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PENSION FUND COMMITTEE

Minutes of Meeting

August 20, 2015

The Sussex County Pension Fund Committee met on August 20, 2015, at 10:00 a.m. in the County Council Chambers, Georgetown, Delaware. Those in attendance included members: Gina Jennings, Todd Lawson, Karen Brewington, Jeffrey James, Hugh Leahy, and Kathleen Ryan. Also in attendance were Michael Shone and Patrick Wing of Peirce Park Group, the County's Pension Investment Consultant. Committee member David Baker was unable to attend.

On August 12, 2015, the Agenda for today's meeting was posted in the County's locked bulletin board located in the lobby of the County Administrative Offices, as well as posted on the County's website.

Ms. Jennings called the meeting to order.

1. **Approval of Minutes**

The minutes of the May 21, 2015 meeting were approved by consent.

2. **Investment Analysis for the Quarter Ended June 30, 2015**

Mr. Shone distributed copies of a booklet entitled, "Sussex County Investment Performance Report, June 30, 2015". Also provided were a "Client Satisfaction Survey" for members to complete, as well as the Summer 2015 edition of "Peirce Park Perspective". The Investment Performance Report includes information regarding the market environment for the second quarter of 2015, as well as quarterly and annual performances of the Pension and OPEB Plans. Although the report should be referenced for a more detailed analysis, discussion highlights include:

Mr. Wing referred members to Market Environment – 2nd Quarter of 2015 (Tab 1).

The U.S. economy grew by 2.3 percent in the second quarter, rebounding from a weak first quarter. Economists expect the U. S. economy to grow 3 percent for the remainder of 2015. The unemployment rate, at 5.3 percent, is the lowest since April 2008. Given the health of the labor market, the futures market is expecting that the Fed will raise interest rates by 0.5 percent by the end of the year; this would be the first interest rate increase since 2006. In Europe, despite recent economic news in Greece, the economy has been accelerating slightly. Internationally, it was noted that China's economy has been slowing for quite some time. From a global perspective, the U. S. economy, despite some ups and downs, is remaining stable, with non-U.S. economies more unsettled. U. S. equities were rather flat in the second quarter, showing a 0.1 percent return; growth stocks outperformed, particularly among small caps. Non-U.S. equities slightly outperformed U. S. equities, reflecting a .5 percent return. Fixed income markets were mostly negative as global benchmark yields increased during the second quarter. For the quarter, equities were flat and fixed income saw slightly negative returns.

Mr. Shone directed members to the Pension Fund Performance Report (Tab II).

As of June 30, 2015, the ending market value of the Pension Plan was $74.2 million and realized a second quarter gain of $129,000, or a 0.2 percent return; and a one-year gain of $3.1 million (net of expenses), or a 4.7 percent return. The County continued to have very strong peer group performance, ranking above average for the quarter, as well as for year-to-date, and one, three, and 5 years; above policy index performance was also seen for these same time periods. Looking ahead, the Committee will be addressing the review of the Pension Investment Policy Statement during today's meeting; Mr. Shone also suggested the possibility of adding international/global stocks to the Pension's portfolio.

The ending market value of $74,254,839 included: DuPont Capital Investment - $14,199,873, Operating Account - $112,859, State of Delaware Investment Pool - $46,158,675, Vanguard Extended Market Index - $3,046,608, Vanguard Mid Cap Value - $2,544,696, Wilmington Trust Bonds - $8,192,129, and Wilmington Trust Short Term - $0. In 2012, the County's Pension Plan had a market value of $53,343,263; of the $21 million increase realized, almost all has been due to investment returns. For this three-year period, the pension fund realized an 11.1 percent return.

As of June 30, 2015, Sussex County's Pension Asset Allocation included: State of Delaware Investment Pool – 62.2 percent; Cash – 0.2 percent; Domestic Fixed Income – 11.0 percent; and Domestic Equity – 26.7 percent.

Year-to-date, the Pension Fund realized a 2.6 percent return and ranked in the top 35th percentile; 4.7 percent return for 1 year (top 7 percent nationwide out of 250 public funds). For the quarter, the fund realized a 0.2 percent return, which was above the policy index of -0.2 percent. Mr. Shone noted it would be very difficult, over the next 5 to 10 years, to meet actuarial assumed rate of returns.

In comparison with the State of Delaware Investment Pool, the County realized a 0.2 percent return for the second quarter versus 0.4 percent (State), 2.6 percent year-to-date versus 3.2 percent (State), one year – 4.7 percent versus 3.9 percent (State), 3 year – 11.1 percent versus 10.8 percent (State); 5 years – 11.0 percent versus 11.5 percent (State). Mr. Shone noted that blending the State's more aggressive investment approach, along with the County's more conservative nature, has worked well. The County has an estimated annual investment management fee of .52 percent and, although the State's fee of .68 percent is more expensive, their returns justify the added cost. Mr. Shone also reported that all of the Pension Fund's managers have performed very well for the quarter.

Mr. Shone referred members to the OPEB Fund Performance Report (Tab III).

As of June 30, 2015, the ending market value of the OPEB Plan was $31.4 million and realized a first quarter loss of $68,000, or a 0.1 percent loss; and a 1-year gain of $1.08 million (net of expenses), or a 4.0 percent return. The OPEB Plan was slightly under the policy index (0.09 percent), and has very low investment fees, 0.26 percent. Looking ahead, the County will be reviewing the investment policy statement during today's meeting. Since its inception (March 1, 2011), at which time the market value was $22,982,102, the OPEB has realized a 6.1 percent return. For the quarter, the plan was down 0.1 percent and ranked in the 65th percentile; year-to-date – 1.8 percent (79th percentile), and 1 year – 4.0 percent (25th percentile). Mr. Shone pointed out that Thornburg continues to have outstanding performance, 11.1 percent year-to-date, versus a 3.6 benchmark.

3. **<u>Pension and OPEB Investment Policy Statements Review</u>**

Committee members were provided with copies of a report prepared by Peirce Park entitled, "Sussex County Pension & OPEB Investment Policy Statement Review", as well as copies of the Investment Policy Statements for both plans (Pension Plan – June 24, 2014 and OPEB – last amended December 16, 2014).

Mr. Shone noted that in the investment process, goals and objectives have to be identified including: (1) ensuring assets are available to pay liabilities when needed, (2) minimizing annual required contributions (ARCs), and (3) minimizing the volatility of the ARCs. After the goal and objectives have been established, also to consider when developing an investment policy statement are allocation mixes, portfolio structure, manager selection, portfolio invested, and monitoring results.

With declining returns, alternative investments and asset classes, including timber and real estate, were discussed. Ms. Jennings explained that the County does not include real estate in its investment portfolio due to its already heavy reliance on real estate through County taxes.

For both plans, the report and discussion included: current asset allocation as of June 30, 2015 (targets, actual allocations, the ranges written within the IPS, and are they within range), current benchmarks, guidelines, restrictions, considerations/next steps. Currently, the Pension Investment Policy statement has a 60 percent equities/40 percent fixed income target, with a target of 65/35 for the OPEB.

Mr. Shone offered that the Committee may want to fine-tune the restrictions for both Investment Policy Statements at the November 2015 meeting.

Mr. Leahy noted the similarities between the restrictions for both investment policy statements and questioned the need for two separate policies, and if it would be prudent to include wording to reflect net versus gross returns of the managers. Mr. Shone explained the need for two statements, as well as that net versus gross returns was an implementation issue and not policy.

It was the consensus of the committee to modify both investment policy statements with the goal to have identical restrictions. Ms. Jennings stated that she and Mr. Shone will work together and present a red-line version of both statements at November's meeting. Due to its many amendments, the OPEB will, most likely, have to be entirely rewritten.

4. **Market Protection**

Mr. Wing reviewed a handout entitled, "Will What Has Worked Recently Continue to Perform Well?", dated August 2015. Although the Pension Fund and OPEB Trust have performed quite well over the past few years, the question had been raised by the Pension Committee when were the funds likely not to do well, particularly against their peers. As such, Peirce Park reviewed recent capital markets performance to help set the context and set reasonable expectations for the future. Because this topic was so timely, Peirce Park used this as their feature article in their most recent quarterly newsletter. Mr. Wing reviewed the charts and graphs included in their report. Included here are the subtopics presented:

Market Review: Traditional assets (e.g. U.S. equities) have done extremely well over the past five years. However, the prior five years looked entirely different (U.S. equities ranked second-to-last among 15 major asset classes, and emerging markets equities were first and natural resources equities second). The lesson learned is the fact that markets are cyclical and, as a result, investors should not conclude that performance trends will carry over into the future.

Meeting Long-Term Return Assumptions: Given the long-term horizon of many institutional investors and the need to meet the assumed rate of return, equities tend to dominate the asset allocation of their portfolios. This approach is viewed as the best way of meeting long-term objectives.

Relative Performance by Economic Environment: The relative performance of various asset classes is a function of the economic environment. The economic environment is defined by two variables: economic growth and inflation. Given equity dominant portfolios, institutional investors have done well recently (equities tend to do best when economic growth is rising and inflation is falling and/or steady; despite ups and downs, such an environment has characterized the economy over the last several years). Other economic environments are more favorable for different assets (some institutions that have costs tied to inflation will make allocations to inflation-sensitive assets, e.g., TIPS). The relative performance for various asset classes, at least in the short-term, runs in cycles depending on the economic environment.

Diversification Spectrum: For illustration purposes, the report compared a traditional portfolio (65 percent U. S. Equities and 35 percent U. S. Bonds) and a highly diversified portfolio (U.S. Equities, Non-U.S. Equities, Private Equities, Hedge Funds, Core Real Estate, U.S. REITs, Commodities, U.S. Bonds, Natural Resource Equities, Core Real Estate, Cash). Where an investor falls on the diversification spectrum is an important driver of peer performance (specifically, how they implement equity exposures – public equities, private equity, hedge funds, etc. – and whether they have assets that perform well in other economic environments).

Performance Cycles: Relative performance between a traditional portfolio and a highly diversified portfolio has moved in pronounced cycles. Most recently, the traditional portfolio has outperformed.

Calendar Year Peer Rankings: Prior to 2008, the environment favored a more diversified approach (the highly diversified portfolios placed in the top quartile in 2005, 2006, and 2007, while the traditional portfolio was at the other end of the spectrum).

Cumulative Peer Rankings: Sussex County's portfolio has benefitted from an environment favoring traditional assets (the performance of a traditional portfolio has been 'off the charts'). In the five years ending December 2009, institutions that had a more diversified portfolio outperformed their more traditional counterparts.

What Could Turn the Tide?: Traditional assets, particularly U.S. equities, have outperformed over the past several years. Given the relative returns, U.S. equities have become expensive compared to their international peers (U.S. equities are, therefore, more likely than not to underperform, leaving the traditional portfolio susceptible to future underperformance). However, as along as investors remain comfortable with their strategic asset allocation, this alone does not signal the need for change (over the very long-term, a traditional portfolio has kept pace with a more diversified approach).

Long-Term Performance: *While the two portfolios – traditional and more diversified – have moved in pronounced cycles, they have generated essentially the same performance over the past 20 years.*

Risk Metrics: Similar to performance, risk metrics between the two portfolios are also in line (downside risk was 5.9 percent for the traditional portfolio, compared to 6.2 percent for the diversified portfolio. The standard deviation of annual excess returns – relative to a constant 7.5 percent – was 12.6 percent for the traditional portfolio compared to 13.0 percent for the diversified portfolio).

Conclusion: Capital markets, particularly U.S. equities, have generated strong returns over the past several years amid a favorable economic environment. Given U.S. equity returns, a traditional portfolio of U.S. stocks and bonds have handily outperformed a more diversified portfolio during this period. Investors should not conclude that this recent performance will extend into the future as the economy and markets are highly cyclical. However, the differences in long-term returns and risk statistics between a traditional portfolio and a diversified portfolio have been minimal (the traditional portfolio is a solid option for the investors wanting a straightforward approach to investing). *Investment decisions must be based on the County's unique situation.*

Next Steps: Mr. Shone noted that the County's portfolios have the best of both worlds (traditional versus diversified). With both plans, the County has 45 percent of their portfolio invested using a diversified approach (State) and 55 percent using a traditional approach. Ms. Ryan questioned the recommended percentage for increasing international exposure. Mr. Shone suggested the OPEB move from 60 percent to 65 percent in equities; implementation would be to add to international managers from current domestic managers. With the pension, a new international or global fund would be introduced. It was the consensus of the Committee for Mr. Shone to present three or 4 manager recommendations – two global and two international – at November's meeting.

Due to his ongoing concern to protect the County's Pension Plan under various market conditions – even with its consistent high peer group performance – Mr. Leahy stated his appreciation for Peirce Park's report and acknowledged the tremendous amount of work required in its preparation.

When asked, Mr. Wing stated that he felt the Feds would not raise short-term interest rates for the remainder of 2015.

5. **<u>Update on FY 15 Pension Reporting</u>**

Ms. Jennings stated the Actuary's Report will be completed in time to present at the November meeting. In the meantime, Ms. Jennings provided a two-side handout showing "How does Sussex County's Pension Compare?" on average. The average State and local pension funded ratios for fiscal years 1993-2014 show an average funding level of 74 percent, with the County's plan being 87.7 percent funded. The distribution of funded ratios for public funds for FY 2014 show 43 percent are between 60 and 78 percent funded; the County falls within the 31 percent that are between 80 and 99 percent funded. The charts also show that the County, historically, funds its Pension Plan above the required contribution. The assumed rate of return for 77.3 percent of plans fall between 7.5 to 7.9 percent; the County's is 7.5.

Ms. Jennings then highlighted, "Preparing for GASB 68", which discussed perceived concerns associated with the new reporting standard now required. The concerns and facts are included below.

<u>Concern</u>: This will cause a tax increase.
<u>Fact</u>: This new GASB is about pension liability reporting, not pension funding. Plan funding takes into consideration amortizing the liability over many years. This regulation will result in a clearer picture of a government's overall liability, this is a long-term consideration and any resulting changes will likely be spread over many years. However, Sussex County has always funded more than the required contribution, so there are no additional requirements in GASB 68 that will placed on our government to cause a tax increase.

<u>Concern</u>: Sussex County will now need to revisit the pension benefits now that this new liability exists.
<u>Fact</u>: Traditionally, government employees give up some 'current pay' by having a relative stronger 'long-term benefit' like a pension. Administration understands that changing long-term benefits need to evaluate the possible impact on obtaining and retaining competent, motivated staff and management. GASB 68 only increases transparency and clarity about a pension fund, and there is no requirement to change benefit levels.

<u>Concern</u>: Size of net liability may spur governments to advocate for faster funding.
<u>Fact</u>: Governments need a long-term solution to this long-term matter. A government's greatest asset is its employees. GASB 68 may result in a reconsideration of government's funding policies, but governments must balance short-term requirements and needs with long-term solutions to long-term issues.

<u>Concern</u>: Funding this new liability will drive up taxes, inhibit existing business, and deter new business.
<u>Fact</u>: There is no new liability. GASB 68 is about financial statement reporting of a long-known funding responsibility. Sussex County has done an excellent job funding this liability. We are above average in our funded percentage and plan to continue to fund our pension.

<u>Concern</u>: Governments have been hiding huge liabilities.
<u>Fact</u>: Governments' retirement plans have already been disclosed with increasing detail for many years. Most of this information was included in the footnotes of the financial

statement. GASB 68 continues to progress toward clarity and transparency in every governmental financial statements.

Ms. Jennings noted that the Actuary's report will include the assumptions used, i.e. colas, mortality table, etc.

6. **Additional Business**

Ms. Jennings announced the upcoming retirement of Committee member Mr. James (December 2015). Members congratulated and thanked Mr. James for his valuable service on the Committee.

7. **Adjourn**

At 11:35 a.m., a Motion was made by Mr. Leahy, seconded by Mr. James, to adjourn.

Motion Adopted: 6 Yea.

Vote by Roll Call: Mr. James, Yea; Ms. Brewington, Yea; Mr. Leahy, Yea; Ms. Ryan; Yea; Mr. Lawson, Yea; Ms. Jennings, Yea

The next meeting of the Pension Fund Committee is scheduled for November 19, 2015, at 10:00 a.m. in the Sussex County Council Chambers.

Respectfully submitted,

Nancy Cordrey

Nancy J. Cordrey
Administrative Secretary