

**City of Kalamazoo, Michigan
Employees' Retirement System**

FINANCIAL STATEMENTS

December 31, 2016 and 2015

City of Kalamazoo, Michigan
Employees' Retirement System

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INDEPENDENT AUDITOR'S REPORT

To the Members of the Employees'
Retirement System Investment Committee
and the City Commission of Kalamazoo
Kalamazoo, Michigan

Report on the Financial Statements

We have audited the accompanying statements of plan net position of the City of Kalamazoo Employees' Retirement System (the System), as of December 31, 2016 and 2015, and the related statements of changes in plan net position for the years then ended, and the related notes to the financial statements, which collectively comprise the System's basic financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the plan net position of the City of Kalamazoo Employees' Retirement System as of December 31, 2016 and 2015, and the respective changes in its plan net position for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of a Matter

As discussed in Note B, the financial statements present only the City of Kalamazoo Employees' Retirement System and do not purport to, and do not present fairly the financial position of the City of Kalamazoo, Michigan, as of December 31, 2016 and 2015, and the changes in its financial position for the years then ended, in conformity with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Change in Accounting Principles

As discussed in Note J to the financial statements, the System implemented GASB Statement No. 72, *Fair Value Measurement and Application*, during the year. As a result, this statement provides guidance for determining a fair value measurement for financial reporting purposes. This statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements. Our opinion is not modified with respect to this matter.

Other Matter

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis and schedules of pension information, as identified in the table of contents, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Abraham & Gaffney, P.C.

ABRAHAM & GAFFNEY, P.C.
Certified Public Accountants

June 28, 2017

City of Kalamazoo, Michigan
Employees' Retirement System

MANAGEMENT'S DISCUSSION AND ANALYSIS

December 31, 2016 and 2015

The following is a discussion and analysis of the financial performance and position of the City of Kalamazoo Employees' Retirement System's ("The Retirement System"). It is intended to provide an overview of the Retirement Systems' financial activities for the fiscal year ended December 31, 2016 and 2015. This analysis should be read in conjunction with the Independent Auditor's Report and with the financial statements, which follows this section.

Condensed Financial Information

The table below compares key financial information in a condensed format between the current year and the prior years:

	Year Ended December 31,		
	2016	2015	2014
Total assets	\$ 634,781,714	\$ 589,568,535	\$ 625,490,216
Total liabilities	<u>21,754,339</u>	<u>41,474</u>	<u>18,134</u>
Net position held in trust for pension benefits	<u>\$ 613,027,375</u>	<u>\$ 589,527,061</u>	<u>\$ 625,472,082</u>
Net investment income (loss)	\$ 72,939,990	\$ (9,974,517)	\$ 41,065,447
Contributions:			
Plan members	1,085,940	1,084,798	1,067,029
Employer	<u>-</u>	<u>1,602,053</u>	<u>760,912</u>
Total additions	74,025,930	(7,287,666)	42,893,388
Pension benefits	28,474,218	28,156,585	27,775,096
Refund payments to terminated employees	<u>22,652</u>	<u>200,115</u>	<u>27,035</u>
Total benefits paid	28,496,870	28,356,700	27,802,131
General and administrative expenses	<u>328,746</u>	<u>300,655</u>	<u>232,433</u>
Total deductions from net position	28,825,616	28,657,355	28,034,564
Special item	<u>(21,700,000)</u>	<u>-</u>	<u>-</u>
Net increase (decrease) in net position held in trust	23,500,314	(35,945,021)	14,858,824
Net position held in trust for pension benefits			
Beginning of Year	<u>589,527,061</u>	<u>625,472,082</u>	<u>610,613,258</u>
End of Year	<u>\$ 613,027,375</u>	<u>\$ 589,527,061</u>	<u>\$ 625,472,082</u>

City of Kalamazoo, Michigan
Employees' Retirement System

MANAGEMENT'S DISCUSSION AND ANALYSIS

December 31, 2016 and 2015

Special Item

On October 1, 2017, the City transferred operations of its Metro Transit System (Metro) to the Central Transportation Authority (CCTA), a newly formed component unit of Kalamazoo County. The CCTA established its own pension plan and trust. As part of the transition agreement, the ERS transferred 75% of Metro's Plan Assets to the CCTA's pension trust. This transfer is included in the Statements of Changes in Plan Net Position as a \$21.7 million Special Item. The ERS will make another transfer in 2017 based on final valuation results to ensure that the CCTA's pension plan receives 100% of the Metro Transit System's plan assets. This additional transfer amount is still being reviewed as of the date of this report. See Note I in the footnotes for further information.

Overall Fund Structure and Objectives

The Retirement System is a single-employer defined benefit contributory retirement plan. It was established to provide retirement, disability, and death benefits to city retirees and their beneficiaries. Active members earn service credit that entitles them to receive benefits in the future. Benefits currently being paid are significantly greater than contributions currently being received. Plan members are required to contribute 1.0% to 6.5% of their annual covered salary to the Retirement System, depending upon their bargaining unit. The City contributes such additional amounts, as necessary, based on actuarial determinations, to provide assets sufficient to pay for member benefits.

The City was not required to make a contribution for 2016 or 2015. The excess of benefits over contributions is funded through investment income. The Retirement System is authorized by the State's Pension Investment Act, as amended, to invest in common stocks, real estate, and various other obligations, subject to certain limitations.

Each year, an actuarial valuation of the Retirement System is completed. As of the December 31, 2016, actuarial report, the valuation of assets represents 134.0 percent of accrued liabilities. Last year the ratio was 129.7 percent. The increase in overfunding is the result of the accrual of benefits during the year offset by the year's unfavorable experience.

Asset Allocation

It is the responsibility of the City of Kalamazoo Retirement Investment Committee (RIC) to recommend to the City Commission the investment policies and strategies, and retaining/monitoring the various investment managers, trustees, advisors, actuaries and other fiduciaries utilized by the Retirement System. The RIC determines the allocation of assets in accordance with allowable legal limits. In setting asset allocation policy, the RIC reviews the expected returns of various asset classes, the Plan's actuarial assumption rate, and the risks associated with alternative asset mix strategies. The RIC has established the following asset allocation:

<u>Asset Class</u>	<u>Target</u>
Micro Capitalization Domestic Equity	5.00%
Small Capitalization Domestic Equity	10.00%
Small Capitalization Value International Equity	10.00%
S&P Index Funds	30.00%
Large Capitalization Domestic Equity	5.00%
Emerging Markets Equity	10.00%
Intermediate Fixed Income	12.50%
Long Fixed Income	12.50%
Real Estate Securities	2.50%
Real Estate	2.50%

This asset allocation policy offers the optimal mix for meeting longer term goals at an acceptable level of risk. The asset classes stated above shall be further diversified (where possible) as to style and manager type to reduce risk further, while providing the opportunity for enhanced return. The Retirement System's investments are held in nine portfolios administered by five investment managers.

City of Kalamazoo, Michigan
Employees' Retirement System

MANAGEMENT'S DISCUSSION AND ANALYSIS

December 31, 2016 and 2015

Economic Factors, Investment Returns, and Other Important Matters

The global financial crisis of 2008 was followed by a fast and broad rebound of equities and fixed income securities. Because the stock market is the principal investment forum utilized by the Retirement System, the market's 2010 market rate of return had a positive impact on net position.

In May and June of 2010, global markets were shaken badly by the sovereign debt crisis in Greece, and the potential repetition on a larger scale in Portugal, Spain, and even Great Britain, which caused retrenching mid-year in 2010. Markets recovered for the remainder of 2010, buoyed in part by a second round of "quantitative easing" by the Federal Reserve Bank in the form of roughly \$850 billion of purchases of U.S. government instrumentalities.

In 2011, global markets experienced a deepening of negative investor sentiment based on the continuation of the sovereign debt crisis in Europe and the possible breakup of the European monetary system, the related exposure of the global banking system to asset losses and the potential for a worldwide credit crunch. The showdown over the U.S. federal budget in August 2011 also roiled markets badly for several months in the 3rd quarter.

In 2012, the broad domestic stock market posted double-digit gains despite ongoing sovereign debt issues. The first real signs of a sustainable recovery in the U.S. housing market emerged in 2012, and the European Central Bank managed to keep the Eurozone intact. The Federal Reserve restated its commitment near-zero short-term interest rates and Quantitative Easing measures until a more fundamental improvement in the job market emerged.

In 2013, relative global quiet around unemployment, housing and sovereign debt, and corporate earnings continued to stabilize the environment for investment growth, resulting in one of the strongest investment returns for the System in the last 15 years. Broad-based domestic and international equity price appreciation drove increases in all but one of the System's asset allocation classes, with Emerging Markets being the decliner. All other equity classes gained at least 10%, with Large and Micro cap leading the way with over 20% gains. Fixed income and Real estate investments also gained 5% and 8% respectively, a rare win across- the-board for equities, bonds, and real estate.

In 2014, the global economy experienced a slowdown, although systemic risk factors (such as sovereign debt, the evolving Greek crisis, global tension regarding Russian relations with its neighbors and with the G-8 nations, and the continuing destabilization of the Middle East and North Africa) failed to manifest any major damage to the global economy or broad-based equity values. Large-cap equity and equity index funds roared ahead with double-digit gains, while small cap stalled in low single digits, and international and emerging market funds faltered with modest losses. Fixed income outgained equities with nearly 7 percent gains, and real estate investments also gained over 20 percent. Equities as a group, fixed incomes, and real estate each gained ground.

In 2015, the global economy grew at 3.1 percent, continuing a trend of moderate if unspectacular expansion seen since the end of the Great Recession. Emerging markets experienced deceleration of growth from 2014, with Russia having experienced a major slowdown of negative 3.8 percent. Large-cap equity and equity index funds fell back slightly at negative 1.94 percent, while small cap and international equities shrunk by 2.38 percent and emerging market funds shrunk by 23.07 percent. Equities as a group lost 5.19 percent. Fixed income investment-grade bonds grew by a modest 3.29 percent, and real estate investments also gained 11.61 percent.

In 2015, the Retirement System's net position held in trust for pension benefits decreased by 5.75 percent, reflecting a 1.66 percent loss in investment earnings of \$9.9 million plus \$2.7 million of other income. The System experienced \$28.6 million in outflows, including \$28.1 million for retiree benefit payments, and \$300 thousand for system administrative expenses.

City of Kalamazoo, Michigan
Employees' Retirement System

MANAGEMENT'S DISCUSSION AND ANALYSIS

December 31, 2016 and 2015

Economic Factors, Investment Returns, and Other Important Matters - continued

In 2016, Global growth is projected to grow at 3.1 percent and 3.4 percent in 2017. The forecast reflects a more subdued outlook for advanced economies following the June 2016 U.K. vote in favor of leaving the European Union (Brexit) and weaker-than-expected growth in the United States. These developments have put further downward pressure on global interest rates, as monetary policy is now expected to remain accommodative for longer. Financial market sentiment toward emerging market economies has improved with expectations of lower interest rates in advanced economies, reduced concern about China's near-term prospects following policy support to growth, and some firming of commodity prices. <http://www.imf.org/external/pubs/ft/weo/2016/02/pdf/exesum.pdf>

In 2016, the City's Group Trust, which contains the City's Pension and OPEB investment assets, had a very strong year, with advances in every major segment of the portfolio.

Large-cap equity funds advanced strongly in 2016 at 12.94 percent, small cap and international equities gained 19.74 percent, while emerging market funds gained 19.86 percent. Equities as a group gained 16.56 percent.

Fixed income investment-grade bonds grew by a modest 2.86 percent, and real estate investments also gained 8.37 percent.

The Retirement System's purpose is to provide long-term benefit payments to its members and it is through long-term investing, as shown by the 25 year history of returns realized by the investments made by the RIC, that these promised benefits will be primarily funded. Through its investment policy asset allocation, the RIC has positioned the portfolio for this long-term investment objective.

In addition, to further maximize investment returns and preserve fund assets, the RIC carefully monitors the performance of each of its investment managers and takes the necessary corrective action to ensure acceptable investment results. To this end, the RIC voluntarily complies with the guidelines put forth by the Employee Retirement Income System Act (ERISA), which is designed to protect the interests of members and beneficiaries of pension systems.

Contacting the System's Financial Management

This financial report is designed to provide the public, citizens, and other interested parties with a general overview of the Retirement System's financial position. If you have questions about this report or need additional financial information, contact Thomas C. Skrobola, Director of Management Services, City of Kalamazoo, 241 W. South Street, Kalamazoo, MI 49007, (269) 337-8468.

City of Kalamazoo, Michigan
Employees' Retirement System

STATEMENTS OF PLAN NET POSITION

December 31, 2016 and 2015

	2016	2015
ASSETS		
Cash and cash equivalents	\$ 375,575	\$ 411,012
Receivables		
Interest and dividends	1,212,348	973,017
Investments, at fair value		
U.S. Treasuries	78,580,836	71,968,941
U.S. Agencies	1,332,567	4,323,279
Corporate bonds	63,850,025	49,068,590
Collateralized mortgage obligations	20,365,231	20,322,949
Equity mutual funds	435,933,185	411,530,267
Real estate mutual funds	33,131,947	30,970,480
Total investments	633,193,791	588,184,506
Total assets	634,781,714	589,568,535
LIABILITIES		
Accounts payable	54,339	41,474
Due to other governmental unit	21,700,000	-
Total liabilities	21,754,339	41,474
NET POSITION		
Net position restricted for pension benefits	\$ 613,027,375	\$ 589,527,061

See accompanying notes to financial statements.

City of Kalamazoo, Michigan
Employees' Retirement System

STATEMENTS OF CHANGES IN PLAN NET POSITION

Years Ended December 31, 2016 and 2015

	2016	2015
ADDITIONS TO NET POSITION		
Investment income		
Change in fair value of investments	\$ 58,071,951	\$ (24,387,321)
Interest	3,714,047	3,594,674
Dividends	13,177,492	12,857,529
Total investment income (loss)	74,963,490	(7,935,118)
Less: investment expense	(2,023,500)	(2,039,399)
Net investment income (loss)	72,939,990	(9,974,517)
Contributions		
Employer	-	1,602,053
Plan members	1,085,940	1,084,798
Total contributions	1,085,940	2,686,851
Total additions to net position	74,025,930	(7,287,666)
DEDUCTIONS FROM NET POSITION		
Benefits	28,474,218	28,156,585
Refunds of contributions	22,652	200,115
Administrative expenses	153,024	125,770
Other expenses	175,722	174,885
Total deductions from net position	28,825,616	28,657,355
SPECIAL ITEM		
Transfer of assets to other governmental unit	(21,700,000)	-
CHANGE IN PLAN NET POSITION	23,500,314	(35,945,021)
Net position - beginning of year	589,527,061	625,472,082
Net position - end of year	\$ 613,027,375	\$ 589,527,061

See accompanying notes to financial statements.

City of Kalamazoo, Michigan
Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE A: PLAN DESCRIPTION

Plan Administration

The City of Kalamazoo Employees' Retirement System (the System) is a single-employer defined benefit contributory plan which provides pension, disability, and death benefits to all full-time employees and some part-time employees of the City of Kalamazoo, Michigan (the City).

The System is administered by the City of Kalamazoo Employees' Retirement System Pension Board of Trustees. The Board consists of five (5) individual trustees either elected or appointed in accordance with the City Ordinance. One (1) member is a City Commissioner and one (1) member is the City Manager. The remaining three (3) members, including one (1) Public Safety representative and one (1) General Member representative, are elected by active members of the retirement system. All elected terms are three (3) years. The Plan benefit provisions were established and may be amended under the authority of City Ordinances. Employee contribution requirements were established and may be amended subject to collective bargaining agreements and approval by the City Commission of the City of Kalamazoo.

Plan Membership

System membership consisted of the following at December 31, 2016 and 2015, according to actuarial valuations as of those dates:

	<u>2016</u>	<u>2015</u>
Retirees and beneficiaries receiving benefits	906	957
Terminated plan members entitled to, but not yet receiving, benefits	53	48
Active plan members	<u>522</u>	<u>628</u>
Total	<u><u>1,481</u></u>	<u><u>1,633</u></u>
Number of participating employers	1	1

Benefits Provided

The System provides retirement, death and disability benefits to plan members and their beneficiaries as follows:

Regular retirement - General members are eligible for benefits at age 57 with 25 or more years of service or age 62 with 10 or more years of service. American Federation of State, County and Municipal Employees (AFSCME) members are eligible for benefits at age 60 with 20 or more years of service. Public safety members are eligible for benefits with 25 years of service or at age 50 with 10 or more years of service. Retirement benefits are calculated as final average compensation (highest 3 consecutive years out of the last 10) times 2.1 percent for each year of service for general plan members, Kalamazoo Municipal Employee's Association (KMEA) members, AFSCME members, and Metro Transit members, 2.3 percent for each year of service for exempt members and 2.7 percent for each year of service for public safety members. The maximum benefit is 70.2 percent of final average compensation for public safety members.

City of Kalamazoo, Michigan
Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE A: PLAN DESCRIPTION - CONTINUED

Benefits Provided - continued

Early retirement - General members are eligible for benefits at age 55 with 15 or more years of service. Public safety members are eligible for benefits with 20 years of service. Retirement benefits are calculated as regular retirement but reduced by 4/10 of 1 percent for each month and fraction of a month by which retirement precedes age 62 if less than 25 years of service or age 57 if 25 or more years of service for general plan members and 2 percent of final average compensation multiplied by years of credited service for public safety members.

Deferred retirement - Members are eligible for benefits with 10 years of service for most members, 5 years for exempt members hired before September 1, 2010, 9 years for AFSCME members, and 8 years for KMEA members hired before January 1, 2009. Benefits begin at age 62 for general members, and at age 50 for public safety members. Retirement benefits are calculated as regular or early retirement but based upon service and final average compensation at termination date for general members as early retirement for public safety members.

Death and disability - Members are eligible for benefits, in accordance with plan provisions, after 10 years of service for most members, 5 years for exempt members hired before September 1, 2010, 9 years for AFSCME members, and 8 years for KMEA members hired before January 1, 2009. Service requirements are waived for duty disability and death benefits.

Benefit terms provide for annual cost-of-living adjustments to each member's retirement allowance subsequent to the member's retirement date. Pensions of AFSCME members who retire on or after October 25, 1999, are increased 1 percent per year, compounded annually, beginning 1 year after retirement and 2 percent per year, compounded annually, beginning at age 75. Pensions of KMEA members are increased 1.5 percent per year, compounded annually, beginning the latter of the retirees' 64th birthday and 1 year after retirement and 2 percent per year, compounded annually, beginning at age 75. Pensions of Transit Union members are increased 1 percent per year, compounded annually, beginning 1 year after retirement and 2 percent per year, compounded annually, beginning at age 75. Pensions of public safety members who retire on and after January 1, 1995, with 25 or more years of service, are increased 2 percent per year, compounded annually. Pensions of exempt members are increased 1.5 percent per year, compounded annually, beginning 1 year after retirement for members who elected to contribute by May 2006.

Contributions

System members are required to contribute between 1.0 to 6.5 percent of annual compensation to the System for pension benefits, depending on bargaining unit. The City is required to contribute such additional amounts, as necessary, based on actuarial determinations, to provide assets sufficient to pay for member benefits. No employer contributions were required for years ended December 31, 2016 and 2015; however the City chose to contribute \$0 and \$1,602,053 for the years ended December 31, 2016 and 2015, respectively.

NOTE B: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The System's more significant accounting policies are described below:

Reporting Entity - The accompanying financial statements are exclusive presentations of the financial condition and results of operations of the City of Kalamazoo Employees' Retirement System. The City of Kalamazoo is the plan sponsor of the City of Kalamazoo Employees' Retirement System. As a result, industry standards require the City to include the financial activities of the System in the City's Annual Financial Report. The Annual Financial Report of the City of Kalamazoo is available for public inspection at the Kalamazoo City Hall.

City of Kalamazoo, Michigan
Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE B: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Basis of Accounting - The System's financial statements are prepared using the accrual basis of accounting. Plan member contributions are recognized in the period in which the contributions are due. The City's contributions are recognized when due and the employer has made a formal commitment to provide them. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

Valuation of Investments - Investments are reported at fair value. Short-term investments are reported at cost, which approximates fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Mortgages are valued on the basis of future principal and interest payments, and are discounted at prevailing interest rates for similar instruments. The fair value of real estate investments is based on independent appraisals. Investments for which market quotations are not readily available are valued at their fair value as determined by the custodian under the direction of the Board with the assistance of a valuation service.

Beginning in 2013, the investments of the System have been pooled with those of the City's Other Post-Employment Benefits (OPEB) Trust. The purchases, maturities, and investment performance are allocated between the System and the OPEB Trust fund based on the fair value of their respective investments. As of December 31, 2016 and 2015, the System's investments represented approximately 86.8 percent and 86.6 percent of the portfolio, respectively.

Administration - Administrative costs are financed through the System's investment earnings.

Use of Estimates - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make significant estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

NOTE C: DEPOSITS AND INVESTMENTS

Deposits

The System does not maintain any checking or other demand/time deposit accounts. Amounts reported as cash and cash equivalents in the statements of plan net position include cash and short-term investments in money market accounts held by the System's investment managers. These accounts are insured by the Securities Investors Protection Corporation for up to \$500,000 each. The balances of these accounts as of December 31, 2016 and 2015, were \$375,575 and \$411,012, respectively. These amounts were fully insured during 2016 and 2015.

Investments

The Michigan Public Employees Retirement Systems' Investment Act, Public Act 314 of 1965, as amended, authorizes the System to invest in stocks, government and corporate securities, mortgages, real estate, and various other investment instruments, subject to certain limitations. The System's Investment Committee is responsible for recommending to the City Commission the investment policies and strategies, and retaining/monitoring the various investment managers, trustees, advisors, actuaries and other fiduciaries utilized by the System. The City Commission is responsible for approving the recommendations of the Investment Committee. All investment decisions are subject to Michigan law and the investment policy established by the City Commission.

City of Kalamazoo, Michigan
Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE C: DEPOSITS AND INVESTMENTS - CONTINUED

Investments - continued

The adopted asset allocation policy as of December 31, 2016 and 2015, was as follows:

<u>Asset Class</u>	<u>Target</u>	<u>Long Term Expected Rate of Return</u>
Micro Capitalization Domestic Equity	5.00%	6.00%
Small Capitalization Domestic Equity	10.00%	6.00%
Small Capitalization Value International Equity	10.00%	5.00%
S&P Index Funds	30.00%	5.00%
Large Capitalization Domestic Equity	5.00%	5.00%
Emerging Markets Equity	10.00%	6.75%
Intermediate Fixed Income	12.50%	0.75%
Long Fixed Income	12.50%	0.75%
Real Estate Securities	2.50%	3.75%
Real Estate	2.50%	3.75%

The System's investments are held in nine (9) portfolios administered by five (5) investment managers. Following is a summary of the System's investments as of December 31:

	<u>2016</u>	<u>2015</u>
U.S. Treasuries	\$ 78,580,836	\$ 71,968,941
U.S. Agencies	1,332,567	4,323,279
Corporate bonds	63,850,025	49,068,590
Collateralized mortgage obligations	20,365,231	20,322,949
Equity mutual funds	435,933,185	411,530,267
Real estate mutual funds	33,131,947	30,970,480
Total investments	<u>\$ 633,193,791</u>	<u>\$ 588,184,506</u>

Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value hierarchy is also established which requires an entity to maximize the use of observable and minimize the use of unobservable inputs.

There are three (3) levels of inputs that may be used to measure fair value:

- Level 1: Quoted prices in active markets for identical securities.
- Level 2: Prices determined using other significant observable inputs. Observable inputs are inputs that other market participants may use in pricing a security. These may include quoted prices for similar securities, interest rates, prepayment speeds, credit risk and others.
- Level 3: Prices determined using significant unobservable inputs. Unobservable inputs may be used in situations where quoted prices or observable inputs are unavailable or deemed less relevant (for example, when there is little or no market activity for an investment at the end of the period). Unobservable inputs reflect the organization's own assumptions about the factors market participants would use in pricing an investment, and would be based on the best information available.

City of Kalamazoo, Michigan
Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE C: DEPOSITS AND INVESTMENTS - CONTINUED

Fair Value Measurements - continued

As of December 31, 2016, the carrying amounts and fair values for each investment are as follows:

<u>INVESTMENT TYPE</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
U.S. Strips	\$ 1,332,567	\$ -	\$ -	\$ 1,332,567
Federal Home Loan	197,224	-	-	197,224
Fannie Mae	20,168,007	-	-	20,168,007
U.S. Treasury Notes	78,580,836	-	-	78,580,836
Corporate Bonds	-	63,850,025	-	63,850,025
Equity mutual funds	435,933,185	-	-	435,933,185
Real estate mutual funds	33,131,947	-	-	33,131,947
	<u>\$ 569,343,766</u>	<u>\$ 63,850,025</u>	<u>\$ -0-</u>	<u>\$ 633,193,791</u>

Custodial Credit Risk

For investments, custodial credit risk is the risk that, in the event of the failure of the counterparty to a transaction, the System will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The System's investment policy does not address custodial credit risk. Although uninsured and unregistered, the System's investments are not exposed to custodial credit risk since the securities are held by the counterparty's trust department in the System's name. Short-term investments in money market funds and investments in mutual funds are not subject to custodial credit risk because their existence is not evidenced by securities that exist in physical or book form.

Credit Risk

The System's investment policy provides that its investments in bonds must be rated in the top four (4) major investment grades as determined by two nationally recognized statistical rating organizations. As of December 31, 2016 and 2015, the System's investments in fixed income securities were rated by Standard & Poor's and Moody's as follows:

<u>Standard & Poor's</u>	<u>2016</u>			<u>2015</u>		
	<u>U.S. Agencies</u>	<u>Corporate Bonds</u>	<u>CMO</u>	<u>U.S. Agencies</u>	<u>Corporate Bonds</u>	<u>CMO</u>
AAA	\$ -	\$ 6,656,935	\$ -	\$ -	\$ 952,796	\$ 3,566,745
AA	-	7,538,130	20,365,231	-	7,197,024	84,283
A	-	24,469,544	-	-	18,819,130	-
BBB	-	24,490,967	-	-	21,819,931	-
Not rated	1,332,567	694,449	-	4,323,279	279,709	16,671,921
	<u>\$ 1,332,567</u>	<u>\$ 63,850,025</u>	<u>\$ 20,365,231</u>	<u>\$ 4,323,279</u>	<u>\$ 49,068,590</u>	<u>\$ 20,322,949</u>

Moody's

Aaa	\$ -	\$ 4,959,524	\$ 20,365,231	\$ -	\$ 1,421,130	\$ 1,245,697
Aa	-	6,251,884	-	-	4,383,149	-
A	-	25,072,735	-	-	21,869,833	-
Baa	-	24,292,452	-	-	21,114,769	-
Not rated	1,332,567	3,273,430	-	4,323,279	279,709	19,077,252
	<u>\$ 1,332,567</u>	<u>\$ 63,850,025</u>	<u>\$ 20,365,231</u>	<u>\$ 4,323,279</u>	<u>\$ 49,068,590</u>	<u>\$ 20,322,949</u>

City of Kalamazoo, Michigan
Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE C: DEPOSITS AND INVESTMENTS - CONTINUED

Concentration of Credit Risk

The System's investment policy requires that the securities of any one company or government agency should not exceed 5% of the total fund. At December 31, 2016 and 2015, the System's investments were within that range.

The System's investment policy and State statutes provide that no more than 70% of the total investments may be in equity holdings and no more than 5% in real estate. As of December 31, 2016 and 2015, the System's equity holdings accounted for 69%, of the total investment portfolio; the System's holdings in real estate were 5% at December 31, 2016 and 2015.

Rate of Return

For the year ended December 31, 2016 and 2015, the annual money-weighted rate of return on pension plan investments, net of pension plan investment expense, was 12.64 percent and (1.62) percent, respectively. The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for the changing amounts actually invested.

Interest Rate Risk

For investments, the risk that changes in interest rates will adversely affect the fair value of the investment is known as interest rate risk. The System's investment policy does not address interest rate risk. As of December 31, 2016, and 2015, maturities of the System's debt securities were as follows:

<u>2016</u>	<u>Fair Value</u>	<u>Investment Maturities (fair value by years)</u>			
		<u>Less than 1</u>	<u>1-5</u>	<u>6-10</u>	<u>More than 10</u>
U.S. Treasuries	\$ 78,580,836	\$ -	\$ 41,287,101	\$ 5,767,264	\$ 31,526,471
U.S. Agencies	1,332,567	-	-	-	1332567
Corporate Bonds	63,850,025	1,896,438	23,116,504	24,631,928	14,205,155
Collateralized Mortgage Obligations	20,365,231	-	5,924	-	20,359,307
	<u>\$ 164,128,659</u>	<u>\$ 1,896,438</u>	<u>\$ 64,409,529</u>	<u>\$ 30,399,192</u>	<u>\$ 67,423,500</u>

<u>2015</u>	<u>Fair Value</u>	<u>Investment Maturities (fair value by years)</u>			
		<u>Less than 1</u>	<u>1-5</u>	<u>6-10</u>	<u>More than 10</u>
U.S. Treasuries	\$ 71,968,941	\$ 3,704,736	\$ 33,874,643	\$ -	\$ 34,389,562
U.S. Agencies	4,323,279	-	3,882,232	-	441,047
Corporate Bonds	49,068,590	925,287	9,319,757	21,405,413	17,418,133
Collateralized Mortgage Obligations	20,322,949	792	2,568,506	84,283	17,669,368
	<u>\$ 145,683,759</u>	<u>\$ 4,630,815</u>	<u>\$ 49,645,138</u>	<u>\$ 21,489,696</u>	<u>\$ 69,918,110</u>

Derivatives

The System's investment policy permits the prudent use of derivatives to reduce portfolio risk and enhance investment return. Under the terms of the investment agreements, portfolio managers are required to report all derivative holdings on a quarterly basis. The Investment Committee monitors these reports to evaluate the System's exposure to credit, market, and legal risk.

The portfolios managed by Jennison Associates have utilized U.S. currency futures contracts, a type of derivative, to reduce overall portfolio volatility caused by interest rate risk. At December 31, 2016 and 2015, the portfolio had no U.S. currency futures contracts.

City of Kalamazoo, Michigan
Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE C: DEPOSITS AND INVESTMENTS - CONTINUED

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. The System's exposure to foreign currency risk derives from its positions in foreign currency-denominated fixed-income investments. The System's investment policy permits it to invest up to 10 percent of total investments in foreign currency-denominated investments.

The System's exposure to foreign currency risk in U.S. dollars as of December 31, 2016, is summarized below:

Currency	Fixed Income
Canadian Dollar	\$ 788,654
Euro	5,844,588
Norwegian Krone	163,158
British Pound Sterling	2,779,647
Mexican Peso	297,328
	\$ 9,873,375

NOTE D: RESERVES

Member contributions - Members contribute at rates stated in the City Ordinance or collective bargaining agreements for the applicable unit. Interest is credited at least annually to the reserve for member contributions. The balance represents active members' contributions and interest, less amounts transferred to funds for retirement, amounts refunded to terminated members, and transferred inactive accounts.

Employer contributions - All employer contributions are credited to the reserve for employer contributions. Interest is credited at least annually, and transfers are made to the reserve for retired benefit payments to fund the employer's share of retirement allowances, as recommended by the System's actuaries and approved by the Board of Trustees.

Retired benefit payments - The reserve represents the reserves for payment of future retirement benefits to persons already on the retirement rolls. At retirement, a member's accumulated contributions (with interest) are transferred to the reserve for retired benefit payments from the reserves for employer contributions and member contributions. Interest is credited at least annually.

The reserve balances as of December 31, 2016 and 2015, are as follows:

	2016	2015
Member contributions	\$ 43,640,870	\$ 43,895,684
Employer contributions	243,144,234	223,389,846
Retired benefit payments	347,956,463	329,712,540
Total investments	\$ 634,741,567	\$ 596,998,070

City of Kalamazoo, Michigan
Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE E: PENSION BENEFITS

During 2001, the City Ordinance was amended to provide for a supplemental benefits payment to certain retirees. Subject to certain limitations as described in the Ordinance, these payments may occur every third year commencing in 2001. Although the City could have made these payments in 2016, no amounts were paid in 2016. Also, no amounts were paid in 2015.

NOTE F: ADMINISTRATIVE AND INVESTMENT EXPENSES

The following provides additional details related to administrative and investment expenses for the years ended December 31, 2016 and 2015:

	2016		2015	
	Amount	Percent of Net Position	Amount	Percent of Net Position
Investment advisor fees	\$ 1,810,110	0.295%	\$ 1,818,855	0.309%
Trust and custodial fees	213,390	0.035%	220,544	0.037%
Administrative expenses	153,024	0.025%	125,770	0.021%
Other expenses	175,722	0.029%	174,885	0.030%
	\$ 2,352,246		\$ 2,340,054	

NOTE G: RISK MANAGEMENT

The System is exposed to various risks of loss related to torts, errors and omissions. The System participates in the City of Kalamazoo's risk management program for all of these exposures. The City's risk management program is primarily a self-insured program with reinsurance amounts in excess of aggregate loss funds. The City estimates the liability for unpaid claims (including claims incurred but not reported) and allocates the cost to all appropriate entities and funds. There is no further exposure to the System that would require a liability to be recorded in the financial statements.

NOTE H: NET PENSION ASSET

The components of the net pension asset of the System at December 31, 2016, were as follows:

TOTAL PENSION LIABILITY	
Service cost	\$ 5,683,351
Interest	33,892,669
Changes of benefit terms	(23,809,450)
Differences between expected and actual experience	(2,513,167)
Benefit payments, including refunds of member contributions	(28,496,870)
NET CHANGE IN TOTAL PENSION LIABILITY	(15,243,467)
TOTAL PENSION LIABILITY, BEGINNING	463,309,018
TOTAL PENSION LIABILITY, ENDING (A)	\$ 448,065,551

City of Kalamazoo, Michigan
Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE H: NET PENSION ASSET - CONTINUED

PLAN FIDUCIARY NET POSITION	
Contributions - member	\$ 1,085,940
Net investment income	72,939,990
Benefit payments, including refunds of member contributions	(28,496,870)
Administrative expenses	(153,024)
Other	<u>(21,875,722)</u>
NET CHANGE IN PLAN FIDUCIARY NET POSITION	23,500,314
PLAN FIDUCIARY NET POSITION, BEGINNING	<u>589,527,061</u>
PLAN FIDUCIARY NET POSITION, ENDING (B)	<u>\$ 613,027,375</u>
SYSTEM'S NET PENSION (ASSET), ENDING (A)-(B)	<u>\$ (164,961,824)</u>
Plan fiduciary net position as a percentage of the total pension liability	136.82%
Covered-employee payroll	\$ 37,291,474
System's net pension (asset) as a percentage of covered-employee payroll	(442.36)%

Actuarial Assumptions

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan understood by the employer and plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

The total pension liability was determined by an actuarial valuation as of December 31, 2016, using the following actuarial assumptions, applied to all periods included in the measurement:

Actuarial cost method	Entry age normal
Amortization method	Level percentage of payroll, open period
Remaining amortization period	10 years
Asset valuation method	5 years smoothed market
Inflation	3.5% (which includes price inflation of 2.75%)
Projected salary increases	3.5% to 15.5% (includes inflation)
Investment rate of return	7.50%
Retirement Age	Experience-based table of rates that are specific to the type of eligibility condition. Last updated for the 2014 valuation pursuant to an experience study of the period 2009-2013.
Mortality rates	RP-2000 Mortality Combined Healthy Tables, projected 20 years with U.S. Projection Scale BB.

City of Kalamazoo, Michigan
Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE H: NET PENSION ASSET - CONTINUED

Actuarial Assumptions - continued

The actuarial assumptions used in the December 31, 2016, valuation were based on the results of an actuarial experience study for the period January 1, 2009 through December 31, 2013.

Discount Rate

The discount rate used to measure the total pension liability was 7.5 percent. The projection of cash flows used to determine the discount rate assumed that member contributions will be made at the current contribution rate and that City contributions will be made at rates equal to the difference between actuarially determined contribution rates and the member rate. Based on these assumptions, the pension plan's fiduciary net position was projected to be available to make all projected future benefit payments of current plan members. Therefore, the long term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

Sensitivity of the Net Pension Liability (Asset) to Changes in the Discount Rate

The following presents the System's net pension liability (asset), calculated using the discount rate of 7.5 percent, as well as what the System's net pension liability (asset) would be if it were calculated using a discount rate that is 1 percent lower (6.5 percent) or 1 percent higher (8.5 percent) than the current rate:

	<u>1% Decrease (6.5%)</u>	<u>Current Discount Rate (7.5%)</u>	<u>1% Increase (8.5%)</u>
Total pension liability	\$ 501,029,951	\$ 448,065,551	\$ 403,925,336
Plan fiduciary net position	<u>613,027,375</u>	<u>613,027,375</u>	<u>613,027,375</u>
Net pension liability (asset)	<u>\$ (111,997,424)</u>	<u>\$ (164,961,824)</u>	<u>\$ (209,102,039)</u>

NOTE I: SPECIAL ITEM

The Kalamazoo Metro Transit System ceased operations on September 30, 2016. All operational and financial responsibility, as well as all assets and liabilities, of the Kalamazoo Metro Transit System were assumed by the Central County Transportation Authority (CCTA). CCTA is a component unit of Kalamazoo County. The net position of the City of Kalamazoo Employees' Retirement System related to the Kalamazoo Metro Transit System was transferred to the new CCTA employee retirement system as of September 30, 2016. This event was both unusual in nature and infrequent in occurrence and within the control of management, therefore, the transfer of assets is reported in the audited financial statements as a special item in the current year.

NOTE J: CHANGE IN ACCOUNTING PRINCIPLES

GASB Statement No. 72, *Fair Value Measurement and Application*, was implemented during the year. This statement addresses accounting and financial reporting issues related to fair value measurements. The definition of fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This statement provides guidance for determining a fair value measurement for financial reporting purposes. This statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements.

City of Kalamazoo, Michigan
Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE K: UPCOMING ACCOUNTING PRONOUNCEMENTS

In March 2016, the GASB issued Statement No. 82, *Pension Issues - An Amendment of GASB Statements No. 67, No. 68, and No. 73*. The statement addresses issues regarding (1) the presentation of payroll-related measures in required supplementary information, (2) the selection of assumptions and the treatment of deviations from the guidance in an Actuarial Standard of Practice for financial reporting purposes, and (3) the classification of payments made by employers to satisfy employee (plan member) contribution requirements. The System is currently evaluating the impact this standard will have on the financial statements when adopted during the 2018 fiscal year.

REQUIRED SUPPLEMENTARY INFORMATION

City of Kalamazoo, Michigan
Employees' Retirement System

SCHEDULE OF CHANGES IN THE SYSTEM'S NET PENSION ASSET AND RELATED RATIOS

Last Three Fiscal Years (ultimately ten fiscal years will be displayed)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
CHANGE IN TOTAL PENSION LIABILITY			
Service cost	\$ 5,683,351	\$ 6,187,334	\$ 6,259,728
Interest	33,892,669	32,334,356	31,603,299
Changes of benefit terms	(23,809,450)	-	-
Difference between expected and actual experience	(2,513,167)	(1,574,739)	-
Changes of assumptions	-	12,509,343	-
Benefit payments, including refunds of member contributions	<u>(28,496,870)</u>	<u>(28,356,700)</u>	<u>(27,802,129)</u>
NET CHANGE IN TOTAL PENSION LIABILITY	(15,243,467)	21,099,594	10,060,898
TOTAL PENSION LIABILITY, BEGINNING	<u>463,309,018</u>	<u>442,209,424</u>	<u>432,148,526</u>
TOTAL PENSION LIABILITY, ENDING (A)	<u>\$ 448,065,551</u>	<u>\$ 463,309,018</u>	<u>\$ 442,209,424</u>
CHANGE IN PLAN FIDUCIARY NET POSITION			
Contributions - employer	\$ -	\$ 1,602,053	\$ 760,912
Contributions - member	1,085,940	1,084,798	1,067,029
Net investment income	72,939,990	(9,974,517)	41,065,447
Benefit payments, including refunds of member contributions	(28,496,870)	(28,356,700)	(27,802,131)
Administrative expenses	(153,024)	(125,770)	(122,107)
Other	<u>(21,875,722)</u>	<u>(174,885)</u>	<u>(110,326)</u>
NET CHANGE IN PLAN FIDUCIARY NET POSITION	23,500,314	(35,945,021)	14,858,824
PLAN FIDUCIARY NET POSITION, BEGINNING	<u>589,527,061</u>	<u>625,472,082</u>	<u>610,613,258</u>
PLAN FIDUCIARY NET POSITION, ENDING (B)	<u>\$ 613,027,375</u>	<u>\$ 589,527,061</u>	<u>\$ 625,472,082</u>
SYSTEM'S NET PENSION (ASSET), ENDING (A)-(B)	<u>\$ (164,961,824)</u>	<u>\$ (126,218,043)</u>	<u>\$ (183,262,658)</u>
Plan fiduciary net position as a percentage of the total pension liability	136.82%	127.24%	141.44%
Covered-employee payroll	\$ 37,291,474	\$ 37,198,788	\$ 3,631,892
System's net pension (asset) as a percentage of covered-employee payroll	(442.36)%	(339.31)%	(504.41)%

City of Kalamazoo, Michigan
Employees' Retirement System

SCHEDULE OF CITY CONTRIBUTIONS

Last Ten Fiscal Years

	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007
Actuarially determined contribution	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Contributions in relation to the actuarially determined contribution	-	1,602,053	760,912	905,746	905,746	-	-	-	-	-
Contribution deficiency (excess)	\$ -0-	\$ (1,602,053)	\$ (760,912)	\$ (905,746)	\$ 905,746	\$ -0-	\$ -0-	\$ -0-	\$ -0-	\$ -0-
Covered-employee payroll	\$ 37,291,474	\$ 37,198,788	\$ 36,331,892	\$ 36,539,969	\$ 42,305,663	\$ 43,007,800	\$ 44,435,753	\$ 44,159,590	\$ 42,889,419	\$ 42,165,958
Contributions as a percentage of covered-employee payroll	0.00%	4.31%	2.09%	2.48%	2.14%	0.00%	0.00%	0.00%	0.00%	0.00%

Actuarial valuation information relative to the determination of contributions:

Valuation date Actuarially determined contribution rates are calculated as of December 31 each year, which is immediately prior to the beginning of the fiscal year in which contributions are reported.

Methods and assumptions used to determine contribution rates:

Actuarial cost method Entry age normal
Amortization method Level percentage of payroll, open period
Remaining amortization period 10 years
Asset valuation method 5 years smoothed market
Inflation 3.5% (which includes price inflation of 2.75%)
Salary increases 3.5% to 15.5% including inflation
Investment rate of return 7.50%
Retirement Age Experience-based table of rates that are specific to the type of eligibility condition. Last updated for the 2014 valuation pursuant to an experience study of the period 2009-2013.
Mortality rates RP-2000 Mortality Combined Healthy Tables, projected 20 years with U.S. Projection Scale BB.

City of Kalamazoo, Michigan
Employees' Retirement System

SCHEDULE OF INVESTMENT RETURNS

Last Three Fiscal Years (ultimately ten fiscal years will be displayed)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Annual money-weighted rate of return, net of investment expense	12.64%	(1.62)%	6.82%