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PENSION FUND COMMITTEE

Minutes of Meeting

August 21, 2014

The Sussex County Pension Fund Committee met on August 21, 2014, at 10:00 a.m. in the County Council Chambers, Georgetown, Delaware. Those in attendance included members: Gina Jennings, Todd Lawson, Jeffrey James, David Baker, Hugh Leahy, and Kit Ryan. Also in attendance were Michael Shone of Peirce Park Group, the County's Pension Investment Consultant, as well as Michael Schooley, of Aon, the County's Actuary. Committee member Karen Brewington was unable to attend.

On August 13, 2014, the Agenda for today's meeting was posted in the County's locked bulletin board located in the lobby of the County Administrative Office, 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 22, 2014 meeting were approved by consent.

2. **2014 Annual Actuary Report**

Committee members were provided with two reports entitled, "Sussex County 2014 Pension Actuarial Report" and "Sussex County Draft Actuarial Report for GASB 43 and 45" prepared by Aon; both have a valuation date of January 1, 2014. Ms. Jennings also provided members with a one-page summary of both reports, "2014 Actuarial Report as of January 1, 2014". Comparing 2013 and 2014, Ms. Jennings noted that the Pension Plan had a \$10,505,682 increase. Using 2013 standards, the Pension Plan would reflect a 93.8 percent funding level, which is a 10 percent increase; under the new standards, the Pension Plan would be 87.7 percent funded. Below are recent annual required contributions, as well as actual contributions, for both the Pension and OPEB Trust Funds:

Pension Trust Fund

Fiscal Year	Annual Req'd Contribution	Actual Contribution	% Contributed
2010	$2,036,037	$2,738,014.00	134%
2011	$2,169,173	$2,370,522.00	109%
2012	$2,342,663	$3,668,932.00	157%
2013	$2,798,351	$3,198,312.00	114%
2014	$2,868,624	$3,587,012.00	125%
2015 Budget	$2,757,068	$3,287,217.78	119%

OPEB Trust Fund

Fiscal Year	Annual Req'd Contribution	Actual Contribution	% Contributed
2010	$2,932,734	$2,747,989.00	94%
2011	$1,278,049	$1,356,683.00	106%
2012	$1,488,338	$2,661,772.00	179%
2013	$1,863,189	$2,106,808.00	113%
2014	$1,744,289	$2,433,752.00	140%
2015 Budget	$1,723,687	$2,055,130.51	119%

GASB regulations have not changed for the OPEB, which allowed the plan to realize an 8 percent funding increase from 2013 to 2014; 70.5 percent in 2013 and 78.2 percent in 2014. For easy reference, below is Ms. Jennings summary:

Description	2013	2014	Change
Market Value of Pension Assets	$57,641,924	$68,147,606	$10,505,682
Pension Funded % - previous standard	83.8%	93.8%	10%
Pension Actuarial Liability – previous standard	$12,891,124	$8,239,626	($4,651,498)
Pension Funded Percentage – new standard	83.8%	87.7%	4%
Pension Actuarial Liability – new standard	$12,891,124	$9,574,062	($3,317,062)
Total Pension Liability – new standard	$70,565,693	$77,721,668	$7,155,975
Pension Annual Req'd Contribution (ARC)	$2,868,624	$2,757,068	($111,556)
Market Value of OPEB Assets	$26,289,375	$30,120,575	$3,831,200
OPEB Funded Percentage	70.6%	78.2%	8%
OPEB Annual Req'd Contribution (ARC)	$1,744,289	$1,723,687	($20,602)
OPEB Actuarial Liability	$12,585,421	$10,945,590	($1,639,831)
Average Compensation	$41,930	$42,557	$627
Average Age	46.4	47.0	0.6
Average Service	11.7	11.9	0.2
Number of Retirees	180	185	5

It was pointed out that the County has been consistently contributing more than the annual required contribution and will continue in the Fiscal 2015 Budget Year.

The meeting was turned over to Mr. Schooley who was in attendance to review the new GASB (Governmental Accounting Standards Board) regulations. Mr. Schooley provided members with a two-page handout reflecting the changes and their impact to the County. At the current time, the GASB 67 and 68 Statements have been released. GASB 68 will affect the Pension Plan for Fiscal Year 2015, and GASB 67 will affect Fiscal Year 2014. Statement No. 67, *Financial Reporting for Pension Plans*, addresses note disclosure reporting for state and local government pension plans. Statement No. 68, *Accounting and Financial Reporting for Pensions*, establishes new accounting and financial reporting requirements for governments that provide their employees with pensions. The regulations in these Statements will change how governments calculate and report the costs and obligations associated with pensions in their financial statements. The changes in reporting methods provide consistency and comparability of pension information used by all government entities. For the OPEB Plan, changes will take effect in Fiscal Year 2018. The main change of Statement 68 from GASB 27 is what has to be reported as a liability.

For reference, Mr. Schooley's overview of 'GASP 68 – Key Changes in Account Rules' and their impact include:

GASB 68 – Key Changes in Accounting Rules

'GASB has significantly changed how the pension results are reported for fiscal years ending 2015 and later. This will be a major step toward getting the full pension obligation into the financial statement. Until now, even though the actuarial liability or true obligation was footnoted in the Comprehensive Annual Financial Report (CAFR), in the balance sheet a pension obligation was reported as the running total of the annual expense less employer contributions. This sent a confusing message to most readers. The obligation will be replaced by the unfunded liability, which is the difference in the actuarial liability, or what the employer owes participants, and trust assets. Making the unfunded liability not just a footnoted item, but a disclosed obligation in the face of the financial statement alongside other liabilities, such as outstanding bonds and long-term leases, emphasizes that the pension liability is another obligation that the government agency will be required to fulfill. This could impact cash outlays and employer bond ratings.'

'There are key decisions that will need to be made in the upcoming year relating to plan funding, measurement timing and assumption review. Below is an overview of the key items that impact the County:'

	Current GASB 27	Current GASB 68	Impact
Separation of Funding/Accounting	Defined a contribution approach in order to keep the obligation at zero	No contribution method	Need to work with actuary to develop appropriate funding approach
Annual Pension Cost (APC)	Normal cost plus amortization of the unfunded	Normal cost plus Full plan change recognition plus liability gain/loss amortization, plus interest on the actuarial liability less expected asset returns	Plan changes will have significant impact in any given year, see attached exhibit of how the initial year could be impacted
Balance Sheet Liability (NPO)	Cumulative difference between APC and contributions	Funding Status at Measurement Date	Large Increase, see attached exhibit of example of how the initial year could be impacted
Timing – Measurement Date	Lots of leeway, practice varies	As early as prior fiscal year end; results from an earlier valuation (up to 30 months and 1 day prior to FYE) may be rolled forward to Measurement	Would be good to discuss, Recommend 6 months prior to fiscal year or change timing of data collection
Discount Rate	Based on expected long-term return on funding vehicle	Same method for projected benefits that do not exceed the projected trust, else 20 year municipal bond rate (AA/Aa or higher)	May need to state the policy to avoid discount rate issues
Funding Method	May use one of seven approved methods, currently using Entry Age for Accounting	Must use Entry Age	Different liability from funding
Asset Method	Asset value may be based on an asset gain/loss smoothed method	Market value	For Accounting purposes the 5 year smoothing method will be set to market value.
Amortization Method	A factor based on 30 years, optional projected payroll growth and optional open/closed method that allows reamortization each year	A factor equal to 5 years for assets gains/losses, average expected service including inactive lives for liability gains/losses with no option to reamortize. Plan changes are recognized immediately.'	Shorter recognition of the unfunded liability.

According to Mr. Schooley's additional financial information, the County had a liability at the end of fiscal year 2014 that was actually an asset of almost $19 million ($18,807,623); the new rules will require the County to show this a liability of $9,574,062. Since the County is not 100 percent funded (87.7 percent), the key impact is that some assets will move to a liability. The County, however, is better funded than most of the public sector plans, who are at the 80 percent mark. The other main change will be the breakdown of funding versus expensing. The County's funding calculations will remain the same, but the calculations will be done using different assumptions – different cost methods. The 7.5 percent assumed rate of return will still be used. Mr. Schooley noted that the overall present value of future benefits is the same under each method ($91,920,999), and revisions will result in a greater expense fluctuation. Key disclosures under the new GASB Statement include: (1) a funding policy is required and (2) a measurement date, or timing of measurements. Currently, this date is January 1 for the County and Aon is recommending it remain the same. Mr. Schooley noted that he would provide the County with a sample funding policy.

Mr. Schooley referred members to a "Forecast of Results" illustrating a 5-year projection resulting from GASB changes. In Fiscal Year 2017, it is projected the County will have a $4,494,795 asset showing on the County's balance sheet. Looking ahead to 2018, it will be seen as a liability of $13,889,281. Although these changes will impact the bond ratings of many governments, Mr. Schooley noted the County's Pension Plan is so well funded that no impact is expected to the County's bond ratings.

Pension Plan contributions are 13.5 percent of gross salaries and 10 percent for the OPEB; Ms. Jennings noted that 25 percent was used for the budget, which is over the required contribution of 23 percent for both.

It was also noted that the percentages used in the "Sensitivity" information should have been 6.50 percent (1% decrease), 7.50 percent (current rate), and 8.50 percent (1% increase). The dollar amounts stated are accurate.

Ms. Jennings stated that if the current funding method is used, the County will meet the obligation to become fully funded. She noted concern that if the expense method is used and reduces the percentage, the new method will get the County closer to becoming fully funded. Mr. Schooley explained that the County could switch from a projected to an entry age funding method, which may increase the County's contributions now, but would ultimately lower them later on. The two funding methods will come together as the group ages so one method will not necessarily be a faster funding method over the other. In switching to an entry age funding method, a probable contribution increase of $10,000 would be realized. Ms. Jennings stated that the differing methods might be confusing to those not well versed in pension reporting. Mr. Schooley was requested to provide both numbers (expense and entry age) in the next actuary report.

Ms. Jennings thanked Mr. Schooley for his time and presentation.

3. **<u>Investment Analysis for the Quarter Ended June 30, 2014</u>**

Mr. Shone began by stating that the County has one of the best funded Pension Plans, and is absolutely better funded than most funds on the OPEB side. Mr. Shone distributed copies of a booklet entitled, "Sussex County Investment Performance Report, June 30, 2014". The report includes information regarding the market environment for the second quarter of 2014, 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. Shone referred members to Market Environment – 2nd Quarter of 2014 (Tab 1). Although negative for the first quarter of 2014, the real GDP (Gross Domestic Product) growth (inflation adjusted) realized an increase in Quarter 2 of 4 percent. Initial jobless claims and the unemployment rate have been decreasing. Despite various economic volatility in the first half of 2014, inflation expectations have remained fairly stable. Both market and consumer expectations have changed little over the past two years. The Federal Reserve has kept its short-term interest rates at approximately zero and has lowered its bond purchases.

For the second quarter, U. S Equities realized a 4.9 percent return, and 6.9 for the year-to-date. Emerging Equities have been the big winner for the quarter. Bonds have performed better than expected and saw a return of 3.9 percent for the first half of 2014. The County does not have exposure to high yield (junk) bonds in the OPEB Fund, and only a slight exposure – through the State Pool – in the Pension Plan. Inflation-sensitive investments (TIPS, commodities and U.S. REITs) have performed well this year.

At 10:28 a.m., Mr. Lawson exited the meeting.

The U. S. Equity Markets posted a positive second quarter of nearly 5 percent; Small Caps continued to lag; and Mid Cap Value were the best performers year-to-date. The County's OPEB Fund has a slight tilt toward Value Stocks.

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

Observations for the Sussex County Pension Fund:

- As of June 30, 2014, the Pension Fund had a market value of $70.9 million and realized a second quarter gain of $2.69 million (net of all investment management fees), or 3.8 percent; a year-to-date gain of $4.38 million (net), or 6.3 percent.

- Continued very strong performance/returns

Looking Ahead

- Cash Management
- Fidelity Replacement?

Mr. Shone noted that he and Ms. Jennings had been in discussion regarding cash management. For quite a few years, the County's process has been to make the ARC contribution in December, which covers the actual pension costs for the year that are paid out in June. It is recommended that monthly ARC contributions be made, which are closely equal to actual expenses, instead of on a one-time yearly basis. This will allow investments to remain invested and permit the portfolio to remain better balanced, realizing a more even cash flow.

The ending market value of the Sussex County Pension Plan as of June 30, 2014 was $70,904,338, which included DuPont Capital Investment - $13,217,885, Fidelity Low Priced Stock - $5,230,299, Operating Account - $689,823, State of Delaware Investment Pool - $44,534,700, Wilmington Trust Bonds - $7,231,631, and Wilmington Trust Short Term – $0.

As of June 30, 2014, Sussex County's Pension Asset Allocation included: State of Delaware Investment Pool – 62.8 percent; Cash – 1.0 percent; Domestic Fixed Income – 10.2 percent; and Domestic Equity – 26.0 percent.

For the second quarter of 2014, the County's Pension Fund was up 3.8 percent. Year-to-date the fund increased 6.4 percent and ranked in the top 10 percent nationwide (out of approximately 230 public plans). The County's Plan is much more conservative (60 percent in equities) than Peirce Park's average plan, which is in the 65 percent range for equities. The one year annualized returns were 17.2 percent; 2 year – 14.5 percent, and 3-year – 10.3 percent. Since its inception in January 2009, the County's Pension Plan has realized an average return of 12.2 percent per year. Sixty percent of the County's portfolio is handled by the State.

For the second quarter of 2014, DuPont Capital realized returns of 5.8 percent and year-to-date 8.8 percent. The State had a very good quarter realizing 4.2 percent returns and year-to-date of 7.3 percent. Over the past three years, the total Pension Fund realized returns of 10.3 percent, DuPont Capital – 18.0 percent, Fidelity – 16.4 percent, Wilmington Trust Bonds – 2.2 percent, and State of Delaware – 10.1 percent. For the first quarter, the County realized returns of 3.8 percent versus 4.2 percent for the State.

4. Review Fidelity's Low-Priced Fund

Mr. Shone referred members to the second handout entitled, "Sussex County – Discussion Materials August 2014". As a result of discussion held at the May 2014 meeting, the Committee had requested Mr. Shone to present an analysis regarding Fidelity's Low-Priced Stock. Low-priced refers to the price of the stock which can range only from $5 to $20 per share. Regarding holdings style, Fidelity has a slight tilt to value, with most being mid-cap. From a returns-based perspective, the Fidelity Low-Priced Stock Fund has drifted significantly. Fund assets are approximately $48 billion; the fund holds more than 900 securities; and contains a material amount in non-U.S. stocks (approximately 50 percent U. S. and 50 percent non-U.S.). Options include:

- No change
- Move funds to DuPont
    - DuPont can manage their small-cap strategy along with the large-cap portfolio they currently manage for Sussex Pension
    - They have proposed a fee of 0.50% for the small-cap portfolio (the normal fee is 0.85%, but they have decided to lower it as trading costs would cause a large drag on portfolio performance, given the potential portfolio size ($2 million)

- Passive Index Exposure
    - Vanguard Extended Market Index provides small and mid-cap exposure

The below manager information was provided for DuPont, Vanguard and Fidelity:

	DuPont Small Cap Equity	Vanguard Extended Market Index	Fidelity Low-Priced Stock Fund
Location	Wilmington, DE	Malvern, PA	Boston, MA
Firm Inception	1975	1975	1946
Firm Assets ($B)	38	2,843	2,004
Style	Quantitative & Fundamental, bottom-up	Index	Fundamental, bottom-up
Strategy Inception	1999	1987	1990
Strategy Assets ($B)	0.2	38.3	48.4
Fees	0.50%	0.10%	0.83%
Vehicle	Separate Account	Mutual Fund	Mutual Fund
Preferred Benchmark	Russell 2000	S & P Completion Index	Russell 2000
# of Holdings	182	3200	902

Yearly percentage returns include:

	2008	2009	2010	2011	2012	2013
DuPont	-30.3	20.0	28.1	2.6	11.8	34.3
Vanguard	-38.6	37.6	27.6	-3.6	18.5	38.4
Fidelity	-36.2	39.1	20.7	-0.1	18.5	34.3
Russell 2000	-33.8	27.2	26.9	-4.2	16.4	38.8
Russell 2500	-36.8	34.4	26.7	-2.5	17.9	36.8

Cumulative Returns Annualized (%) include:

	Q2	YTD	1 Year	5 Year	7 Year
DuPont	1.1	2.4	20.3	20.2	6.8
Vanguard	3.3	6.1	27.0	21.9	8.1
Fidelity	2.8	4.9	22.2	20.1	7.8
Russell 2000	2.0	3.2	23.6	20.2	6.7
Russell 2500	3.6	5.9	25.6	21.6	7.6

It was noted that, cumulatively, Vanguard has been the best performer at 8.1 percent. All information presented is net of fees.

Pros and cons given for each manager include:

	Pros	Cons
DuPont Small Cap Equity	Long-term track record All U.S. equities managed by same firm Inexpensive option for active management	Moderate performance Minimal mid-cap exposure
Vanguard Extended Market Index	Very inexpensive approach Access to small and mid-cap exposures Mutual fund vehicle	No value tilt
Fidelity Low-Priced Stock	Existing manager Decent long-term track record Mutual fund vehicle	Expensive Has many off-bench allocations

The Committee discussed the information presented and the various options available, as well as the oversight the Committee may need to provide with some options. More specifically, the Committee inquired as to whether DuPont Capital would be willing to manage half of the Fidelity money for the same fee. Mr. Shone noted that DuPont Capital would not be able, but noted that Vanguard could manage half of the fund.

A Motion was made by Mr. Leahy, seconded by Ms. Ryan, that the Sussex County Pension Fund Committee recommend to the Sussex County Council to transfer \$2.6 million from Fidelity Low-Priced Stock to the Vanguard Extended Market Index.

Motion Adopted: 5 Yea.

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

It should be noted that the $2.6 million transferred to Vanguard does represent half of the Fidelity money, and the Committee will continue to monitor the allocation.

5. **Investment Education (Fixed Income) – Types of Bonds and Duration of Investments**

Wilmington Trust's fixed income bonds include treasuries, government agency bonds, and corporates (short term duration). In remaining with very high credit quality investments, the tradeoff is lower returns. After discussion held at the May 2014 meeting regarding the possibility of taking on more risk to realize higher returns, the Committee requested Mr. Shone to report – from an educational perspective – regarding the types of investments available for the County's consideration.

Mr. Shone's report, "Sussex County – Discussion Materials August 2014", included 'Fixed Income Discussion' under Tab II. This report included types of bonds (Treasuries, Agencies, Mortgaged Backed Securities, Commercial Mortgaged Backed Securities, Asset Backed Securities, Investment Grade Corporates, High Yield, and Bank Loans), definitions (maturity, duration, quality, yield-to-maturity and spread), bond quality ratings (investment and non-investment grade bonds), the rationale of interest rates and the impact on bond prices; characteristics of U. S. Bonds (credit risk, benchmark and benchmark duration); fixed income guidelines for the County's Pension and OPEB Plans; roles of fixed income (investors must first define the role they want bonds to play in their portfolios before determining the appropriate fixed income securities, relevant benchmark, and proper implementation); portfolio protection (treasury and agency bonds are solid portfolio protection amid periods of economic contraction and financial stress); the fixed income spectrum (some areas of fixed income have higher equity risk (beta) than others); maximize total return (bonds with more credit risk should add return (relative to low credit risk securities) to the portfolio and provide some diversification to equities); current environment (yields across all types of fixed income are near or at historic lows); return outlook; and a summary.

Mr. Shone noted that he would present a few highlights and the committee could review the specifics in further detail at the next meeting.

According to the Investment Policy Statement, the County is allowed to go down to 50 percent in U. S. Treasuries and Agencies (Government Securities); the County is currently at 72.7 percent. Mr. Shone will consult with Wilmington Trust as to their current allocation and how to achieve enhanced returns without greater additional risk.

3. <u>Investment Analysis for the Quarter Ended June 30, 2014 – (Con't.)</u>

Mr. Shone continued with the investment analysis and referred members back to the <u>OPEB Fund Performance Report (Tab III)</u>. As of June 30, 2014, the OPEB Fund had a market value of $30.3 million and realized a second quarter gain of $1.0 million (net of all investment management fees), or 3.4 percent; a one year gain of $3.8 million (net), or 14.7 percent. The County was reimbursed at the end of the fiscal year.

Mr. Shone noted that the following items should be considered by the Committee: Investment Policy Statement (cash target, equity target, international equity target); and cash flow management.

Currently, the County's Investment Policy Statement does not have a target for cash. Although the County has a target of 12 percent in international equities, Mr. Shone made the recommendation to increase this target to at least 14 percent, or possibly 16 percent.

Mr. Leahy stated the possible benefit of a singular approach in handling the OPEB and Pension Plans under one Investment Policy Statement.

6. **OPEB Allocations**

Mr. Shone referred members to a separate handout regarding a proposed addendum to the OPEB Investment Policy Statement. Proposed revisions include the following:

a. decreasing fixed income target from 40 percent to 39 percent
b. increasing cash target from 0% to 1%
c. increasing international equity target from 12% to 14%
d. decreasing domestic equity target from 48% to 46%
e. change international equity benchmark from MSCI EAFE (net) to MSCI ACWI ex U.S. (net)

A Motion was made by Mr. Leahy, seconded by Mr. Baker, that the Sussex County Pension Fund Committee recommend to the Sussex County Council to adopt the Addendum, as presented by Mr. Shone, to the Sussex County, Delaware Employee OPEB Plan Investment Policy Statement Dated December 2010 (amended April 22, 2013).

Motion Adopted: 5 Yea.

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

The Committee thanked Mr. Shone for his time and presentation.

7. **Additional Business**

Ms. Jennings reported that the State of Delaware had recently passed a regulation that would allow County Paramedics to participate in the State's Pension Plan (not the OPEB) if they so choose. An analysis is currently being performed by the State as to the cost to the County. The County will then have their actuary review and make comment as to the impact to the County. Participation is voluntary, but all County Paramedics would have to elect to take part in the State's Pension Plan.

Ms. Jennings explained that Mr. Lawson exited the meeting earlier due to a scheduled visit from Senator Carper at the Sussex County Airport. Ms. Jennings thanked everyone for their attendance.

At 11:58 a.m., a Motion was made by Mr. Leahy, seconded by Ms. Ryan, to adjourn.

Motion Adopted: 5 Yea.

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

Respectfully submitted,

Nancy Cordrey

Nancy J. Cordrey
Administrative Secretary