

PENSION ADVISORY BOARD/HEALTH & WELFARE BOARD OF TRUSTEES
MARCH 13, 2013
QUARTERLY MEETING

The Pension Advisory Board/Health & Welfare Board of Trustees, met for their Quarterly Meeting on Wednesday, March 13, 2013, 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: Supervisor Greg Waks, Board of Supervisors Liaison; David Kravnik, Township Manager and Secretary; Nick Hiriak, Finance Director; Chief Tom Nolan, Vice Chairperson; Eric Medrow, Chairman; Sgt. Andy Andreyko, Police Representative; Sudha Suryadevara, Non-Uniformed Representative.

MEETING MINUTES:

It was moved by Chief Nolan, seconded by Sgt. Andreyko, all voting "Aye" to approve the January 16, 2013 Reorganization Meeting Minutes as submitted. None opposed. Motion approved 5-0.

PRESENTATION BY DANIEL F. DENT, DF DENT & COMPANY, INC. RE:
POLICE PENSION PLAN AND FUND

Mr. Daniel Dent, Investment Manager, presented the performance report for the Upper Merion Township Police Pension Plan dated March 13, 2013. Highlights are as follows:

- For 2012 the account had a total return of 11.92%, Equities were up 16.57%, S&P up 16%, and Fixed Income beat the Barclay's Government Credit Index. All of these numbers are net of fees.
- In looking at the Equities in the last three years there have been good markets, the Equities total net of fees on an annual basis was up about 14 ½ %, about almost 4% per year better than the S&P.
- The five-year numbers that include the market decline in 2008 still reflect nice returns both in equities and in the bond market.
- At the beginning of 2012 the value of the pension plan was \$36 million and it ended the year at \$38.9 million. As of the week of March 4, 2013, the Plan is slightly over \$40 million which brings it up another \$1,500,000 for the last three years.

Mr. Medrow asked if the additions, withdrawals and expenses include the

amounts being paid to retirees. Mr. Dent responded in the affirmative. He pointed out the five-year number incorporates the severe market decline. At the end of 2007 before the decline of 2008 the Plan was at \$36 million, \$7 million was withdrawn, and with interest, dividends and capital gains has been in excess of \$9 million.

Mr. Medrow commented it is good to note that the gains and income from interest and dividends continues to be more than withdrawals from the Plan.

Mr. Dent stated the present value of the liability has increased significantly with the lower interest rates which is what all pension plans are fighting. He said future benefits are discounted back at a lower interest rate which means that the present value is more; therefore, the present value of the liabilities is going up because of low interest rates which are common with all pension plans.

Mr. Dent reviewed the best performing stocks and the lowest performing stocks in the portfolio. The ten highest as a group contributed 9.83 and the ten poorest performers as a group had a negative 1.58.

Mr. Medrow pointed out there may have been some buy programs on some of these as well and that may throw off the figures somewhat as well.

Mr. Dent explained the table on pages 10 and 11 of the report. Highlights as follows:

- The first column reflects percentages for the equities, the second column is the Standard and Pores 500 with a comparable analysis and the third column represents what contributed to the better return or what was a drawback on the better return.
- There are 10 sectors in the S&P
- Strongest performing sector was technology which was the second largest sector within the portfolio
- The largest within the portfolio was the General Industrial category, but the weighting under Information Technology was 23 ½ % average over the course of the year. Those stocks were the leading performers of the return on that group which was over 30% - almost twice the return on the equities in the portfolio.

Mr. Medrow asked if Fastenal is still a large holding within the portfolio. Mr. Dent responded in the affirmative. He indicated they are holding Fastenal and if there is any weakness in the market, they will buy. They bought some last year when it was available in the mid-to-low 40's and it is back over 50 now.

Mr. Medrow asked about the total holding within the Fastenal account. Mr. Dent responded it is 8.2%.

Mr. Medrow commented typically an investment advisor would try to keep the holdings below 5% of any one particular stock in order to meet diversification, but because Fastenal has performed so well, the Pension Board specifically asked Mr. Dent in the past that he may hold stocks that have performed well in order to go over the total balance between stocks and bonds because of the tenuousness of the bond market. This is one of the reasons why DF Dent has been going over the 5% limitation on that particular stock.

Mr. Dent indicated last year when the market was up 16%, Fastenal's return last year was 10%, but the two preceding years it was very strong. It was up 40% each of the two years in 2010 and 2011.

Referring to the bar chart on page 12, Mr. Dent stated the largest sector is Industrials representing 28% of the group and the second largest is Information Technology at 25%. The first four (Industrials, Information Technology, Financials, and Health Care) are overweighted; therefore, it is necessary to be under weighted in the remaining sectors.

Mr. Medrow asked for clarification on the financials. Mr. Dent responded the financials in the portfolio are not the kind of stocks that are in the various benchmarks. The portfolio does not contain any banks, but rather one insurance company, Markel Corp., which is a very conservatively run company that has had an excellent return over the years. Also in the financials is Fiserv which is a service company to the financial industry, and T. Rowe Price is another one. Mr. Dent pointed out these are not companies that are heavily leveraged and have assets that could suffer from severe impairment. It is a very untypical group of financials and is a risk averse group.

Sgt. Andreyko asked if Real Estate Investment Trust (REIT) would be in that category. Mr. Dent responded in the affirmative.

Mr. Medrow asked if any REITs are being carried. Mr. Dent responded in the negative. He stated the financials in the Plan are Markel Corp., W. R. Berkley Corp., T. Rowe Price, Ventas, Inc., America Tower, and SEI Investments, which was added a little more than a year ago.

Mr. Dent explained the bar chart on page 13. He pointed out the Large Cap is 56% of Equities, Mid Cap is about 40% of Equities, and Small Cap is 4.03%. Mr. Dent indicated that given the strength in many of these stocks in the last year quite a few have graduated from Mid Cap to Large Cap. The arbitrary number DF Dent uses to determine large cap is \$10 billion and above. Referring to the Market Capitalization column for Large Cap (reading up from the bottom), O'Reilly Automotive is at the bottom with 10.1 and then Range Resources is at 10.2. The first five when reading up from the bottom of the Market Capitalization group are just barely into Large Cap and have within the last year or two graduated into Large Cap and are now over \$10 billion.

For the benefit of new members, Mr. Medrow asked for an explanation of Market Capitalization. Mr. Dent responded each number under Market Capitalization for the companies represents the total value of that company in the market place. The largest one is Johnson and Johnson with a \$194 billion Market Cap.

Mr. Medrow followed up and indicated it is the number of total shares outstanding times the market prices.

Returning to his explanation of page 13, Mr. Dent stated the names at the top are most familiar since they are the larger companies and the companies down at the lower end are not as familiar. He pointed out it is important in managing the portfolio to recycle some of the money from the companies that have done really well into the ones that are anticipated to do better going forward. Mr. Dent indicated it is balanced between Large Cap and Mid Cap within this portfolio.

With regard to Equity Sales on page 15, Mr. Dent noted about 7,000 shares of Fastenal were sold all over 50. Fastenal was getting to be too large a portion of the portfolio and it had to be cut back. Mr. Dent stated while Fastenal is still too large a portion, he does not like to keep selling it at the same price because the company is continuing to grow.

Mr. Medrow asked if there is a specific sell program. Mr. Dent responded in the affirmative. He said when it [equities] gets up to 8% of the portfolio which is where it is now. He pointed out since 7,000 shares have already been sold at \$350,000 which is almost a percent of the portfolio he will wait awhile to sell more and that is what has been done with Fastenal.

Mr. Dent stated in the investment program there is a ceiling in equities of 55%; however, the Pension Advisory Board has indicated not to arbitrarily cut back if all the companies are doing well. He noted the equities are now at 65% to 66%, and he thought about cutting the portfolio from 65% down to 60% at the end of the second quarter and then at the end of the third quarter down to 55% or so.

Mr. Medrow pointed out there is only one problem with that scenario. He said if equities are cut back at 60%, there are three basic asset classes – cash, bonds, and equities. Cash is earning less than 1% if at all. Bonds are down at 1 ½% so as an asset class where do you go. Mr. Medrow noted the 55% ceiling in the investment program was done because of concern over the bond market. Mr. Dent stated the question is how much further can the equities be weighted. He pointed out because of the retiree and pension obligations; there is generally a lower risk profile. He said equities have been great for the last four years, but it could turn.

Mr. Medrow commented historically the risk profile was such that there was a lesser risk in bonds, but that is not the case now. He pointed out we now have a greater risk in bonds and that is why the change was made last year allowing equities to go up. He reiterated the question and asked in going out of equities, into which asset class do you go. Mr. Dent responded since there is no return in cash, the maturities would be laddered in very short bonds. He said now that we have the incremental \$1,500,000 in equities within the last year, the idea is to take some of that back. Mr. Dent suggested going back with the equity percentage to the ceiling which is 55% over the course of the year.

With regard to laddering of bonds, Mr. Medrow explained bonds have a fixed maturity and laddering them simply means sequencing them out with their maturities so that there will almost always be something coming due maturing within a two or three month period.

Mr. Medrow pointed out when laddering bonds or looking at the purchase of bonds, you are buying it with a very low interest rate. If the interest rates go up, the price of bonds will come down and money is lost. He emphasized we do not want to do that. Mr. Medrow said the only way you cannot lose money in bonds is to hold them to maturity at which time you receive 100 cents on the dollar. If a bond is sold any time prior to maturity date at market value there is a lot of risk and the possibility of loss because bonds may be priced much lower because of interest rate fluctuation.

Mr. Dent commented this is the fifth year the market is up, an occurrence which has not happened too often. When the stock market is up everyone is enthusiastic and thinks everything looks fine and that is when one should be cautious. The idea of exiting a portion of the stocks and going into bonds at a very low return is intended for the preservation of capital. Mr. Dent stated we do not want to lose the gains we have by having 65% in stocks versus the investment guidelines of 55%.

Mr. Medrow stated the key point is laddering the short term bonds.

Returning to the discussion of equity sales, Mr. Dent stated Fastenal, Techne Corp, Gardner Denver and Idexx were sales of securities that have all done well and have been cut back. In the case of Ultra Petroleum and Sodastream they had not done well and were exited.

Referring to the bar chart on page 16, Mr. Dent indicated these are capital flows in the Pension Plan for the last 20 years. The market value of the portfolio at the end of 1994 was \$14 million plus and each year since it has grown. The cumulative withdrawals over the 20 year period amounted to \$17.7 million against a portfolio that started at \$14 million and is now over \$40 million.

Mr. Kraynik asked if that was net of everything. Mr. Dent responded in the affirmative.

With regard to the Bond Market Analysis on page 17, Mr. Dent stated the Upper Merion Fixed Income Average Maturity as of the end of last month compared to the Barclay's Government Credit Index, was considerably less and represents a significant variance from the benchmark. The last half of last year when interest rates went down we underperformed because of being very cautious a little too early. Mr. Dent noted; however, if and when rates go back up the Plan is very defensively positioned since there are no long maturities that would suffer from an increase in interest rates and bring the prices down.

Mr. Dent stated the Modified Duration is another measurement of the volatility and indicates what the performance of the bond would be for a 1% change in interest rates. He pointed out if interest rates went down 1% and the prices went up it is hard for them to go down 1% because they are already less than 1%; however, negative interest rates have occurred in the past. Mr. Dent explained the duration means if rates went up by 1% there would be a 2.3% loss in the portfolio which would give a negative return. The Yield to Maturity is better than the index because in corporates the index is very heavy in US Treasuries and we do not own treasuries because the returns are so horrendous. Mr. Dent also called attention to the Sector Allocation, and pointed out the index has 53% and 7% in Treasuries and Government Agencies respectively and the Police Plan has zero in that the Plan is heavily weighted in corporates.

Mr. Medrow commented treasuries would be a very difficult investment at this time and we are out of treasuries completely. He said with 87% in Corporates there is a little more room to move one way or the other and the 13% in Variable Rate Bonds are the "inflation bonds."

Mr. Dent commented those are the variable rates and most of them are known as "step ups." When the bond came out, it had a relatively low interest rate of about 1%, but every half year depending on which bond it is, the interest rate steps up and it keeps going up. Those bonds are callable and if rates in the markets go up there is some buffer of protection. If the coupon goes up faster than what is going on in the market, the issuer will call them and that is the disadvantage.

Mr. Medrow asked for clarification about the call features. Mr. Dent responded the "step ups" have call features. The good thing for investors is a bigger coupon interest rate and the offset to that is if the issuer wants an out they can call it.

Referring to page 18 and 19, Mr. Dent stated there were more purchases and sales of bonds last year than we normally have since these bonds are all very short term and these are simply maturities.

Mr. Dent discussed the Fixed Maturity Distribution on page 20. Of the total bond portfolio, \$3.6 million matures within the next year and then \$5.3 million in the following year. The longer term bonds are a little less than \$1 million.

Mr. Dent explained the benchmark for the securities on page 21 and the bar chart on page 22 which shows what the return would be on the portfolio for given changes in rates.

Mr. Dent stated the bond market returns will stay very low, but the bond market valuation mechanism with bond market investors is such that if there is the prospect of increasing rates, the bond market will sell off before it happens. The bond market does not wait for the Federal Reserve to say we are increasing rates by half a percent then all of a sudden the next day sell off. This is why everyone analyzes in excruciating detail what the Federal Reserve Chairman has said. There is a lot of analysis of his comments and what the leaning is because the bond market investors want to anticipate what will happen before it happens. For the next year, Mr. Dent indicated we are okay with interest rates, but in looking at a year from now it is likely the bond market could then anticipate discount rates going up in late 2014 and then it could get quite weak.

Mr. Medrow asked what could cause that to happen. Mr. Dent responded a strengthening of the economy would be the main thing. More investment and more capital expenditure in the economy would cause interest rates to go up.

Mr. Medrow commented if interest rates go up the interest rates also goes up for the government which means the deficit would go up tremendously.

Mr. Dent stated this is the problem. The news about the sequester is \$85 billion is the number that has been floated around. Some people think they will work out a deal of \$45 to \$50 billion. The Federal Reserve and the Treasury have done the financing at the short end because they are not paying anything. They are paying 1/8th of a percent so the U.S. Treasury bond portfolio is heavily weighted at the short end. If interest rates go up by 1 percent it would mean that short interest rates would be at 1.1% which is still well below historic levels and that would cost of debt would be \$170 billion just from interest rates going up.

Mr. Medrow commented it behooves the Treasury Department to keep those interest rates very, very low.

Mr. Dent commented the Federal Reserve can do that with short term interest rates by simply buying bonds all the time and they have been doing that for the last two and a half years, but the Federal Reserve cannot really control long term rates. They can control short term rates, but not long term. Mr. Dent emphasized this is a "time bomb" waiting to happen with accounting costs on the debt. It is not going to happen this year and probably will not happen in early

2014, but it is out there. It is serious because the increase in the cost of carrying the debt is multiples of what the whole sequester is. The sequester is insignificant compared to the much bigger debt problem.

Mr. Medrow commented with all the QE programs we have seen in the past and with more anticipated in the future more cash will go into the economy and cause a greater strain as well.

Mr. Dent stated if the Treasury then has to borrow at higher rates at some point down the road they are going to also have to borrow in the mid term and in the long term and the increase in the carrying cost is going to be tremendous. It just gets bigger and bigger as the deficits continue.

Mr. Medrow said that is why we have to be very cautious about any money going into the bond market or into the cash market and that is the major reason why the equity market is going up, because people have no place else to go with their money.

Mr. Dent stated as long as we are in high quality short-term bonds that are going to pay off at maturity there will be good returns; however, there will not be the kind of returns overall that we have had in the last year or two. With the valuations there have been with the run of the prices it is incumbent to have additional emphasis on the preservation of capital. Mr. Dent stated there will be changes by mid 2014. He said the capital flows in the last three years have been very heavy into bond markets at the expense of equity markets. The Investment Company Institute comes out with weekly numbers and there is a continual increase in flows of money into bond markets and out of domestic equity markets. It has turned in the last two months after four years of this pattern. In looking at the mutual fund flows more money is coming out of equities. In the last two months it has reversed, money is going into equities and there is a certain cumulative effect of that and investors see that they are not making money in bonds which was not the case before this year when they were doing well. This year money is being lost in bonds and the stock market is up 8 or 9 percent. Investors collectively want to get in and not "miss the boat" so the money is starting to flow back into equities. He emphasized we are okay for equities.

Mr. Dent stated it comes down to the investment program and how much goes in equities and right now we are 10% over the ceiling. Given the money that is coming into the equity market, corporate earnings are quite good and corporate balance sheets are strong. It is okay for the time being, but Mr. Dent's concern is that it does not go on forever. He said caution should be exercised with an increased emphasis on preservation of capital.

Mr. Dent stated he does not want to see profits erode. He said the outlook for the equity market for the next year going into next summer is pretty good and

by that time there will be the likelihood that interest rates will increase which will have an impact on the bond market, but not on the stock market. If it goes to 1 ½% it is because the economy is strong which would be good for the stock market.

Mr. Medrow commented we have about a 7.7% unemployment rate which is more than is considered adequate for a growing market. He said there is less than 2% growth in the GDP and as of now we do not have a growing economy.

Mr. Dent said the economy is growing very slowly from the steep recession we had in 2008/2009.

Mr. Dent stated there are a number of things going on that are going to favor US Equities versus outside the US and the rest of the world. There has been a significant improvement in productivity in this country which is part of the problem with the unemployment rate. When there is an improvement in productivity, that industry does not need a lot of new workers and that is a contributing factor for unemployment. Conversely, it is good for ownership of companies because they become more productive and more efficient. In addition there has been in the last four years against our “basket” of currencies of our trading partners about a 20% decline in the dollar. Another significant development is what is going on with energy. The International Petroleum Agency has estimated that the United States will be completely energy independent by 2020. Our net imports of petroleum products in the last four years have gone from negative \$22 billion to \$11 billion. It has been cut in half in the last four years. The increased drilling for natural gas is changing many industries. For instance the chemical industry that is a big user of natural gas is now going to be at a competitive advantage because of the cheap energy sources. This is something that is going to go on for a while and between the weakness in the dollar and the improvement in productivity and the significant shift in energy, we are going to have cheaper energy in this country. In Mr. Dent’s view, US Equities relative to the rest of the world will look quite good.

Mr. Medrow commented the question is not going to be getting the energy up from the ground, but rather distributing it and that is the real barrier in terms of exporting our energy to other countries.

Mr. Dent agreed and said one of the investments in the portfolio is Quanta Services, Inc. which builds pipelines. There will be more building of pipelines as liquefied natural gas is exported. Liquefied natural gas (LNG) is really natural gas that is cryogenically frozen into a liquid state, and in order to export LNG tankers must be built as well as terminals. Contracts are being let out now and this is a significant infrastructure development in terms of ships, terminals and pipelines which is all very favorable for us. Energy costs which had been a big problem five or ten years ago, is now at a competitive advantage which means that US Equities will do quite well.

Mr. Medrow commented going into the drilling of natural gas may not be the best for the investment dollar because with all the new technology it will keep the price of natural gas down. Money will be made in the way the natural gas gets from the field to Europe at \$8. If there is an \$8 market in Europe as opposed to \$2 here, it needs to be exported but it cannot be done without a distribution system.

Mr. Dent reiterated the International Petroleum Institute indicates in 2020 we will not have to import our energy from the Mid East. That has all kinds of repercussions internationally and diplomatically. But this is a megatrend and what is going on with energy. It will be very different and is something that is going to go on for decades.

A question was asked if the Pension Board has to vote on Mr. Dent's recommendation to start the segue into some more bonds. Mr. Medrow responded in the negative and said that was done last year and we are okay as long as he is up to our limit.

Mr. Dent explained the way his firm normally manages accounts is they have investment guidelines and most committees say do not violate the guidelines. He pointed out the Pension Advisory Board provided the latitude for his firm as to how far do to stretch beyond the 55%.

Mr. Medrow stated DF Dent has been given an investment policy statement and in that statement it is spelled out what they can put into equities and what can be put in bonds. It was noted that the policy has not been looked at in awhile.

Mr. Kraynik stated the investment policy statement should be looked at every couple of years, and Mr. Medrow agreed.

OLD BUSINESS

Mr. Medrow stated a policy was established at the last meeting to provide Pension Advisory Board meeting dates for the rest of the year to assist Board members in notating their schedules accordingly. (note: next meetings will be held on Wednesdays, July 10 and November 13 at 5:30 p.m. (Dan Dent will provide his presentation at the November meeting)).

NEW BUSINESS

None

ADJOURNMENT

With no further business to come before the Board, it was moved by Chief Nolan, seconded by Mr. Kraynik, all voting "Aye" to adjourn the meeting 6:38 p.m.

David G. Kraynik
Township Manager and Secretary

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Minutes Approved:
Minutes Entered: