PENSION ADVISORY BOARD/HEALTH & WELFARE BOARD OF TRUSTEES
MAY 5, 2010
QUARTERLY MEETING

The Pension Advisory Board/Health & Welfare Board of Trustees, met for their Quarterly Meeting on Wednesday, May 5, 2010, in the Township Building. The meeting was called to order at 7:00 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: Ronald G. Wagenmann, Township Manager & Trustee; Fred Santoro, Staff Liaison; Ron M. Fonock, Chief of Police/Trustee; Andy Andreyko, Police Representative; Eric C. Medrow, Chairman; Vince Mallon, Civilian Member. Supervisor Erika Spott, Trustee and Liaison and Robert S. McKernan, Non-Uniformed Representative were absent.

MEETING MINUTES:

It was moved by Chief Fonock, seconded by Mr. Mallon, all voting "Aye" to approve the January 20, 2010 Reorganization Meeting Minutes as submitted. None opposed. Motion unanimously passed.

PRESENTATION BY DANIEL F. DENT, INVESTMENT MANAGER RE: POLICE PENSION PLAN AND FUND

Mr. Daniel Dent, Investment Manager, presented the Pension Board with the portfolio performance reviews for the period ending March 31, 2010 and commented that quarterly commentary letters will now be provided on a regular basis whereas in the past a letter accompanied the portfolio only when there were significant items to report. He indicated that the April 2010 letter outlines portfolio thoughts on the market and includes a commentary on the rationale for the negative outlook for the bond market.

Mr. Dent stated that markets have strengthened from the March 2009 lows in a liquidity driven market and that we are now in an earnings-driven phase of the cycle. He explained that the earnings were stronger than anticipated due in large measure to the cost cutting in the infrastructure of many companies in the prior year.

Mr. Dent noted that there is overweighting in the health care area. He said that there is uncertainty surrounding implementation of the new health care law and that the anticipation worries investors more than the reality of what happens. Markets hate uncertainty. After Medicare and Medicaid legislation was introduced in 1965, health care stocks drifted lower. However, once legislation was enacted, the sector outperformed for the next several months.

Mr. Dent indicated that the subprime lending problems were the first indication of financial problems in the system in 2007. As time went on the markets recognized there were much more extensive problems than just low quality debt. He related this to what is going on in Greece with the most mismanaged economy in the Eurozone. The companies that are known as the PIGS (Portugal, Italy, Greece and Spain) all have similar problems of huge government deficits, too much debt relative to the size of the economy and union problems. Greece is the worst one and there are other countries that are in bad shape and the contagion is spreading and will become more prevalent.

Mr. Dent cautioned that markets in this country and others will extract a penalty from those countries or companies that are profligate in their ways.

Mr. Dent discussed the bond market and reviewed the bar chart and pointed out the trailing 10-year return from the S&P 500 that was negative in 2009.

Mr. Medrow asked if the returns on the equity side of the S&P 500 include capital gains and dividends. Mr. Dent responded in the affirmative and said that it is total returns.

Mr. Medrow asked if total returns are in fixed income as well. Mr. Dent responded in the affirmative.

In reviewing the bar chart, Mr. Dent pointed out that for the last ten years if you were in bonds instead of stocks you would have done 7% better on an annual basis over that ten year period which is unprecedented. Bonds have never outperformed stocks by so much.

Mr. Medrow asked if that was for government and corporate domestic bonds not international. Mr. Dent responded in the affirmative.

Mr. Dent said because of the cyclical nature of the market, when there is a period with one asset class so significantly outperforming the other, careful attention must be given to a cycle turning and going the other way. He said that when interest rates go up the bond prices go down so there is heightened risk in the bond market which is the exact opposite of what has happened in the last ten years. The general public normally tends to invest and be influenced by what has been observed in the most recent past. Over the period of the last year the general public in spite of the negative outlook for bonds has been buying bonds because the general public is looking at what happened in the last ten years where bonds outperformed stocks 7% a year. Stocks did terribly in the last year and the general public is getting into bonds at exactly the wrong time. The public overall does not want to be in U.S. equities because of the negative turn in the last ten years. It wants to be in emerging markets which have done quite well. Emerging markets have been the leading asset class in six out of the last seven years. Mr. Dent predicted that long term the emerging markets will do well because they tend to be smaller economies that can have higher growth rates from that smaller base. However, he cautioned that right now there is considerable vulnerability there.

Mr. Medrow said at this time the dollar and bond market are relatively strong compared to what is happening in the PIGS countries. However, he pointed out that with the tremendous deficits piling up in this country the longer term outlook would indicate a weakening dollar and a greater inflation rate which would point to a very poor outlook for the American bond market. He asked if this is Mr. Dent's view. Mr. Dent responded in the affirmative.

Mr. Medrow asked if there is a greater opportunity in some of the foreign bond markets, such as the Brazilian bond purchased last year, as opposed to American bond market given the long term. Mr. Dent responded that is something we are doing now.

Mr. Medrow asked for clarification about the current position of equities in the portfolio. Mr. Dent responded it is now right under the ceiling of 55%.

Mr. Medrow asked if this means that we are forced into going into bonds. Mr. Dent responded in the affirmative.

Mr. Medrow asked if there is a way to establish a benchmark for the portfolio whereby the amount going into the equity side can be increased.

Mr. Dent stated that benchmarks are useful afterwards to evaluate performance relative to the rest of the world as described in a particular index. Mr. Dent indicated that an important distinction in the way his company works is that attention is not paid to what the weightings are within the benchmark are unless there is overweighting in some areas. He explained that the April commentary addresses the fact that the overweighting in health care was intentional and is being watched.

Mr. Medrow said he does not see a temporary overweighting as a problem, if that overweighting is due to the fact that the stocks are going up.

Mr. Dent commented with regard to Mr. Medrow's previous question about the percentage in equities, he pointed out the purchase in sales since the last meeting where we were a net liquidator of equities. He said the reason for that is that the performance and equities were bumping up against the ceiling so it was cut back. Mr. Dent explained that we keep scaling back on net purchases and sales as though we are a net seller of equities to keep the percentage under the ceiling.

Mr. Medrow said if the stock is good you want to keep it even if it causes a temporary overweighing in the portfolio. Mr. Dent said that is what we have done.

Mr. Medrow reiterated that he would like to see a benchmark to provide justification for moving a little bit heavier into equities. He indicated that we are stuck right now at 55% and there is no way to get around it because that is our investment policy statement.

Mr. Wagenmann said what we need to do is amend our investment policy.

Mr. Medrow said professional guidance is needed to create a benchmark.

Mr. Dent indicated that the original investment policy began with a lower ceiling on equities. Mr. Wagenmann recalled it was in the 35% range and since then has worked its way up over the twenty year period.

Mr. Dent pointed out that this is a public pension plan and as such there is a layer of conservatism in the asset allocation.

Mr. Medrow commented that conservative means prudence and prudence means getting the best performance with the least risk. He expressed the view that it does not necessarily mean going more into fixed income than into equities at any specific time. Mr. Medrow pointed out that right now it is more risky to go into the bond market than it is to go into the equity market and it would be prudent to take a look at that and get ourselves out of this situation.

Chief Fonock recalled that after the 9-1-1, the stock market went down and Mr. Dent correctly deduced that the federal government was going to have to stimulate the stock market at reduced rates and bonds would then be improved. He noted that they reached historic levels in three consecutive years. Chief Fonock said we are presented with the idea that inflation is coming back so bonds are going to lose value. One part of his question is that in the 1970's when we had runaway inflation, the stock market call was basically flat so that running to equities could be a good thing. He asked if chasing equities may not be this superior better performer.

Mr. Medrow said we should be looking at three asset classes: money market accounts, equities and bonds, but at this point it is hardly worth talking about equities. He commented that in the 1970's the reserve fund and money market funds were yielding 14/15% so it was a viable alternative in those days to go into a money market account, but that is not happening now.

Chief Fonock asked: (1) do we want to be chasing positions in equities if inflation and high interest rates dampen equity markets so that we do not necessarily want to raise the ceiling and (2) should we be laddering our bond portfolio. He agrees with raising the ceiling when it is prudent to do so, but it might not be necessary since equities are not going to be double digit.

Mr. Medrow pointed out that equities are not one market and that there are stocks within that equity market which will be inflation type stocks or high dividend paying stocks. He agreed that Chief Fonock made a good point about laddering. Mr. Medrow said that beyond the laddering we should also be taking a look at international bonds with stronger currencies in the nations which have the stronger ability to avoid inflation problems. He pointed out that we are not looking at inflation here yet since the unemployment rate is still hovering at 10%; however, as prudent trustees of this money now is the time to start thinking about some of the events that may be occurring a year or two from now.

Mr. Dent cautioned that comparing this with the prior period can be dangerous and said that from 1968 to 1981 the stock market did not move. This is a time his office refers to as "wandering in the desert." He said there were a lot of individual opportunities in great growth companies in that thirteen year period even though the overall market went nowhere. He said that going forward with the equity market would be "wandering in the desert" again. Mr. Dent indicated that his company is targeting specific areas where there are very positive trends and it is going to be a stock pickers market that is going to be earnings driven as opposed to 2009 which was liquidity driven where the rising tide "raised all boats." An analysis of the market calendar 2009 is that the highest quality companies had the worst performance and the lowest quality companies did the best. Mr. Dent explained that the reason is that entering into 2009 after the financial credit crisis of 2008, many of the weaker companies were essentially valued in the market and priced to extinction. Many of those stocks were down at \$2 and \$3 a share and as the markets came back, they went to \$5 ½ a share.

The issue of the benchmark came up several times during the course of the presentation, Mr. Wagenmann said he believes there is more than one approach and that we need to discuss and move forward. However, he would like to see the concept written out that explains how it would work. He also advised seeking Mr. Dent's input and looking at several alternatives. Mr. Wagenmann stated that a policy could be written that would give Mr. Dent flexibility of a certain number of percentage points so that if it exceeds 55% he is not forced to sell.

Mr. Medrow indicated that because of liability issues he is looking for a safety valve to provide protection.

Chief Fonock commented that it would be helpful to have input on similar pension plans and what they are doing.

Mr. Dent followed up by saying that with a public pension there is a lower equity allocation than would be the case for private retirement plans and the difference is who pays for it. The taxpayer pays for a public pension and companies in the private sector can assume more risk and risk is generally defined as volatile variability of returns.

Chief Fonock asked of the plans managed by D.F. Dent and Company what percentage is government. Mr. Dent responded a small percentage are government and that most of his clients are non profits and endowments for schools and colleges.

Mr. Dent said that Upper Merion's investment program has not been changed for years with the intent that it would be held over a long period of time. He noted that there is something called the variable ratio that has the range within equities. The idea is that when the top percentage range is reached they begin trimming back and conversely if the bottom of the range is reached that is the buying opportunity. Mr. Dent noted that the buying opportunity at the bottom of the range would have been in November 2008 and March 2009 when the markets hit the bottom. Not that it is known at the time but when the market gets to the point where it is under duress it is at that point to be increasing the percentage and when the market is real high that is the time when we should not be jumping on board and buying more because that is what the general public does. The purpose of this variable ratio is to be buying at successively lower levels within the market and conversely selling at higher levels.

Mr. Medrow asked if there is any information as to what other people do in terms of the variable ratio.

Mr. Dent said the variable ratio works when an investment manager exercises contrarian judgment and goes against the grain and that is when it works.

Mr. Dent pointed out that best performing asset class in calendar 2008 was U.S. treasuries because when the stock market went into the tank, the Federal Reserve dropped interest rates to deal with the credit crisis and there was an intense flight to safety. That was the time to get out of treasuries and we got out of treasuries. Mr. Dent explained that for those buying into treasuries for protection from disaster, prices of treasuries went up and yields went down. Mr. Dent noted that you have a couple of days when the treasury bills which are priced at a discount, you get your return, not with an interest coupon, but with the amortization of the discount to par value at maturity. He said there were a couple of days in late 2008 when the Treasury bill went to a premium which meant that in buying a treasury bill, you received no interest. You were paying the government to keep your money and the flight to safety was so intense that people were willing to pay the government to be in treasury bills, pay a premium and only get par back. In 2009 the situation reverses. The best performing asset class was equities and the emerging markets. The worst performing asset class was U.S. treasuries because interest rates then came up from being at ridiculously low levels.

Mr. Medrow asked where treasury bills are now. Mr. Dent responded probably 16 to 18 basis points for 90 days.

Mr. Medrow asked what is the risk with 16 to 18 basis points and would it go down any further. Mr. Dent responded that there is no risk in the Treasury bill itself. The risk is missing the opportunity in some other asset class that could do better.

Mr. Dent stated that we are going to continue to buy international bonds and we are going to continue to shorten maturities. The shortening of maturities is going to reduce the risk. That is the strategy.

Chief Fonock commented that it is his understanding that the safest way to keep the bond component in the portfolio is to have these fixed term, non callable, recent yield bonds that can be relied on.

Mr. Medrow asked Mr. Dent if he ever buys callable bonds. Mr. Dent responded in the affirmative. He said the bonds that are callable are priced to call, not to maturity.

Mr. Medrow commented that the yield to maturity means nothing at a callable bond.

Chief Fonock said that was his point.

Mr. Medrow said that Chief Fonock's earlier comment about laddering is absolutely on point because if you ladder, then you are holding the bond to maturity and you cannot lose. He suggested that laddering be done as much as possible in the portfolios.

Mr. Dent provided specific details on the portfolio for the period ending April 30, 2010 for the Upper Merion Township Police Plan. He explained the reason for the very strong month in equities and pointed out that the equities are up 36% slightly below the S&P because equities are sold to stay within the range. Mr. Dent said it is his responsibility to trim back on those large holdings where there has been a big run in certain stocks. He noted that fixed income is probably the best single year against the benchmark and the reason is that the treasuries performed poorly and we were largely very much under weighted in treasuries and had cut back on them. Mr. Dent reported that corporates did very well as the spreads or the differential in interest rates between those and treasuries narrowed. He explained that another way of saying the spreads are narrowing is to say that the perceived risk which was represented by higher yields in the corporate bond sector declined and calm returned to the corporate sector which provided superior performance in the bonds relative to the Barclay Index which has a heavy weighting in treasuries.

Mr. Dent discussed page 2 of the handout and provided specific details on the change in market value from April 30, 2000 to April 30, 2010.

Mr. Dent mentioned one new promising area that we have not invested in directly until just recently is education. The company is called K12 and as the name implies it is basically Kindergarten through 12th grade online for public education.

Mr. Medrow stated that after China and the Far East, Brazil is probably the strongest economy in energy and agriculture. Brazil has had high inflation, but the Prime Minister and Finance Minister have a very aggressive interest rate policy similar to what Paul Volker did in raising interest rates to squeeze the inflation out of the economy. The Brazil bond that was purchased is a very high coupon. The idea is as those high interest rates are affected inflation is squeezed out of the economy and then interest rates come back down. If interest rates come down and inflationary expectations come down that will be beneficial for the exchange rate and also for the bond in terms of interest rates going down.

On page 5 of the handout Mr. Dent pointed out that Wachovia is a floating rate variable to provide protection against rising interest rates.

Mr. Medrow asked if Wachovia is a good credit now. Mr. Dent responded in the affirmative.

Mr. Dent summarized and said that during this session he discussed the portfolio of bonds, the laddering feature, risk and treasuries versus yield and the Moody and S&P rating.

Mr. Dent stated that in his experience managing municipals they do not want to issue a high coupon debt that does not have a call feature. He said if you are in a market and you have to issue debt, you will want to have a call feature. Mr. Dent pointed out that it is very difficult to get a non callable municipal paper where the issuing township, county, or agency is going to sell a bond and be saddled with a high coupon all the way to maturity consequently they all have call features. With individual accounts in the last couple years his company has tried to avoid calls as much as possible but that in almost all cases municipals had various call features and those issuing agencies were refinanced.

With regard to a benchmark, Mr. Dent said a key number to keep in mind is what the actuarial assumed rate of return is.

Mr. Wagenmann stated that rate had been at 8% for quite awhile and at the last report it was knocked down. He asked if discussions should be held with Anderson Associates to do a special actuarial report if permitted under state law. Mr. Wagenmann pointed out that if we can change that interest rate it would mean a significant difference in the contribution that the officers have to make in the pension plan or even beyond.

Mr. Dent referred to page 1 of the report and pointed out that for almost twenty years the pension plan had a total return net of basis 8.5%, equities were 8.9% and bonds were 8.2% which is much closer than it has been historically. That reflects that last ten years which was an unusual period when the bonds have done so well.

Mr. Wagenmann said he would like to present this because it would help a great deal in 2011 and put Upper Merion Township compared to a lot of other municipalities in a much better position. He noted that the school districts are being faced with probably a tripling of the minimum pension obligations on an annual basis.

Mr. Medrow said that has also been one of his concerns since the pension situation in the state is unknown.

Mr. Wagenmann pointed out that GASB 45 requires actuarial reports associated with post retirement benefits that have been granted by allowing people to stay in health care plans. GASB 45 requires the actuarial report to be done now, but there is still no requirement to fund that debt. He commented on some states with billions in unfunded liability. Mr. Wagenmann pointed out that in the case of Upper Merion a GASB 45 rate has been created so that the retirees are allowed to stay in the health care plan, but they pay a GASB 45 rate that is 19% higher than the Township's rate. This eliminates the need to create a trust fund and there is no liability.

Mr. Dent said a company that is returning capital to shareholders can do it in two ways. They pay out the cash in dividends or they repurchase their own stock which becomes a more attractive option for corporate managements. He explained that the second option creates value for shareholders by increasing their equity in the company instead of paying cash out that is taxed at higher rates next year.

OLD BUSINESS:

Mr. Medrow stated that at the last meeting an Ad Hoc Committee was appointed to report on anything on the legislative horizon which could cause any problems in terms of consolidating statewide pension plans.

Mr. Wagenmann stated that he will comment on the general pension issues and Chief Fonock will discuss the police issues. Mr. Wagenmann reported that the Pennsylvania State Association of Township Supervisors adopted Upper Merion Township's suggested resolution to request a comprehensive study by the state's retirement commission to determine what financial liabilities or responsibilities exist for state pension plans. Mr. Wagenmann explained that the idea is get a true picture of the situation so that this problem can be properly addressed since no one currently has their hands around the entire issue. Mr. Wagenmann explained that one of the reasons the resolution was adopted was that no one knew what pension issues were facing the other municipalities in the state. He provided examples of a few municipalities that have not been providing adequate funding.

Mr. Wagenmann explained that the 205 money is the tax on foreign casualty insurance policy sold in Pennsylvania. In the insurance business the term "foreign" means not with the Commonwealth of Pennsylvania. He explained the drain on 205 money which is now allocated on an annual formula basis. Another part of the problem is that every year more non uniform than uniform pension plans are created and that then dilutes the unit benefit.

In response to a question, Mr. Wagenmann indicated that the police pension is a defined benefit plan and the non uniformed plan is a defined contribution plan. The non uniformed plan is just a fixed percentage of payroll and there is no guarantee of a benefit and for that reason an actuarial study is not required.

Chief Fonock stated that he received an email from the State Pension Committee forwarding the latest bill introduced for a statewide pension. For the past ten years or so similar legislation has been introduced. Chief Fonock will be in touch with his contacts to determine if there is any difference in this bill from all the previous legislation and get a feel if there is any traction this time.

Mr. Wagenmann commented that he and Chief Fonock are in complete agreement with regard to the statewide pension plan.

Sgt. Andy Andreyko followed up on the issue he raised at the last meeting with regard to Act 64 (2002 Ad Hoc COLA) and whether a certain police officer who has been retired for 25 years might be eligible for this benefit. After checking this matter with the pension consultant, he was informed that Act 64 does not apply since it was a one time provision for the year 2002.

Chief Fonock stated specifically for the record that this was in reference to the issue Sgt. Andreyko raised at the last meeting asking for clarification of access for an Ad Hoc COLA and the answer is the specific officer is not eligible because of his timing.

Mr. Santoro reported that last year the township employees were allowed to take out loans on their 401's and 457's. He reported that notification was received from our pension consultants that the State Auditor General took issue with that practice. For this reason loans have been suspended for the time being. The pension plan has been amended and the township will no longer offer loans on 401's; however, loans will be allowed against the 457's since that is entirely employee money. These loans will be limited to $50,000 or 50% of the vested balance whichever is less.

Mr. Medrow commented that the employees should continue to be discouraged from borrowing against the 457.

Mr. Wagenmann reported that there is a situation regarding police pensions that came about when a number of employees in the police department switched from civilian to police status. The Township has allowed these employees to vest the money that was on the civilian side. The State Auditor General has indicated that these employees would have to forfeit that. The argument they used was that these employees terminated employment before vesting and therefore they should pay it back. The Township position is that they did not terminate with the employees, but simply changed their work position and category. The Township disagrees with the Auditor General in this regard.

Mr. Medrow asked about the rate of retirement going forward for the next ten years.

Chief Fonock responded that there are six or seven officers in the DROP Program consequently in the next five years there will be at least this number leaving. He then provided a brief summary of previous officer retirements and indicated that currently about $1 million a year is spent on pensions.

NEW BUSINESS:

Mr. Wagenmann said the Township is changing its medical insurance provider (Aetna), hired the Delaware Valley Insurance Trust (DVIT) to administer and will no longer be self insured.

Mr. Medrow asked what prompted that decision. Mr. Wagenmann responded that cost was a factor and this was the only plan that would provide the exact same coverage that the officers and civilian employees had under the previous medical plan. From a cost standpoint the Township previously carried the risk, had reserves and purchased the stop gap insurance. Mr. Wagenmann pointed out that there are 60 communities and over 10,000 individuals that are covered under the DVIT plans. For the final six months of the year the Township will save between $90,000 to $300,000. DVIT not only offers the same coverage of the previous plan it provides additional employee incentives, actual dollar rewards.

Mr. Santoro provided additional cost information and noted that the cost of self insurance for the Township in 2009 was $4,261,000. The DVIT plan on an annual basis is going to save the Township somewhere between $186,000 and $838,000 and provide exactly the same benefits.

Mr. Medrow asked if this is a community experience. Mr. Santoro responded that DVIT has a pool experience.

Mr. Wagenmann said the other advantage is that DVIT provides retired employees with several multiple options of coverage so that it will be possible to move the retirees off to their own experience and they will still realize a savings.

Mr. Medrow asked if retirees are covered ad infinitum. Mr. Wagenmann responded that they can stay in the plan with all those benefits if they pay the full cost (GASB 45).

Mr. Medrow asked if they are paying the premium into the plan. Mr. Wagenmann responded in the affirmative.

Mr. Wagenmann discussed the VEBA Plan and explained that the Township and officer make equal contributions when the officer works based on the officer's salary. When the officer stops working the Township's contributions cease and there is a committee that controls that benefit.

In response to a question regarding VEBA, Mr. Santoro indicated that the cost the police retiree under age 65, pays is $1,033.30 a month to stay on the health care plan. Retirees over age 65 [after Medicare] pay $740.63.

Mr. Wagenmann noted that DVIT has agreed that the appeal process which would come back to this committee can stay in place. He explained that if Aetna were to deny a claim it would first be appealed through DVIT, but DVIT has also said that the current appeal process would remain in place as well.

Chief Fonock asked if the Pension Board meetings could be scheduled during the day and experiment with a 5:30 p.m. start. It was agreed that Mr. Santoro would check with Dan Dent and Mr. Wagenmann would check with Supervisor Erika Spott and get back to the committee on this matter.

ADJOURNMENT

With no further business to come before the Board, the meeting was adjourned at 9:18 p.m.

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Alfred E. Santoro, III
Board Liaison

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Minutes Approved:
Minutes Entered: