

The payroll growth assumption is 3.5%. We reviewed the assumption based on the last 6 years of average payroll growth. The average over the last 6 years was 2.4%, well below the 3.5% assumption. However, the 2015 Experience Study states that the annual average payroll growth over the 10 years prior to 2015 was 4.3%.

We note that the 3.5% payroll growth assumption is higher than the general wage inflation assumption of 3.0%. This effectively implies that the payroll is expected to increase faster than wage inflation. The payroll growth assumption is used solely for determining the appropriate amortization amount to be reflected in determining the Actuarially Determined Contribution (ADC). Assuming that payroll will grow 3.5% annually results in the UAL reaching \$0 in either 17 years (using the actuarial value of assets to determine the UAL) or 10.5 years (using the market value of assets to determine the UAL). If payroll were to grow at 3.0%, rather than 3.5%, the amortization period (reflecting the actuarial value of assets) would increase to 18 years. We recommend that the actuary consider lowering the payroll growth assumption but do not expect a material impact to the results of the valuation due to this change.

Demographic

ASOP 35 provides actuaries guidance for the selection of demographic assumptions and section 3.3.5 provides the criteria for a reasonable assumption:

- a. It is appropriate for the purpose of the measurement;
- b. It reflects the actuary's professional judgment;
- c. It takes into account historical and current demographic data that is relevant as of the measurement date;
- d. It reflects the actuary's estimate of future experience, the actuary's observation of the estimates inherent in market data (if any), or a combination thereof; and
- e. It has no significant bias (i.e., it is not significantly optimistic or pessimistic), except when provisions for adverse deviation or plan provisions that are difficult to measure are included (as discussed in section 3.10.1) and disclosed under section 4.1.1 or when alternative assumptions are used for the assessment of risk.

Service Retirement for Active Participants

Normal retirement for participants in the AFRS is at age 50 with 10 or more years of service or after the completion of 25 years of service at any age. Early retirement is the earlier of age 45 and the completion of 10 or more years of service or the completion of 20 years of service at any age. The assumption for active members retiring is based on the number of years the member has been eligible for early retirement.

Because participants are eligible to retire and receive their full retirement benefits at relatively young ages, the retirement assumption has a significant impact on the value of the AFRS' liabilities. The early retirement rates were determined from the 2015 Experience Study. All participants are assumed to retire within 18 years after first becoming eligible for retirement. Given there are no members over the age of 64,

this assumption is reasonable. We also believe the retirement rates reflect the observed results in the 2015 Experience study and do not recommend any changes to the retirement rates.

Service Retirement for Inactive Participants

The 2017 actuarial report does not disclose the assumption for inactive retirements. Most actuaries assume inactive participants start their benefits at their Normal Retirement Dates. Given that there are only 9 Terminated Vested Participants in the plan as of December 31, 2017, this assumption does not have any material impact on the valuation results. We recommend that the actuary disclose this assumption in their report.

Disability

The disability benefit provides that the accrued retirement benefit based on service earned as of the disability date, but not less than 66% of Average Monthly Compensation, be paid immediately for life. If the disability was service related, the benefit is calculated with a minimum of 20 years of service. The qualification for a disability benefit is based on the Member's ability to perform the duties of a firefighter during the first 2.5 years of disability or any employment after 2.5 years of disability.

We compared the disability rates to the 2015 Experience Study. The actual disability observations in the 2015 Experience Study were much less than the assumed rates. In the 2018 Experience Study, Foster and Foster proposed halving the disability rates based on the observed experience. However, the prior disability rates were retained for the 2017 valuation. Given the small number of disabilities that occurred over the observation period and the small impact on the liabilities, we find the disability rates to be reasonable.

Employee Termination

The termination assumption is service based and is extremely low. This is a typical termination pattern in firefighter pension plans. The rates are particularly low (0.5% or less) for years of service in excess of four. We compared the termination rates to the actual observed rates in the 2015 Experience Study and found the assumed rates to be reasonable. We do not recommend any changes to this assumption.

Healthy Retiree Mortality

There are multiple choices in selecting a mortality table. Many actuaries generally prefer the use of generational mortality tables, as this includes a projection of future mortality improvement. ASOP 35, section 3.5.3 ii requires either the use of a mortality improvement scale or the disclosure of why one is not reasonable.

Foster & Foster is using the RP-2000 Sex Distinct Combined Healthy mortality table with a generational projection using scale AA.

Since 2012, the Society of Actuaries (SOA) has published two mortality studies. The first study produced the RP 2014 mortality tables and MP projection scales which were based on the mortality experience of corporate pension plans from 2004 to 2008, with the central year of 2006. The study resulting in the RP 2014 tables showed a significant improvement in mortality from the RP-2000 mortality table which is based

on a central year of 1992.¹ The Society of Actuaries issued an Exposure Draft of Pub-2010 Public Retirement Plans Mortality Tables Report in August 2018, which develops public plan mortality tables based on public plan participant mortality experience from 2008 to 2013. The exposure draft develops mortality tables for three separate job classifications: General Employees, Teachers, and Public Safety Employees. The study published in 2018 shows that public safety mortality does track closely to the RP-2000 table. The study recommends using a projection scale with the table. The projection scale used for comparison purposes in the study is the MP-2017 projection scale.

We believe the RP 2000 Table with generational projection at scale AA is reasonable. We recommend that the actuary consider the new public safety mortality tables in the next few years, perhaps with the next experience study.

Disabled Retiree Mortality

Foster & Foster assumes the RP 2000 Disability Mortality Table for disabled lives. The assumption section neither indicates if an improvement table is assumed, nor provides an explanation as to why the use of a mortality improvement is inappropriate. We recommend that a mortality improvement scale be used with the disability mortality table. We do note that, due to the paucity of disabled retirees, this change will have a minimal impact on the valuation results.

DROP Assumptions

The AFRS provides for a Retro DROP which allows the member to elect the start of the DROP period up to 84 months prior to the date of election as long as the member retires within 84 months of the Retro DROP date. The member must be eligible for early or normal retirement to elect the DROP. We note that Foster & Foster recognizes in the 2015 Experience Study the significant cost of this DROP.

We compared the 2017 assumed DROP elections and periods to the actual observed rates in the 2015 Experience Study. We found the assumed rates and expected durations to be reasonable and do not recommend any changes.

Assumed COLA

While the Plan provides for a Cost of Living Adjustment (COLA) if the actuary determines that the COLA will not impair the financial stability of the AFRS, no mention of a COLA assumption is included in the valuation report. According to the AFRS website, there were COLA increases in 2018 (2.2%), 2017 (1.5%), and 2015 (1.3%). In addition, there were fixed dollar increases in retirees' benefit in 2014 (\$64/mo.) and 2013 (\$93/mo.). Prior to 2013, the most recent COLA increase was 2006 (\$100/mo.). The COLA assumption should be included in the *Assumptions* section of the valuation report even if the assumed COLA increase is 0%, especially since there have been several COLAs granted in the last five years. In addition, given the recent history of COLAs (five increases in the last six years) consideration should be given to including some assumption for future COLA increases. Generally, we recommend that,

¹ Based on the Society of Actuaries RP-2014 Mortality Tables Report dated October 2014 (Revised November 2014)

if an ad hoc COLA is granted and future COLAs are not assumed (i.e. the valuation does not include a COLA assumption), that the change in unfunded liability due to granting the ad hoc COLA be amortized over a short period of not more than one to three years (or longer if the next ad hoc COLA is not reasonably anticipated in the near future). However, since the contributions to the Plan are set by statute as a Fixed Rate rather than as a normal cost plus amortization payment, this methodology cannot be applied. Instead, the ad hoc COLAs should be reflected in the valuation by assuming a regular pattern of ad hoc COLAs are granted in the future similar to the number of ad hoc COLAs that have been granted in the last 10 to 20 years.

Furthermore, while reviewing compliance with GASB 68 is not part of this review, paragraph 24 of GASB 68 requires a COLA assumption be reflected for ad hoc COLAs, to the extent that they are considered to be substantially automatic. Five COLAs in the last six years could be considered substantially automatic.

We note that Foster & Foster created a document discussing the conditions that the AFRS would need to meet for Foster & Foster to determine that a COLA will not impair the financial stability of the AFRS. We believe that this is a valuable step in defining the parameters of the COLA provision.

ACTUARIAL METHODS

Funding Method

The 2017 actuarial report uses the entry age normal cost method as a level percentage of pay to determine the normal cost and accrued liability of the plan. Because the contributions are set by statute, the actuarial cost method is used to test whether contributions will meet reasonable funding levels.

Section 3.13 of ASOP 4 defines the guidelines for selecting a funding method as follows:

When assigning periodic costs or actuarially determined contributions to time periods in advance of the time benefit payments are due, the actuary should select an actuarial cost method that meets the following criteria:

- a. *The period over which normal costs are allocated for a participant should begin no earlier than the date of employment and should not extend beyond the last assumed retirement age. The period may be applied to each individual participant or to groups of participants on an aggregate basis.*

When a plan has no active participants and no participants are accruing benefits, a reasonable actuarial cost method will not produce a normal cost for benefits. For purposes of this standard, an employee does not cease to be an active participant merely because he or she is no longer accruing benefits under the plan.

- b. *The attribution of normal costs should bear a reasonable relationship to some element of the plan's benefit formula or the participant's compensation or service. The attribution basis may be applied on an individual or group basis. For example, the actuarial present value of projected benefits for each participant may be allocated by that participant's own compensation or may be allocated by the aggregated compensation for a group of participants.*
- c. *Expenses should be considered when assigning periodic costs or actuarially determined contributions to time periods.*
- d. *The sum of the actuarial accrued liability and the actuarial present value of future normal costs should equal the actuarial present value of projected benefits and expenses, to the extent expenses are included in the actuarial accrued liability and normal cost. For purposes of this criterion, under a spread gain actuarial cost method, the sum of the actuarial value of assets and the unfunded actuarial accrued liability, if any, shall be considered to be the actuarial accrued liability.*

The funding method used is reasonable and meets the criteria outlined in ASOP 4.

Asset Smoothing Method

The Asset Method used in the 2017 actuarial report recognizes gains and losses in investments each year over a 5-year period without any limiting collar adjustment (such as limiting the actuarial value to be between 80% and 120% of market value).

An essential part of the public sector budgeting process is that material budget items, including pension contributions, should have a level cost pattern from year to year to the extent possible. Bolton recognizes the importance of this requirement and assists clients in establishing reasonable methodologies for recognizing investment gains and losses and limiting the potential volatility that may result in increased contributions due to investment results.

The actuary's guide for determining the reasonableness of an asset smoothing method is ASOP 44. The following is an excerpt from this ASOP that establishes the qualities a reasonable asset smoothing method must exhibit.

3.3 Selecting Methods Other Than Market Value -- If the considerations in section 3.2 have led the actuary to conclude that an asset valuation method other than market value may be appropriate, the actuary should select an asset valuation method that is designed to produce actuarial values of assets that bear a reasonable relationship to the corresponding market values. The qualities of such an asset valuation method include the following:

- a. The asset valuation method is likely to produce actuarial values of assets that are sometimes greater than and sometimes less than the corresponding market values.*
- b. The asset valuation method is likely to produce actuarial values of assets that, in the actuary's professional judgment, satisfy both of the following:*
 - 1. The asset values fall within a reasonable range around the corresponding market values. For example, there might be a corridor centered at market value, outside of which the actuarial value of assets may not fall, in order to assure that the difference from market value is not greater than the actuary deems reasonable.*
 - 2. Any differences between the actuarial value of assets and the market value are recognized within a reasonable period of time. For example, the actuary might use a method where the actuarial value of assets converges toward market value at a pace that the actuary deems reasonable, if the investment return assumption is realized in future periods.*

In lieu of satisfying both (1) and (2) above, an asset valuation method could satisfy section 3.3(b) if, in the actuary's professional judgment, the asset valuation method either (i) produces values within a sufficiently narrow range around market value or (ii) recognizes differences from market value in a sufficiently short period.

Two key principles for asset smoothing arise from ASOP 44: (1) the smoothed asset values must fall

within a reasonable range around market value and (2) differences between the actuarial and market values must be recognized in a reasonable period of time. In lieu of satisfying both of these principles, a smoothing method could satisfy the requirements if, in the actuary's professional judgment, the range around market value is sufficiently narrow or the differences are recognized in a sufficiently short period.

The asset smoothing method was changed in 2015 with a reset to market value in 2015. The method was changed from an asset method that projected the actuarial asset value at the assumed investment return and adjusted it by 20% of the difference between the projected actuarial asset value and the market value. The new method recognizes gains and losses over a five year period. A major reason for the change in method was the previous method's lack of convergence to market value if the expected investment returns were exactly met. The method used in the 2017 actuarial report meets both of the objectives listed above and is one of the most common asset smoothing methods used for public pension plans. We find the method to be reasonable and would not recommend any changes. We believe that the current method is more appropriate than the method used prior to 2015.

Unfunded Liability Amortization Method

Foster & Foster uses the level percent of payroll method, assuming that payroll grows 3.5%, to determine the period of time necessary for the unfunded accrued liability to be funded. This method is widely used for plans, like the AFRS, which use a fixed contribution rate. We note that the covered payroll has increased 2.4% annually over the last 6 years. However, the 2015 experience study states that the payroll growth over the 10 years prior to 2015 was 4.3% per year. There seems to be a decreasing trend in payroll growth and, as previously mentioned, we recommend this assumption be reviewed, particularly in light of the 3.0% wage growth assumption. We also recommend that the amortization method of level percentage of pay of the unfunded liability clearly be stated in the assumptions and methods section of the actuarial report.

STATUTORY REQUIREMENTS

Texas Government Code

Key Government Code Requirements

Title 8, Subtitle A, Chapter 802 of the Texas Government Code provides guidelines for Actuarial Valuations, Audits of Actuarial Valuations, Studies, and Reports, and Actuarial Experience Studies and Actuarial Soundness among a host of other guidelines.

Section 802.101 of the Government Code provides the following requirements for actuarial valuations:

- A valuation must be done by a qualified actuary once every three years.
- The actuary shall make recommendations to the governing body of the public retirement system to ensure the actuarial soundness of the system.
- The actuary shall define each actuarial term and enumerate and explain each actuarial assumption used in making the valuation.

Furthermore, Chapter 802 requires that if a public retirement system's actuarial valuation shows that the system's amortization period has exceeded 40 years for three consecutive annual actuarial valuations, or two consecutive actuarial valuations in the case of a system that conducts the valuations every two or three years, the governing body of the public retirement system and the associated governmental entity shall formulate a funding soundness restoration plan.

The Pension Review Board has provided the following pension funding guidelines effective June 30, 2017:

1. The funding of a pension plan should reflect all plan obligations and assets.
2. The allocation of the normal cost portion of the contributions should be level or declining as a percentage of payroll over all generations of taxpayers and should be calculated under applicable actuarial standards.
3. Funding of the unfunded actuarial accrued liability should be level or declining as a percentage of payroll over the amortization period.
4. Actual contributions made to the plan should be sufficient to cover the normal cost and to amortize the unfunded actuarial accrued liability over as brief a period as possible, but not to exceed 30 years, with 10 - 25 years being a more preferable target range.* For plans that use multiple amortization layers, the weighted average of all amortization periods should not exceed 30 years.* Benefit increases should not be adopted if all plan changes being considered cause a material increase in the amortization period and if the resulting amortization period exceeds 25 years.
5. The choice of assumptions should be reasonable and should comply with applicable actuarial standards.

6. Retirement systems should monitor, review, and report the impact of actual plan experience on actuarial assumptions at least once every five years.

Compliance with Government Code

An actuarial valuation has been conducted every year for the nine years of reports that were available on the AFRS website. Each year's report was signed by actuaries that meet the requirements of Chapter 802. The 2009 and 2010 actuarial valuation reports were completed by Buck consultants. The 2011 to 2017 actuarial valuation reports were completed by Foster & Foster. The 2017 actuarial report provides a section labeled *Valuation Notes* defining the key terms used in the valuation and a section labeled *Actuarial Assumptions and Methods* that summarizes all of the major assumptions used in the report.

The following is our commentary on whether the actuarial valuation meets the pension funding guidelines of the Pension Review Board:

1. The funding obligations of the AFRS appear to reflect all of the AFRS's obligations and assets.
2. The normal cost is calculated using the Entry Age Normal Cost method which allocates the annual liability cost as a level percent of pay.
3. The unfunded actuarial accrued liability (UAAL) amortization period is measured by amortizing the UAAL as a level percentage of pay.
4. The average amortization period for the 2017 valuation is approximately 15 years and has been under 17 years for the previous 5 years. We note that this is within the preferable target range of 10 to 25 years, as stated in the Pension Review Board's June 30, 2017 guidelines. We further note that if the inflation rate of 3.0% was used for the payroll growth assumption, the amortization period would still be under 20 years, well within the Pension Review Board's guidelines.
5. We provided commentary on the reasonableness of the assumptions under the *Assumptions* section.
6. An experience study was conducted in 2015.

Other ASOPs

Data Quality

ASOP 23 provides guidance to actuaries when selecting data, performing a review of data, using data, or relying on data supplied by others, in performing actuarial services. Sections 3.1, 3.3 and 3.5 of ASOP 23 state the following:

The actuary should use available data that, in the actuary's professional judgment, allow the actuary to perform the desired analysis. However, if significant data limitations are known to the actuary, the actuary should disclose those limitations and their implications in accordance with section 4.1(b). The following sections discuss such considerations in more detail.

The actuary should perform a review [of the data], unless, in the actuary's professional judgment, such review is not necessary or not practical. In exercising such professional judgment, the actuary should take into account the purpose and nature of the assignment, any relevant constraints, and

the extent of any known checking, verification, or audit of the data that has already been performed.

The accuracy and completeness of data supplied by others are the responsibility of those who supply the data. The actuary may rely on data supplied by others, subject to the guidance in sections 3.3 and 3.4. The actuary should disclose reliance on data supplied by others in an appropriate actuarial communication, in accordance with section 4.1(h).

The cover letter of the 2017 actuarial report states “*In conducting the valuation, we have relied on personnel, plan design, financial reports, and asset information supplied by the AFRRF staff, and the actuarial assumptions and methods described in the Actuarial Assumptions section of this report. While we cannot verify the accuracy of all this information, the supplied information was reviewed for consistency and reasonableness. As a result of this review, we have no reason to doubt the substantial accuracy of the information and believe this it has produced appropriate results. This information, along with any adjustments or modifications, is summarized in various sections of this report.*” Pages 20 and 21 of the 2017 actuarial report provide summaries of the data used to produce the valuation results.

The statement made in the 2017 actuarial report provides evidence that the actuary performed a review of the data and appropriately disclosed their reliance on data supplied by others as required by ASOP 23. The data summaries disclosed in the 2017 actuarial report assist readers of the report in gaining an understanding of the appropriateness of the data. We believe that the actuary has appropriately followed the requirements of ASOP 23 regarding the quality of the data used for the 2017 actuarial report.

ASOP 41 (Actuarial Communications) governs the requirements for all actuarial communications, including the 2017 actuarial report. The 2017 actuarial report appears to comply with the standard, other than the failure to mention the COLA assumption.

Please note that ASOP 51, related to assessment and disclosure of risk in pension plans, will become effective for the December 31, 2018 valuation report. This ASOP will require the disclosure of qualitative measures regarding risks to the AFRS. We anticipate that your actuary, Foster & Foster, will discuss this in detail with the next valuation report.

COMPLETENESS & BEST PRACTICES

The Statement of Work for this project requested commentary on the completeness of the valuation report and any additional items which the reviewing actuary believes should be included in future valuation reports and also items which could be omitted from future reports.

We reviewed the 2017 actuarial valuation report for completeness and best practices. The valuation report generally provides all of the necessary information required by the Texas State Board and the ASOPs.

We recommend the following enhancements that may improve the understanding of the results provided in the valuation report:

- The report does not show any measures of the “riskiness” and/or maturity of the plan. We recommend showing some risk measures to give the readers of the report some context for the ability to maintain and/or achieve targeted funding levels for the plan. Some examples are the ratio of retiree liability to total liability, the ratio of assets to payroll, the ratio of liabilities to payroll, and ratio of benefit payments to contributions. All of these measures show how large the plan is compared to the City’s ability to make contributions to fund any losses in the plan’s liabilities or assets and achieve targeted funding goals.
- The Actuarial Standards Board recently issued ASOP 51, *Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions*. This ASOP provides guidance to actuaries when measuring obligations under a defined benefit pension plan and calculating actuarially determined contributions for such plans, with regard to the assessment and disclosure of the risk that actual future measurements may differ significantly from expected future measurements. The ASOP is effective for measurement dates after November 1, 2018. The requirements of ASOP 51 are not effective for the 2017 actuarial valuation report but will be for the 2018 actuarial valuation report. The 2017 actuarial valuation report would most likely not comply with ASOP 51 and we recommend that the actuary provide recommendations to the Board on including information to satisfy the requirements of ASOP 51.
- We recommend that the actuary include some 5- or 10-year projections of the funded status of the plan as well as the total Actuarial Determined Contributions and the Net City Contribution rates for 20-, 30-, and 40-year amortizations. We also recommend doing the projections at alternative asset returns to demonstrate the downside risk of the Plan of lower than expected investment returns. This last suggestion may satisfy some of the requirements of ASOP 51.
- We recommend that the actuarial report include a participant reconciliation from the prior year valuation to the current year valuation.
- We recommend that the actuarial valuation include some statistics on the inactive participant data such as average age and average benefit in the *Participant Data* section of the report.

CONCLUSION

Based on our review, we concluded that:

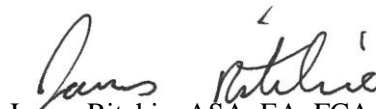
- The valuation report appears to be in compliance with the requirements of the Texas State Pension Review Board Guidelines for Actuarial Soundness (State Board).
- The valuation report is generally in compliance with the Actuarial Standards of Practice (ASOPs), including ASOPs 4, 23, 27, 35, 41 and 44.
- The actuarial assumptions were mainly selected from the 2015 Experience Study and appear to provide an accurate financial profile of the participant demographics and plan's liabilities.
- The inflation assumption is high and inconsistent with the general wage inflation assumption used in the valuation. In particular, the general wage inflation assumption was reduced in accordance with the 2015 experience study, which cites the historical increases of the CPI-U. The CPI-U is a better measurement for price inflation than for wage inflation and the price inflation assumption should have been reduced based on the rationale given to reduce the general wage inflation assumption.
- Foster & Foster should consider reviewing the mortality assumption in light of the recently published Public Sector Public Safety table.
- Some margin for mortality improvement should be included in the disability mortality assumption. Currently, none is assumed.
- The Foster & Foster should consider reducing the payroll growth assumption based on the last six years of payroll growth. A decrease in the payroll growth assumption would increase the amortization period by one to three years.
- We recommend that a COLA assumption be disclosed and a COLA assumption that reflects the last three to six years' COLA increases be included in the valuation.
- We recommend that Foster & Foster consider adding some measures of risk to provide the trustees a better understanding of the "riskiness" of the plan.
- We recommend that Foster & Foster consider adding some projections of the funded status and amortization levels covered by the current contribution rate to give the trustees a better understanding of the adequacy of the current contribution levels.
- We recommend that Foster & Foster add a participant reconciliation from the prior valuation to the current valuation and add some statistical information like average age and average benefits for the inactive population.


ACTUARIAL CERTIFICATION

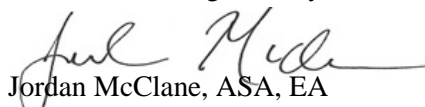
The undersigned credentialed actuaries meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained herein. They are currently compliant with the Continuing Professional Development Requirement of the Society of Actuaries. We are not aware of any direct or material indirect financial interest or relationship, including investments or other services that could create a conflict of interest that would impair the objectivity of our work.


We are available to answer any questions on the material in this report to provide explanations or further details as appropriate.

BOLTON


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APPENDIX A – RELEVANT ASOPS

See link at <http://www.actuarialstandardsboard.org/standards-of-practice/>

APPENDIX B – HORIZON 2018 SURVEY



Survey of Capital Market Assumptions

2018 Edition



Horizon Actuarial Services, LLC is proud to serve as the actuary to over 100 multiemployer defined benefit pension plans across the United States and across various industries. As actuary to these plans, we must develop assumptions regarding future investment returns on plan assets. We then use those assumptions as we determine the actuarial values of the benefits promised by these plans to their participants and beneficiaries, as well as to project plan funding and solvency levels years into the future.

At Horizon Actuarial, we are actuaries, not investment professionals. Therefore, when developing assumptions as to what returns a pension plan's assets might be expected to earn in the future, we look to our colleagues in the investment advisory community. Each year, as part of this survey, we ask different investment firms to provide their "capital market assumptions" – their expectations for future risk and returns for different asset classes in which pension plans commonly invest. The information gathered from this survey can help answer the common question: "Are my plan's investment return assumptions reasonable?"

There are many factors to consider when evaluating a plan's investment return assumptions, such as its asset allocation and the maturity of its participant population. Any of these factors can make the expected return for one plan very different from others. Therefore, this report does not opine on the reasonableness of any one plan's investment return assumptions. Nevertheless, we hope this report will be a useful resource for trustees, actuaries, and investment professionals alike.

Horizon Actuarial sincerely thanks the 34 investment advisors who participated in this survey.

Atlanta ■ Cleveland ■ Denver ■ Irvine ■ Los Angeles
Miami ■ San Diego ■ Washington, D.C.

Survey of Capital Market Assumptions: 2018 Edition

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Summary

Horizon Actuarial first conducted this survey in 2010, and it included 8 investment advisors. In 2012, we first published a report on the survey results, which included 17 advisors. The survey has expanded considerably over the past few years; this 2018 edition of the survey includes assumptions from 34 different investment firms.

In general, expected returns have declined in recent years. When we focus on the 22 advisors who participated in each of the last five surveys, we see that expected returns for equity and alternative investments generally decreased from 2014 to 2018. During the same period, expected returns for core fixed income and U.S. Treasuries have remained relatively flat. Expected volatilities for alternative investments have decreased in recent years, but have not changed significantly for other asset classes.

As we have seen in prior surveys, expected returns are noticeably lower over the short term than over the long term. This trend is apparent when we focus on the 13 advisors who provided assumptions for both the short term (up to 10 years) and long term (20 years or more). In fact, the difference between short-term and long-term expectations is more pronounced in this 2018 survey than it has been in any year since the survey began developing separate 10-year and 20-year expected returns in 2013.

For ongoing pension plans without solvency issues, we believe a horizon of 20 years or more is appropriate for evaluating the reasonableness of the long-term investment return assumption. A shorter horizon, such as 10 years, may be more appropriate for evaluating the return assumption for a plan that is more mature or has solvency issues. Even for plans with long-term investment horizons, it is important to understand the potential impact of lower expected returns over the short term. Therefore, this survey shows return expectations over horizons of both 10 years and 20 years.

For illustration, this report also constructs an asset allocation for a hypothetical multiemployer pension plan and uses the results from the survey to develop a range of reasonably expected returns for the plan. When compared to the 2017 edition of the survey, the expected returns for this 2018 edition were lower over 10-year and 20-year horizons by 23 and 16 basis points, respectively. These decreases were primarily driven by lower expected returns across most asset classes for many of the advisors who participated in both the 2017 survey and the 2018 survey.

If you have questions about how the results of this survey relate to your multiemployer plan, please contact your consultant at Horizon Actuarial or visit the “contact us” page on our website, www.horizonactuarial.com. For questions about the survey itself, please contact Ben Ablin at ben.ablin@horizonactuarial.com.

Horizon Actuarial Services, LLC is an independent consulting firm specializing in providing actuarial and consulting services to multiemployer benefit plans. Horizon Actuarial does not provide investment, legal, or tax advice. Please consult with your investment advisor, legal counsel, or tax advisor for information specific to your plan's investment, legal, or tax implications.

Survey of Capital Market Assumptions: 2018 Edition

Survey Participants

Exhibit 1 below lists the 34 investment advisors whose capital market assumptions are included in the 2018 survey. This report does not attribute specific assumptions to individual firms, which is a precondition of the survey.

Originally, this survey was exclusive to the multiemployer plan community; it included only assumptions from investment advisors to multiemployer pension plans. The survey has expanded over the years, and it now includes assumptions from investment advisors outside of the multiemployer plan community.

Of the 34 sets of capital market assumptions included in the 2018 edition of the survey, 27 were provided by investment advisors to multiemployer plans, 4 were obtained from published white papers, and 3 were provided by investment advisors who do not consult with multiemployer plans. A complete listing of the firms participating in the survey is provided below.

Exhibit 1

2018 Survey Participants	
<i>AJ Gallagher</i>	<i>Marquette Associates</i>
<i>Alan Biller</i>	<i>Meketa Investment Group</i>
<i>AndCo Consulting</i>	<i>Merrill Lynch Global Institutional Consulting</i>
<i>Aon Hewitt</i>	<i>Morgan Stanley Wealth Management</i>
<i>The Atlanta Consulting Group</i>	<i>New England Pension Consultants (NEPC)</i>
<i>Bank of New York Mellon*</i>	<i>Pavilion Advisory Group</i>
<i>BlackRock*</i>	<i>Pension Consulting Alliance</i>
<i>Callan Associates</i>	<i>PFM Asset Management, LLC</i>
<i>Cambridge Associates</i>	<i>RVK</i>
<i>CapTrust</i>	<i>Segal Marco Advisors</i>
<i>Ellwood Associates</i>	<i>SEI</i>
<i>Envestnet**</i>	<i>Sellwood Consulting</i>
<i>Goldman Sachs Asset Management</i>	<i>Summit Strategies Group</i>
<i>Graystone Consulting</i>	<i>UBS</i>
<i>Investment Performance Services, LLC (IPS)</i>	<i>Verus</i>
<i>Janney Montgomery Scott, LLC</i>	<i>Voya Investment Management*</i>
<i>J.P. Morgan Asset Management*</i>	<i>Willis Towers Watson**</i>

* Assumptions obtained from published white paper
 ** Advisor from outside multiemployer community

Investment Horizons

When evaluating the expected return assumption for an active, ongoing multiemployer pension plan, actuaries usually consider investment returns over a long-term investment horizon of 20 years or more. A shorter time horizon, say over the next 10 years, may be more appropriate when evaluating the return assumption for a mature plan, a plan that has high negative cash flows, or a plan that is projected to become insolvent.

It is also important to understand the sensitivity of plan funding to changes in future investment returns. For example, the actuary for an active, ongoing pension plan will typically set the plan's investment return assumption based on expectations over a long-term horizon. However, evaluating the sensitivity of funding results to short-term investment returns that are expected to be higher or lower than the long-term assumption also plays an integral role in the decision making process.

Survey participants were requested to provide their most recent capital market assumptions: expected returns for different asset classes, standard deviations (i.e., volatilities) for those expected returns, and a correlation matrix. The survey participants were also requested to indicate the investment horizon(s) to which their assumptions apply. If the participant develops separate assumptions for different time horizons, they were requested to provide each set of assumptions.

In the 2018 edition of the survey, 21 advisors provided one set of assumptions: of those, 19 specified a time horizon of 10 years and 2 specified a time horizon of 10 to 15 years. The remaining 13 advisors provided assumptions over both shorter-term (5 to 10 years) and longer-term (20 years or more) horizons.

Exhibit 2 below summarizes the time horizons specified by each advisor, grouped by type.

Exhibit 2

Investment Time Horizons				
Advisor Type	(A)	(B)	(C)	Total
10 Years	14	3	2	19
10 to 15 Years	1	1	-	2
<u>Both Short- and Long-Term</u>	<u>12</u>	<u>-</u>	<u>1</u>	<u>13</u>
Total	27	4	3	34

(A) Multiemployer plan investment advisor
 (B) Published white paper
 (C) Advisor from outside multiemployer community

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Short-Term vs. Long-Term

As noted in the previous section, survey participants provided expected returns over different time horizons. Given current market conditions, many investment advisors may expect returns for certain asset classes to be different in the short term versus over the long term.

For comparability, this survey groups expected returns into two time horizons: 10 years and 20 years. As pension plan actuaries, we often refer to the 10-year expected returns as “short-term” and the 20-year expected returns as “long-term.” Note, however, that many investment firms consider 10-year expectations to be “long-term.”

When comparing the expected returns for the 13 advisors who provided both short-term and long-term assumptions,¹ we see some interesting differences. See Exhibit 3 below. Expected returns are geometric and are generally considered to be indexed and net of fees.

Exhibit 3

Average Expected Returns: Short-Term vs. Long-Term			
Subset of 13 Survey Respondents			
Asset Class	10-Year Horizon	20-Year Horizon	Difference
US Equity - Large Cap	6.24%	7.42%	1.18%
US Equity - Small/Mid Cap	6.97%	8.18%	1.21%
Non-US Equity - Developed	7.05%	7.71%	0.66%
Non-US Equity - Emerging	7.85%	8.82%	0.97%
US Corporate Bonds - Core	3.59%	4.46%	0.87%
US Corporate Bonds - Long Dur.	3.36%	4.44%	1.08%
US Corporate Bonds - High Yield	4.81%	5.82%	1.01%
Non-US Debt - Developed	2.19%	3.22%	1.03%
Non-US Debt - Emerging	5.24%	6.13%	0.89%
US Treasuries (Cash Equivalents)	2.51%	3.05%	0.54%
TIPS (Inflation-Protected)	3.23%	4.04%	0.81%
Real Estate	5.87%	6.66%	0.79%
Hedge Funds	5.46%	6.19%	0.73%
Commodities	4.73%	4.92%	0.19%
Infrastructure	6.77%	7.14%	0.37%
Private Equity	8.59%	9.52%	0.93%
Inflation	2.41%	2.47%	0.06%

The 10-year and 20-year returns shown above are the averages for the 13 advisors who provided both short-term and long-term assumptions. Expected returns are annualized (geometric).

The consensus among these 13 advisors was that returns are expected to be lower in the short term compared to the long term. In general, the difference between long-term and short-term returns is more pronounced for US equity and fixed income investments.

As noted earlier, the results shown in Exhibit 3 are based on a subset of 13 advisors. If we include all 34 survey advisors, the short-term and long-term expected returns do not change dramatically. See Exhibit 4 below.

Exhibit 4

Average Expected Returns: Short-Term vs. Long-Term			
All Survey Respondents			
Asset Class	10-Year Horizon	20-Year Horizon	Difference
US Equity - Large Cap	6.07%	7.42%	1.35%
US Equity - Small/Mid Cap	6.57%	8.18%	1.61%
Non-US Equity - Developed	6.71%	7.71%	1.00%
Non-US Equity - Emerging	7.64%	8.82%	1.18%
US Corporate Bonds - Core	3.37%	4.46%	1.09%
US Corporate Bonds - Long Dur.	3.32%	4.44%	1.12%
US Corporate Bonds - High Yield	4.78%	5.82%	1.04%
Non-US Debt - Developed	2.18%	3.22%	1.04%
Non-US Debt - Emerging	5.00%	6.13%	1.13%
US Treasuries (Cash Equivalents)	2.48%	3.05%	0.57%
TIPS (Inflation-Protected)	2.88%	4.04%	1.16%
Real Estate	5.90%	6.66%	0.76%
Hedge Funds	4.96%	6.19%	1.23%
Commodities	3.97%	4.92%	0.95%
Infrastructure	6.56%	7.14%	0.58%
Private Equity	8.33%	9.52%	1.19%
Inflation	2.24%	2.47%	0.23%

*10-year horizon results include all 34 survey respondents.
20-year horizon results include a subset of 13 survey respondents.
Expected returns are annualized (geometric).*

The 10-year expected returns shown above include assumptions from all 34 advisors, while the 20-year expected returns include assumptions from only the 13 advisors who provided longer-term assumptions.

While past editions of this survey have indicated lower expected returns over the short term than over the long term, the difference has increased in recent years for most asset classes. For example, the difference between short term expected returns and long term expected returns for large cap US equity based on the average assumptions from the 2018 survey is 135 basis points. For comparison, the difference was 88 basis points based on the average assumptions from the 2014 survey.

For this reason, it may be more important than ever for the actuary to evaluate the sensitivity of funding results to short-term investment returns that are expected to be lower than the long-term assumption.

¹ In cases where an advisor indicated a time horizon shorter than 10 years, the shorter-term expected returns were combined with the longer-term expected returns to achieve a 10-year horizon. Similarly, if an advisor indicated a time horizon longer than 20 years, the longer-term expected returns were combined with the shorter-term expected returns to achieve a 20-year horizon.

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Differing Opinions

Exhibit 5 below shows the distribution of expected returns and standard deviations (i.e., volatilities) for each asset class in the survey, as provided by the 34 individual advisors in the survey. Expected returns are geometric and apply to a 10-year investment horizon. Average assumptions from the 2018 survey are listed in brackets for each asset class. As noted earlier, returns are assumed to be indexed and net of fees.

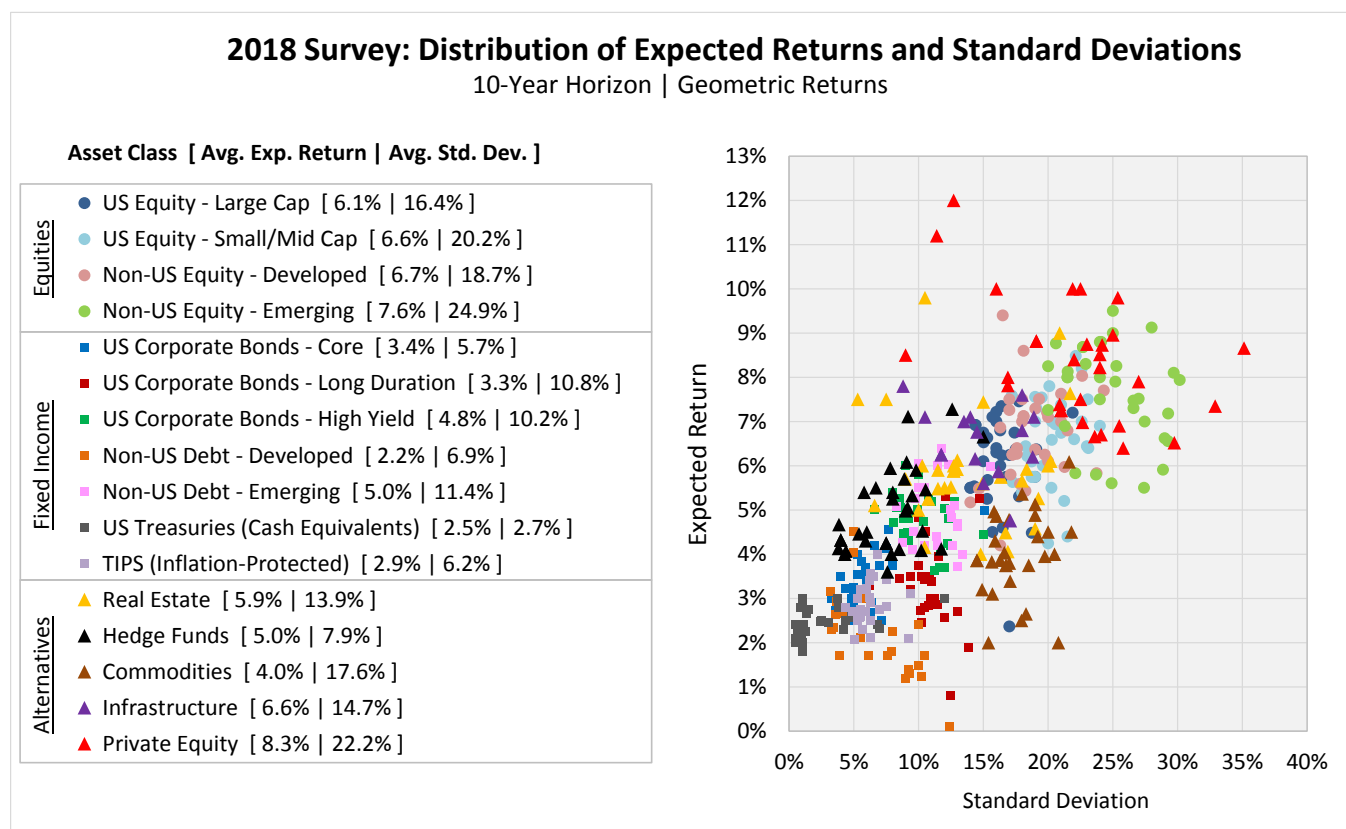
Note that the exhibit below focuses on a 10-year horizon in order to include assumptions from all 34 advisors. See Exhibit 16 in the appendix to this report for the assumptions over a 20-year horizon, based on the 13 advisors who provided longer-term assumptions. Also note that the exhibit considers both expected returns and standard deviations. The ranges of expected returns by asset class can be found in the appendix as Exhibits 17 and 18.

The exhibit below shows that there are significant differences in expected returns and standard deviations among investment advisors. As the saying goes, “reasonable people may differ.”

The differences in assumptions are more pronounced for alternative investments such as real estate, hedge funds, and private equity. A contributing factor may be differences in the underlying strategies different advisors apply to these alternative investments (for example, opportunistic versus defensive). To contrast, the differences in expected returns and volatilities are smaller for more traditional investments, such as US equity and US fixed income.

A summary of the average survey assumptions can be found in the appendix to this report as Exhibit 15. This summary includes expected returns, standard deviations, and a correlation matrix.

Exhibit 5



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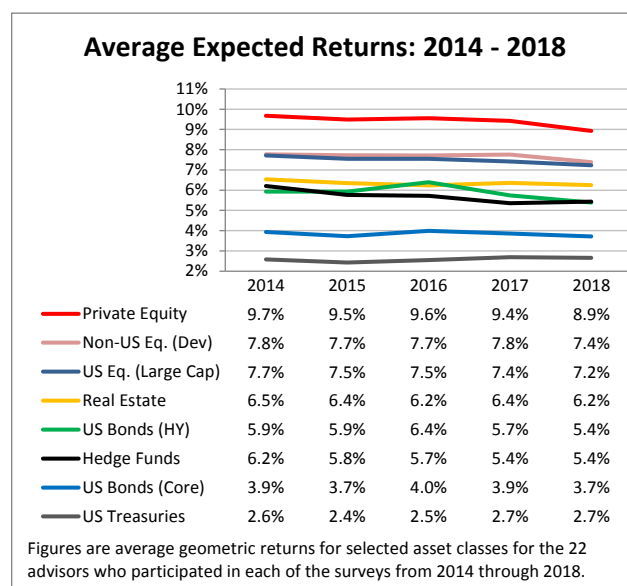
Changing Outlooks: 2014 to 2018

In recent years, there has been much discussion about whether it is reasonable to expect that future investment returns will be as high as they have been historically. Citing various reasons such as increased equity prices, tightening credit spreads, and continuing low interest rates, many advisors have lowered their expectations over the last five years, especially from 2017 to 2018.

Exhibit 6 below shows average expected returns for selected asset classes each year from 2014 to 2018. For consistency, this exhibit includes only the 22 advisors who participated in the survey in each of these years.

Note that the expected returns shown below are based on a 20-year horizon for advisors who provided longer-term assumptions and a 10-year horizon for others.² For that reason (as well as the fact that we include only a subset of advisors), the expected returns shown below are not directly comparable with those in other sections or previous surveys.

Exhibit 6



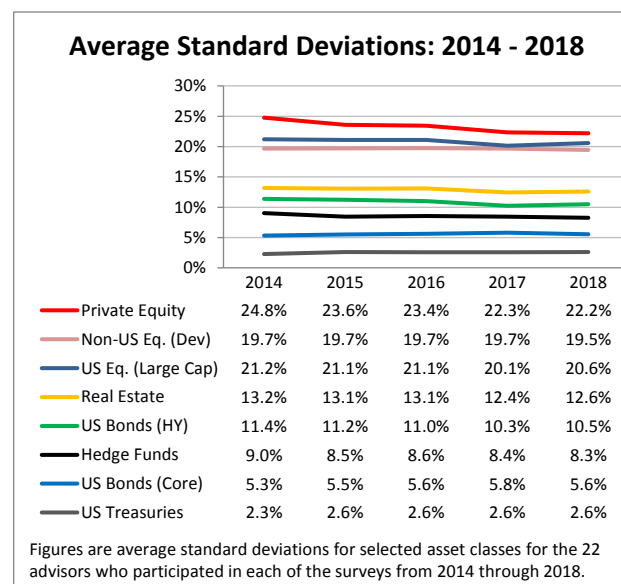
For this subset of advisors, average expected returns have decreased for every asset class except US Treasuries over the last five years. The sharpest declines from 2017 to 2018 were for the asset classes with the highest expected returns – private equity and non-US developed equity.

Other asset classes, such as large cap US equity, real estate, high-yield bonds, and hedge funds have seen more gradual declines over the course of the last five years.

Average expected returns asset classes with lower expected returns such as core fixed income and US Treasuries remained relatively flat from 2014 to 2018.

In addition to expected returns, it is also important to consider expected volatility of the returns, measured by standard deviations. Average standard deviations over the last five years are shown in Exhibit 7 below.

Exhibit 7



In general, average standard deviations have decreased from 2014 to 2018. This decrease may be related to the decrease in average expected returns over the same period as investments with lower expected returns are often less volatile than investments with higher expected returns. This trend of decreasing standard deviations is most apparent for private equity, but noticeable shifts have occurred for large cap US equities, real estate, and high-yield bonds as well.

On the contrary, average standard deviations have increased for investments whose returns are more closely tied to interest rates such as core US bonds and US Treasuries. This increase may indicate greater uncertainty about the timing of future changes in interest rates or the rate at which those rates are expected to change.

² Of the 13 survey advisors who provided both shorter-term and longer-term assumptions, 11 of them indicated no difference in the standard deviations of the expected returns over the short term versus the long term. For the other 2 advisors, the differences between short-term and long-term standard deviations were very minor.

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Evaluating the Return Assumption

Multiemployer pension plans are usually invested in a well-diversified mix of stocks, bonds, real estate, and alternative investments structured to meet the goals of the Trustees. This typically involves maximizing returns over the long term while minimizing return volatility.

The actuary of a multiemployer pension plan must evaluate the plan's asset allocation and, based on expectations of future returns, develop an assumption for what plan assets are projected to earn over the long term. This assumption is then used (along with others) to determine the actuarial present value of the benefits promised by the plan to its participants and beneficiaries.

The actuary will often rely on the future return expectations of the plan's investment advisor in developing the plan's investment return assumption. However, as noted earlier, different investment advisors often have widely differing opinions on what future returns will be. Therefore, it can be beneficial to keep in mind other advisors' expectations when setting the investment return assumption.

In the following exhibits, we will evaluate the investment return assumption for a hypothetical multiemployer pension plan. Exhibit 8 below shows the asset allocation for this hypothetical plan. The asset allocations are arbitrary, except for the fact that we made sure to include at least a small allocation to every asset class in the survey.

Exhibit 8

Hypothetical Multiemployer Plan	
Asset Class	Weight
US Equity - Large Cap	20.0%
US Equity - Small/Mid Cap	10.0%
Non-US Equity - Developed	7.5%
Non-US Equity - Emerging	5.0%
US Corporate Bonds - Core	7.5%
US Corporate Bonds - Long Duration	2.5%
US Corporate Bonds - High Yield	5.0%
Non-US Debt - Developed	5.0%
Non-US Debt - Emerging	2.5%
US Treasuries (Cash Equivalents)	5.0%
TIPS (Inflation-Protected)	5.0%
Real Estate	10.0%
Hedge Funds	5.0%
Commodities	2.5%
Infrastructure	2.5%
Private Equity	5.0%
TOTAL PORTFOLIO	100.0%

Exhibit 9 shows expected annualized (geometric) returns for the hypothetical plan over a 10-year horizon. These results may be appropriate for modeling sensitivities of future funding results to short-term investment returns, or for evaluating the return assumption for a plan with severely negative cash flows or solvency issues.

Exhibit 9

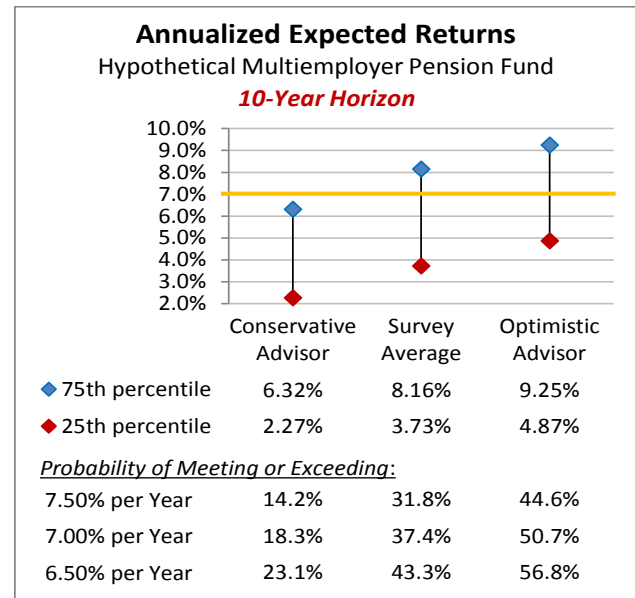
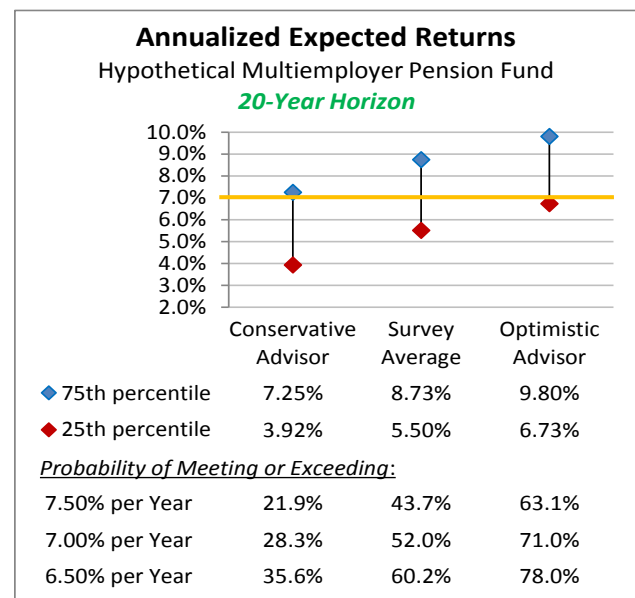


Exhibit 10 shows expected annualized (geometric) returns for the hypothetical plan over a 20-year horizon based on assumptions from the 13 advisors who provided longer-term assumptions. These results may be more appropriate for evaluating the return assumption for an ongoing plan with no projected solvency issues.

Exhibit 10



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Evaluating the Return Assumption (cont)

It is important to keep in mind that the expected returns shown in Exhibits 9 and 10 apply only to the hypothetical asset allocation shown in Exhibit 8. The expected returns will be different – perhaps significantly – for different asset allocations.

Exhibit 13 in the appendix to this report shows more detail regarding the derivation of the expected returns for this hypothetical pension plan.

The following are points to consider when reviewing the results in Exhibits 9 and 10:

Range of Reasonable Assumptions: When setting the investment return assumption for pension valuations, actuaries traditionally constructed a range of reasonable assumptions and then selected a best-estimate point within that range. Actuaries would often consider the reasonable range to be the middle 50 percent of possible results, bounded by the 25th and 75th percentiles.

The applicable actuarial standards of practice were updated in 2013, and the new standards de-emphasize use of the reasonable range when setting the investment return assumption. Nevertheless, considering this range remains instructive; it may be difficult for an actuary to justify an assumption outside of this range.

Based on the average assumptions in this 2018 survey, the middle 50 percent range for this hypothetical pension plan is very wide: 5.50% to 8.73% over the next 20 years. Note that the range is even wider for a 10-year horizon: 3.73% to 8.16%. This is due to the fact that, while returns may be volatile from one year to the next, deviations will be lower when returns are annualized (in other words, smoothed out) over longer horizons.

Probability of Meeting/Exceeding the Benchmark: For example, say that the actuary for this hypothetical pension plan expects its investment returns to be 7.00% per year, represented by the gold lines in Exhibits 9 and 10. Based on the average assumptions in this 2018 survey, there is a 52.0% probability the plan will meet or beat its 7.00% benchmark on an annualized basis over a 20-year period. The probability is lower, 37.4%, that the plan will meet or beat its benchmark over the next 10 years.

Also note that over a 20-year period, the probability that the annualized investment return will exceed 7.50% (arbitrarily, 50 basis points above the benchmark return) is 43.7%. The probability that the annualized return will exceed 6.50% (50 basis points below the benchmark) is 60.2%. These probabilities are a bit lower when focusing on a 10-year horizon rather than a 20-year horizon.

Optimistic and Conservative Assumptions: As previously noted, different investment advisors may have widely varying future capital market expectations. Therefore, it may also be interesting to consider the range of expected returns based on the assumptions provided by the most conservative and most optimistic advisors in the survey.

For this hypothetical asset allocation, the assumptions from the most conservative advisor indicate that the probability of beating the 7.00% benchmark assumption over the next 20 years is 28.3%. Using assumptions from the most optimistic advisor results in a probability of 71.0%. Again, reasonable people may differ.

Limitations: The following are some important limiting factors to keep in mind when reviewing these results. In most cases, adjustments made to account for these limitations tended to slightly lower the expected returns in the survey, for the sake of conservatism.

- The asset classes in this survey do not always align perfectly with the asset classes provided by the investment advisors. Adjustments were made to standardize the different asset classes provided.
- Many of the advisors develop their future assumptions based on investment horizons of no more than 10 years, and returns are generally expected to be lower in the short term. The typical multiemployer pension plan will have an investment horizon that is much longer than 10 years.
- The return expectations are based on indexed returns. In other words, they do not reflect any additional returns that may be earned due to active asset managers outperforming the market (“alpha”), net of investment expenses.
- The return expectations do not adjust for plan size. Specifically, they do not take into account the fact that certain investment opportunities are more readily available to larger plans, as well as the fact that larger plans may often receive more favorable investment fee arrangements than smaller plans.
- The ranges of expected annualized returns were constructed using basic, often simplified, formulas and methodologies. More sophisticated investment models – which may consider various economic scenarios, non-normal distributions, etc. – could produce significantly different results.

Use of the Survey: This survey is not intended to be a substitute for the expectations of individual portfolio managers, advisors, or actuaries performing their own independent analyses. The actuarial standards of practice provide for various methods of selecting the investment return assumption. This survey is intended to be used in conjunction with these methods, with appropriate weighting of various resources based on the plan actuary’s professional judgment.

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Comparison with Prior Surveys

Exhibits 6 and 7 showed how expected returns and standard deviations for certain asset classes have changed over the past few years. Similarly, Exhibits 11 and 12 below show how return expectations for the hypothetical multiemployer pension plan whose asset allocation is shown in Exhibit 8 have changed from 2014 to 2018.

Both exhibits show the probabilities that the hypothetical pension plan will meet or exceed its 7.00% benchmark return on an annualized basis over the given time horizon. Exhibit 11 focuses on expected returns over a 10-year period, and Exhibit 12 focuses on expected returns over a 20-year period. Probabilities are shown for the survey average for each year from 2014 through 2018. For comparison, probabilities are also shown for the most conservative and optimistic advisors in each survey.

Exhibit 11

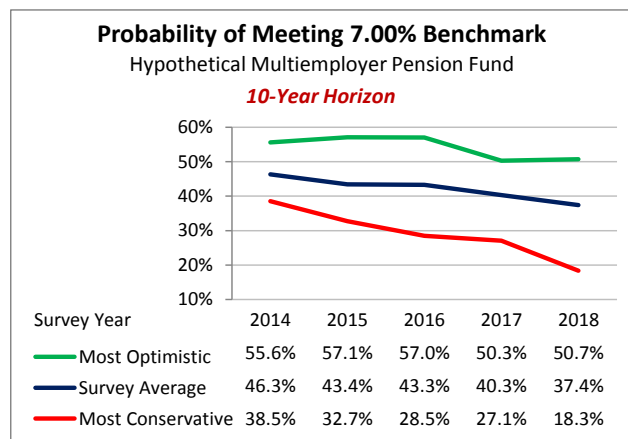
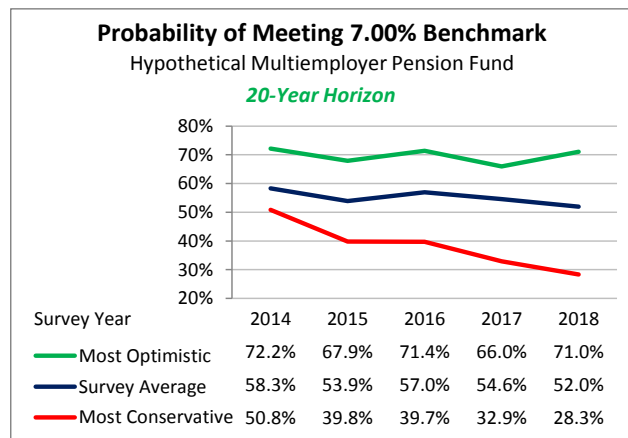


Exhibit 12



As shown in Exhibits 11 and 12, the probabilities that this hypothetical pension plan would meet or beat a benchmark return of 7.00% have generally decreased from 2014 to 2018. The decrease is more pronounced when considering a 10-year horizon versus a 20-year horizon.

For example:

- Based on the average assumptions from the 2018 survey, the probability of this hypothetical plan meeting or exceeding an annualized return of 7.00% over the next 10 years is 37.4%. For comparison, the probability was considerably higher (46.3%) five years ago when the 2014 survey was conducted.
- Based on the average assumptions from the 2018 survey, the probability of this hypothetical plan meeting or exceeding an annualized return of 7.00% over the next 20 years is 52.0%. While the probability was higher (58.3%) based on the average assumptions from 2014, the decrease over time for longer-term expectations is less pronounced than it has been for shorter-term expectations.

Other points of note when comparing the results from the 2018 survey to those from prior years:

- The results for the most conservative advisor in each survey from 2014 through 2018 have changed more dramatically than the results for the survey average and the most optimistic advisors. Based on the assumptions of the most conservative advisor in the 2014 survey, the probability of this hypothetical plan meeting or exceeding its 7.00% benchmark over the next 20 years was 38.5%. This can be compared to a probability of only 18.3% for the most conservative advisor in the 2018 survey.
- The results for the most optimistic advisor in each survey have generally remained more stable over the past five years, though there was a significant decrease in the probability of meeting the 7.00% benchmark over a 10-year horizon from 2016 to 2017. Nevertheless, the probability of meeting the 7.00% benchmark over a 10-year horizon based on the most optimistic advisor in the 2017 and 2018 surveys is still greater than 50%.
- Note that the most conservative and most optimistic advisors are not necessarily the same from year to year.

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Glossary

The following are basic definitions of some of the investment terminology used in this report.

Expected Return

The *expected return* is the amount, as a percentage of assets, that an investment is expected to earn over a period of time. Expected returns presented in this survey are generally assumed to be indexed and net of fees.

Arithmetic vs. Geometric Returns

The *arithmetic* return is the average return in any one year; in other words, it has a one-year investment horizon. A *geometric* return is the annualized return over a multi-year period. In general, when evaluating expected returns over multi-year horizons, it is more appropriate to focus on geometric returns. However, arithmetic returns are also important. For example, the expected return of a portfolio is calculated as the weighted average of arithmetic returns, not geometric returns.

This survey focuses on geometric returns. Many advisors provide both arithmetic and geometric expected returns. For advisors who provided expected returns only on an arithmetic basis, we converted them to geometric returns for consistency. The following formula was used in making this conversion.

$$E[R_G] = ((1 + E[R_A])^2 - \text{VAR}[R])^{1/2} - 1$$

In this formula, $E[R_G]$ is the expected geometric return, $E[R_A]$ is the expected arithmetic return, and $\text{VAR}[R]$ is the variance of the expected annual return.

Standard Deviation

The *standard deviation* is a measure of the expected volatility in the returns. Generally, the standard deviation expresses how much returns may vary in any one year. Assuming that returns are “normally distributed,” there is about a 68% probability that the actual return for a given year will fall within one standard deviation (higher or lower) of the expected return. There is about a 95% probability that the actual return will fall within two standard deviations of the expected return.

Correlation

An important aspect of capital market assumptions is the degree to which the returns for two different asset classes move in tandem with one another: this is their *correlation*. For example, if two asset classes are perfectly correlated, their correlation coefficient will be 1.00; in other words, if one asset class has a return of X% in a given market environment, then the other asset class is expected to also have a return of X%. A portfolio becomes better diversified as its asset classes have lower (or even negative) correlations with each other.

Methodology

The following is a high-level description of the methodology used in compiling the survey results.

Standardized Asset Classes

Not all investment advisors use the same asset classes when developing their capital market assumptions. Some are very specific (more asset classes), while others keep things relatively simple (fewer asset classes).

We exercised judgment in classifying each advisor’s capital market assumptions into a standard set of asset classes. In the event that an advisor did not provide assumptions for a given asset class, the average assumptions from the other advisors was used when developing expected returns for that advisor.

Investment Horizons

This survey considers “short-term” expected returns to apply to a 10-year investment horizon, and “long-term” expected returns to apply to a 20-year horizon.

In this 2018 edition of the survey, 23 of the 34 advisors provided only short-term assumptions, indicating a horizon of no more than 10 years. Included in this group are 2 advisors who provided assumptions over a horizon of 10 to 15 years.

All 13 advisors who provided long-term assumptions over horizons of 20 years or more also provided short-term assumptions. In cases where such an advisor indicated a horizon shorter than 10 years, the shorter-term expected returns were combined with the longer-term expected returns to achieve a 10-year horizon. If an advisor indicated a time horizon longer than 20 years, the longer-term expected returns were combined with the shorter-term expected returns to achieve a 20-year horizon.

No Adjustment for Alpha

No adjustment was made to reflect the possible value added by an active investment manager outperforming market returns (earning “alpha”).

Normally-Distributed Returns

This survey assumes that investment returns will be normally distributed according to the capital market assumptions provided. The survey also assumes that the investment return in one year does not affect the investment return in the following year.

Equal Weighting

Each advisor was given equal weight in developing the average assumptions for the survey, regardless of factors such as total assets under advisement, number of clients in common with Horizon Actuarial, etc.

Exhibit 13

The following exhibit evaluates the investment return assumption for a hypothetical multiemployer pension plan. It reflects the same hypothetical asset allocation as shown in Exhibit 8, and it provides more detail than Exhibits 9 and 10. Note that the most conservative and optimistic advisors for the 10-year horizon are not necessarily the same as the most conservative and optimistic advisors for the 20-year horizon. This hypothetical pension plan has a benchmark return of 7.00% per year, which is indicated by the gold line in the exhibit below.

Hypothetical Multiemployer Plan 2018 Survey of Capital Market Assumptions

Asset Class	Portfolio Weight	Average Survey Assumptions		
		10-Year Horizon	20-Year Horizon	Standard Deviation
US Equity - Large Cap	20.0%	6.07%	7.42%	16.39%
US Equity - Small/Mid Cap	10.0%	6.57%	8.18%	20.20%
Non-US Equity - Developed	7.5%	6.71%	7.71%	18.67%
Non-US Equity - Emerging	5.0%	7.64%	8.82%	24.89%
US Corporate Bonds - Core	7.5%	3.37%	4.46%	5.71%
US Corporate Bonds - Long Duration	2.5%	3.32%	4.44%	10.83%
US Corporate Bonds - High Yield	5.0%	4.78%	5.82%	10.24%
Non-US Debt - Developed	5.0%	2.18%	3.22%	6.86%
Non-US Debt - Emerging	2.5%	5.00%	6.13%	11.43%
US Treasuries (Cash Equivalents)	5.0%	2.48%	3.05%	2.74%
TIPS (Inflation-Protected)	5.0%	2.88%	4.04%	6.25%
Real Estate	10.0%	5.90%	6.66%	13.86%
Hedge Funds	5.0%	4.96%	6.19%	7.87%
Commodities	2.5%	3.97%	4.92%	17.60%
Infrastructure	2.5%	6.56%	7.14%	14.74%
Private Equity	5.0%	8.33%	9.52%	22.16%
Inflation	N/A	2.24%	2.47%	1.76%
TOTAL PORTFOLIO	100.0%	<i>Expected returns are geometric.</i>		

Considerations and Limitations

- Allocations may be approximated if certain asset classes are not included in the survey.
- Many investment advisors provided only shorter-term assumptions (10 years or less).
- Assumptions are based on indexed returns and do not reflect anticipated alpha.
- Assumptions do not reflect investment opportunities or fee considerations available to larger funds.

SOURCE: Horizon Actuarial 2018 Survey of Capital Market Assumptions

Expected returns over a 10-year horizon include all 34 survey participants.

Expected returns over a 20-year horizon are based a subset of 13 survey participants who provided longer-term assumptions.

	10-Year Horizon			20-Year Horizon		
	Conservative Advisor	Survey Average	Optimistic Advisor	Conservative Advisor	Survey Average	Optimistic Advisor
Expected Returns						
Average Annual Return (Arithmetic)	4.72%	6.45%	7.55%	6.16%	7.65%	8.74%
Annualized Return (Geometric)	4.29%	5.95%	7.06%	5.59%	7.12%	8.26%
Annual Volatility (Standard Deviation)	9.48%	10.38%	10.27%	11.03%	10.72%	10.19%
Range of Expected Annualized Returns						
◆ 75th Percentile	6.32%	8.16%	9.25%	7.25%	8.73%	9.80%
◆ 25th Percentile	2.27%	3.73%	4.87%	3.92%	5.50%	6.73%
Probabilities of Exceeding Certain Returns						
7.50% per Year, Annualized	14.2%	31.8%	44.6%	21.9%	43.7%	63.1%
7.00% per Year, Annualized	18.3%	37.4%	50.7%	28.3%	52.0%	71.0%
6.50% per Year, Annualized	23.1%	43.3%	56.8%	35.6%	60.2%	78.0%

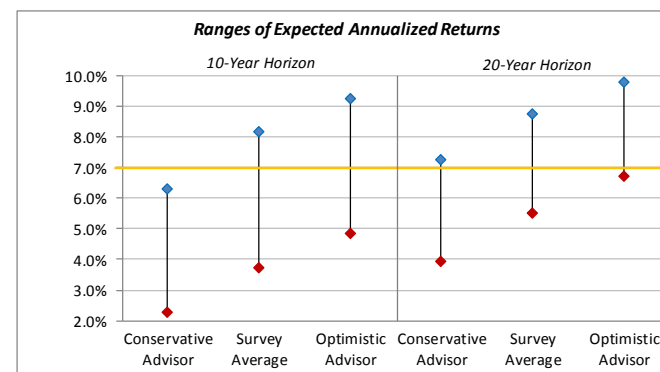


Exhibit 14

The following exhibit shows the distribution of expected annualized returns and annual standard deviations for the same hypothetical asset allocation that is shown in Exhibit 13. The expected annualized return and annual standard deviation of the hypothetical asset allocation are shown separately for each advisor who participated in the survey. Individual advisors are grouped by type and investment horizon, and the survey average assumptions are shown in red. The exhibit shows that there are a wide variety of investment return assumptions that could be considered to be reasonable for any given asset allocation.

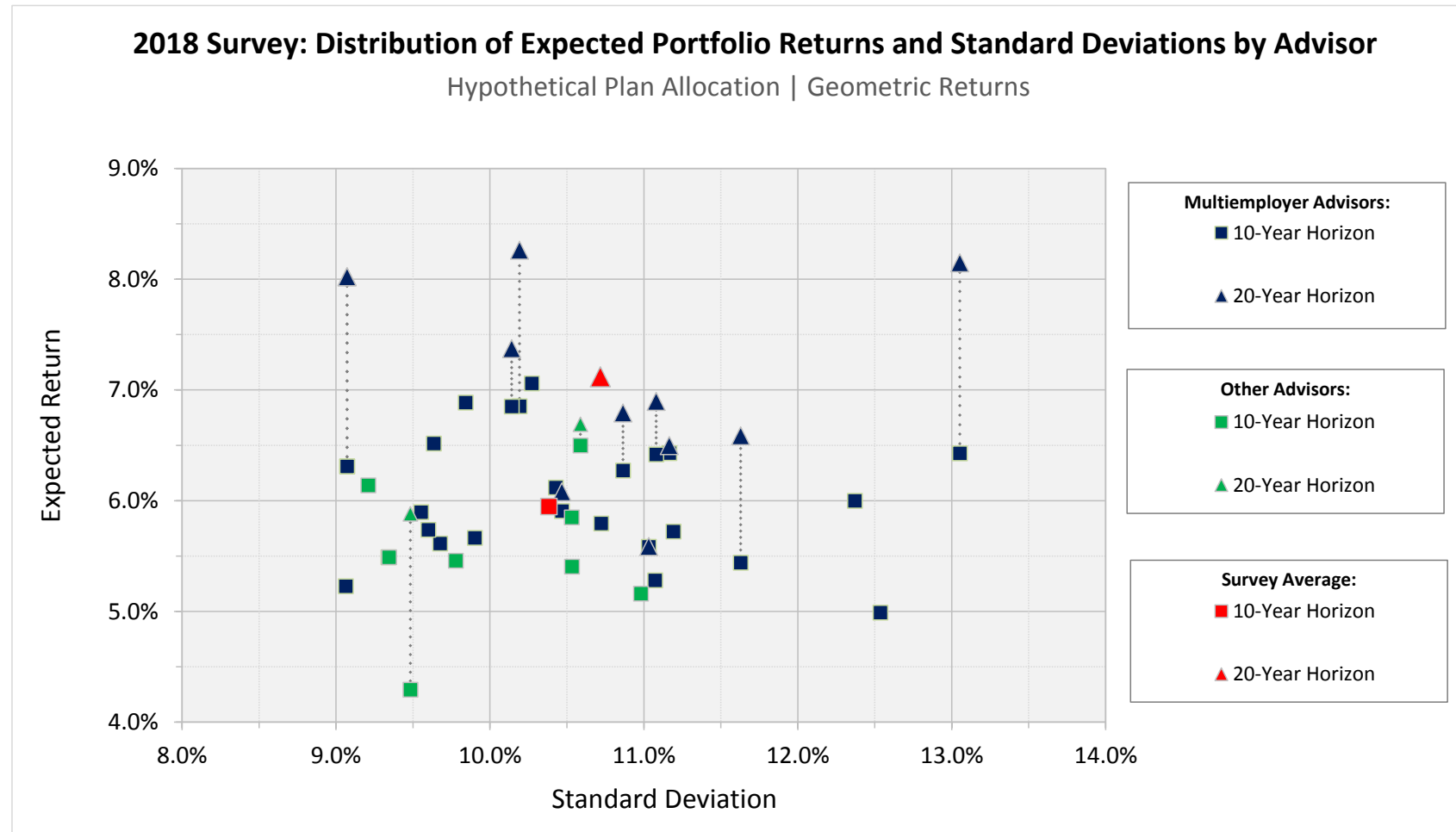


Exhibit 15

The following exhibit provides the average capital market assumptions for all 34 investment advisors in the 2018 survey. Each of the 34 advisors was given equal weight in determining the average assumptions. For reference, expected returns are shown over 10-year and 20-year horizons. Expected returns are also provided on both an arithmetic basis (one-year average) and geometric basis (multi-year annualized). The standard deviations (volatilities) and correlations apply to both arithmetic and geometric expected returns.

Horizon Actuarial 2018 Survey of Capital Market Assumptions

Average Survey Assumptions

Asset Class		Expected Returns				Standard Deviation
		10-Year Horizon		20-Year Horizon		
		Arith.	Geom.	Arith.	Geom.	
1	US Equity - Large Cap	7.34%	6.07%	8.73%	7.42%	16.39%
2	US Equity - Small/Mid Cap	8.49%	6.57%	10.13%	8.18%	20.20%
3	Non-US Equity - Developed	8.36%	6.71%	9.46%	7.71%	18.67%
4	Non-US Equity - Emerging	10.52%	7.64%	11.94%	8.82%	24.89%
5	US Corporate Bonds - Core	3.54%	3.37%	4.63%	4.46%	5.71%
6	US Corporate Bonds - Long Duration	3.90%	3.32%	5.14%	4.44%	10.83%
7	US Corporate Bonds - High Yield	5.29%	4.78%	6.44%	5.82%	10.24%
8	Non-US Debt - Developed	2.37%	2.18%	3.56%	3.22%	6.86%
9	Non-US Debt - Emerging	5.63%	5.00%	6.85%	6.13%	11.43%
10	US Treasuries (Cash Equivalents)	2.55%	2.48%	3.10%	3.05%	2.74%
11	TIPS (Inflation-Protected)	3.08%	2.88%	4.26%	4.04%	6.25%
12	Real Estate	6.89%	5.90%	7.67%	6.66%	13.86%
13	Hedge Funds	5.29%	4.96%	6.61%	6.19%	7.87%
14	Commodities	5.46%	3.97%	6.47%	4.92%	17.60%
15	Infrastructure	7.61%	6.56%	8.24%	7.14%	14.74%
16	Private Equity	10.72%	8.33%	12.17%	9.52%	22.16%
	Inflation	2.24%	2.24%	2.48%	2.47%	1.76%

Correlation Matrix

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1	1.00															
2	0.89	1.00														
3	0.84	0.76	1.00													
4	0.72	0.67	0.79	1.00												
5	0.12	0.07	0.14	0.14	1.00											
6	0.11	0.05	0.13	0.10	0.83	1.00										
7	0.61	0.60	0.60	0.62	0.36	0.26	1.00									
8	0.17	0.11	0.30	0.24	0.55	0.55	0.24	1.00								
9	0.54	0.49	0.58	0.66	0.44	0.37	0.59	0.41	1.00							
10	(0.10)	(0.12)	(0.09)	(0.07)	0.33	0.28	(0.03)	0.26	0.06	1.00						
11	0.05	0.01	0.10	0.16	0.68	0.57	0.31	0.52	0.40	0.33	1.00					
12	0.44	0.41	0.40	0.33	0.10	0.11	0.30	0.09	0.24	0.03	0.10	1.00				
13	0.66	0.64	0.68	0.67	0.14	0.06	0.58	0.15	0.48	(0.07)	0.13	0.35	1.00			
14	0.31	0.29	0.39	0.43	0.10	0.03	0.35	0.22	0.34	0.02	0.26	0.24	0.42	1.00		
15	0.54	0.49	0.53	0.47	0.20	0.21	0.41	0.33	0.43	(0.08)	0.18	0.31	0.41	0.29	1.00	
16	0.73	0.69	0.70	0.61	0.03	0.03	0.48	0.10	0.40	(0.08)	0.04	0.39	0.60	0.30	0.39	1.00

Expected returns over a 10-year horizon include all 34 survey participants.

Expected returns over a 20-year horizon are based a subset of 13 survey participants who provided long-term assumptions.

Exhibit 16

Earlier in this report, Exhibit 5 showed the distribution of expected returns and standard deviations over an investment horizon of 10 years. The exhibit below shows the same distribution, but for a horizon of 20 years. Note that while Exhibit 5 included assumptions for all 34 advisors in the survey, the exhibit below includes only assumptions for the 13 advisors who provided longer-term assumptions (horizons of 20 years or more).

2018 Survey: Distribution of Expected Returns and Standard Deviations

20-Year Horizon | Geometric Returns

Asset Class [Avg. Exp. Return | Avg. Std. Dev.]

Equities	● US Equity - Large Cap [7.4% 16.7%]
	● US Equity - Small/Mid Cap [8.2% 20.5%]
	● Non-US Equity - Developed [7.7% 19.5%]
	● Non-US Equity - Emerging [8.8% 26.0%]
Fixed Income	■ US Corporate Bonds - Core [4.5% 5.8%]
	■ US Corporate Bonds - Long Duration [4.4% 12.0%]
	■ US Corporate Bonds - High Yield [5.8% 11.2%]
	■ Non-US Debt - Developed [3.2% 7.8%]
	■ Non-US Debt - Emerging [6.1% 12.3%]
	■ US Treasuries (Cash Equivalents) [3.0% 2.4%]
	■ TIPS (Inflation-Protected) [4.0% 6.7%]
Alternatives	▲ Real Estate [6.7% 14.4%]
	▲ Hedge Funds [6.2% 9.0%]
	▲ Commodities [4.9% 17.9%]
	▲ Infrastructure [7.1% 15.4%]
	▲ Private Equity [9.5% 23.9%]

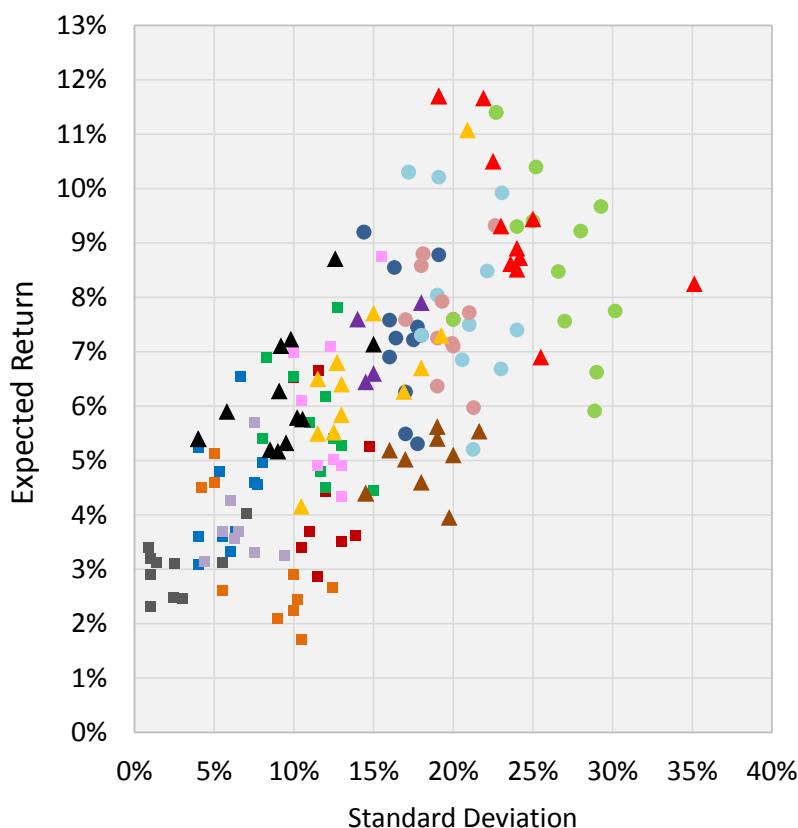


Exhibit 17

The exhibit below shows the ranges of expected annual returns for different asset classes over a 10-year investment horizon. The ranges shown below include assumptions for all the 34 advisors in the 2018 survey. Expected returns shown below are annualized (geometric).

To illustrate the distribution of expected returns, the exhibit shows the range of the middle 50 percent of results: the range between the 25th and 75th percentiles. It also shows the median expected return for each asset class: the 50th percentile. Note that the expected returns for the *median* advisor shown below are not the same as the *average* expected returns shown elsewhere in the report. In most cases, however, the differences between median and average expected returns are relatively small.

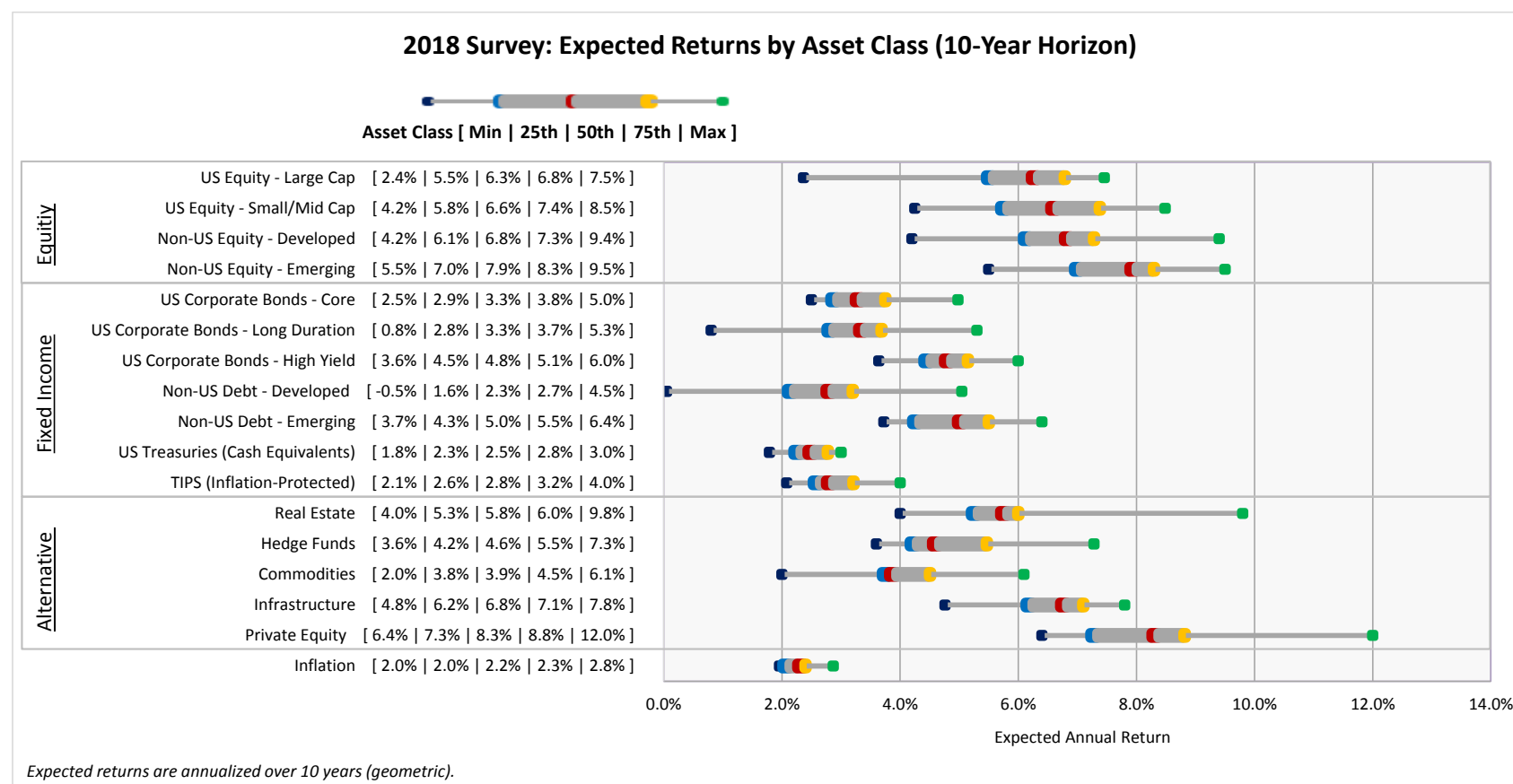
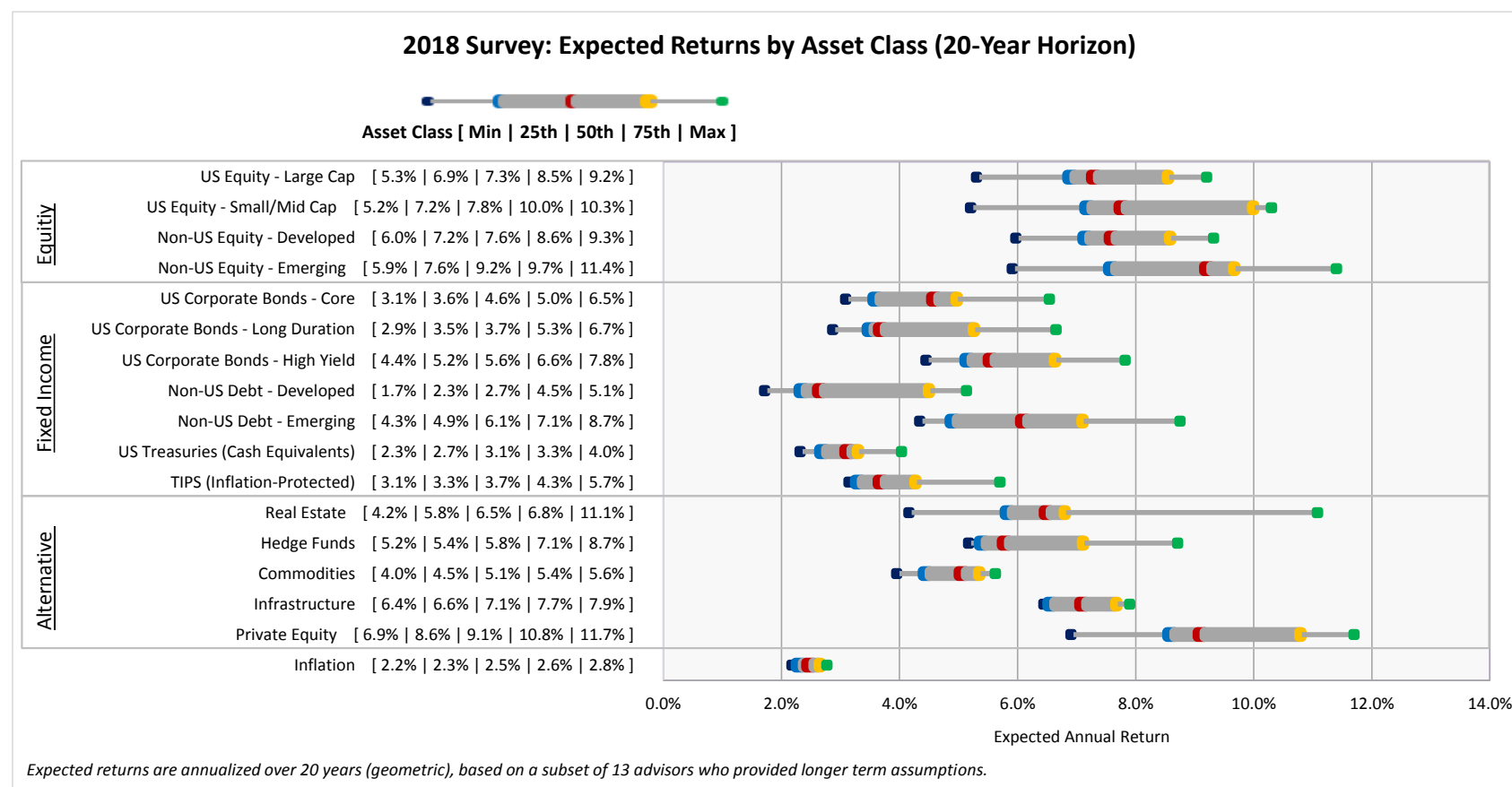


Exhibit 18

The exhibit below shows the ranges of expected annual returns for different asset classes over a 20-year investment horizon. The ranges shown below are based on the assumptions for 13 advisors who provided longer-term assumptions (horizons of 20 years or more). Expected returns shown below are annualized (geometric). Note that the ranges of expected returns are somewhat narrower when the investment horizon is longer.

To illustrate the distribution of expected returns, the exhibit shows the range of the middle 50 percent of results: the range between the 25th and 75th percentiles. It also shows the median expected return for each asset class: the 50th percentile. Note that the expected returns for the *median* advisor shown below are not the same as the *average* expected returns shown elsewhere in the report. In most cases, however, the differences between median and average expected returns are relatively small.



APPENDIX C – NASRA BRIEF

NASRA Issue Brief: Public Pension Plan Investment Return Assumptions



Updated February 2018

As of September 30, 2017, state and local government retirement systems held assets of \$4.16 trillion.¹ These assets are held in trust and invested to pre-fund the cost of pension benefits. The investment return on these assets matters, as investment earnings account for a majority of public pension financing. A shortfall in long-term expected investment earnings must be made up by higher contributions or reduced benefits.

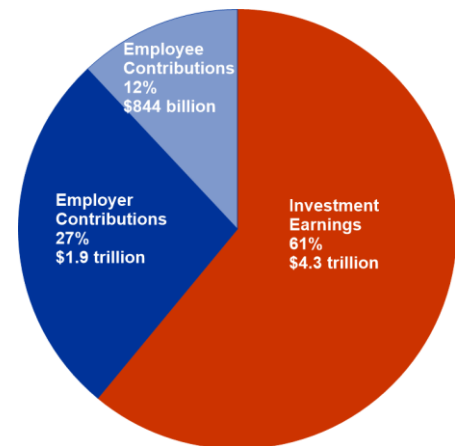
Funding a pension benefit requires the use of projections, known as actuarial assumptions, about future events. Actuarial assumptions fall into one of two broad categories: demographic and economic. Demographic assumptions are those pertaining to a pension plan's membership, such as changes in the number of working and retired plan participants; when participants will retire, and how long they'll live after they retire. Economic assumptions pertain to such factors as the rate of wage growth and the future expected investment return on the fund's assets.

As with other actuarial assumptions, projecting public pension fund investment returns requires a focus on the long-term. This brief discusses how investment return assumptions are established and evaluated, compares these assumptions with public funds' actual investment experience, and the challenging investment environment public retirement systems currently face.

Because investment earnings account for a majority of revenue for a typical public pension fund, the accuracy of the return assumption has a major effect on a plan's finances and actuarial funding level. An investment return assumption that is set too low will overstate liabilities and costs, causing current taxpayers to be overcharged and future taxpayers to be undercharged. A rate set too high will understate liabilities, undercharging current taxpayers, at the expense of future taxpayers. An assumption that is significantly wrong in either direction will cause a misallocation of resources and unfairly distribute costs among generations of taxpayers.

As shown in Figure 1, since 1987, public pension funds have accrued approximately \$7.0 trillion in revenue, of which \$4.3 trillion, or 61 percent, is from investment earnings. Employer contributions account for \$1.9 trillion, or 27 percent of the total, and employee contributions total \$844 billion, or 12 percent.²

Figure 1: Public Pension Sources of Revenue, 1987-2016



Compiled by NASRA based on U.S. Census Bureau data

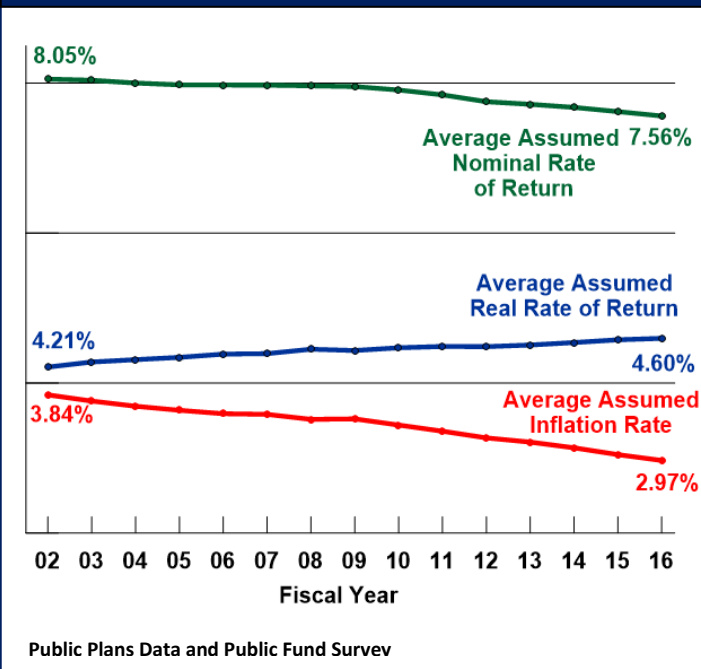
Most public retirement systems review their actuarial assumptions regularly, pursuant to state or local statute or system policy. The entity (or entities) responsible for setting the return assumption, as identified in Appendix B, typically works with one or more professional actuaries, who follow guidelines set forth by the Actuarial Standards Board in Actuarial Standards of Practice No. 27 (Selection of Economic Assumptions for Measuring Pension Obligations) (ASOP 27). ASOP 27 prescribes the factors actuaries should consider in setting economic actuarial assumptions, and recommends that actuaries consider the context of the measurement they are making, as defined by such factors as the purpose of the

¹ Federal Reserve, *Flow of Funds Accounts of the United States: Flows and Outstandings, Third Quarter 2017*, Table L.120

² US Census Bureau, Annual Survey of Public Pensions, State & Local Data

measurement, the length of time the measurement period is intended to cover, and the projected pattern of the plan's cash flows.

Figure 2: Average nominal and real rate of return, and average assumed inflation rate, FY 02 – FY 16



ASOP 27 also advises that actuarial assumptions be reasonable, defined in subsection 3.6 as being consistent with five specified characteristics; and requires that actuaries consider relevant data, such as current and projected interest rates and rates of inflation; historic and projected returns for individual asset classes; and historic returns of the fund itself. For plans that remain open to new members, actuaries focus chiefly on a long investment horizon, i.e., 20 to 30 years, which is the length of a typical public pension plan's funding period. One key purpose for relying on a long timeframe is to promote the key policy objectives of cost stability and predictability, and intergenerational equity among taxpayers.

The investment return assumption used by public pension plans typically contains two components: inflation and the real rate of return. The sum of these components is the nominal return rate, which is the rate that is most often used and cited. The system's inflation assumption typically

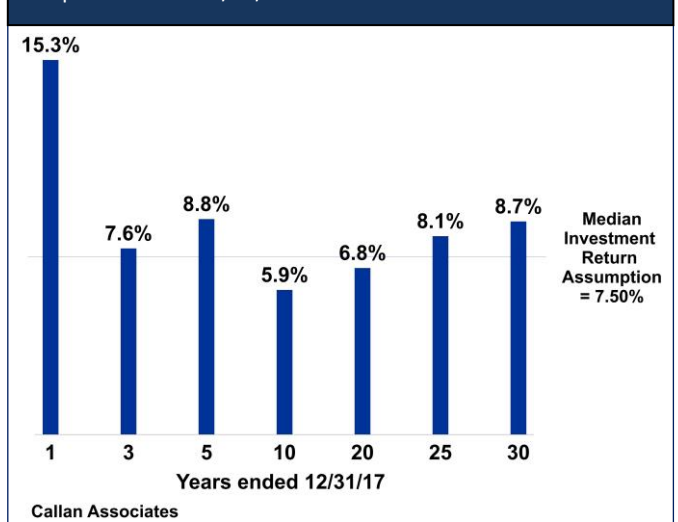
is applied also to other actuarial assumptions, such as the level of wage growth and, where relevant, assumed rates of cost-of-living adjustments (COLAs). Achieving an investment return approximately commensurate with the inflation rate normally is attainable by investing in securities, such as US Treasury bonds, that are often characterized as risk-free, i.e., that pay a guaranteed rate of return.

The second component of the investment return assumption is the real rate of return, which is the return on investment after adjusting for inflation. The real rate of return is intended to reflect the return produced as a result of the risk taken by investing the assets. Achieving a return higher than the risk-free rate requires taking some investment risk; for public pension funds, this risk takes the form of investments in assets such as public and private equities and real estate, which contain more risk than Treasury bonds.

Figure 2 illustrates the changes in the average nominal (non-inflation-adjusted) return, the inflation assumption, and the resulting real rate of return assumption. As the chart shows, although the average nominal public pension fund investment return has been declining, because the average rate of assumed inflation has been dropping more quickly, the average real rate of return has risen, from 4.21 percent in FY 02 to 4.60 percent in FY 16. One factor that may be contributing to the higher real rate of return is public pension funds' higher allocations to alternative assets, particularly to private equities, which usually have a higher expected return than other asset classes.

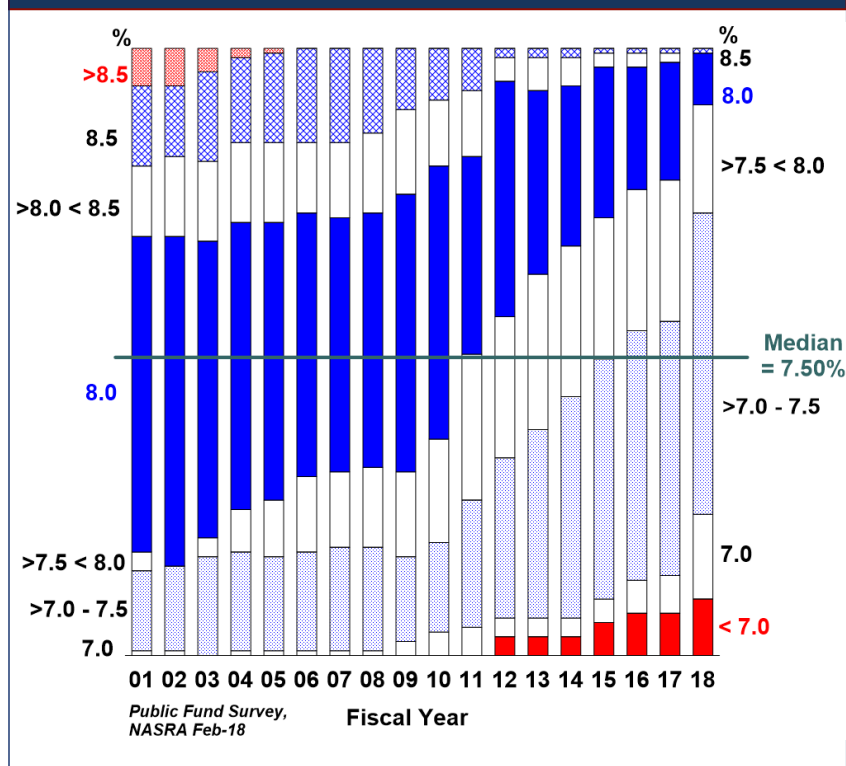
Figure 3 plots median public pension fund annualized investment returns for a range of periods ended December 31, 2017. As the figure shows, relatively strong returns in recent years are somewhat offset by the effects of market declines of 2000-02 and 2008-09, which are affecting returns for the 10- or 20-year periods ended 12/31/17, or both.

Figure 3: Median public pension annualized investment returns for period ended 12/31/2017



In the wake of the 2008-09 decline in capital markets and Great Recession, global interest rates and inflation have remained low by historic standards, due partly to so-called quantitative easing of central banks in many industrialized economies, including the U.S. Now in their ninth year, these low interest rates, with low rates of projected global economic growth, have led to reductions in projected returns for most asset classes, which, in turn, have resulted in an unprecedented number of reductions in the investment return assumption used by public pension plans. This trend is illustrated by Figure 4, which plots the distribution of investment return assumptions among a representative group of

Figure 4: Change in Distribution of Public Pension Investment Return Assumptions, FY 01 to FY 18



plans since 2001. Among the 129 plans measured, nearly three-fourths have reduced their investment return assumption since fiscal year 2010, resulting in a decline in the average return assumption from 7.91 percent to 7.36 percent. If projected returns continue to decline, investment return assumptions are likely to also to continue their downward trend. Appendix A lists the assumptions in use or adopted for future use by the 129 plans in this dataset.

One challenging facet of setting the investment return assumption that has emerged more recently is a divergence between expected returns over the near term, i.e., the next five to 10 years, and over the longer term, i.e., 20 to 30 years³. A growing number of investment return projections are concluding that near-term returns will be materially lower than both historic norms as well as projected returns over longer timeframes. Because many near-term projections calculated recently are well below the long-term assumption most plans are using,

some plans face the difficult choice of either maintaining a return assumption that is higher than near-term expectations, or lowering their return assumption to reflect near-term expectations.

If actual investment returns in the near-term prove to be lower than historic norms, plans that maintain their long-term return assumption risk experiencing a steady increase in unfunded pension liabilities and corresponding costs.

Alternatively, plans that reduce their assumption in the face of diminished near-term projections will experience an immediate increase unfunded liabilities and required costs. As a rule of thumb, a 25 basis point reduction in the return assumption, such as from 8.0 percent to 7.75 percent, will increase the cost of a plan that has a COLA, by three percent of pay (such as from 10 percent to 13 percent), and a plan that does not have a COLA, by two percent of pay.

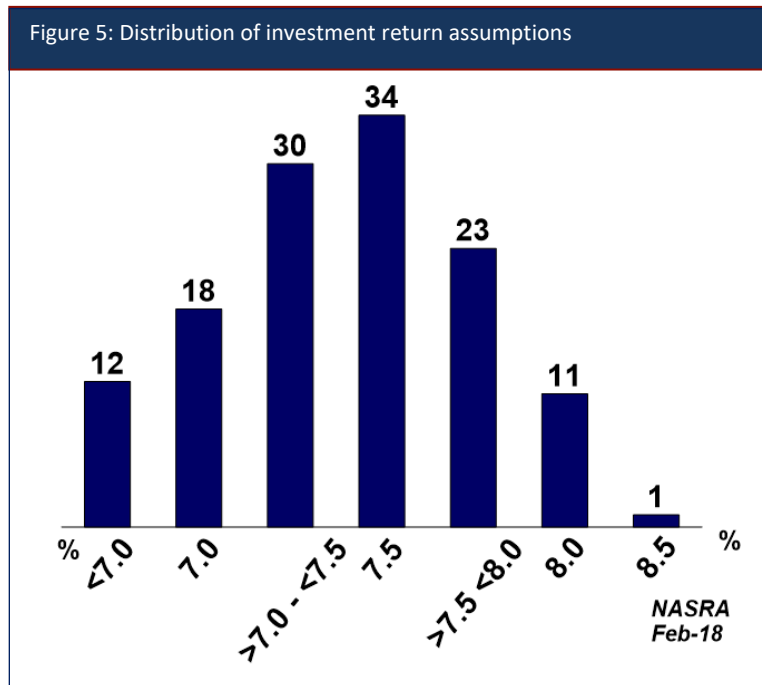
Conclusion

The investment return assumption is the single most consequential of all actuarial assumptions in terms of its effect on a pension plan's finances. The sustained period of low interest rates since 2009 has caused many public pension plans to re-evaluate their long-term expected investment returns, leading to an unprecedented number of reductions in plan investment return assumptions. Absent other changes, a lower investment return assumption increases both the plan's unfunded liabilities and cost. The process for evaluating a pension plan's investment return assumption should include abundant input and feedback from professional experts and actuaries, and should reflect consideration of the factors prescribed in actuarial standards of practice.

³ Horizon Actuarial Services, "Survey of Capital Market Assumptions, 2017 Edition (August 2017) p4

See Also:

- [Actuarial Standards of Practice No. 27](#), Actuarial Standards Board
- [The Liability Side of the Equation Revisited](#), Missouri SERS, September 2006



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[National Association of State Retirement Administrators](#)

Appendix A: Investment Return Assumption by Plan

(Figures reflect the nominal assumption in use, or announced for use, as of February 2018¹)

Plan	Rate (%)
Alabama ERS	7.75
Alabama Teachers	7.75
Alaska PERS	8.0
Alaska Teachers	8.0
Arizona Public Safety Personnel	7.40
Arizona SRS	7.50
Arkansas PERS	7.15
Arkansas State Highway ERS	8.0
Arkansas Teachers	7.50
California PERF ²	7.375
California Teachers ³	7.25
Chicago Teachers	7.75
City of Austin ERS	7.50
Colorado Affiliated Local	7.50
Colorado Fire & Police Statewide	7.50
Colorado Municipal	7.25
Colorado School	7.25
Colorado State	7.25
Connecticut SERS	6.90
Connecticut Teachers	8.0
Contra Costa County	7.25
DC Police & Fire	6.50
DC Teachers	6.50
Delaware State Employees	7.0
Denver Employees	7.75
Denver Public Schools	7.25
Duluth Teachers	8.0
Fairfax County Schools	7.50
Florida RS	7.50
Georgia ERS	7.50
Georgia Teachers	7.50
Hawaii ERS	7.0
Houston Firefighters	7.0
Idaho PERS	7.0
Illinois Municipal	7.50
Illinois SERS	7.25
Illinois Teachers	7.0
Illinois Universities	7.25
Indiana PERF	6.75
Indiana Teachers	6.75
Iowa PERS	7.0
Kansas PERS	7.75
Kentucky County	6.25
Kentucky ERS ⁴	5.25
Kentucky Teachers	7.50

Los Angeles County ERS	7.50
Louisiana Parochial Employees	7.0
Louisiana SERS ⁵	7.70
Louisiana Teachers ⁵	7.70
Maine Local	6.875
Maine State and Teacher	6.875
Maryland PERS ⁶	7.50
Maryland Teachers ⁶	7.50
Massachusetts SERS	7.50
Massachusetts Teachers	7.50
Michigan Municipal	7.75
Michigan Public Schools ⁷	7.05
Michigan SERS	7.0
Minnesota PERF	8.0
Minnesota State Employees	8.0
Minnesota Teachers ⁸	8.50
Mississippi PERS	7.75
Missouri DOT and Highway Patrol	7.75
Missouri Local	7.25
Missouri PEERS	7.60
Missouri State Employees	7.65
Missouri Teachers	7.60
Montana PERS	7.65
Montana Teachers	7.75
Nebraska Schools	7.50
Nevada Police Officer and Firefighter	7.50
Nevada Regular Employees	7.50
New Hampshire Retirement System	7.25
New Jersey PERS ⁹	7.50
New Jersey Police & Fire ⁹	7.50
New Jersey Teachers ⁹	7.50
New Mexico PERA ¹⁰	7.51
New Mexico Teachers	7.25
New York City ERS	7.0
New York City Teachers	7.0
New York State Teachers	7.25
North Carolina Local Government	7.20
North Carolina Teachers and State Employees	7.20
North Dakota PERS	7.75
North Dakota Teachers	7.75
NY State & Local ERS	7.0
NY State & Local Police & Fire	7.0
Ohio PERS	7.50
Ohio Police & Fire	8.0
Ohio School Employees	7.50

Ohio Teachers	7.45
Oklahoma PERS	7.0
Oklahoma Teachers	7.50
Orange County ERS	7.0
Oregon PERS	7.20
Pennsylvania School Employees	7.25
Pennsylvania State ERS	7.25
Phoenix ERS	7.50
Rhode Island ERS	7.0
Rhode Island Municipal	7.0
San Diego County	7.25
San Francisco City & County	7.46
South Carolina Police	7.25
South Carolina RS	7.25
South Dakota RS	6.50
St. Louis School Employees	7.50
St. Paul Teachers	8.0
Texas County & District	8.0
Texas ERS	7.50
Texas LECOS	7.50
Texas Municipal	6.75

Texas Teachers	8.0
Tennessee Political Subdivisions	7.25
Tennessee State and Teachers	7.25
Utah Noncontributory	6.95
Vermont State Employees	7.50
Vermont Teachers	7.50
Virginia Retirement System	7.0
Washington LEOFF Plan 1 ¹¹	7.70
Washington LEOFF Plan 2 ¹²	7.50
Washington PERS 1 ¹¹	7.70
Washington PERS 2/3 ¹¹	7.70
Washington School Employees Plan 2/3 ¹¹	7.70
Washington Teachers Plan 1 ¹¹	7.70
Washington Teachers Plan 2/3 ¹¹	7.70
West Virginia PERS	7.50
West Virginia Teachers	7.50
Wisconsin Retirement System	7.20
Wyoming Public Employees	7.0

1. This list of nominal investment return assumptions is updated at www.nasra.org/latestreturnassumptions
2. CalPERS is reducing its investment return assumption from 7.50 percent to 7.0 percent over three years. In February 2017 the CalPERS Board adopted a risk mitigation policy, effective beginning FY 2021, that calls for a reduction in the system's investment return assumption commensurate with the pension fund achieving a specified level of investment return. Details are available online: <https://www.calpers.ca.gov/docs/board-agendas/201702/financeadmin/item-9a-02.pdf>.
3. CalSTRS is reducing its investment return assumption from 7.50 percent to 7.0 percent over two years.
4. The Kentucky ERS is composed of two plans: Hazardous and Non-Hazardous. The rate shown applies to the plan's Non-Hazardous plan, which accounts for more than 90 percent of the Kentucky ERS plan liabilities. The investment return assumption used for the Hazardous plan is 6.25 percent.
5. The Louisiana State Employees' Retirement System and Teachers' Retirement System are reducing their discount rate from 7.75 percent to 7.50 percent by 2021 in annual increments of 0.05 percent. The discount rate used to determine the FY 2018/2019 funding requirement is 7.65%, which is net of gain-sharing. The investment return assumption differs from the discount rate because of the effective cost of providing potential future ad hoc postretirement benefit increases, or gain-sharing. The investment return assumption, which includes gain-sharing, is reducing incrementally to 7.50% by 2021.
6. The assumed rate of return for the Maryland Public Employees' Retirement System and Teachers Retirement Systems is scheduled to decrease to 7.45 percent beginning July 1, 2018.
7. The Michigan Public School Employees' Retirement System administers three plans: a defined benefit plan and two hybrid plans (Pension Plus and Pension Plus 2). The rate shown applies to the defined benefit plan. The investment return assumption used for the Pension Plus plan is 7.0 percent, and 6.0 percent for Pension Plus 2.
8. Legislation approved by the Minnesota Legislature in 2016 would have reduced the return assumption of the Teachers' Retirement Association to 8.0 percent, but was vetoed by the governor for reasons extraneous to the assumption.
9. The assumed rate of return for the New Jersey PERS, Police & Fire, and Teachers plans is scheduled to decrease to 7.3 percent for FY 21 and FY 22, and to 7.0 percent effective FY 23.
10. Reflects a weighted average rate based on 7.25 percent for FY17-26 and 7.75 percent thereafter.
11. For all Washington State plans except LEOFF Plan 2, the assumed rate of return is scheduled to decrease to 7.5 percent for the 2019-21 biennium.
12. The assumed rate of return for the Washington LEOFF Plan 2 is scheduled to decrease to 7.4 percent for the 2019-2021 biennium.

Appendix B: Entity Responsible for Setting Investment Return Assumption for Selected State Plans

State	System	Investment Return Assumption Set By
AK	Alaska Public Employees Retirement System	Alaska Retirement Management Board
AK	Alaska Teachers Retirement System	Alaska Retirement Management Board
AL	Retirement Systems of Alabama	Retirement board
AR	Arkansas Public Employees Retirement System	Retirement board
AR	Arkansas State Highway Employees' Retirement System	Retirement board
AR	Arkansas Teachers Retirement System	Retirement board
AZ	Arizona Public Safety Personnel Retirement System	Retirement board
AZ	Arizona State Retirement System	Retirement board
CA	California Public Employees Retirement System	Retirement board
CA	California State Teachers Retirement System	Retirement board
CO	Colorado Public Employees Retirement Association	Retirement board
CO	Fire & Police Pension Association of Colorado	Retirement board
CT	Connecticut State Employees Retirement System	State Employees Retirement Commission
CT	Connecticut Teachers Retirement Board	Retirement board
DC	District of Columbia Retirement Board	Retirement board
DE	Delaware Public Employees Retirement System	Retirement board
FL	Florida Retirement System	FRS Actuarial Assumption Estimating Conference ¹
GA	Georgia Employees Retirement System	Retirement board
GA	Georgia Teachers Retirement System	Retirement board
HI	Hawaii Employees Retirement System	Retirement board
IA	Iowa Public Employees Retirement System	IPERS Investment Board
ID	Idaho Public Employees Retirement System	Retirement board
IL	Illinois State Universities Retirement System	Retirement board
IL	Illinois State Employees Retirement System	Retirement board
IL	Illinois Municipal Retirement Fund	Retirement board
IL	Illinois Teachers Retirement System	Retirement board
IN	Indiana Public Retirement System	Retirement board
KS	Kansas Public Employees Retirement System	Retirement board
KY	Kentucky Retirement Systems	Retirement board
KY	Kentucky Teachers Retirement System	Retirement board
LA	Louisiana State Employees Retirement System	Retirement board
LA	Louisiana Parochial Employees' Retirement System	Retirement board
LA	Louisiana Teachers Retirement System	Retirement board
MA	Massachusetts State Employees Retirement System	Collaborative between the legislature, state treasurer, governor, and the Massachusetts Public Employee Retirement Administration Commission
MA	Massachusetts Teachers Retirement Board	Collaborative between the legislature, state treasurer, governor, and the Massachusetts Public Employee Retirement Administration Commission
MD	Maryland State Retirement and Pension System	Retirement board
ME	Maine Public Employees Retirement System	Retirement board
MI	Michigan Public School Employees Retirement System	Retirement board
MI	Michigan State Employees Retirement System	Retirement board
MI	Municipal Employees' Retirement System of Michigan	Retirement board
MN	Minnesota Public Employees Retirement Association	Legislature
MN	Minnesota State Retirement System	Legislature
MN	Minnesota Teachers Retirement Association	Legislature

MO	Missouri Local Government Employees Retirement System	Retirement board
MO	Missouri Public Schools Retirement System	Retirement board
MO	Missouri State Employees Retirement System	Retirement board
MO	MoDOT & Patrol Employees' Retirement System	Retirement board
MS	Mississippi Public Employees Retirement System	Retirement board
MT	Montana Public Employees Retirement Board	Retirement board
MT	Montana Teachers Retirement System	Retirement board
NC	North Carolina Retirement Systems	Retirement board
ND	North Dakota Public Employees Retirement System	Retirement board
ND	North Dakota Teachers Fund for Retirement	Retirement board
NE	Nebraska Public Employees Retirement System	Retirement board
NH	New Hampshire Retirement System	Retirement board
NJ	New Jersey Division of Pension and Benefits	Retirement board and state treasurer
NM	New Mexico Educational Retirement Board	Retirement board
NM	New Mexico Public Employees Retirement Association	Retirement board
NV	Nevada Public Employees Retirement System	Retirement board
NY	New York State & Local Retirement Systems	State comptroller
NY	New York State Teachers Retirement System	Retirement board
OH	Ohio Police and Fire Pension Fund	Retirement board
OH	Ohio Public Employees Retirement System	Retirement board
OH	Ohio School Employees Retirement System	Retirement board
OH	Ohio State Teachers Retirement System	Retirement board
OK	Oklahoma Public Employees Retirement System	Retirement board
OK	Oklahoma Teachers Retirement System	Retirement board
OR	Oregon Public Employees Retirement System	Retirement board
PA	Pennsylvania Public School Employees Retirement System	Retirement board
PA	Pennsylvania State Employees Retirement System	Retirement board
RI	Rhode Island Employees Retirement System	Retirement board
SC	South Carolina Retirement Systems	Legislature
SD	South Dakota Retirement System	Retirement board
TN	Tennessee Consolidated Retirement System	Retirement board
TX	Teacher Retirement System of Texas	Retirement board
TX	Texas County & District Retirement System	Retirement board
TX	Texas Employees Retirement System	Retirement board
TX	Texas Municipal Retirement System	Retirement board
UT	Utah Retirement Systems	Retirement board
VA	Virginia Retirement System	Retirement board
VT	Vermont State Employees Retirement System	Retirement board
VT	Vermont Teachers Retirement System	Retirement board
WA	Washington Department of Retirement Systems	Legislature
WI	Wisconsin Retirement System	Retirement board
WV	West Virginia Consolidated Public Retirement Board	Retirement board
WY	Wyoming Retirement System	Retirement board

1. The Conference consists of staff from the Florida House, Senate, and Governor's office

APPENDIX D – FOSTER & FOSTER REPOSE

February 8, 2019

VIA EMAIL

Board of Trustees
c/o Mr. William E. Stefka
Austin Firefighters'
Relief and Retirement Fund
4101 Parkstone Heights Drive, Suite 270
Austin, TX 78746

Re: Response to Actuarial Audit

Dear Board:

We are in receipt of the draft actuarial audit completed by Bolton dated January 9, 2019. As you are aware, all systems with at least \$100 million in assets must complete an actuarial audit at least once every five years. We have reviewed their report and would welcome the opportunity to discuss it with the Board at an upcoming meeting. The body of this report summarizes our response to Bolton's conclusions outlined in their draft report.

First, and most importantly, we are pleased to read that Bolton agrees that our Valuation Report is in compliance with the requirements of the Texas State Pension Review Board (PRB) and the Actuarial Standards of Practice (ASOPs). Further, they concluded that the actuarial assumptions chosen depict an accurate reflection of the plan's liabilities.

As with any actuarial audit, the auditing actuary typically makes suggestions for the Board actuary and Pension Board to consider. The remainder of this letter will address some of those suggestions.

Audit Suggestion #1: Recommend a modification to the inflation assumption

Generally, we agree with the findings surrounding the price inflation and general wage inflation assumptions as represented in Bolton's draft report. Based on the more recent historical increases in the CPI-U, a reduction in the inflation assumption is probably warranted and we plan on revisiting the inflation assumptions used in the actuarial valuation with the Board prior to completion of the December 31, 2018 actuarial valuation.

It is important to point out that on page 9 of Bolton's draft response, they indicate that they determined the net geometric expected return of the expected portfolio over a 20-year period is 7.57% per year which was based on an assumed inflation rate of 2.47% (from the Horizon survey). This means that should the inflation assumption be lowered to a level that aligns more closely to the recent historical increases in the CPI-U and other public pension plans across the nation, the expected returns for the Fund over the long-term would be in line with the current assumed investment return of 7.70% per year. This means that Bolton's recommendation, if implemented, would still not impact the results in our valuation report.

Audit Suggestion #2: Recommend a reduction in the payroll growth assumption

As you may recall, this is an item that was discussed in conjunction with the most recent Experience Study, dated June 2015. The Board determined that the anticipated future growth of the City of Austin will generate growth within the Fire Department, and reducing the payroll growth assumption would be imprudent given the expansion that is expected within the community.

Our experience study noted that because of its significance when calculating the amortization period, it is important that this assumption continue to be monitored. Furthermore, even if the payroll growth assumption was reduced to be in line with the most recent payroll growth increases (2.4% as noted in Bolton's draft report), the amortization period would still fall well below any preferred thresholds as stated by the PRB.

Audit Suggestion #3: Recommend a reduction to the investment return assumption

This has also been a consistent item for discussion with the Board each year. It should be noted that the Board's assumption is still near the average of public funds nationwide. The most recent NASRA study shows that the median investment return assumption is just below 7.40%. Also, the Bolton draft notes that based on the parameters used in their study and the target allocation of the fund, the net expected return is equal to 7.57% per year which is just below the current assumption used in the actuarial valuation. With that said, we do think that another discussion with the Board's investment consultant would be appropriate to learn how they believe the portfolio is currently situated to perform over long term.

Audit Suggestion #4: Recommend that Board consider reviewing the mortality assumption

As you may remember, we discussed waiting for the new public plans mortality table to be released prior to making any adjustments to the mortality table assumption. The exposure draft of this new table was released this last fall (subsequent to our report), and we agree that moving to a mortality table that is predicated upon historical data of public safety workers makes reasonable sense. It is likely that we will recommend implementing this change for the next actuarial valuation.

Audit Suggestion #5: Recommend that the Cost of Living Adjustment (COLA) assumption be disclosed, and further consider adding a COLA assumption that reflects the last five COLA increases

This topic was a hot button for purposes of the GASB reports as well as this audit. We argued with the auditors and with the auditing actuaries that the AFRS COLA is NOT automatic and is instead dependent upon the results of an elaborate 10-year projection of the funded status and amortization period for the plan. If under that projection, certain criteria are met, AND the Board AND actuary feels that a COLA is appropriate, only then will a COLA be granted.

We have felt that since the COLA is not substantively automatic, we should not load up the liabilities to suggest that the COLA will annually occur. With that said, we are happy to reconsider our approach if the Board feels differently.

Audit Suggestion #6: Recommend that the actuary consider adding some measures of risk to give the trustees a better understanding of the factors that affect the “riskiness” of the AFRS

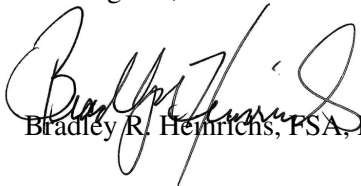
This topic has been addressed by the newest ASOP #51, which the Actuarial Standards Board voted to adopt in September 2017 and is effective for any actuarial work product with a measurement date on or after November 1, 2018. We certainly intend to comply with this ASOP and include some additional information in the next actuarial valuation. With that said, please note that ASOP 51 was not applicable to the actuarial reports that were reviewed by Bolton.

Audit Suggestion #7: Recommend that the actuary consider adding some projections of funded status and amortization levels covered by the current contribution rate to give the trustees a better understanding of the adequacy of the current contribution rate levels

As you know, projections of funded status and amortization levels are provided as part of our COLA policy. So, projections of funded status and amortization levels are performed on an annual basis. We do not include them as part of the actuarial valuation, as there is no requirement to do so, but we do perform them each year for purposes of determining whether to provide a COLA or not. Bolton also recommended doing the projections at alternative asset returns to demonstrate the downside risk of the plan of lower than expected investment returns and notes this may satisfy some of the requirements of ASOP No. 51. As previously noted, we certainly intend to comply with the ASOP No. 51 requirements.

In summary, we hope that the Trustees are pleased with the results of this audit. We take any auditing actuary's comments and suggestions very seriously, and we look forward to further addressing a few of these topics at an upcoming Board meeting.

Best regards,



Bradley R. Hennrichs, FSA, EA, MAAA