



CITY OF NOVI CITY COUNCIL

MAY 19, 2025

SUBJECT: Recommendation to adopt amended Novi Retirement Health Care Fund (OPEB) investment policy

SUBMITTING DEPARTMENT: Finance

KEY HIGHLIGHTS:

- Independent third-party review (AON) of the City's OPEB investment policy completed, with recommendations to improve long-term sustainability and reduce portfolio volatility.
- Updated investment strategy shifts target asset allocation from 50/50 to a more conservative 40/60 equities-to-fixed income mix.
- Revised portfolio is expected to reduce volatility from 11.26% to 7.03% and increase the probability of remaining fully funded over 15 years from 80.7% to 82.2%.
- Introduction of diversified asset classes, including alternatives, real estate, and infrastructure, to further reduce risk and enhance return stability.
- City remains committed to avoiding future contributions to the OPEB plan through disciplined investment management and periodic third-party reviews.

BACKGROUND INFORMATION:

The Treasury Department periodically reviews all investment policies. After the fiscal year 2022, the actuary and the audit confirmed that the overall funding level for the OPEB plan remained at approximately 110% funded. As a result of the continued strong funding level, Treasury made edits to the existing investment policy and presented them to Council for approval on 7/22/24. The following are the key items changed with that amendment:

- Given the high funding levels, the policy was amended to begin the shift to a more conservative, less volatile, less risky portfolio
- The investment mix in the policy was changed from the standard 70/30 equities to a fixed income ratio with a 50/50 mix

- The change in the policy also acknowledged that with the overall investment rate of return target would decrease to around 6% with the change in investment mix
- Treasury began exploring alternate investments to continue to reduce risk, but these types of investments were not included in the policy at the time
- Goal of no future city contributions ever to the OPEB plan continued

During the review of the amendments to the OPEB policy that was ultimately approved by the Council, the finance committee recommended hiring a third party to review the overall OPEB investment policy and related investments and make recommendations on possible improvements. A contract was awarded to AON in January 2025 to perform the review, and their review was completed and presented to the finance committee in April 2025. The following were their findings and recommendations:

- The investment mix by the City in the OPEB plan at the time of the review was a 58/42 investment mix with portfolio volatility of 11.26%, with an 80.7% chance that the plan remained fully funded over the next 15 years (attached)
- AON ran numerous models and ultimately recommended a 40/60 model (compared to the current 50/50 model), which will reduce volatility to 7.03% and increase the probability of remaining fully funded over the next 15 years to 82.2% (attached)
- To achieve the investment mix and return, AON recommended introducing return-seeking, asset diversification, fixed income securities, alternate investments, and real estate and infrastructure investments (attached)

Treasury appreciated the recommendations and recommended that a similar review occur regularly every 3-5 years.

The finance committee recommended adopting the AON recommended model and directed the City Manager to make the necessary changes to implement the model. The City currently uses Morgan Stanley as its investment advisor (since 4/25/03), as they are the top-rated firm in the country as far as understanding the investment rules for OPEB plans, and have helped the city outperform our target return consistently over the past 20+ years. Treasury met with Morgan Stanley, provided the entire AON study, discussed the changes needed, including the timing of the transition, and ensured alignment.

The first step to implement the new investment model is to amend the current OPEB investment policy. Attached is a red-lined version of the changes along with the final copy without the edits. The amendments include minor grammatical edits but are primarily based in the revised asset mix. Please note that some of the maximums noted are higher than the target to acknowledge the current investment levels while we adjust the buy/sell investments to achieve our targeted mix over the next month or so.

RECOMMENDED ACTION: Recommendation to adopt amended Novi Retirement Health Care Fund (OPEB) investment policy

Risk Tolerance

Novi's allocation as of 9/30/2024 is expected to result in an ever-increasing funded ratio

- Taking some risk off the table is expected to increase the likelihood of remaining overfunded, reduce the portfolio's volatility, and reduce the probability of any future contributions

A 40% return-seeking portfolio aligns with the expected long-term actuarial rate of return (6.00%)

- The current expected return is 7.00% but feedback from Novi is that it will be decreasing to 6.00%
- Portfolios below 40% return-seeking assets can provide narrower ranges of outcomes, but will start to erode the funded status

¹ Expected returns are using Aon's 30-Year Capital Market Assumptions as of 9/30/2024. CMAs contain projections about future returns on asset classes. Our CMA projections are designed to reflect the typical cost of implementing an investment program. Expected returns are calculated using weighted allocations of the underlying CMAs. Expected Returns are geometric (long-term compounded; rounded to the nearest decimal) assuming portfolio weights are rebalanced annually. Expected returns presented are models and do not represent the returns of an actual client account. Your actual returns will be reduced by your advisory fees and other expenses you may incur as a client. Aon's advisory fees are described in Part 2A of Aon's Form ADV. Not a guarantee of future results. Totals may not sum to 100% due to rounding.

| | 9/30/2024 Allocation | 40% Return-Seeking Assets |
|---|----------------------|---------------------------|
| Return-Seeking (R-S) % | 58% | 40% |
| New Asset Classes | N/A | No |
| Expected Return¹ | 6.45% | 5.96% |
| Portfolio Volatility | 11.26% | 8.25% |
| Probability of 100% Funded after 15 Years | 80.7% | 81.1% |
| Probability of Contributions During 15 Years | 38.0% | 34.3% |

Portfolio Diversification

Novi's return-seeking allocation as of 9/30/2024 is primarily public equity

- Diversifying into additional asset classes is expected to further reduce the portfolio's volatility, increase the probability of staying overfunded, and decrease the probability of any future contributions

Additional diversification is recommended in the following asset classes:

- **Return-Seeking Fixed Income**
 - Diversifies public equities and core fixed income
 - Rotates among credit sub-strategies including, but not limited to: high yield, emerging markets debt, bank loans, and securitized
- **Open-Ended Real Assets**
 - Diversifies public equities
 - Income and inflation protection
 - Modeled as 50% core real estate / 50% core infrastructure

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| | 9/30/2024 Allocation | 40% Return-Seeking Assets | 40% Return-Seeking Assets with Diversification |
|---|----------------------|---------------------------|--|
| Return-Seeking % | 58% | 40% | 40% |
| New Asset Classes | N/A | No | Yes |
| Expected Return¹ | 6.45% | 5.96% | 5.91% |
| Portfolio Volatility | 11.26% | 8.25% | 7.03% |
| Probability of 100% Funded after 15 Years | 80.7% | 81.1% | 82.2% |
| Probability of Contributions During 15 Years | 38.0% | 34.3% | 30.1% |

Summary of Results

Given Novi's strong funding position, there can be a range of appropriate solutions that balances Novi's desire to (1) remain fully funded, (2) minimize contributions, and (3) minimize portfolio

Our analysis highlights that a range from 20% to 40% return-seeking assets balances these objectives

The 40% return-seeking portfolio (shown to the right) was selected from that range due to its alignment with the projected long-term actuarial rate of return (6.00%), which is expected to keep the funded ratio steady over time

Aon recommends revisiting the asset allocation with another asset-liability in 3-5 years, or sooner if circumstances warrant

| Asset Class | Target Allocation |
|--------------------------------------|-------------------|
| Return-Seeking Assets | |
| - Public Equity | 30% |
| - Liquid Return-Seeking Fixed Income | 4% |
| - Open-End Real Assets | 6% |
| Risk-Reducing Assets | |
| - Risk-Reducing Fixed Income | 60% |
| Total | 100% |

**STATEMENT OF INVESTMENT POLICY,
OBJECTIVES & GUIDELINES**

Of the

**CITY OF NOVI
RETIREMENT HEALTH CARE FUND**

Statement of Investment Policy, Objectives, and Guidelines City of Novi, Retiree Health Care Fund

A. GENERAL INFORMATION

The City of Novi Retiree Health Care Fund was established to provide for the retirement health care benefits for covered retirees and their beneficiaries. The Fund is financed by contributions from the City and investment earnings. Distributions from the Fund are to pay for the medical insurance premiums and for investment and administrative expenses.

The Plan is created under the authority of the Public Employee Health Care fund Investment Act, Public Act 149 of 1999, as amended to invest the assets of the Plan in accordance with the provisions of Public Act 314 of 1965, as amended.

| | |
|----------------------|---|
| Federal Tax ID# | 38-6032551 |
| Fund Fiscal Year End | June 30 th |
| Primary Contacts | Carl Johnson, Finance Director/Treasurer Tina Glenn, Assistant Treasurer |

B. SCOPE OF THIS INVESTMENT POLICY

This statement reflects the investment policy, objectives and guidelines (“Investment Policies”), which the City of Novi (City Council and Administration) currently considers appropriate for the City of Novi Retiree Health Care Fund.

C. PURPOSE OF THIS INVESTMENT POLICY STATEMENT

This statement of Investment Policies is set in order to:

- Establish a long-term strategic investment plan for the Fund. Including, but not limited to, evaluating the City’s risk tolerance and determining a long-term asset allocation policy consistent with the long-term investment objectives, financial needs and circumstances of the Fund and the City.
- Define and assign the responsibilities of all involved parties.
- Establish a clear understanding for all involved parties of the investment goals and objectives of the City of Novi Retiree Health Care Fund assets.
- Offer guidance and limitations to all Investment Managers regarding the investment of City of Novi Retiree Health Care Fund assets.
- To monitor and evaluate the performance of the Fund’s assets as a whole and each investment manager.

- Manage City of Novi Retiree Health Care Fund assets according to prudent standards as described herein under the “General Investment Policy.”

This document will identify and present a set of Investment Policies which will serve to provide guidance to any Investment Management Consultant(s) and/or Investment Manager(s). The policy is intended to be sufficiently specific to be meaningful, yet flexible enough to be practical. This document is intended to supplement the *City of Novi Investment Policy*, and provide additional guidance for the management of the investments of the City of Novi Retiree Health Care Fund.

D. ACTUARIAL INFORMATION

Actuarial valuations will be performed as required by the State of Michigan.

E. RESPONSIBILITIES OF INVESTMENT MANAGER

The City intends to utilize separately managed accounts with an investment management firm, however mutual or other commingled funds may be used from time to time to implement the investment strategy of the Fund, where practical. For mutual and other commingled funds, the prospectus or Declaration of Trust documents of the fund(s) will govern the investment policies of fund investments.

Fiduciary Responsibilities

The investment manager is expected to manage the Fund’s assets in a manner consistent with the investment objectives, guidelines and constraints outlined in this statement and in accordance with applicable laws. This would include discharging responsibilities with respect to the Fund consistent with “Prudent Investor” standards, and all other fiduciary responsibility provisions and regulations. The Fund’s assets will be managed by an experienced investment management firm.

The investment manager shall:

- Obtain and maintain bonds and other surety agreements sufficient in amount to comply with all applicable laws and to protect the interests of the City. The investment manager shall provide proof of such insurance and amounts of coverage to the City’s Treasurer’s Department on an annual basis;
- At all times be registered as an investment advisor under the Investment Advisers Act of 1940 (where applicable); and
- Acknowledge in writing that they are a fiduciary with respect to the assets they manage.

Investment Consultant Responsibilities

The primary role of the investment consultant(s) is to provide objective, third party advice and counsel that will enable the fund fiduciaries to make well-informed and well-educated decisions regarding the investment of Plan assets

The investment consultant's role is that of an advisor to the Retiree Health Care Fund. The investment consultant acknowledges its responsibilities as a co-fiduciary under Act 314 of 1965, as amended. The investment consultant acknowledges that it is a registered investment advisor under with the Investment Advisors Act of 1940 or the Michigan Uniform Securities Act.

Investment advice offered by the Investment Consultants will be consistent with the investment objectives, policies, guidelines and constraints as established in this statement.

Security Selection/Asset Allocation

- Except as noted below, the investment manager shall have the discretion to determine their portfolio's individual security selections;
- The investment manager has been delegated responsibility for establishing and maintaining the asset allocation strategy for their individual portfolio. It is expected however, that the investment manager will utilize a stable asset allocation strategy and not engage in market-timing asset allocation decisions. The performance of the investment manager is measured versus a fully invested market index, or combination of market indexes, representative of the investment manager's investment style, asset allocation and risk level;
- The asset allocation strategy for the investment manager's portfolio can deviate from the overall Fund's asset allocation, however, the City's Treasury Department is responsible for monitoring the aggregate asset allocation, and may re-balance to the target allocation on a periodic basis.

Proxy Voting

The investment manager is responsible and empowered to exercise all rights, including voting rights, as are required through the purchase of securities, where practical. Each investment manager shall vote proxies according to their established Proxy Voting Guidelines. A copy of those guidelines, and/or a summary of proxy votes shall be provided to the City upon request. The City's Treasury Department is responsible for voting any proxies received from Investment Companies retained in the Fund and for any other "Self-Directed" investments.

F. INVESTMENT MANAGEMENT OBJECTIVES

The priority listing of investment objectives is as follows:

1. Preservation of Capital - Consistent with their respective investment styles and philosophies, investment managers should make reasonable efforts to preserve capital, understanding that losses may occur in individual securities.
2. Risk Aversion - Understanding that risk is present in all types of securities and investment styles, the City recognizes that some risk is necessary to produce long-term investment results that are sufficient to meet the City of Novi Retiree Health Care Fund's objectives. However, the investment managers are to make reasonable efforts to control risk, and will be evaluated regularly to ensure that the risk assumed is commensurate with the given investment style and objectives.
3. Diversification of Assets – Investments of the City of Novi Retiree Health Care Fund shall be so diversified as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.
4. Liquidity of Assets – Cash is to be employed productively at all times, by investment of short term cash equivalents to provide safety, liquidity, return, and restructuring of the City of Novi Retiree Health Care Fund portfolio to meet the City of Novi Retiree Health Care Fund's changing needs over time.
5. Adherence to Investment Discipline - Investment managers are expected to adhere to the investment management styles for which they were hired. Investment managers will be evaluated regularly for adherence to investment discipline.

G. INVESTMENT RETURN OBJECTIVES

In order to meet its obligations, the investment objective of the City of Novi Retiree Health Care Fund is to emphasize total return; that is, the aggregate return from capital appreciation and dividend and interest income.

The *primary* investment return objective shall be:

Asset Preservation and Risk Reduction – Preservation of capital and reducing risk and volatility to meet a stated rate of return.

The *secondary* investment return objective shall be:

Income and Growth - To achieve a balanced return of current income and modest growth of principal.

H. Performance Objectives

The City's Treasurers Department will monitor the performance of the fund. The City's Treasurers Department will evaluate the investment manager's contribution toward meeting the investment objectives outlined below over a three-to-five-year time period and a full market cycle, unless otherwise noted.

Style Index: Over a given market cycle, (typically defined as 3 to 5 years), the time weighted total rate of investment return should exceed, for the total fund, an appropriately designed custom benchmark. The custom benchmark is based on the fund's and investment manager's investment style, actual asset allocations, and constructed with appropriate indices given the asset mix. For example: 20% Russell 1000 Growth Index, 20% Russell 1000 Value Index, 10% MSCI EAFE, 10% Russell 2000 Value Index, 30% Barclays Capital Aggregate Bond Fund (using appropriate sub-category based on credit quality, duration, etc.), 10% 90 Day T-Bill.

Secondary Performance Targets:

1. The real return goal (return after adjusting for inflation) for the Fund assets is **3.0%** Inflation shall be measured by the U.S. All Urban Consumers Price Index ("CPI"); and
2. The Fund is expected to outpace the style index return measured on a compound average annual return basis after the deduction of investment management fees and annualized over a three-to-five-year rolling time period and a full market cycle.

I. Risk Tolerance

Investment theory and historical capital market return data suggests that, over long periods of time, there is a relationship between the level of risk assumed and the level of return that can be expected in an investment program. In general, higher risk (i.e. volatility of return) is associated with higher return.

Given this relationship between risk and return, a fundamental step in determining the investment policy for the Fund is the determination of an appropriate risk tolerance. The Investment Committee examined two important factors that affect the City's risk tolerance:

Financial Ability to accept risk within the investment program and,

Willingness to accept return volatility.

Positive factors that contribute to a higher risk tolerance are:

- The financial strength of the City provides the ability to withstand some uncertainty in changes in funding cost of the Fund;
- Contributions to the Fund are determined during the budget process based on recommended actuary percentages of payroll, and other financial considerations, and thus are generally known in advance and stable from year-to-year;
- The City's willingness to accept short-term volatility in the market value of the Fund and in the funding ratio for the sake of earning higher long-term returns; and
- The long-term time horizon available for investment provides the opportunity to benefit from the opportunities for growth that may accrue to a patient investment strategy.

Offsetting these factors are:

- The cash flow requirements of the Fund are on-going, thus requiring the Fund to maintain sufficient liquidity to finance required distributions;
- The medical cost inflation rate has historically been significantly higher and more volatile than the overall inflation rate of the US economy. This implies greater uncertainty in future costs of this Fund; and
- Cyclical economic activity can significantly influence the finances of the City and its financial ability to fund large unexpected contributions.

J. INVESTMENT GUIDELINES

All investment guidelines and restriction of Federal and Michigan law as well as Retiree Health Care fund investment policy must be complied with, including and specifically Public Act 314.

1. Permitted Securities

(a). Cash Equivalents

- ◆ Treasury Bills
- ◆ Money Market Funds
- ◆ STIF Funds
- ◆ Commercial Paper
- ◆ Banker's Acceptances
- ◆ Repurchase Agreements
- ◆ Certificates of Deposit

(b). Fixed Income Securities – must have a readily ascertainable market value and must be readily marketable.

- ◆ U.S. Government and Agency Securities
- ◆ Corporate Notes and Bonds
- ◆ Mortgage Backed Bonds
- ◆ Fixed Income Securities of Foreign Governments and Corporations
- ◆ Convertible Notes and Bonds

(c). Equity Securities – all equity investments will be made within the guidelines of the prudent trustee rule and within the requirements of Public Act 314. Investments in American Depositary Receipts (ADR's) will be designated as foreign securities for asset allocation purposes under the act.

- ◆ Common Stocks
- ◆ American Depositary Receipts (ADRs) of Non-U.S. Companies
- ◆ Stocks of Non-U.S. Companies (Ordinary Shares)
- ◆ Preferred Stock
- ◆ Convertible Preferred Stocks

(d). Other Assets

- ◆ Mutual Funds, which invest in securities as allowed in this document.
- ◆ Real Estate Securities (i.e. equity REITs, mortgage REITs, CMO or mortgage-related securities REITs, Health Care REITs, and equities of real estate operating companies)
- ◆ International Securities
- ◆ Other Alternative Investments – in compliance with Public Act 314

2. Asset Allocation Guidelines

In line with the return objectives and risk parameters of the Fund, the mix of assets should be generally maintained as follows (percentages are of the market value of the Fund):

| | <u>Minimum</u> | <u>Maximum</u> | <u>Target</u> |
|--|----------------|----------------|---------------|
| Domestic Equity | 15% | 50% | 20% |
| International Equity | 5% | 20% | 10% |
| Total Equity | 20% | 50% | 30% |
| Fixed Income - Risk Reducing | 40% | 65% | 55% |
| Cash/Cash Equivalents | 1% | 15% | 5% |
| All Alternative Investments: Real Estate, Absolute Return, Private Equity, Private Credit, Hedged Assets, etc. | 0% | 15% | 10% |
| | | | |

- All in compliance with PA 314

3. Diversification Requirements

To minimize the risk of large losses, the investment manager shall maintain adequate diversification in their portfolio. Subject to the constraints outlined in this policy, each investment manager shall have the discretion to determine their portfolio's individual security selections.

In order to achieve a prudent level of portfolio diversification, the securities of any one company should not exceed 5% of the total fund, and no more than 20% of the total fund should be invested in any one industry. The total allocation to treasury bonds and notes may represent up to 100% of the City of Novi Retiree Health Care Fund's aggregate bond position and treasury securities may represent up to 60% of the total fund.

4. Prohibited Transactions

Prohibited transactions include those identified under Public Act 314 including Michigan Compiled Laws 38.1133(5) and those specifically identified below:

Short Selling
Margin Transactions
Agency Cross Trades

K. PROCEDURAL GUIDELINES

1. The Investment Manager will:

- a) Provide monthly portfolio appraisals including the market value and cost of all assets as well as the estimated annual level of interest and dividend income.
- b) Meet periodically, at not less than once each year with the City of Novi staff to review the portfolio under supervision, discuss the investment outlook for the economy and securities markets, and indicate anticipated portfolio changes.
- c) Provide written information of security transactions.

2. The City of Novi will notify the Investment Manager of:

- a) Any changes in the Investment Policies and procedures noted above.
- b) Provide information regarding significant anticipated changes in cash flow and/or cash flow needs.

L. INVESTMENT MANAGER PERFORMANCE REVIEW AND EVALUATION

The investment performance of total portfolios, as well as asset class components, will be measured against commonly accepted performance benchmarks. Consideration shall be given to the extent to which the investment results are consistent with the

Investment Policies. The City intends to evaluate the portfolio(s) over at least a three-year period, but reserves the right to terminate an Investment Manager for any reason including, without limitation, the following:

1. Investment performance, which is significantly less than anticipated given the discipline employed, and the risk parameters established, or unacceptable justification of poor results.
2. Failure to adhere to any aspect of these Investment Policies, including communication and reporting requirements as well as their investment management agreement.
3. Significant qualitative or quantitative changes to the Investment Manager's organization.

Investment managers shall be reviewed regularly regarding performance, personnel, strategy, research capabilities, organizational and business matters, and other qualitative or quantitative factors that may impact their ability to achieve the desired investment results in conformance with these Investment Policies.

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- Offer guidance and limitations to all Investment Managers regarding the investment of City of Novi Retiree Health Care Fund assets.
- To monitor and evaluate the performance of the Fund’s assets as a whole and each investment manager.

Revised Investment Policy Strike-through

- Manage City of Novi Retiree Health Care Fund assets according to prudent standards as described herein under the “General Investment Policy.”

This document will identify and present a set of Investment Policies which will serve to provide guidance to any Investment Management Consultant(s) and/or Investment Manager(s). The policy is intended to be sufficiently specific to be meaningful, yet flexible enough to be practical. This document is intended to supplement the *City of Novi Investment Policy*, and provide additional guidance for the management of the investments of the City of Novi Retiree Health Care Fund.

D. ACTUARIAL INFORMATION

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E. RESPONSIBILITIES OF INVESTMENT MANAGERS

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Fiduciary Responsibilities

~~Each~~The investment manager is expected to manage the Fund’s assets in a manner consistent with the investment objectives, guidelines and constraints outlined in this statement and in accordance with applicable laws. This would include discharging responsibilities with respect to the Fund consistent with “Prudent Investor” standards, and all other fiduciary responsibility provisions and regulations. The Fund’s assets will be managed by an experienced investment management firms.

~~Each~~The investment manager shall:

- Obtain and maintain bonds and other surety agreements sufficient in amount to comply with all applicable laws and to protect the interests of the City. The investment manager shall provide proof of such insurance and amounts of coverage to the City’s Treasurer’s Department on an annual basis;
- At all times be registered as an investment advisor under the Investment Advisers Act of 1940 (where applicable); and
- Acknowledge in writing that they are a fiduciary with respect to the assets they manage.

Investment Consultant Responsibilities

Revised Investment Policy Strike-through

The primary role of the investment consultant(s) is to provide objective, third party advice and counsel that will enable the fund fiduciaries to make well-informed and well-educated decisions regarding the investment of Plan assets

The investment consultant's role is that of an advisor to the Retiree Health Care Fund. The investment consultant acknowledges its responsibilities as a co-fiduciary under Act 314 of 1965, as amended. The investment consultant acknowledges that it is a registered investment advisor under with the Investment Advisors Act of 1940 or the Michigan Uniform Securities Act.

Investment advice offered by the Investment Consultants will be consistent with the investment objectives, policies, guidelines and constraints as established in this statement.

Security Selection/Asset Allocation

- Except as noted below, ~~each the~~ investment manager shall have the discretion to determine their portfolio's individual security selections;
- ~~Each The~~ investment manager has been delegated responsibility for establishing and maintaining the asset allocation strategy for their individual portfolio. It is expected however, that ~~each the~~ investment manager will utilize a stable asset allocation strategy and not engage in market-timing asset allocation decisions. The performance of ~~each the~~ investment manager is measured versus a fully invested market index, or combination of market indexes, representative of the investment manager's investment style, asset allocation and risk level;
- The asset allocation strategy for ~~each the~~ investment manager's portfolio can deviate from the overall Fund's asset allocation, however, the City's Treasury Department is responsible for monitoring the aggregate asset allocation, and may re-balance to the target allocation on a periodic basis.

Proxy Voting

~~Each The~~ investment manager is responsible and empowered to exercise all rights, including voting rights, as are required through the purchase of securities, where practical. Each investment manager shall vote proxies according to their established Proxy Voting Guidelines. A copy of those guidelines, and/or a summary of proxy votes shall be provided to the City upon request. The City's Treasury Department is responsible for voting any proxies received from Investment Companies retained in the Fund and for any other "Self-Directed" investments.

F. INVESTMENT MANAGEMENT OBJECTIVES

The priority listing of investment objectives is as follows:

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2. Risk Aversion - Understanding that risk is present in all types of securities and investment styles, the City recognizes that some risk is necessary to produce long-term investment results that are sufficient to meet the City of Novi Retiree Health Care Fund's objectives. However, the investment managers are to make reasonable efforts to control risk, and will be evaluated regularly to ensure that the risk assumed is commensurate with the given investment style and objectives.
3. Diversification of Assets – Investments of the City of Novi Retiree Health Care Fund shall be so diversified as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.
4. Liquidity of Assets – Cash is to be employed productively at all times, by investment of short term cash equivalents to provide safety, liquidity, return, and restructuring of the City of Novi Retiree Health Care Fund portfolio to meet the City of Novi Retiree Health Care Fund's changing needs over time.
5. Adherence to Investment Discipline - Investment managers are expected to adhere to the investment management styles for which they were hired. Investment managers will be evaluated regularly for adherence to investment discipline.

G. INVESTMENT RETURN OBJECTIVES

In order to meet its obligations, the investment objective of the City of Novi Retiree Health Care Fund is to emphasize total return; that is, the aggregate return from capital appreciation and dividend and interest income.

The *primary* investment return objective shall be:

Asset Preservation and Risk Reduction – Preservation of capital and reducing risk and volatility to meet a stated rate of return. ~~Long-Term Growth of Capital – To emphasize long-term growth of principal while avoiding excessive risk. Short-term volatility will be tolerated inasmuch as it is consistent with the volatility of a comparable market index.~~

The *secondary* investment return objective shall be:

Income and Growth - To achieve a balanced return of current income and modest growth of principal.

H. Performance Objectives

The City's Treasurers Department will monitor the performance of the fund. The City's Treasurers Department will evaluate ~~each~~the investment manager's contribution toward meeting the investment objectives outlined below over a three-to-five-year time period and a full market cycle, unless otherwise noted.

Style Index: Over a given market cycle, (typically defined as 3 to 5 years), the time weighted total rate of investment return should exceed, for the total fund, an appropriately designed custom benchmark. The custom benchmark is based on the fund's and investment manager's investment style, actual asset allocations, and constructed with appropriate indices given the asset mix. For example: 20% Russell 1000 Growth Index, 20% Russell 1000 Value Index, 10% MSCI EAFE, 10% Russell 2000 Value Index, 30% Barclays Capital Aggregate Bond Fund (using appropriate sub-category based on credit quality, duration, etc.), 10% 90 Day T-Bill.

Secondary Performance Targets:

1. The real return goal (return after adjusting for inflation) for the Fund assets is **3.0%** Inflation shall be measured by the U.S. All Urban Consumers Price Index ("CPI"); and
2. The Fund is expected to outpace the style index return measured on a compound average annual return basis after the deduction of investment management fees and annualized over a three-to-five-year rolling time period and a full market cycle.

I. Risk Tolerance

Investment theory and historical capital market return data suggests that, over long periods of time, there is a relationship between the level of risk assumed and the level of return that can be expected in an investment program. In general, higher risk (i.e. volatility of return) is associated with higher return.

Given this relationship between risk and return, a fundamental step in determining the investment policy for the Fund is the determination of an appropriate risk tolerance. The Investment Committee examined two important factors that affect the City's risk tolerance:

Financial Ability to accept risk within the investment program and,

Willingness to accept return volatility.

Positive factors that contribute to a higher risk tolerance are:

- The financial strength of the City provides the ability to withstand some uncertainty in changes in funding cost of the Fund;
- Contributions to the Fund are determined during the budget process based on recommended actuary percentages of payroll, and other financial considerations, and thus are generally known in advance and stable from year-to-year;
- The City's willingness to accept short-term volatility in the market value of the Fund and in the funding ratio for the sake of earning higher long-term returns; and
- The long-term time horizon available for investment provides the opportunity to benefit from the opportunities for growth that may accrue to a patient investment strategy.

Offsetting these factors are:

- The cash flow requirements of the Fund are on-going, thus requiring the Fund to maintain sufficient liquidity to finance required distributions;
- The medical cost inflation rate has historically been significantly higher and more volatile than the overall inflation rate of the US economy. This implies greater uncertainty in future costs of this Fund; and
- Cyclical economic activity can significantly influence the finances of the City and its financial ability to fund large unexpected contributions.

J. INVESTMENT GUIDELINES

All investment guidelines and restriction of Federal and Michigan law as well as Retiree Health Care fund investment policy must be complied with, including and specifically Public Act 314.

1. Permitted Securities

(a). Cash Equivalents

- ◆ Treasury Bills
- ◆ Money Market Funds
- ◆ STIF Funds
- ◆ Commercial Paper
- ◆ Banker's Acceptances
- ◆ Repurchase Agreements
- ◆ Certificates of Deposit

(b). Fixed Income Securities – must have a readily ascertainable market value and must be readily marketable.

- ◆ U.S. Government and Agency Securities
- ◆ Corporate Notes and Bonds

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- ◆ Mortgage Backed Bonds
- ◆ Fixed Income Securities of Foreign Governments and Corporations
- ◆ Convertible Notes and Bonds

(c). Equity Securities – all equity investments will be made within the guidelines of the prudent trustee rule and within the requirements of Public Act 314.

Investments in American Depository Receipts (ADR's) will be designated as foreign securities for asset allocation purposes under the act.

- ◆ Common Stocks
- ◆ American Depository Receipts (ADRs) of Non-U.S. Companies
- ◆ Stocks of Non-U.S. Companies (Ordinary Shares)
- ◆ Preferred Stock
- ◆ Convertible Preferred Stocks

(d). Other Assets

- ◆ Mutual Funds, which invest in securities as allowed in this document.
- ◆ Real Estate Securities (i.e. equity REITs, mortgage REITs, CMO or mortgage-related securities REITs, Health Care REITs, and equities of real estate operating companies)
- ◆ International Securities
- ◆ Other Alternative Investments – in compliance with Public Act 314

2. Asset Allocation Guidelines

In line with the return objectives and risk parameters of the Fund, the mix of assets should be generally maintained as follows (percentages are of the market value of the Fund):

| | <u>Minimum</u> | <u>Maximum</u> | <u>Target</u> |
|---|---------------------------|---------------------------|------------------------------|
| Domestic Large/Medium Cap Equities: 30% to 70% | | | |
| Domestic Large Cap Equities (growth & value) Equity | 30 <u>15</u> % | 70 <u>50</u> % | 40 <u>20</u> % |
| Domestic Small/Medium Cap Equities: 0% to 30% | | | |
| Domestic Small/Mid Cap Equities (growth & value) | 0 % | 20 % | 5 % |
| International Equity | 5% | <u>20</u> % | 45 <u>10</u> % |
| Total Equity | 50 <u>20</u> % | 70 <u>50</u> % | 60 <u>30</u> % |
| Real Estate | 0 % | 5 % | 2-5 % |
| Fixed Income – Risk Reducing* | 20 <u>40</u> % | 50 <u>65</u> % | 25-35 <u>55</u> % |
| Cash/Cash Equivalents | 1% | 15% | 5% |
| Other All Alternative Investments: Real Estate, Absolute Return, Private Equity, Private Credit, Hedged Assets, etc. | 0% | 15% | 0 <u>10</u> % |

- All in compliance with PA 314

3. Diversification Requirements

To minimize the risk of large losses, ~~each~~the investment manager shall maintain adequate diversification in their portfolio. Subject to the constraints outlined in this policy, each investment manager shall have the discretion to determine their portfolio's individual security selections.

In order to achieve a prudent level of portfolio diversification, the securities of any one company should not exceed 5% of the total fund, and no more than 20% of the total fund should be invested in any one industry. The total allocation to treasury bonds and notes may represent up to 100% of the City of Novi Retiree Health Care Fund's aggregate bond position and treasury securities may represent up to 60% of the total fund.

4. Prohibited Transactions

Prohibited transactions include those identified under Public Act 314 including Michigan Compiled Laws 38.1133(5) and those specifically identified below:

Short Selling
Margin Transactions
Agency Cross Trades

K. PROCEDURAL GUIDELINES

1. The Investment Manager will:

- a) Provide monthly portfolio appraisals including the market value and cost of all assets as well as the estimated annual level of interest and dividend income.
- b) Meet periodically, at not less than once each year with the City of Novi staff to review the portfolio under supervision, discuss the investment outlook for the economy and securities markets, and indicate anticipated portfolio changes.
- c) Provide written information of security transactions.

2. The City of Novi will notify the Investment Manager of:

- a) Any changes in the Investment Policies and procedures noted above.
- b) Provide information regarding significant anticipated changes in cash flow and/or cash flow needs.

L. INVESTMENT MANAGER PERFORMANCE REVIEW AND EVALUATION

The investment performance of total portfolios, as well as asset class components, will be measured against commonly accepted performance benchmarks. Consideration shall be given to the extent to which the investment results are consistent with the Investment Policies. The City intends to evaluate the portfolio(s) over at least a three-year period, but reserves the right to terminate an Investment Manager for any reason including, without limitation, the following:

1. Investment performance, which is significantly less than anticipated given the discipline employed, and the risk parameters established, or unacceptable justification of poor results.
2. Failure to adhere to any aspect of these Investment Policies, including communication and reporting requirements as well as their investment management agreement.
3. Significant qualitative or quantitative changes to the Investment Manager's organization.

Investment managers shall be reviewed regularly regarding performance, personnel, strategy, research capabilities, organizational and business matters, and other qualitative or quantitative factors that may impact their ability to achieve the desired investment results in conformance with these Investment Policies.