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PENSION FUND COMMITTEE

Minutes of Meeting

May 23, 2016

The Sussex County Pension Fund Committee met on May 23, 2016, at 10:00 a.m. in the County Council Chambers, Georgetown, Delaware. Those in attendance included members: Gina Jennings, Todd Lawson, Karen Brewington, Kathy Roth, David Baker, Hugh Leahy, and Kathleen Ryan. Also in attendance were Michael Shone of Peirce Park Group, the County's Pension Investment Consultant; as well as Janet Cranna, Margaret Tempkin, and Brett Warren, of Cheiron, the County's new Actuary.

On May 13, 2016, 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. Ms. Roth was welcomed to the Committee; she fills the vacancy resulting from the recent retirement of Jeffrey James, and serves as a current County employee. Ms. Roth has 30 years of accounting experience, is a licensed CPA, and is the Deputy Finance Director for the County. Mr. Baker and Mr. Leahy were also thanked for their willingness to serve a second 4-year term; they both serve as community members and were appointed by Council on January 26, 2016. (Note: No quarterly meeting was held in February 2016).

1. **Approval of Minutes**

   The minutes of the November 16, 2015 meeting were approved by consent.

2. **Performance Reports of the Pension and OPEB Funds**

   Mr. Shone distributed copies of a booklet entitled, "Sussex County Investment Performance Report, March 31, 2016". The Investment Performance Report includes information regarding the market environment for the first quarter of 2016, 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 – 1st Quarter of 2016 (Tab 1).

   The first quarter saw the worldwide economy growing at a slower pace than expected; the Gross Domestic Product (GDP) Growth for the U.S. was 0.5 percent. Weaker than expected consumer spending was the primary cause of the slowdown in economic growth.

The Federal Reserve raised short-term interest rates for the first time in almost 10 years at the end of 2015. Only two additional increases are expected in 2016, instead of the four indicated by the Fed's September 2015 projections. Mr. Shone did not think there was concern for recession, but did foresee a continued slowing of the economy. In 2016, the global economy is projected to expand by 3.4 percent, instead of the expected 3.7, according to International Monetary Fund (IMF) estimates. Brazil is expected to realize the largest decline, or -3.5 percent; the U.S. economy is forecasted to increase 2.6 percent.

Equities realized a sharp decline at the beginning of 2016, with global stocks down 6.8 percent at the end of January. U.S. Equities were up 1.0 percent for the quarter and down 0.3 percent for the year; and international equities were down 3.0 percent for the quarter and -8.3 percent for the year. Emerging market equities were the outperformer for the quarter, up 5.7 percent, but down 12.0 percent for the year (April 1 thru March 31, 2016). U. S. bonds were positive for the quarter (3.0 percent) and 2.0 percent for the year. Commodities performed extremely poorly for the year, -19.6. Large cap stocks were up 0.7 for the quarter; mid cap: up 2.2 percent; but, the big winner for the quarter was mid cap value: up 3.9 (within U.S. Equity returns, mid cap value has outperformed over a 5 to 10 year period, while small cap performed the worst, or -9.8 percent for the year and -1.5 percent for the quarter).

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

As of March 31, 2016, the ending market value of the Pension Plan was $72.6 million and realized a first quarter investment gain of $644,000, or 0.9 percent (gross) versus a benchmark of 1.6 percent; a 1 year (April 1 thru March 31, 2016) loss of $1.4 million; a one year return of -1.8 percent versus a -0.3 percent benchmark. Mr. Shone noted that the State Investment Pool had some significant underperformance (0.9 percent below their benchmark for the quarter, and 1.7 percent below for the year); for a 5-year period the State has outperformed by 40 basis points, and has performed well for the County overall, but their fees are more expensive, 68 basis points. He recommended for the 3 managers (the State, Wilmington Trust, and DuPont Capital) to report to the Committee annually. Looking ahead, the Committee will be discussing a possible increase in their international equities allocation.

The ending market value of $72,647,333 included: DuPont Capital Investment: $14,235,136, Operating Account: $132,865, State of Delaware Investment Pool: $44,568,189, Vanguard Extended Market Index: $2,786,955, Vanguard Mid Cap Value: $2,507,945, Wilmington Trust Bonds: $8,416,244, and Wilmington Trust Short Term: $0. Over the last 3 years, the pension fund saw an investment gain of $12.7 million, or a 6.8 percent return.

As of March 31, 2016, Sussex County's Pension Asset Allocation included: State of Delaware Investment Pool: 61.3 percent; Cash: 0.2 percent; Domestic Fixed Income: 11.6 percent; and Domestic Equity: 26.9 percent.

Over the last 5 years, the Pension Fund realized a 6.9 percent return and ranked in the top 27th percentile nationwide (250 public funds); 6.8 percent return for 3 years (top 22nd percent); 1 year: -1.8 percent (66th percent). For the quarter, the fund realized a return of 0.9 percent (68th percent), which was below the policy index of 1.6 percent.

Since its inception, the pension plan has realized a return of 9.5 percent, which is slightly below the 9.8 percent policy index.

The portfolio returns for the quarter: DuPont Capital Investment: 1.0 percent return versus benchmark of 1.3; Vanguard Extended Market Index (added October 2014): -0.8 percent; Vanguard Mid Cap Value (added December 2014): 1.7 percent; Wilmington Trust Bonds: 2.4 percent; and State of Delaware Investment Pool: 0.7 percent versus 1.6 percent benchmark. Growth significantly outperformed value during 2015. A brief discussion was held regarding the State's underperformance, as well as their higher investment management fees (.68 percent). It was the consensus of the Committee for Peirce Park to report on "net" results, in addition to gross returns, for both the Pension and OPEB Plans. Mr. Shone reported that Wilmington Trust was performing exactly as expected.

Mr. Shone referred members to the <u>OPEB Fund Performance Report</u> (Tab III).

As of March 31, 2016, the ending market value of the OPEB Plan was $31.4 million and realized a first quarter gain of $494,000, and a one year (April 1, 2015 thru March 30, 2016) gain of $20,000. The OPEB Plan has lower investment fees than the Pension Plan, and has outperformed its policy index by approximately 1 percent, 0.3 percent versus a -0.6 benchmark. Looking ahead, the Committee will be discussing a possible increase in their International Equities allocation.

As of March 31, 2016, Sussex County's OPEB Asset Allocation included: Domestic Equity: 44.1 percent; Global Equity: 12.7 percent; International Equity: 6.6 percent; Domestic Fixed Income: 35.6 percent; and Cash: 1 percent. All allocations were within policy ranges.

Since its inception (March 1, 2011), at which time the market value was $22,982,102, the OPEB has realized a 5.2 percent return ($6,801,813). For the quarter, the OPEB Plan realized a 1.6 percent return versus a 1.4 percent benchmark, and ranked in the top 28th percent nationwide; 6.3 percent return for 3 years (top 36th percent); and 1 year: 0.3 percent (16th percent).   Mr. Shone noted that the OPEB Plan had very good peer group rankings, and for the last two years has been in the top 15th percent, 3.9 percent versus a benchmark of 3.1. Since March 2011, the OPEB plan has realized a return of 5.2 percent versus a 6.2 percent policy index. The equity managers outperformed their benchmarks both for the quarter and year. Mr. Shone reported that the winner for the quarter and year was MFS Low Volatility, which was up 4.2 percent versus its benchmark of 0.2; since it was added to the portfolio in December 2014, it has realized a return of 5.3 percent versus a -1.7 benchmark. He explained that low volatility equities are designed to do well when the markets are down. Since Thornburg Global was added to the County's portfolio in January 2014, it has realized a return of 8.8 percent versus a benchmark of 0.9. Although they outperformed their benchmark, Mr. Shone reiterated that Peirce Park is still watching Thornburg due to corporate wide instability during 2015 as a result of significant decrease in international equity assets and several portfolio manager changes.

Mr. Shone noted that other than fine-tuning the international target, he would not recommend any additional changes to the OPEB Plan.

3. **International Allocation**

Mr. Shone distributed copies of a report entitled, "Portfolio Considerations, May 2016", which included an Asset Allocation Update, Global/International Equity Manager Search, and Portfolio Options. The report notes the challenge of lower than average returns (both in domestic and fixed equities) in the coming decade, which may result in a reduced funded ratio and an increase in contributions. Possible solutions include: higher contributions, lower assumed rate of return, increase allocation of international stocks, and/or consider other asset classes.

Over the next 10 years, lower fixed income and U. S. stock returns are expected.

Peirce Park's asset class estimate projections for the next 10 years versus 40 years include:

	PROJECTIONS	
	Next 10 years	Next 40 years
U.S. Equities	6.50%	8.30%
Non-U.S. Equities	9.75%	9.40%
Fixed Income	2.50%	3.60%

*After the next 10 years, PPG assumes returns will be more in line with historical averages.

With Mid-Cap's outperformance, Ms. Ryan questioned if the Committee should consider increasing this allocation instead of a possible increase in international equity targets; there would be less risk. She also questioned lessening the investment expenses for the pension plan, and noted her agreement to invite the State to appear before the Committee as soon as possible. She made note of the fact that if returns are going to be much lower in the future, the expense ratio will become much more important.

Before any possible changes are made regarding international targets, it was the consensus of the Committee for Mr. Shone to bring a draft copy of the Investment Policy Statement to the next meeting reflecting a 65 percent equity target, as well as inviting the State to a future meeting to discuss their portfolio, including their recent underperformance and fee structure. Mr. Baker also requested for the Committee to review the State's annual report prior to the next meeting. Mr. Shone noted that the State's underperformance for the year was due, in large part, to hedge funds (-10.81).

Ms. Jennings thanked Mr. Shone for his time in preparing the information presented today.

4. **Cheiron – Actuary Report**

Ms. Jennings noted that Cheiron was the County's new actuary and would be discussing the Pension and OPEB assumptions used to determine the County's unfunded liability, FY 17 recommended contributions in the current budget, the sustainability of the County's Pension Plan, and possible pension changes due to inquiries from 12-hour employees (dispatchers and paramedics).

In the transition with a new client, Ms. Cranna noted that a replication study was performed for both the Pension and OPEB Plans. In this study, data was received from Aon and the County, the data was reconciled, and Cheiron independently programmed their valuation system trying to duplicate the results of the prior actuary (plan provisions, assumptions, and methodology) to see if they could match the same results that the prior actuary used in their reports. Although the report should be referenced for a more detailed analysis, discussion highlights are included.

Ms. Cranna reported that the pension matching results were reasonable with Aon (within 1.1% on PVB (present value of future benefits) and AL (actuarial liability) and within -0.3 percent on normal cost). The OPEB matching results were reasonable with Aon (within 0.6% on AL and within -1.8 percent on normal cost). The actuarial standard range is within +/- 5 percent; differences between actuaries are common, and can occur from different actuarial valuation software and different programming approaches. Ms. Cranna noted that Cheiron is very comfortable with the plan provisions and methodology used on the pension side.

Ms. Tempkin noted that Cheiron was able to replicate Aon's valuation results for the OPEB Plan within 0.6 percent, and normal costs within -1.8 percent.

Mr. Warren reviewed the assumptions used for both the Pension and OPEB Plans, which included demographic, actuarial methods, and economic. Due to the amount of information presented, only recommended changes are included.

PENSION – DEMOGRAPHIC ASSUMPTIONS (Mortality, Retirement, Termination, Salary, COLA. and Marital) – No recommended changes

Mr. Warren reported that Cheiron did not perform their own experience study, instead using the prior actuary's experience results, as well as reviewing the last two years of reports (looking at gains/losses and methods).

OPEB – DEMOGRAPHIC ASSUMPTIONS (Benefit Election, Medical Plan Election, Marital, Spousal Election, and All Other) – No recommended changes

PENSION – ECONOMIC ASSUMPTIONS

Assumption	Current	Recommendation
Interest Rate	7.5%; did not specify whether this assumption is net of investment expenses, administrative expenses, or both	7.5% interest rate net of administrative expenses only
Inflation	2.5%	No change
Administrative Expenses	No explicit expense assumption	Explicit assumption based on prior year's expenses increased by inflation

OPEB – ECONOMIC ASSUMPTIONS

Assumption	Current	Recommendation
Interest Rate	7.5%, same as Pension	See pension commentary

Healthcare Trends	Graded down to ultimate over 8 years. Single trend for Pre-Medicare and Medicare costs.	Grade trends down to ultimate over 15 years and split pre-Medicare and Medicare trends.
Dental & Vision Trends	7% to 5% graded over 8 years	Flat 5% trend
Claim Costs	Based on current premiums with aging factors applied for Medical	No Change
Administrative Expenses	No explicit expense assumption	Explicit assumption based on prior year's expenses increased by inflation

GASB 67/68 states that an explicit assumption for administrative expenses must now be included. The County's required contribution would now consist of three components: employer normal costs (the value of benefits that accrue), a component to amortize the County's unfunded liability, and also administrative expenses that would include staff salaries and actuarial fees (fees not related to investment expenses). Ms. Jennings stated that the County does not charge staff salaries, but does include actuarial costs. The 7.5% interest rate used would be net of investment fees (not including administrative fees), which will be added to the recommended required annual contribution. Ms. Jennings noted that she will provide the Committee with a summary showing the County's administrative fees.

PENSION – ACTUARIAL METHODS

Assumption	**Current**	**Recommendation**
Cost Method	Entry Age Normal	No Change
Amortization Method	20-year closed amortization period starting July 1, 2015 (amortized as level dollar)	No change; as closed period approaches 10-15 years, we suggest using a layered approach
Asset Method	Reset to market value in 2015 with expectation to phase into a 5-year smoothed asset value	Implement an asset corridor – limit smoothed asset value to be in any year no more than 120% of market value of no less than 80% of market value

Mr. Warren explained that using a Depletion Test ensures that future assets can pay future benefit payments. Regarding the amortization method, Mr. Shone stated that some actuaries like to see a written Funding Policy, which specifically states the methodology for each year's needed funding; GASB requires a funding policy. Mr. Shone noted that Peirce Park would draft a Funding Policy for both the Pension and OPEB Plans, which would ultimately have to be adopted by the Council. GASB also requires that investment gains and losses have to amortized over a 5-year period; benefit changes have to be reflected immediately; and experience gains or losses (other than the asset side) have to be analyzed over what is called 'future working lifetime", which is the average number of years that a person works. A layered approach reduces the volatility of the costs and makes setting budgets easier from year to year.

For funding purposes, moving forward, gains and losses would be smoothed out over a 5-year period. Cheiron would also recommend using an asset corridor, which essentially keeps the actuarial value of assets between 80 percent and 120 percent of the market value; corridors keep the actuarial value of assets within a certain range of the market value, which offers protection if there are large swings in the market. Mr. Leahy expressed concern in reporting the unfunded liability.

The County's Pension Plan is currently 84 percent funded.

OPEB – ACTUARIAL METHODS

Assumption	Current	Recommendation
Cost Method	Projected Unit Credit Method	Change to Entry Age Normal to comply with GASB 74/75
Amortization Method	30-year open amortization, level percent of pay	No change
Asset Method	Market value of assets	No change

Ms. Tempkin noted that GASB 74/75 requires using Entry Age Normal in determining the liability on the financial statements. She also stated that she did not see any anticipated changes in funding versus disclosure liability.

Ms. Cranna reviewed the Pension FY 2017 recommended contribution. An estimated total contribution of $3,229,000 is recommended for the Pension Plan, which is 14.94 percent of payroll. In reviewing sustainability projections for the Pension Plan, it would be expected that the plan would be 100 percent funded after 20 years. For the OPEB, Ms. Tempkin estimated a total contribution of $2,075,009 is recommended for FY 17, or 9.03 percent of payroll. Sustainability projections were reviewed for both plans; figures were adjusted to show the potential impact to the plan.

It was requested that Cheiron provide the numbers reflecting the impact of a lower assumed rate of return, i.e. 7.25 percent, along with the impact of still lower returns of 6.5 percent for example, as well as using various discount rates.

Mr. Lawson and Ms. Roth left the meeting at 12:02 p.m.

Mr. Warren reviewed two proposals for Pension Plan design changes for dispatchers and paramedics (12 hour employees); the first increases the hours worked from 40 to 42 hours, and the second allows up to 30 years of service for the calculation of pension benefits (instead of the current 25 years of service for dispatchers and paramedics hired after July 1, 2000; those hired prior to July 1, 2000 have an uncapped service for benefit calculation purposes). The trend shows that as participants work longer, the cost tends to decrease and the impact appears to be cost neutral when raising the number of years worked to 30. Any of these changes would require an ordinance change by the Council. It was the consensus of the Committee to review this again at the next Committee meeting.

Ms. Jennings stated that Cheiron will provide an analysis regarding the financial impact of changing the required rate of return and discount rate.

Mr. Leahy noted his comfort regarding Cheiron's overall approval of the demographic assumptions that had been in place and were accepting without change.

Regarding actuarial asset methods for the Pension Plan, Cheiron will bring back additional information regarding the implementation of an asset corridor.

A Motion was made by Mr. Leahy, seconded by Ms. Ryan, that the 7.5% rate of return assumption are net of administrative fees for the Pension Plan.

Motion Adopted: 5 Yeas.

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

A Motion was made by Mr. Leahy, seconded by Ms. Ryan, that there would be an explicit administration expense assumption used for the Pension and OPEB Plans.

Motion Adopted: 5 Yeas.

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

A Motion was made by Mr. Leahy, seconded by Mr. Baker, that the OPEB actuarial cost method assumption be changed to Entry Age Normal.

Motion Adopted: 5 Yeas.

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

A Motion was made by Mr. Leahy, seconded by Mr. Baker, that the assumed rate of return for the OPEB Plan net of investment fees would be included.

Motion Adopted: 5 Yeas.

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

A Motion was made by Mr. Leahy, seconded by Ms. Ryan, that healthcare trends for the OPEB Plan be reset to a 15-year smoothing rate, with dental and vision to a flat 5 percent.

Motion Adopted: 5 Yeas.

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

Ms. Jennings and the Committee thanked Ms. Cranna, Ms. Tempkin, and Mr. Warren for their presentation.

5. **Additional Business**

No Additional Business. For informational purposes, the dates for the two remaining Pension Committee meetings for 2016 are: August 18 and November 17; all meetings are held in the Sussex County Council Chambers and begin at 10:00 a.m.

6. **Adjourn**

At 12:21 p.m., a Motion was made by Ms. Ryan, seconded by Ms. Leahy, to adjourn.

Motion Adopted: 5 Yeas.

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

The next meeting of the Pension Fund Committee is scheduled for August 18, 2016, at 10:00 a.m. in the Sussex County Council Chambers.

Respectfully submitted,

Nancy J. Cordrey
Administrative Secretary