PENSION ADVISORY BOARD/HEALTH & WELFARE BOARD OF TRUSTEES
APRIL 25, 2012
QUARTERLY MEETING

The Pension Advisory Board/Health & Welfare Board of Trustees, met for their Quarterly Meeting on Wednesday, April 25, 2012, in the Township Building. The meeting was called to order at 5:35 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: Supervisor Erika Spott, Trustee and Liaison; Ronald G. Wagenmann, Township Manager & Trustee; Fred Santoro, Staff Liaison; Ron M. Fonock, Chief of Police/Trustee; Eric C. Medrow, Chairman; Vince Mallon, Civilian Member, Sudha Suryadevera, Non-Uniformed Representative and Sgt. Andy Andreyko, Police Representative.

MEETING MINUTES:

It was moved by Chief Fonock, seconded by Mr. Mallon, all voting "Aye" to approve the January 18, 2012 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 his performance report dated April 25, 2012 which detailed:

- Portfolio as of March 31, 2012
- Asset Allocation
- Performance Attribution
- Fixed Income
- Portfolio

Mr. Dent stated his presentation will follow the way it is managed on a daily basis by sequencing both fixed income and equities by the size of holdings. He pointed out under Fixed Income the first issue is Roper Industries with the 6.625% coupon due August 15, 2013. That is the largest fixed income holding at $600,000 and represents 1.66% of all the assets.

Mr. Medrow asked if this was a recent purchase, and Mr. Dent responded it was bought approximately a year and a half ago.

On page 1 under Fixed Income, Mr. Medrow asked for an explanation of the term "Whole Call Only" for AMGEN. Mr. Dent responded if the bond is called, the entire issue must be called as opposed to many call features allowing the issuer to call, for example, 20% of the bond. He said if an issuer issues $1,500,000,000, they might get to a point in the future where they would like to redeem a third or fifth of it so they will then call one fifth and then take a random method to select bonds. As a result even though they call a third, you might have 20% of your bonds called or 40%. It is done randomly. The "Whole Call Only" feature is advantageous because it makes it more difficult for the issuer to call the bonds, the entire issue.

Mr. Medrow asked if it is correct that in most cases the investment manager does not like to see a call feature in the bond issue because it takes the control away from the manager and puts the control in the arms of the issuer. Mr. Dent replied in the affirmative.

Following up on that question, Mr. Dent stated AMGEN is due on June 1, 2017 and it is essentially a five year bond and has a 5.85% coupon. This is a coupon you could not get for a five year issue now, and accordingly, the face value of that bond is $500,000. Because it has a much higher coupon then you could get in the market today, it trades a premium which is why there is now a market value of $587,000. That premium of $87,000 will amortize over the next five years, but you could not replicate that coupon and the yield right now on the market.

Mr. Medrow asked for more information about Pacific Bell Telephone with a yield of 6.25. Mr. Dent replied this was purchased when interest rates were much higher. In effect the bond was contracted for the stated coupon which was higher than today's rate; the way the market adjusted to that is we have much lower interest rates today. When you have a bond that is yielding more than the market, the price of the bond goes up and that is reflected in the market values listed in the portfolio.

Mr. Dent noted most of the bonds are selling at premiums over their purchase price; however, that is now in the process of reversing. He explained what happens when bonds are purchased today to replace bonds that are being called. In buying a 2.5 coupon, even with a 2.5 interest rate that sells at a premium of 1.01 or 1.02 in the next six to nine months that premium will amortize and reflect a loss just on the face value of those bonds even though they are bought at times when they offer attractive yields relative to what is in the market.

Mr. Medrow asked about the credit quality of Express Scripts. Mr. Dent responded he believes they are rated BBB. He pointed out that could be under review because, having received Federal Trade Commission and Justice Department approval, Express Scripts is acquiring Medco making them the largest pharmacy benefit manager. Mr. Dent indicated Express Scripts has been one of the strongest performers.

Mr. Medrow observed there are no treasuries in the portfolio.

Mr. Dent commented there is no value in the treasuries. He pointed out in the comparison with the benchmark, Barclays Federal Credit Index, has a component in treasuries while the township's plan has zero in treasuries.

Mr. Dent discussed Equities and noted just as the bonds they are sequenced from the largest holdings on down.

Medrow commented on Fastenal with a total cost of only $190,000 and a current market value of $3,516,000 which represents a considerable capital gain for this security.

Mr. Medrow asked when Fastenal was first purchased. Mr. Dent responded the investment in Fastenal began when it went public in 1987. He has seen reports that Fastenal is the top performing stock in the last 20 years on all exchanges.

Mr. Dent discussed and reviewed the performance history. In the first quarter of this year equities had a total return in the first quarter of 12.55. The total account was up 8% and the bonds were up a little more than 1 ½%. The Barclay's Index has a heavy weighting in government. Equities for calendar year 2011were up 6.95% and the S&P had a total return of 2.11. The S&P price was virtually unchanged for the year which was unusual because of the volatility of the markets. The Fixed Income portfolio generated a return of only 4.42 below the benchmark and the reason for that is becoming defensive when interest rates got low the maturities were shortened in order to reduce the overall risk of portfolio if interest rates were to go up. Interest rates have not gone up, in fact, they went down and the 10 year treasury went from 2.5% yield to a 2% yield. Treasuries did well last year; we were too early in shortening the maturities and reducing the risk and this year it is starting to pay off and the return for the first quarter of this year 1.56% versus the 0.08% for the benchmark is starting to reverse that. In looking at the last three years plus the quarter, fixed income total return is 8.61 versus 6.11 which is about 2.5% above benchmark.

Mr. Medrow asked if fixed income includes capital gain and income. Mr. Dent responded it is total return; the coupon interest plus price appreciation or depreciation.

Mr. Dent discussed the capital flows in the pension for the last one, three and five years. For the period March 31, 2011 to March 31, 2012, the value of the entire portfolio was $36.7 million. Interest/dividends amounted to a little over $1 million.

Mr. Medrow asked about the $1.4 million withdrawal amount and if it is for payments made to retirees. Mr. Dent responded in the affirmative.

For the period March 31, 2009 to March 31, 2012, Mr. Dent noted this period started at a low point in the market to where we are now so it is not really a fair way to look at it because we are looking from the bottom of the market to the top of the market.

Mr. Dent pointed out that the period from March 31, 2007 to March 31, 2012 is a more representative time period because you have the run of the market, but also the bad market of 2008. The five year period beginning in 2007 had a market value of $34.6 million of which $6.9 million was paid out for retirees. Interest and dividend gains are approximately the equal at about $5.5 million, with a $38.7 million market value in 2012.

Mr. Medrow commented the one big number trustees are concerned about is the outflow from the pension plan. He asked Mr. Santoro to explain what percentage of assets we have as compared to total liability. Mr. Santoro responded the Act 205 Report issued from the state indicates Upper Merion Township is above 90% in our capability to pay future obligations.

Referring to page 7 of the report, Mr. Dent stated in the first quarter of this year the best contributors and ten highest contributed a total return of 20.98. The weakest performers had a negative return of 3.94, but the lowest only represented a little less than 13% of the portfolio. The ten best contributors were 47% of the portfolio and we had the weighting in the stocks that did well.

Mr. Dent indicated that the portfolio is broken down in greater detail on page 8. The first column is the portfolio, middle column is the S&P 500 and the last column calculates whether money was made or lost by being in the right sector. Mr. Dent pointed out in the Consumer Discretionary (selection and interaction) there are a lot of blanks because those companies are not in the benchmark. They are not in the S&P 500 so there is no calculation whether they did well or not versus the benchmark. Mr. Dent explained the S&P 500 is used since it is the broadest benchmark. It has big companies, mid-size companies and some relatively small companies, unlike Dow Jones which is all big companies.

Mr. Dent directed the group's attention to page 10, broken down by the sector weightings in the equity portfolio against the benchmark, the S&P 500. The S&P divides the entire S&P 500 into 10 sectors; therefore, in order to make a comparison DF Dent takes every company in the equity portfolio and assigns it to the same sector the S&P. This is done even though D.F. Dent does not agree with the S&P. For example, Stericycle, included in the portfolio, is the largest medical waste disposal company in the country. D.F. Dent considers it a health care company. In the S&P it is assigned under business services, and the business services subsector falls within industrials, so it is not in health care. For this reason, in looking at the portfolio weightings to stack it up against the S&P, Stericycle has to be placed in the industrial sector because the S&P does.

Mr. Dent pointed out that under industrials it is very significantly over weighted relative to the benchmark. The benchmark is a little over 10% and the portfolio is a little over 30%. Mr. Dent explained the industrial sector is a catchall for all the different companies that do not fit neatly into health care or financial, etc. There are many companies almost by default end up assigned to the industrial sector.

Mr. Dent noted that a conscious effort was made to increase the Information Technology weighting within the portfolio. Previously it was not heavier than the benchmark, but this is more of a proactive investment management strategy. This is also the case for health care which is now significantly overweighted versus the benchmark. In order to make it all add up to 100%, the portfolio is underweighted in other things.

Mr. Medrow commented banks at the present time are very close to or under book value which makes them a tremendous value for an investor. However, evaluating a bank can be difficult because the loan portfolio has to be taken into account in order to determine the risk of every loan.

Mr. Dent stated while market value of the stock would be at or below the book value of the bank, if that bank has problems with the quality of its assets, its loan portfolio would be a direct hit to the shareholders equity in the book value. If there was a 10% "haircut" on the loans themselves, that could in effect be a 100% hit on the equities. Banks are really much riskier investments.

Mr. Dent noted the portfolio is underweighted in energy and the consumer sector. The consumer sector will be a weak area as consumers struggle to find jobs, pay off loans, pay off mortgages, and try to save money while savings rates are so low.

On page 11, the portfolio is broken down by market capitalization so that the entire portfolio is sequenced by the size of the companies, with Johnson & Johnson the largest market capitalization in the portfolio at $179 billion.

Mr. Dent pointed out the Equity Purchase and Sales on page 12, and noted the equities at the end of the quarter were 62% of the portfolio which is an all-time high. The equities have been allowed to increase as a percent of the portfolio in the last year or two. With the strength in the market the end of last year and then the March quarter being strong with approximately a 12% return in the quarter from equities, over the period of the quarter equities were cut back. On page 12, Mr. Dent noted sales of equities amounting to $981,000 and only one purchase of Ansys, a western Pennsylvania company. The net liquidation of equities amounted to approximately $860,000 or viewed against the market value of the portfolio was about 2% of the portfolio represented by a net reduction in equities or about 3 ½% of the equities being liquidated in the strong market.

With regard to total sales of 11,000 shares of Fastenal on three occasions, Mr. Dent noted, in November 2011, it sold for $41, in February 2012, it sold for $51, and in March 2012, it sold for almost $53.

Idexx and Techne have done well and are being trimmed back. SodaStream was an elimination from the portfolio.

Referring to page 13 fixed income purchases and sales, Mr. Dent stated on the sales of bonds they are all par because they are all maturities and calls and being replaced with the best returns that can be obtained in the bond market, which is not very good.

The final page of the report shows fixed income portfolio two years ago, one year ago and currently, then compares it with Barclay's Index. Under average maturity the portfolio is significantly shorter from 6.2 years two years ago to on average 5.4 years versus the benchmark for Barclay's which is 8.3 years. It is defensive versus Barclay's Index

Mr. Medrow asked if Modified Duration takes into consideration call features, and Mr. Dent responded in the affirmative.

Mr. Dent followed up and stated that assumes that the bonds that are premiums with high coupons will be called. He explained if there is a 7% coupon on a bond, it matures in 2018 and is callable in 2014. Modified duration means it is assumed it is going to get called because if it is a 7% coupon and there are still the same low rates the Federal Reserve Chairman indicates for 2014, they are going to call that and reissue that at a much lower rate so we are assuming that it is going to get called.

Referring to the Fixed Income Portfolio, Mr. Dent indicated BBB and above is investment grade. The decline from A- to triple BBB+ compares to AA- on the benchmark. The reason for the AA- on the benchmark is the benchmark has 53% in US treasuries which are AAA so that pulls the benchmark way up and the portfolio now has zero. Mr. Dent explained the portfolio has gone from 11% to 9% to 0% in treasuries because there is no value there. He pointed out the portfolio has 91% of fixed income and there is a variable rate bond which is 6% and one non-US dollar bond which is 3%.

Chief Fonock asked for clarification about Roper Industries, Inc. 6.625% due August 15, 2013 and if he can assume that this is not a callable bond. Mr. D ent responded it is not callable and explained the callable bonds have a "C@" notation, such as Pacific Bell Telephone and Chesapeake & Potomac.

Mr. Dent stated Cisco is a huge company, very liquid, very strong, but when Cisco issued that bond 5.5% was an attractive rate for them. Now they could redo that bond at a little over 2% today so they have to call the entire issue which they are financially capable of doing. But it was cheap money at the time.

Medrow asked for comment on Quantitative Easing 3 (QE3) and latest on the "Twist." Mr. Dent replied the "twist" with QE2 was intended to drive down long term rates and when it came out long term rates went up because it was perceived to be inflationary so it had the opposite impact on short term. Mr. Dent does not believe there will be a QE3 as long as we are seeing positive growth, albeit at a slow pace. He pointed out Europe has received the equivalent of a

QE3 with the European Central Bank backing up the banks with a very large loan facility, but Europe is in much worse shape financially than we are in this country.

Mr. Medrow commented Quantitative Easing is a code word for printing money by the Federal Reserve Board and expressed concern about the “twist” and the inflation associated with it.

Mr. Dent stated that is why the bond portfolio is as short as it is to avoid having long term bonds at today’s rates. Inflation will drive up interest rates and that will drive down bond prices.

Chief Fonock asked about the trends for the upcoming months. Mr. Dent responded by referring to a study by Professor Kenneth Rogoff and Professor Carmen Reinhart, titled, “This Time is Different: 8 Centuries of Financial Folly.” Their conclusion was a recession can follow monetary tightening by the central bank, but when a recession followed a financial crisis, the recovery from that recession was very slow and extended for a long period of time at a low recovery rate. Mr. Dent indicated the reason for that most likely is the recession brought on by a financial crisis was caused by excessive debt and excessive leverage so it took a longer time after those recessions to recover. What we are seeing in this country is just following that pattern exactly.

Mr. Dent indicated that 2013 has some troublesome prospects including the expiration of the Bush tax cuts and the increase in unemployment benefits. Mr. Dent predicted there will be some fiscal restraint on spending no matter how the election turns out. At the same time there will be higher taxes in some way, shape or form. He predicted 2013 is going to be a real challenge for sustained growth.

<u>NEW BUSINESS:</u>

Sgt. Andryko raised the possibility of ICMA offering 457 Roth account. Mr. Wagenmann responded ICMA will be for the 401(a) or deferred comp.

Chief Fonock commented it is his understanding if a Roth 457 was instituted there are no or less income restrictions versus a Roth IRA. Mr. Wagenmann responded follow up will be made with ICMA to find out more information as to procedure and bring them in for a presentation. There is no cost to the township.

On behalf of the contract committee, Sgt. Andryko asked at some point for an update if there is any off duty contribution into the pension fund.

<u>ADJOURNMENT</u>

With no further business to come before the Board, it was moved by Chief Fonock, seconded by Mr. Mallon, all voting “Aye” to adjourn. None opposed. Motion unanimously approved and the meeting was adjourned at 6:44 p.m.

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Alfred E. Santoro, III
Board Liaison

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Minutes Approved:
Minutes Entered: