PENSION FUND COMMITTEE

Minutes of Meeting

May 3, 2012

The Sussex County Pension Fund Committee met on May 3, 2012, at 10:00 a.m. in the County Council Chambers, Georgetown, Delaware. Those in attendance included members: Susan Webb, Todd Lawson, Jeffrey James, David Baker, Lynda Messick, and Hugh Leahy. Also attending were Michael Shone of Peirce Park Group, the County's Pension Investment Consultant, as well as Dominick D'Eramo, Nicholas Adams, and Bethany Taylor (of Wilmington Trust). Committee member Karen Brewington was not in attendance.

On April 26, 2012, the Agenda for today's meeting was posted in the County's locked bulletin board located in the lobby of the County Administrative Office Building, as well as posted on the County's website.

Ms. Webb welcomed Hugh Leahy to the committee.

The March 9, 2012 minutes were approved (by email) as follows:

> 4 Yea; 1 Not Voting; 2 Absent
>
> Ms. Webb, Yea; Mr. James, Yea; Ms. Brewington, Yea; Ms. Messick, Yea; Mr. Baker, Not Voting; Mr. Lawson, Absent, and Mr. Leahy, Absent.

(Note: Obtaining approval of Committee minutes via email – prior to each quarterly meeting – allows for a more timely distribution to Council and posting on the County's website.)

Ms. Webb reported that Council – at their March 27, 2012 meeting – approved the Committee's rebalancing recommendations for both the OPEB and Pension Funds (Council also approved to enter into Traditional Consulting Services with Peirce Park Group).

1. **Wilmington Trust Company Presentation**

   Ms. Webb noted that representatives from Wilmington Trust Company, investments managers for the fixed income portion of the County's Pension and

OPEB Plans, were in attendance to present a review of both plans. Mr. D'Eramo stated that he was with the Institutional Fixed Income Group within Wilmington Trust, and Mr. Adams and Ms. Taylor were with client development.

Mr. D'Eramo distributed booklets entitled, "Portfolio Investment Review – Sussex County Employee Pension Plan/OPEB Plan – March 31, 2012". Due to the complexity of the information presented and the fact that not all of the report was evaluated, the report should be referenced for a more thorough and overall review.

Mr. D'Eramo noted that the U. S. economy had slightly improved for the first quarter of 2012, with 200,000 additional jobs being realized for the months of December 2011, January 2012 and February 2012. April's employment numbers will be released on May 4th and will shed a better light as to March's increase of only 120,000 additional jobs. The overall unemployment rate dropped from 10 percent to 8.2 percent, but the numbers do not reflect those individuals who have become discouraged and are no longer actively seeking employment. Strong manufacturing growth was seen among all the major regions of the U. S., which carried over to the equity market and credit spreads. Mr. D'Eramo explained that the Federal Reserve enacted an initiative last fall known as "Operation Twist", which included the selling of securities and treasuries with the intent to push down interest rates to stimulate the housing market, as well as the overall economy. "Operation Twist" will continue through June 30, 2012.

The VIX, or volatility index, reflects the financial crisis of 2008, with two additional spikes influenced by the situation in Europe (restructuring of Greek debt and concern over the possible implications to European and domestic banking sectors if Spain, as a large issuer of sovereign debt, would have to restructure that debt). Mr. D'Eramo noted that as volatility declines, positive influence to the corporate sector is seen.

The Portfolio Analysis of the County's Pension Plan notes a composition of treasury notes (83 percent), corporate notes (16 percent), and money market (1 percent); principal balance of $8,939,601; average duration of 3.59 years; and a yield of .92 percent. The report also includes the individual holdings within the portfolio.

The absolute performance for the pension plan for the fourth quarter of 2010 to date was reviewed. The fourth quarter of 2010 saw the implementation of the County's new investment policy. For the fourth quarter of 2010, the pension plan realized an investment performance of -1.52 percent relative to the benchmark of -1.55 percent. The year-to-date performance for 2011 was 5.87 percent compared to the benchmark of 6.08 percent. The annualized rate of return since

September 30, 2010 was 2.67 percent. In regard to individual holdings, Mr. D'Eramo noted that the County was predominately weighted toward treasuries.

The Portfolio Analysis of the County's OPEB Plan reflected a composition of Treasury Notes (43 percent), Government Agencies (29 percent) and Money Market Fund (28%); principal balance/market value of $8,942,603; average duration of 3.55 years; and a yield of .68 percent (68 basis points). The report also included individual holdings within the portfolio.

Ms. Messick stated concern regarding the 2.67 percent rate of return (for the pension plan) and questioned what Wilmington Trust – within the mandates of the County's investment policy and risk profile – would recommend to realize a better return. Mr. D'Eramo explained that it is always a question of the degree of risk that is willing to be assumed, and then to measure the outcome relative to that risk. He noted that the history with the County has always been one of a very conservative approach (laddered portfolio) to meet the obligations of the County. Mr. D'Eramo explained that although the absolute level of yield, or 2.67 percent, is low, he saw it as a small victory given the current economic environment, in combination with the County's conservative investment approach. To realize greater returns, Mr. D'Eramo felt that a greater degree of corporate bonds would need to be allowed.

Ms. Webb questioned investing in municipal debt. Mr. D'Eramo explained that anytime a move is made away from treasuries some level of risk is incurred and would the County be fairly compensated for that risk. Ms. Messick noted that there were, in fact, municipals realizing a much better yield than treasuries. When asked, Mr. D'Eramo noted that he did not have an aversion to municipals as a category. He stated that if this was something that the County would want to explore, Wilmington Trust would be very happy to provide market data to assist in that decision and could be incorporated into the investment policy.

Mr. Baker inquired as to the prudence of including corporates in the OPEB fund. It was noted that the OPEB fund's investment policy mirrors the pension plan's policy, and the fixed asset portion of that fund was just recently invested, thus the low returns.

Mr. Baker questioned future interest rate expectations if the economy were to continue to improve. Mr. D'Eramo stated that given the low yield environment currently seen, he would recommend any committee to be cautious in reaching for yield. He went on to state that today's fixed income markets have an inherent level of risk that may not be truly understood as the economy goes forward into the next interest rate environment. He noted it was the job of the investment manager to educate their clients relative to those inherent risks so as to better ensure the level of expectations are fairly accurate. On a scale of 1 to 10, with 10 being the most conservative, Mr. D'Eramo would rate the County as an 8, with their other county clients probably a 4. As a result, those other counties would hold about twice as many corporates as the County. Mr. Shone also noted the County's very conservative investment approach, and offered that the County may want to allow Wilmington Trust greater flexibility to allow corporates and agencies. When asked, Mr. Shone noted that he was not advising against municipals. He additionally explained it would be a decision made by the investment manager and that most managers do have the flexibility to allow municipals.

Mr. Leahy stated that in terms of funding adequacy versus risk, if the County's pension fund adequately supports its liabilities, the portfolio's need to stretch might be less than other clients. Mr. D'Eramo and Mr. Shone both noted agreement. Mr. Shone went on to state that the County's funding ratio was definitely higher than most of his clients, but with the County's actuary assuming an 8 percent rate of return in today's market, it would require about 65 percent in equities (the County has an equities target of 60 percent). Mr. Shone explained that many factors have to be considered, including the conservative investment nature of the County, the economic climate, and actuarial assumptions versus actual earnings realized. If returns are not realized, the actuarial assumption rate of 8 percent may have to decrease, which, in turn, would require the County's Annual Required Contribution (ARC) to increase.

In closing, Mr. D'Eramo stated that in terms of other activity within the pension plan, there was a reallocation of assets this past month and the portfolio was extremely liquid.

Ms. Webb thanked Mr. D'Eramo for his presentation, as well as Mr. Adams and Ms. Taylor for their attendance.

2. **<u>Performance Reports – Peirce Park Group</u>**

Mr. Shone distributed copies of two booklets entitled, "Sussex County Investment Performance Report – March 31, 2012" and "Sussex County OPEB Investment Performance Report – March 31, 2012". It should be noted that the reports were not reviewed in their entirety.

"<u>Sussex County Investment Performance Report" (Pension Plan)</u>

Mr. Shone reviewed the Economic Highlights for the first quarter of 2012:

- World stock markets boomed in the first quarter

- Unemployment rate fell to 8.2%, but with continued worries of a slowing job growth;
- Gas prices drove headline inflation to a 4.9% annual rate, while core inflation remained stable around 2 percent. 4.9 percent is the true inflation rate, while core inflation is the underlying inflation rate when food and gas prices are removed. This allows the Federal Reserve the ability to see if the core part of inflation requires action to slow the economy by raising interest rates through monetary policy.
- Total bank lending – gains in the quarter, but stalled in March
- Banks' business lending grew, but consumer loans fell
- Auto sales increased 13 percent over the past year
- Housing starts showed beginning signs of recovery

Mr. Shone reiterated that the country experienced the worst economic downturn since the depression in 2008 and recovery would take 5 to 10 years.

Looking ahead …

- Will corporate profits be strong enough to sustain rally?
- Interest rates tend to be pro-cyclical – rates increase during economic expansions
- Will rising interest rates dampen markets and the economy?

Given the current low interest rates, Mr. Shone stated it was a very good assumption that they would rise; determining how fast and how much is more of a challenge. With low returns, the question is how to meet the actuarial assumed rate of return and the County's pension obligations. If the assumed rate of return is not met, then the ARC will need to increase. Although Mr. Shone is not suggesting that the County take greater risk, he did state it was in a better financial position to take additional risk if wanted. On the other hand, with the County so well-funded, does that risk need to be assumed. For clients who have a very conservative investment approach and are heavily invested in short-term treasuries, it may require annual contributions to dramatically increase and require actuaries to change their assumed rate of returns. Mr. Shone stated there are two components that an actuary looks at regarding their assumed rate of return – the actuarial calculations and GASB requirements. It was noted that the accounting industry is going to force everyone to book their liabilities differently than before.

Ms. Messick inquired if the actuary takes into consideration marked to market when looking at any funding gaps. Mr. Shone explained that the actuaries ‘smooth’ (average) assets over a time period, i.e. five years. Consequently, gains or losses – whether realized or unrealized – are averaged over this 5-year period. He went on to explain that for determining the County’s asset value – from a financial statement – there were two issues: asset values will be marked to market and would result in the County’s liability increasing if not 100 percent funded. When not 100 percent funded, the amount that is not funded is calculated at a lower discount rate.

Mr. Baker noted that in light of the additional Pension and OPEB contributions, it may be a good time to look at possibly reducing – incrementally – the actuary’s assumed rate of return. Ms. Messick inquired as to the prudent course of action. Mr. Shone felt it would be prudent to start moving the actuary’s assumed rate of return down and that the actuary could help make those calculations. He also felt that it would be money well spent by the County to have the actuary show the impact to the County in differing markets and, if the assumed rate of return is decreased, what the impact would be to the funding and contribution levels. Ms. Webb stated that a change in actuaries may be something that the Committee would want to consider.

On the broad market, emerging market equities were up 14.1 percent, U. S. Equity market was up 12.9, International/Nonemerging market was up 10.9 percent, and fixed income was flat. During the third quarter of last year, emerging markets were down 8.5 percent, international down 5.8, but the U. S. market was up 7.2. U.S. fixed income realized the greatest gain, or 7.7 percent. U. S. Equity Returns – by style – reflected that large cap growth stocks outperformed value stocks for the quarter, especially technology. For the year, large growth stocks were the best performing. ‘Mega, large, mid and small’ refer to company size, and ‘style’ refers to growth and value. He noted that the County’s portfolio was very style neutral, but had an over allocation of small cap stocks on the OPEB side. Long maturity bonds were up 19.3 percent for the year, but were the worst performer of last quarter (Page 4).

Mr. Shone noted that future reports prepared by Peirce Park Group will be received prior to meetings to allow for review by members.

<u>Observations for Sussex County Pension Plan</u>

- Overweight in fixed income, which hurt the County relative to its benchmark last quarter

- Overweight in international equities (addressed in April); target is 12 percent in internationals. It was noted that a global manager will buy both U. S. and non U. S. stocks.

- State underperformed benchmark for first quarter; long-term returns have been very good

Looking ahead for Sussex County Pension

- Rebalance to targets – increase equities

- Review and update Investment Policy Statement – originally written in May 2007

The Performance Summary (Page 10) for the quarter reflected the pension fund was up 6.1 percent versus a policy index of 7.6 percent; for the year, 4.6 percent versus 5.6; and for the last 3 years, the fund was up 14.7 percent versus the policy index of 17.5. Compared to peer groups, the County realized average return for the quarter. Underperformance during the fourth quarter was, in part, due to the State not meeting their benchmark (7 percent versus 7.4). An issue to be considered is the amount of fixed income/cash (approximately 5 percent) relative to the policy index. The policy index states a 60 percent stocks/40 percent bonds ratio, but does not contain a piece for cash. Mr. Shone noted he would like the investment policy to recognize the need for a cash component within the fixed income of 40 percent.

Ms. Webb inquired as to making yearly reimbursement to the pension plan in lieu of monthly. At the present time, the monthly reimbursement is approximately $225,000. She did note the need to have the $2.2 million reimbursed to the General Fund before the end of each fiscal year because it was a budgeted amount. If making a yearly contribution, Mr. Baker suggested the possibility of investing the money in a treasury note. Mr. Shone stated that he thought it was a very good idea and would be the perfect opportunity for the County to rebalance its portfolio. With the County paying pension expenses out of General Fund and the pension fund reimbursing the County, Mr. Shone noted that very little would be needed in the pension fund's cash account. In review, Mr. Shone explained that when the pension contribution comes in at the end of November and December, the money would be invested. At the end of June, the County would then look at its investments in regard to its investment policy (60/40 split), and have the additional opportunity to rebalance its portfolios. The State also has a policy index of 60/40 and Mr. Shone noted that he felt that the State was a core piece of the County's overall portfolio.

In regard to the graph reflecting the upside capture ratio versus the downside capture ratio (Page 11), Mr. Shone explained that – in the up markets – the County's pension plan was performing at about 80 percent of what the policy index was doing, and – in the down markets – the county's performance was approximately 80 percent as well. Mr. Leahy inquired if there was any specific action Mr. Shone would recommend to realize 100 percent in both up and down markets. Mr. Shone noted that two components have affected this number: the cash effect on the County's plan (the policy index does not reflect cash) and, secondly, the fairly conservative constraints placed on the bond manager.

For the last quarter, returns were up 6.1 percent (68th percentile), with 1st being the highest return and 99th the lowest. Mr. Shone stated that when looking at returns, the fact that the County's plan is more conservative than the average had to be factored in, along with the fact that it was a period where more aggressive investors performed better. For the year, the County was within the 42nd percentile and although below the policy index, it was still above average for the year. For 2011, the County was in the top 11 percent, and long-term performance has been above average with less risk than most plans.

"Sussex County OPEB Investment Performance Report"

Mr. Shone explained that the first seven pages of the report reflect market information.

Observations for Sussex OPEB

- Fund gained $1.48 million last quarter
- Significantly overweighted in fixed income (bonds, plus cash) – partially due to additional contributions made at the end of the year, as well as the hiring of a fixed income manager. The target for fixed income is 40 percent – on January 1, were at 50 percent and March 31 at 44.4 percent.
- Significantly overweighted in small cap stocks

Mr. Shone referred the Committee to a separate handout containing additional investment manager data and observations (total portfolio allocations, value/growth splits, market weightings, etc.). He reiterated the constraints placed on the County – by the RFP process – when performing their investment manager search approximately 2 to 3 years. He noted that Allianz (large cap core manager) would not have been one of his selections. Presently, the County is indexing their large cap value stocks, but Peirce Park

Group (PPG) would prefer indexing of large cap core, using Vanguard or Fidelity's S & P 500 index fund, with the addition of a defensive value manager on the large cap side. PPG would prefer a conservative value manager, especially for the County, as they offer some protection on the down side and complement the large cap portion.

3. **OPEB Investments**

Mr. Shone noted that in selecting the best managers and building a well-balanced portfolio, the County's ability and willingness to take risk, or uncertainty, has to be considered. PPG likes mid-cap companies, which they refer to as the 'goldilocks' - not too big and not too small. Mr. Shone explained that large cap tends to perform the best when the economy goes down. Small companies can perform well when they come out of a recession, but they are also the ones that get hit the hardest in a downturn. Mid-size companies have room to grow, but their volatility is much like the large cap companies; they are also big enough that they can usually sustain a strong downturn. Mr. Shone noted that he would like to see a little bit of overweighting in the mid-cap area although the County is currently over allocated in small cap. To more broadly diversify the County's portfolio, he would recommend the addition of mid-cap.

Mr. Shone and the Committee continued discussion regarding the various options and strategies for the County to consider in the selection of OPEB managers, as well as portfolio rebalancing. Discussion included manager styles, performance, capitalization - mega, large, mid and small, growth vs. value stocks; global equity, emerging markets, S & P index fund, mutual funds, global volatility and international stocks, etc.

Mr. Shone noted that he will come back to the next meeting with 'choices' – per category – for consideration by the Committee. PPG's information will include how closely each of the managers track their benchmarks, returns (how they performed in both up and down markets), investment strategies (large, mid, and small cap), as well as overall recommendations to rebalance the portfolio. Mr. Shone further reiterated that PPG would base their selections on 'people, process, price and performance'.

In this discussion, Mr. Shone referred the Committee to page 35 of the OPEB Report (Dodge & Cox Global Equities). He stated that the graph and statistics show the comparison of Dodge and Cox against other global managers. Dodge and Cox is the type of manager that performs really well in the up markets and poorly in down markets. He additionally mentioned that the graph on page 38, "Harding Loevner Global Equity Attribution" reflects their outperformance against their benchmark. He noted Dodge and Cox was a deep value manager – they tend to buy and hold, whereas Hoarding Loevner – as a growth manager – tends to have a 'turnover' approach.

When asked by Mr. Shone, Ms. Webb confirmed that the Committee would also like Mr. Shone to review the Pension Fund's Investment Policy Statement – initially adopted in May 2007 – and make proposed recommendations. In light of the County's seemingly comfort level with its current investment percentages of 60/40 (stocks/bonds), Mr. Shone would not recommend changing those ratios unless the Committee noted otherwise; as such, he would recommend changing the actuarial assumption.

4. **Goals of 2012**

Ms. Webb reminded the Committee that one of the goals for 2012 was to take a determined look at the OPEB Fund, "OPEB Manager Restructure", which the Committee will address at the August meeting.

5. **Additional Business**

None

Ms. Webb thanked everyone for their attendance. The next meeting of the Pension Committee is scheduled for Thursday, August 2, at 10:00 a.m.

The meeting was adjourned at 11:35 a.m.

Respectfully submitted,

Nancy J. Cordrey
Administrative Secretary