

PENSION ADVISORY BOARD/HEALTH & WELFARE BOARD OF TRUSTEES
QUARTERLY MEETING
NOVEMBER 8, 2017

The Pension Advisory Board/Health & Welfare Board of Trustees, met for their Quarterly Meeting on Wednesday, November 8, 2017, in the Township Building. The meeting was called to order at 5:30 p.m. followed by a pledge to the flag.

ROLL CALL:

The following members of the Pension Advisory Board/Health & Welfare Board of Trustees were present: David G. Kraynik, Vice Chairperson; Police Chief Tom Nolan; Greg Waks, Supervisor Liaison/Trustee. Others present were: Nick Hiriak, Finance Director; Sibyl H. Bryant, HR Director; Sgt. Andy Fidler, Police Representative; Daniel F. Dent, Chairman, D. F. Dent; Mike Morrill, D. F. Dent.

VICE-CHAIRMAN'S COMMENTS:

Mr. Kraynik announced Eric Medrow has resigned from the position of Chairman of the Pension Advisory Board. Over the past two decades, Mr. Medrow chaired both the Economic and Community Development Committee and the Pension Advisory Board. On behalf of the Pension Advisory Board, Mr. Kraynik expressed appreciation to Mr. Medrow for his diligent and valuable service to Upper Merion Township.

Mr. Kraynik also welcomed Roseann McGrath, the newest member of the Pension Advisory Board and Sibyl H. Bryant, HR Director, as staff liaison.

MEETING MINUTES:

The June 13, 2017 Meeting Minutes were approved unanimously.

PRESENTATION BY D.F. DENT RE: UPPER MERION TOWNSHIP POLICE PENSION PLAN AND FUND

Mr. Daniel F. Dent, Chairman, D.F. Dent, discussed the policy guidelines on page 3. He indicated the current portfolio for equities is at 67.1% (policy guidelines 30-70%). Conversely, the fixed income is at 32.6% (policy guidelines 30-60%). It was noted the portfolio has been very heavily weighted for some time in equities and is now in the process of being trimmed back. Because the equities have done so well, the bond portfolio has been treated defensively at the lower end of the range. Mr. Dent stated a gradual process has begun in moving more of the equities over into fixed income with a schedule that matches the

Federal Reserve's intentions for shrinking their balance sheet and increasing interest rates.

The performance as of October 31, 2017 (net of fees) in the overall portfolio is 15.52% (net of fees) with equities up 22.2% (equities slightly under 70% of the portfolio). The equity performance compares against the S&P 500 benchmark which is up the same period 16.9% (up almost 600 basis points 6% or so more than the benchmark). Fixed income is intentionally slightly below Barclays Government/Credit Index because of the defensive posture. In keeping maturities short for less return there is much less risk of erosion in principal in a rising interest rate environment. It was noted the equities for the last year have a total return of 26.17% which is better than the benchmark. Fixed income in the last year is also better than the benchmark.

Mr. Dent reviewed the portfolio which shows the development of the portfolio since 1990.

During the equity overview, Mr. Dent pointed out some of the larger holdings with Information Technology at 29.6% which is the heaviest weighting; the sector has done well and led in the markets.

Mr. Dent reviewed the change in market value from \$44.2 million on October 31, 2016 to \$50.3 million on October 31, 2017 and provided the three-year and five-year history. It was noted the distributions have been very consistent for all these years.

The beginning value of the Police Pension fund in 1994 was \$14.4 million. Since then cumulative withdrawals amounted to \$25.7 million and the market value of the Police Pension fund is now at \$50.3 million.

Mike Morrill, D. F. Dent, stated at this time last year not much was expected out of the market in 2017; however, equities are up 22% which is unexpected. There are very strong corporate earnings with some expectation of tax reform and performance is based on solid fundamentals with the companies.

Contributions to return as of October 31, 2017 - the best performers were led by Visa Inc. which has a great business model and a weighting in the portfolio over 41% contributing 300 basis points to the performance. Also performing well and diversified across the different business sectors are Red Hat, Roper Technologies, Intuitive Surgical and Moody's. Of the 3 lowest names, O'Reilly Automotive, IMAX Corporation and Signet Jewelers are all consumer discretionary names. The consumer area has been a tougher area for two reasons: (1) in late 2016 and early 2017 mall traffic has declined and (2) companies like O'Reilly have been under pressure because the auto shops are ordering some of the repair parts through Amazon. This is starting to be a trend and there is concern it is going to be a much bigger trend going forward. IMAX

and Signet Jewelers were exited from the portfolio since longer term there is concern about their business model and competitiveness.

Mr. Dent commented on QUALCOMM among the 5 lowest as of October 31st. He pointed out if the report were done as of today it would not be on the list because since the 10/31/17 report QUALCOMM received a tender offer about 30% higher than the price that was there and it might have jumped from one of the lowest to one of the highest.

With regard to Mr. Morrill's comments about the decline of mall traffic, Chief Nolan pointed out that does not apply to the King of Prussia Mall.

Mr. Morrill reviewed the equity sector weights versus S&P where the portfolio is positioned by different sectors. He pointed out the overweight of the benchmark in financials, health care, industrials and technology and underweight in a number of areas like consumer staples and energy. Those two underweights, consumer staples and energy, by being underweight has helped the performance because they have not been good places to be. It was noted there is zero exposure in consumer staples and no exposure in telecom services and utilities which are usually not good growth areas.

Mr. Morrill discussed purchases and sales year to date 2017 as well as those names that have been trimmed. It was noted there have not been any additions of existing positions. As the equities have done very well we kept bumping up to the ceiling of what we are allowed in equities so we were forced to trim the equities. New purchases were Blackline and Core Lab. Blackline is a small cap software company that helps corporations close their quarterly books and makes them more efficient with less people and in a timelier manner. Core Lab is an energy service name that has been owned in the past and just recently placed back into the portfolio. Core Lab does core samples to assist drillers in understanding what is in the sediment and rock and see where they want to drill. IMAX Corp and Signet Jewelers have been sold since the equity cash level was exceeded and cash was needed for fixed income. Visa and Roper Technologies were trimmed because they were doing so well.

Mr. Morrill reviewed investing themes in the portfolio. He mentioned consumer businesses that are enhanced by technology and e-commerce (Google and Amazon). He also noted there is confidence CarMax has a long runway of growth.

Mr. Morrill noted the market capitalization of the portfolio has not changed much since the last meeting. He indicated 10 years ago there was not much in mega cap with more in small cap, but because the market over the last 9 years has gone straight up a lot of the companies in the portfolio have graduated from small cap to mid-cap, mid-caps have graduated to large cap and some of the

large caps have graduated to mega cap. Because companies are owned a long period of time the market cap weighting has shifted upwards.

Mr. Dent discussed the fixed income profile where the majority of shifts were made within the portfolio since the last meeting. He said DF Dent continues to research equities and invest in the best in class companies that dominate their particular field. Experience has proven it is a winning formula to go with the very best dominant companies which means from meeting to meeting there are not dramatic changes. Many of the really good companies have been held for a long period of time and some have been owned for 10-15 years or more. They continue to do well as demonstrated by Visa, but changes have been made in fixed income since last meeting. The average maturity has been changed from 3.2 years to 3.6 years which is still well below the benchmark. It was noted DF Dent has been emphasizing preservation of capital within fixed income rather than trying to get a high coupon. The same can be said for modified duration which has been increased from 2.9 years to 3.3 years. That is a calculation that is made to measure the sensitivity of the fixed income portfolio to changes in interest rates. The higher the number the more sensitive you are to a change in interest rates either up or down. We are still about half the duration of the benchmark. We have been very defensive and in the past 7 months we have purchased \$2.3 million in fixed income instruments within the portfolio with proceeds coming from stock sales. The \$2.3 million in bonds represents roughly 5% of the average value of the portfolio (about \$46 million) over the last year.

Mr. Dent pointed out the fixed income as a percentage of total assets has gone from 31% to 33%. In moving the 5% over it has only increased the percentage of fixed income by 2%. The reason is although we have moved the 5% over to bonds; the equities have done so well that the fixed income has only increased by 2%. DF Dent will continue to recycle the profits on a daily and weekly basis. During previous discussions it was noted the assumed rate of return in the portfolio was ambitious at 8%. Mr. Dent said if we have 20% plus this year we are “flying high in equities” so we want to take that excess return over the 8% and recycle it back. Even though we are going to get 3% or so currently in bonds, it is worth doing that to reduce the risk within the portfolio.

Of the bonds that were purchased, \$1.3 million that has been in government. Under the sector allocation at the last evaluation on March 31, 2017 government agencies was at 0%; as of October 31, 2017 government agencies has been increased to 8%. This represents largest change that has been obtained through a reduction in the percentage of corporates. Corporates have gone from 52% to 43% because all the money that has come into the bond market from equities has gone largely into government agencies therefore it has reduced the portion that is in corporates. Within the government agencies the \$2.3 million that have gone into bonds, \$1.3 million or about 8% of the bond portfolio has gone into government step ups (Federal Home Loan step up notes).

There is a Federal Home Loan step up note which is at 2.5%. While the ultimate maturity is 2032, the modified maturity based on expectations for the rate and call feature is only 2020. Therefore, for analytical purposes it is basically a three-year bond. The reason that these bonds are so attractive now is anticipating the gradual increase in interest rates. The Federal Reserve is shrinking their balance sheet which means they will be selling their fixed income portfolio for cash. The balance sheet has gone from \$1 trillion to \$4.5 trillion of securities owned by the Federal Reserve. They have quadrupled their holdings of government securities and mortgages by going out and buying on the open market buying which has driven up the prices. As the prices go up the yields go down. This has been part of the stimulative monetary policy since 2008 to get the economy going; however, the Federal Reserve intends to reverse that policy. While it has been the wind at the back of the bond market and for all financial assets and injected liquidity into the system has caused financial assets to increase in price over the last eight years. Now they are going to gradually reverse that as gently as possible so as not to upset the markets. Mr. Dent said it is important to note that the direction has been changed from monetary policy being the “wind at our backs” to being the “wind in our face” and that is the reason for the defensive posture. With regard to the step ups, the Federal Home Loan step up has an initial coupon of 2.5% which will increase periodically over the next 4-5 years. The ultimate coupon on that bond if it were to go to maturity is 10%. If that were to happen (which Mr. Dent does not expect to happen) all financial assets would do terribly. With 10% rates the equity market would do as bad as the bond market. While that is not expected to happen it does provide the protection that on a bond against rising interest rates because a couple of years from now the coupon on that will be 3.5% and as the terms for this particular instrument suggests, it steps up with interest rates. We think that is very attractive feature.

Mr. Dent reviewed the fixed income maturity distribution which is heavily weighted towards short maturities. It was noted 60% of the bond portfolio matures in less than 3 years. As interest rates go up over the next three years it is anticipated we will extend out the maturities at a pace that will closely match the pace we anticipate the Federal Reserve will use in raising interest rates. For example, if 6 months from now they increase interest rates by that time by possibly ½% (50 basis points) or ¾ of 1%, DF Dent would extend possibly another 15-20% of the portfolio as the rates go up to protect the principal and the excess return received from the equities in the last year.

With regard to the market outlook, Mr. Dent stated the corporate profits overall have been very strong and will continue to remain strong. Unemployment is very low. Inflation and interest rates are low which suggests a favorable environment for the equity market. He reiterated there will be a gradual shift in the returns. In looking back historically on the returns in the portfolio, when there is a strong period as recently experienced often the market overshoots a bit and it borrows from returns the next few years. More normal returns are expected

and maybe below normal because this is such an above normal period. This is the reason why DF Dent is so defensive at the present time.

Mr. Dent discussed valuation and the average price earnings ratio. He indicated the valuation on the S&P over the last 20 years has been 16.0%. We are currently at 18.0 based on projected earnings and while we are ahead of the average valuation it would not be described as overvaluation.

The outlook going into next year is a continuation of good earnings and part of that is recovery in the energy sector. The energy sector going back a couple of years was doing very poorly as energy prices dropped. Crude oil is now high \$50 per barrel and recovered significantly from the lows that were down close to \$20 a barrel. Energy has been out of the portfolio in the last three years as it has been a terrible performing sector, however, that seems to be turning and this is why Core Labs was added. While it is not a direct energy producer, it is a service company doing analysis for energy companies as they want descriptions of their reservoirs and also they have programs that are used to enhance the production out of existing reservoirs. This is a first step back into energy.

Mr. Dent reviewed the chart showing the correlation between stock returns and interest rates. He said it is a common theory that as interest rates go up it is bad for the stock market. If interest rates go up, the bond market with higher interest rates and higher returns, competes with stocks as money moves from stocks to bonds. When interest rates are going up, stocks are going down. When interest rates are raising at levels below 5% it is because the economy is strengthening. Mr. Dent indicated that is exactly the situation we are in now. The economy is growing, not at a very high rate of growth, but it is positive growth the last quarter which was revised upwards to 3%. Interest rates are most likely on the path upwards. When interest rates over 5% is when bonds become effective competition for stocks and you see money moving from stocks into bonds which results in a negative correlation. As long as interest rates stay below 5% than the returns in equities will be good, although we want to do the shift being more defensive and picking up more fixed income for preservation purposes, once you get to 5% is when the warning flags go up.

Mr. Dent concluded by saying this has been a good year but it is prudent to be realistic and willing to accept for the foreseeable future some lower returns. He said the portfolio is managed in real time daily and weekly. It was noted the \$2.3 million that was moved over from equities has not been done all at once, but gradually and that is a real benefit of the way this has operated.

ADDITIONAL BUSINESS

OLD BUSINESS: None

NEW BUSINESS:

Mr. Kraynik discussed the scheduling for the upcoming 2018 Pension Advisory Board reorganization and quarterly meetings.

ADJOURNMENT

Without further business by the Pension Advisory Board, the meeting adjourned at 6:12 p.m.

David G. Kraynik
Township Manager and Vice Chairman

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Minutes Approved:
Minutes Entered: