Report to the
Board of Estimate and Taxation

by the
BET Pension Liability Special Project Team

DRAFT July 18, 2021
With proposed changes dated September 9 in RED
## List of Exhibits

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Project Team Scope and Process

• Last April, the BET approved the appointment of members Bill Drake (Chair), Andy Duus, Miriam Kreuzer, and David Weisbrod to a special project team (the “Team”). Its purpose was to identify and evaluate potential means to reduce the annual cost ($28 million in 2021) of the Town’s defined benefit pension obligation.

• The Team met six times over a period of several months. Often participating were the Town’s Comptroller Pete Mynarski and the Town’s outside actuary Greg Stump of Boomershine Consulting Group.

• The Team considered the target funded ratio of the pension plan as well as a range of potential options that would increase the funded ratio by either increasing pension assets or reducing pension liabilities.
An impetus for the creation of the Team was interest to capture near-term budget flexibility given the long-term nature of the Town’s liability. Given the long-term nature of the Town’s liability, however, the Team also considered each option’s potential effect over a longer-term.

The Team adopted this report of its findings unanimously in its final meeting, on September 13, 2021.

The Team would like to express its thanks for the guidance and feedback provided by Pete Mynarski, Greg Stump, Ken Berkson, Mike Wacek, Andrew Greco and Larry Simon.
The Team believes that the optimal funded ratio percentage of the pension plan should range from the high 80s to the low 90s. The Town actuary Greg Stump concurs with this range.

Funded ratios above the range pose the following potential issues:

- Increased volatility of the annual ADEC.
- Reduced negotiation leverage with collective bargaining units.
- Contributions are irrevocable. If the plan becomes overfunded - whether due to future market performance, reduction of plan participants, or other - it would not be possible to return the excess to the Town.

As the funded ratio rises, we note that it is possible that the Retirement Board may seek to reduce the riskiness of the pension asset portfolio. Doing so, however, could cause:

(a) a reduction in the assumed return on the portfolio,
(b) a concomitant reduction in the assumed discount rate for the pension liability, and
(c) as a consequence, a reduction in the funded ratio.
Potential Actions Considered to Increase Funded Ratio

• The Team considered certain potential actions that would increase the Pension Plan assets are within the purview of the BET. These options include the following:
  o Pension Bond Obligation ("POB")
  o ‘Hyper-Amortization’

• The Team also considered other potential actions that would decrease the Pension Plan liability (and which would require the cooperation of the Retirement Board). These options include the following:
  o Pension Risk Transfer
  o Deferred Retirement Option Plan ("DROP")
  o Lump-Sum Pension Buyout

• The Team believes that each of these potential actions may pose incremental costs and/or risks for the Town. See Chart 17 for a summary comparison.
Potential Actions Considered to Increase Funded Ratio (cont.)

• The exceptional market performance of the Pension Plan this past fiscal year, however, increased the cash value of the pension assets to $613 million by July 1 2021, the most recent annual valuation date. This places the fund well above the minimal recommend funded ratio range. See Slides 13 and 14.

• Therefore, we do not recommend any action at this time that would either increase pension assets or decrease pension liabilities.

• The required annual cash contributions by the Town to the Plan, however, are based on actuarial values. Therefore, if the Plan’s future investment performance would approximate its assumed return, the Town would recognize increasing budgetary relief - due solely to this past year’s market performance - over the next five years and thereafter. See Slide 15.
Additional Recommendations

1. In a letter dated February 2, 2016, then Town Attorney Wayne Fox indicated that the BET has the right to review the reasonableness of certain assumptions adopted annually by the Retirement Board. These assumptions include the expected return on assets, the liability discount rate and amortization period of investment gain/losses and the underfunding. The Town’s Law Department recently reaffirmed the 2016 opinion. Therefore, we recommend that the BET’s Investment Advisory Committee review the reasonableness of these assumptions annually and (b) recommend their approval, or not, to the full BET.

2. In future years, to the extent there is budget flexibility, the Town might consider making pension plan contributions modestly higher than that required by the ADEC. A significantly greater contribution, however, may expose the Town’s borrowings to recharacterization as arbitrage debt (which would eliminate tax exemption of interest earned by investors).
Background Exhibits

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Calculation of the Annual Town Contribution 11

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Summary of the Town’s Defined Benefit Pension Plan

• The defined benefit pension plan of the Town, formally called the Retirement System (“System”) of the Town of Greenwich, began operations in 1946.

• Historically, participation in the System had been extended to all full-time employees of the Town who are classified as General, Fire or Police personnel. Peak membership was in 2004 (see next slide).

• In recent years, however, membership in the System has been no longer offered to certain new employees hired after a certain date: Teamsters and GMEA (2005), Elected Officials and M&C employees (2006), LIUNA (2008), Nurses (2009), and Police (2019). Newly hired firefighters had been last remaining set of Town employees eligible for the defined benefit pension plan. This past [June 23], however, an arbitration agreement (which the RTM did not choose to reject) disallowed participation of firefighters hired thereafter.
Plan Participation
Has Declined from Peak Enrollment

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<th>Recent</th>
<th>Historical Peak</th>
<th>Recent as % of Peak</th>
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<tr>
<td>Actives *</td>
<td>692</td>
<td>1,475</td>
<td>57% **</td>
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<tr>
<td>Term-vested</td>
<td>145</td>
<td>na</td>
<td>na</td>
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<tr>
<td>Inactives</td>
<td>1,296</td>
<td>1,085</td>
<td>119%</td>
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<tr>
<td></td>
<td>2,132</td>
<td>2,560</td>
<td>83%</td>
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</table>

* Includes [400] participants who are eligible for retirement. This represents an annual benefit for the Town worth approximately $[?].
** Inclusive of term-vested.
Calculation of the Annual Town Contribution

• Accounting rules and the Town Charter (Article 14, Section 205) require that the Town make an annual contribution to the Pension Fund. The contribution is now referred to as the Actuarially Determined Employer Contribution (“ADEC”).

• The ADEC for the current ‘22 fiscal year is $28.3 million, which equals $9.7 million for the current year’s ‘normal’ cost and $18.7 million for amortization of the underfunding.

• The calculation of the ADEC is based on the July 1 valuation date, and becomes the required contribution for the following fiscal year. For example, the contribution required to be made the current ‘22 fiscal year was based on the Pension Plan’s valuation on the first day of fiscal ‘21 (July 1, 2020).

• Assumptions pertaining to the assumed return on pension assets and other affect only the timing of the Town’s contributions. In the long-term, it is the experience results and the realized return on pension assets that determines the required amount of the Town’s contributions.
Factors affecting its calculation include the terms of the pension contracts, certain experience results and demographic assumptions made by the actuary, and the following assumptions made by the Retirement Board:

- **Assumed Return.** The assumed return on assets/discount rate on liability was 6.25% for FY22. Decreasing in recent years, this rate is lower than the average assumed by Connecticut municipalities. The Retirement Board has indicated that it may decrease it to 6.00% for purposes of calculation the FY23 contribution.

- **Amortization of Investment Gains/Losses.** Annual investment gains/losses are amortized uniformly over five years. This is done to smooth the effect of market fluctuations on the ADEC. Greenwich assumes five years, which is the customary period done by municipalities.

- **Amortization of the Underfunding.** For the ADEC payable this year, underfunding was amortized over 13 years. It is scheduled to decrease annually by a year each year until reaching ten years in FY25. Greg Stump recommends keeping the ten-year open structure.
The Funded Ratio

- The funded ratio equals the pension assets divided by the present value of the pension liability.

- The pension plan has been underfunded since July 1, 2008, when the Retirement Board reduced its assumed return on assets from 8.50% to 8.0%, in response to the financial crisis and concomitant market decline.

- Guiding the Retirement Board’s estimate of prospective return on assets are the risk-free rate and the estimated market risk premia associated with different asset classes. As both have continued to decline since 2008, the Retirement Board has made a series of steady reductions in the assumed investment return and discount rate on the pension liability.

- As a consequence, the funded ratio percentage has remained consistently in the 70s, until the most recent July 1 valuation date.
Improved Funded Status

• This past fiscal year, the market value of the pension assets rose 25% to $613 million. (Subsequently, through August 31, plan assets have increased to $648.8 million, due to (a) the Town’s contribution last July of the FY22 ADEC of $28.3 million and (b) investment gains of $7.5 million.)

• We will not know the July 1, 2021, accrued value of the pension liability at until later this year. If the pension liability remains unchanged at $662 million, the funded ratio on a market value basis rose from 74.3% last year to 92.5% this year. Likely, however, the pension liability would be slightly higher, especially if the Retirement Board reduces the discount rate from 6.25% to 6.00%, and the funded ratio close to 90%.

• This recent investment gain, as are all investment gains and losses, will be amortized over five years. Therefore, as shown on the following slide, the ADEC will decline ratably over the next five years, holding all else constant.
Projected ADECs

- ADECs through FY27, projected July 2020 and projected July 2021, assuming future assumed and realized investment performance of 6.25% and of 6.00%. ($ in millions). The Retirement Board has signaled that it may reduce the assumed investment return rate from 6.25% to 6.00% for next year.

<table>
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<tr>
<th>Valuation Date</th>
<th>Contrib. Fiscal Year</th>
<th>Projected 7/20 at 6.25%</th>
<th>Projected @ 7/21 a</th>
<th>ADEC at 6.25%</th>
<th>ADEC at 6.00%</th>
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<tbody>
<tr>
<td>7/1/2020</td>
<td>2022</td>
<td>$28.3</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td>7/1/2021</td>
<td>2023</td>
<td>$27.8</td>
<td>$25.8</td>
<td>$28.6</td>
<td></td>
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<tr>
<td>7/1/2022</td>
<td>2024</td>
<td>$27.8</td>
<td>$22.4</td>
<td>$25.5</td>
<td></td>
</tr>
<tr>
<td>7/1/2023</td>
<td>2025</td>
<td>$27.3</td>
<td>$18.1</td>
<td>$21.3</td>
<td></td>
</tr>
<tr>
<td>7/1/2024</td>
<td>2026</td>
<td>$26.2</td>
<td>$14.2</td>
<td>$17.1</td>
<td></td>
</tr>
<tr>
<td>7/1/2025</td>
<td>2027</td>
<td>$24.6</td>
<td>$10.2</td>
<td>$13.0</td>
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</tbody>
</table>

Assumes future investment returns are realized as assumed, either at 6.25% or 6.00%, with no experience gains or losses.

Source: Greg Stump
Options Exhibits

Summary Comparison of Options

Increase Pension Assets:
• Pension Obligation Bond
• ‘Hyper-Amortization’

Decease Pension Liability:
• Pension Risk Transfer
• Deferred Retirement Option Plan
• Lump Sum Pension Buy-Out
# Summary Comparison of Options

<table>
<thead>
<tr>
<th>Increase Pension Assets:</th>
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<tbody>
<tr>
<td>• Pension Obligation Bond</td>
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<tr>
<td>• ‘Hyper-Amortization’</td>
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</table>

<table>
<thead>
<tr>
<th>Decrease Pension Liability:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Pension Risk Transfer</td>
</tr>
<tr>
<td>• DROP</td>
</tr>
<tr>
<td>• Lump-Sum Pension Buyout</td>
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</table>
Pension Obligation Bond Description

• A pension obligation bond (“POB”) is a taxable bond issued by a state or municipality to help fund a pension plan.

• A POB captures the difference between the future (unknown) investment returns and the cost of the taxable funding. Because it is a taxable bond, the investment of the POB proceeds is not subject to does not bi the federal anti-arbitrage rules.

• In effect, a POB converts a less-defined ‘soft’ cost (the future pension liability) into a defined ‘hard’ cost (the future debt service on the POB).

• Many states and municipalities have issued POBs. Notably, the State of Connecticut issued $2.3 billion POB in 2008 and contributed the proceeds into the State Teachers’ pension Plan. Most recently, on June 24, 2021, West Hartford priced a $325 million POB, maturing over 25 years, at an all-in cost of 2.539%.
Pension Obligation Bond
Potential Issues

• Market timing is the biggest risk. The potential investment gains may not be realized.
  o The longer the term of the POB, the higher is the probability that the return on a diversified portfolio would exceed the cost of the POB.
  o To minimize the risk of investing at the top of the markets, possibly a series of smaller POBs could be issued by the Town over time.

• Taxable bond
  o As interest rates have declined, the difference between taxable and tax-exempt rates have narrowed significantly.

• Increase in debt
  o It is not clear to the extent the increased debt would be offset by the reduced pension liability in the minds of the debt rating agencies and investors. In any event, the BET’s debt policy would require revision.
“Hyper-Amortization”
Description

• “Hyper-Amortization” means that the Town would contribute more than the ADEC every year to the Pension Plan.

• An extreme example would be a POB. In this context, however, we suggest that the Town might consider making slightly higher annual payments into the pension every year.

• Because money is fungible, the marginal advantage would be a return higher (at least in the early years) than the cost of the funding.

• Tax counsel advises that if the incremental contributions are done on a modest scale, the Town would not need State approval (unlike POBs) and the Town’s borrowings would not risk characterization as ‘arbitrage’ bonds (which would cause the loss of tax-exempt status by investors).
“Hyper-Amortization”
Potential Future Consideration

• In recent years there have been advocates for hyper-amortization of the pension underfunding - achieved by reducing the amortization period of the underfunding to below the current target of ten years - and funding the incremental increase in the ADEC with the proceeds of longer-term borrows.

• The key rationale for hyper-amortization is the opportunity to earn more than the Town’s cost of funding. It would require integration with the BET debt and fund balance policies.

• Although the concept may have potential merit, the recent market performance of the pension asset portfolio and the prospective decline of the ADEC have reduced the opportunity for this, as it has for other options.
Pension Risk Transfer Description

• The Town might consider the purchase of an annuity from an insurance company to cover the pension obligation (called ‘Pension Risk Transfers”).

• Many public companies have done these transactions with insurance companies.
  o The primary motivation has not been economic. Typically, companies that have purchased contracts had fully funded pensions and already use discount rates for their pensions similar to that used by the insurers (< 3%) assuming the pension obligation.
  o Rather, the motivation has been to reduce earnings volatility. The volatility stems from the GAAP requirement that public companies report the changes in the value of their net pension liability.

• Likely for reasons summarized on the next slide, however, we are not aware of any state or municipality purchasing an annuity for this purpose.
Pension Risk Transfer
Potential Issues

• The annuity would be extremely costly, due primarily to the discount rate applied by the insurer would likely be significantly less than the 6.25% rate used by the Town, thereby increasing the cost payable by the Town approximately by $100 -200 million above the Plan’s recent accrued value.

Other potential issues:

  o It is not clear that a Connecticut municipality would be allowed to issue non-POB debt for this (non-capital) purpose.

  o A state or municipality may not be permitted to re-assign the obligation for the retirement payments to the insurance company. If the state or municipality would remain the obligor, auditors would require that the pension liability to remain continue to be reported in its financials.

  o Even if the reassignment would be legal, the retirees might object if there is a possible reduction in the credit quality of the obligor. There may be no diminution of credit quality, however, to the extent the state in which the insurance company is domiciled guarantees annuity contracts.
Pension Risk Transfer
Illustrative Example UPDATE?

• Based on the July 1, 2020, valuation, the Town has a total pension liability of $662 million, based on a discount rate of 6.25%. Of this, $278 million was owed to active members and $384 million was owed to inactive members.

• The total cost of an annuity contract is estimated (per Greg Stump) to be $1,021 million, or $476 million for active members and $545 million for inactive members. This contrasts to Plan assets of $613 million.

• The annuity could be more expensive due to changes in the discount rate and other assumptions.
Deferred Retirement Option Plan Description

• A deferred retirement option plan (or “DROP”) permits an employee eligible to retire to keep working without any further increase in their future retirement benefits.

• Therefore, as compensation, the Town would either (a) begin placing lump sums into an interest-bearing account annually, or (b) make payments while the employees continues to work either directly to the employee or into a fund on the employee’s behalf over-time.

• More frequently seen for public sector employees, a DROP would apply to someone who (a) has a defined benefits retirement plan from their employer and (b) is of retirement age, but chooses to continue working.

• The key difference of a DROP versus an early retirement plan would have the employee leave, whereas the DROP would have the employee remain.
Deferred Retirement Option Plan
Potential Issues

• The key advantages include (a) the employer gets to retain the employee’s services (without further increasing that employee’s pension payout), and (b) the employee who accepts a DROP may begin to receive incremental cash payments while still working.

• The key disadvantages are (a) too generous incentive payments to the employee can be more expensive for the employer, and (b) any lump sum paid to the employee, if not rolled over into another qualified plan, would be taxed at ordinary rates and possibly in a higher tax bracket.

• The source of potential economic value for the Town is not clear. On a simple cash flow basis, any cash incentive provided the employee costs the Town the same. On a present value basis, however, to the extent the Town has a lower discount rate than does the employee (and it generally would), a DROP may create potential value which could be shared between the Town and the employee. Greg Stump estimates that the Town would owe $70 million more in annual pension payments if eligible employees accepted a DROP.
Deferred Retirement Option Plan
Design Considerations

• Plan Design Considerations
  o Participation length is usually limited to three to four years.
  o Need for the employer to specify the payment amount and interest, and whether the payments are made directly to the employee or invested on their behalf. May affect the employee’s taxation.
  o Need to specify whether the employee who accepts the DROP is deemed “formally retired” and how would that affect their benefits.

• Note that another form of DROP in which the plan participant's retirement benefits are frozen but paid early while the participant continued working was considered, but ultimately viewed unfavorably by the Team. This structure would undermine the actuarial assumptions and experience study which forms the basis of the ADEC calculation. The likely outcome would be an acceleration of the liability payment and hence an increase in the ADEC.
Lump-Sum Pension Buyout Description

• The Town could offer to purchase the pension owed each pensioner based on a discount rate could be higher, equal to, or lower than the assumed investment return of 6.25%. The lower the rate, the more attractive for the pensioner.

• Many companies have made lump-sum buyouts of participants in their pension plans, primarily motivated to reduce the volatility of reported earnings.

• Far less common are lump-sum pension buyouts by states and municipalities. Some years ago, the State of Connecticut did a debt-funded lump-sum buyout of participants in its Second Injury Fund, cited as a “perfect precedent” by Richard Siegal, bond counsel. The only other state, to our knowledge, to offer a pension buyout is Missouri, which in 2017 offered 17,000 former state employees lump sums, based on their age.
Lump-Sum Pension Buyout
Potential Issues

• A buyout at a discount rate higher than the rate assumed by the Retirement Board could be fully funded by the assets in the plan. To the extent the buyout discount rate would be below the rate assumed by the Retirement Board, the more expensive the buyout would be and greater would be the need to obtain supplemental funding.

• Pensioners who accept the offer would gain control of their pension assets that would allow them to invest as they see fit, and to bequeath potentially to their heirs. Any potential taxable gain on the buyout could be deferred by rolling the distribution in to an IRA or equivalent.

• The primary disadvantage of a buyout for the Town is potential “adverse selection” by the retirees; in other words, those retirees who believe that they (and their beneficiaries) would live less than average might accept the offer. If that were to happen, the realized savings might be much less, if any, over time.
Appendix

Pension Fund Historical Data
Pension Fund Asset Portfolio at June 30, 2021
Graphs of Future ADECs, assuming 6.25% and 6.00% returns
## Pension Fund Historical Data (in $millions)

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<td><strong>Recommended ADEC (a)</strong></td>
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<tr>
<td>Normal</td>
<td>$9.6</td>
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<td>Amortization of Underfunding</td>
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<td>$13.3</td>
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<td>Recommended ADEC</td>
<td>$28.3</td>
<td>$26.1</td>
<td>$23.7</td>
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<td>$22.0</td>
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<td>$22.7</td>
<td>$19.8</td>
<td>$16.4</td>
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<td>Actual TOG Contribution</td>
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<td>$26.1</td>
<td>$23.7</td>
<td>$21.1</td>
<td>$21.9</td>
<td>$22.0</td>
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### Actuarial values:

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<td>Accrued Liability (&quot;AAL&quot;)</td>
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<td>$629.8</td>
<td>$602.3</td>
<td>$561.2</td>
<td>$545.3</td>
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<td>$497.5</td>
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<td>Assets</td>
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<td>$433.6</td>
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<td>Funded ratio</td>
<td>76.1%</td>
<td>76.5%</td>
<td>76.6%</td>
<td>77.3%</td>
<td>74.6%</td>
<td>73.2%</td>
<td>71.7%</td>
<td>67.6%</td>
<td>70.6%</td>
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### Market values:

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<td>Assets</td>
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<td>303.2</td>
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<td>Funded ratio</td>
<td>74.3%</td>
<td>78.9%</td>
<td>77.8%</td>
<td>78.1%</td>
<td>70.7%</td>
<td>73.8%</td>
<td>77.9%</td>
<td>69.6%</td>
<td>67.4%</td>
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<tr>
<td>Investment return, net</td>
<td>1.1%</td>
<td>5.7%</td>
<td>9.6%</td>
<td>14.8%</td>
<td>-1.0%</td>
<td>1.4%</td>
<td>16.9%</td>
<td>11.3%</td>
<td>0.8%</td>
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### Participants:

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<td>Active</td>
<td>729</td>
<td>788</td>
<td>842</td>
<td>892</td>
<td>932</td>
<td>978</td>
<td>1,019</td>
<td>1,056</td>
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<td>Retired</td>
<td>1,424</td>
<td>1,415</td>
<td>1,391</td>
<td>1,363</td>
<td>1,347</td>
<td>1,333</td>
<td>1,303</td>
<td>1,286</td>
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<td>Total</td>
<td>2,153</td>
<td>2,203</td>
<td>2,233</td>
<td>2,255</td>
<td>2,279</td>
<td>2,311</td>
<td>2,322</td>
<td>2,342</td>
<td>2,381</td>
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### Key Assumptions:

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<tbody>
<tr>
<td>Assumed investment return, net</td>
<td>6.25%</td>
<td>6.50%</td>
<td>6.50%</td>
<td>6.75%</td>
<td>6.75%</td>
<td>6.75%</td>
<td>7.00%</td>
<td>7.25%</td>
<td>7.50%</td>
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<td>Amor. of investment returns</td>
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<tr>
<td>Amor. of underfunding (yrs)</td>
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<td>15</td>
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**Notes**

- (a) Payable in the immediately following fiscal year.
- (b) The recommended ADEC is after the effect of a $3.2 million increase in the Police COLA benefit, to be amortized over 5 years, increasing the ADEC from 22.9 MM.

**Sources:**

- Annual Actuarial Reports
- Comprehensive Annual Financial Reports
- Ken Berkson, Pension Administrator
Pension Fund Asset Portfolio
(at June 30, 2021)

- Alternative Investment: 149,424,121.35
- Cash & Receivables: 5,458,936.74
- Cash Equivalents: 18,066,418.24
- Equities: 279,980,731.79
- Fixed Income: 164,750,330.83
- Liabilities: 4,654,478.80

Total: 613,026,060.15
Graphs of Future ADECs (assuming 6.25% and 6.00% returns)

6.25%

6.00%

Source: Greg Stump