

PENSION ADVISORY BOARD/HEALTH & WELFARE BOARD OF TRUSTEES
MARCH 11, 2015
QUARTERLY MEETING

The Pension Advisory Board/Health & Welfare Board of Trustees, met for their Quarterly Meeting on Wednesday, March 11, 2015, 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 and Trustee; Nick Hiriak, Finance Director; Eric Medrow, Chairman; Sgt. Andy Fidler, Police Representative; Sudha Suryadevara, Non-Uniformed Representative, Thomas Minger, Jr.; Sara Evans, Human Resources Director. David Kraynik and Chief Tom Nolan were absent. Phil Fogli, a resident, was present at this meeting.

MEETING MINUTES:

A motion was made and seconded, all voting "Aye" to approve the January 14, 2015 Reorganization Meeting Minutes as submitted. Motion unanimously approved.

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

Mr. Daniel Dent, Investment Manager, stated the most important consideration for this pension committee is the status of the current fund versus funding requirements going forward. He noted Thomas J. Anderson & Associates, Inc. will be providing an actuarial report by mid-2015. The previous report is dated as of January 1, 2013. The portfolio has a market value of approximately \$44 million and the present value of the benefits is approximately \$41/\$42 million. Depending on whether market value or smoothing value is used the plan is between 92 to 100 percent funded. Mr. Dent suggested the Pension Advisory Board look at the fact there is an 8% assumed rate of return making the balance of the portfolio quite a challenge given the low level of interest rates and the fact we have now completed six years of a stock market recovery. Obtaining the returns such as we have enjoyed in the last five to 10 years is going to be challenging going forward.

Mr. Medrow asked if the aforementioned \$44 million figure is as of the January 1, 2013 actuarial report. Mr. Dent responded in the negative and indicated the \$44 million is the current market value as of today or the end of last

year which is about the same. Mr. Dent indicated the actuarial report will reflect good returns which have increased the funding of the plan, but going forward there currently is a balance of 70% in equities and 30% in fixed. Because of current interest rates Fixed Income markets are not providing very good returns so the 70% in equities which is at the highest level it has been at in years has been allowed to creep up in order to try to get close to the 8% overall return. In other words, the bond portion in round numbers is 30% of the portfolio and is only returning about 3%. In order to get to 8% the 70% in equities has to work really hard going forward.

Mr. Medrow asked if there is the likelihood of a hike in interest rates this summer. Mr. Dent responded in the affirmative. Mr. Medrow commented with that looming over us it is definitely something we have to look at in terms of the 70/30% issue. Mr. Dent stated the fixed income portfolio is structured in anticipation of that scenario. He noted Mr. Morrill will go through some of the metrics and details of the portfolio.

Mr. Dent presented the performance report for the Upper Merion Township Police Pension Plan dated March 11, 2015 which is sequenced in terms of equities and bond market by size of position. The first listed positions are the largest positions and the smallest positions are at the end of the Fixed Income and Equities. In Fixed Income there are a lot of the \$200,000 to \$300,000 position sizes and represent anywhere from .4 to .7 or .8% of the portfolio which is a very small portion. The reason for this is that many of these holdings are bank CD's which are backed by the FDIC which is the full faith and credit of the U.S. Government.

Mr. Medrow asked about the farthest out maturity, and Mr. Dent responded it looks like four years out at 2019 for the CD portion. Mr. Dent said one might look at this and say these positions represent .5% of the portfolio and seem very small. The reason for that is in looking at the yields at 1.6, 1.8 or 1.3; we are getting 50 to 70 basis points more yield out of CD's than with comparable maturity treasuries. In this environment of very low yields there will be many small positions in CD's. Mr. Dent pointed out the CD's have a face amount of less than \$250,000 which is the government insurance so the face amount of \$240,000 in these CD's include the accrued interest and the principle and interest which are both covered by the insurance. D. F. Dent would rather get larger positions and not have so many positions and by using these instead of comparable credit quality treasuries we are getting approximately 40-50 basis points more yield. While this may not sound like a lot of yield every little basis point that can be obtained in this low yield environment counts. With regard to the Equities starting out with Visa which is the largest single position, it is going to be splitting 4 for 1 next week. It is at a position size which would probably tend to be reduced going forward because it is such a large position. The current value is approximately 4 ½ times the cost basis which is 6% of the portfolio and we would probably want to reduce it.

With regard to the performance on page 5, last year the portfolio's total return including the Fixed and the Equities was 4.66% annually, for the last three years it was 9.21% and a little over 10% annually for the last 5 years. Mr. Dent pointed out for the last 3 years and the last 5 years it has exceeded the assumed rate of return of 8%; however, it did not exceed that last year. Last year was a low return for the equities and for the portfolio. Combined with the year 2013 when the equities in the portfolio were in excess of 25%, those two together provide a very high rate of return. Mr. Dent pointed out the markets do not necessarily operate on a calendar year basis. In 2013 there were very strong markets and the portfolio's equities had a very strong run.

Mr. Medrow asked how much of the Fixed Income portfolio is in treasury bills, bonds and notes. Referring to page 17 of the report, Mr. Dent responded there is zero in Government Agencies and the benchmark of the Barclays Government Credit Index has 7%. Treasuries are also at zero with a benchmark at 53%. To be an indexer would be a monumental mistake with approximately 50-53% in treasuries, but the way to get around that is what was said earlier about the CD's. We are getting comparable maturities and more yield out of the CD's going from last fall at 14% in CD's to 17% in CD's versus 0% for the benchmark.

Mr. Medrow asked about corporate fixed income. Mr. Dent responded corporates are presently at 73% versus 35% on the benchmark. The portfolio is double weighted in corporates thereby providing the spread and more yield. The portfolio like most portfolios is experiencing a scarcity of income. In order to get income it is necessary to extend maturities which would be the wrong thing to do in the face of increased rates.

Mr. Medrow asked how income compares with what is needed to cover benefits. Mr. Dent responded the draw out is a little less than 5% of the portfolio to meet annual requirements. The monthly amounts have recently been approximately \$160,500 which is close to \$2 million a year. The \$2 million is against the \$44 million, which is a little less than 5% annually of the market value which is an achievable and realistic level to sustain the portfolio. Mr. Dent indicated his concern is the 8% requirement year after year.

Mr. Minger asked what is more realistic than the 8%. Mr. Dent responded a projection to about 7 ¾% has been submitted for the GASBE 45. Mr. Minger commented that it still too high. Mr. Dent commented it is very difficult to get to 8% with 70% equity and 30% fixed balance. The equities have 11-12-13% returns. He said after six years of a bull market that is asking a lot because after six years of this market the equities do not grow forever. If it were March of 2009 it would not be as difficult.

Mr. Medrow commented the problem with trying to move from the 8% is the township is going to have to come up with the difference. The 8% is an immovable object at this time. He said he is pleased to see that on the smoothing side we are 92% covered.

Mr. Dent indicated the higher number is on the smoothing the lower number is on the market value. The market value is based on the two-year old actuarial report, but that is good because we have had two very positive years. The market value is 87% on the report and the smoothing is 97%. He anticipates the next actuarial report will be very close to 100% on the smoothing basis.

Referring to page 7, Mr. Dent indicated the overall portfolio had a 19.3% return in 2013 and a 4.48% in 2014 versus 8% a year assumption, the plan as of January 1, 2015 should be about 90% and 100% funded on a market value and smoothing basis respectfully.

Mr. Medrow asked when the next actuarial report is due, and Mr. Hiriak responded it should be ready by mid-year.

Mr. Dent referred to the quote from the Anderson actuarial analysis about the Upper Merion Township Police Pension plan as "one of the best in state." He said because of the large percentage the portfolio had in equities relative to other municipal plans he thought its relative position is even stronger though it might be slightly underfunded.

Mr. Medrow asked if there is any danger of the equity position forcing the sale of the higher priced securities to bring us down from the 70% level. Mr. Dent responded his latest instructions are when equities are bought an equal amount of equities are sold. He said we do not put new money into equities because we start at 50% and over the years can go to 55%, 60% and 65% with some latitude to move up. He interprets the instructions as the 70% as a hard limit on equities unless the Pension Advisory Board wanted to make a change it is not protecting the portfolio from a downdraft in the market.

Mr. Minger commented in looking at the equity side we are at the point where it is time to start asking about the overweight of equities that served so well in the past and at what point it becomes a liability where the only potential on the fixed income side is super short duration bonds. He asked if there is a way to potentially balance the equity exposure and protect the downside by extending the maturities. Mr. Dent responded that is what has been done. He said some of the CD's mature in 2018 and 2019 and pointed out six months to a year ago the maturities were under two years.

In response to a question, Mr. Dent indicated there is the likelihood of an increase in rates sometime in June which would suggest on a short term tactical basis not to extend maturities.

Mr. Minger commented equities drop quickly and the funding number can vanish and that is why he viewed the 30% as a saving grace right now.

Mr. Dent commented as an investment manager he cannot speak for Anderson but he believes their response would be this is a 25-30 year pension plan not only for current but also future retirees who have joined the police force recently. In terms of 30-year returns not so much will happen with short term market volatility because the ultimate obligation is in the long term. In looking at the historic returns of stocks and bonds and given the 8% "bogey" you would have to have a high percent in the equities.

Mr. Medrow stated the 60/40% split was originally placed into the investment policy statement years ago and did not anticipate today's market, the QE policies, or the long-term low interest rates. It was fortuitous that everything possible was done to allow DF Dent to go to 70% because we could always have a balance in asset allocation between equities and bonds.

Mr. Dent commented he did not intentionally go to 70% but reached that point in 5% increments. He pointed out the 70% is \$31 million of the total cost basis which is \$14 million and the portfolio has benefited not so much from DF Dent solely, but from a doubling in the value of the equities consisting of some big holdings such as Visa and Fastenal which have made the difference in the portfolio. Without the first 15 stocks in terms of size within the portfolio the big gains would not be there.

Sgt. Fidler asked if the smoothing numbers come down if we do not make the 8%. Mr. Dent responded in the affirmative. Sgt. Fidler commented that changes the funding levels and if the officers are "maxed" it would theoretically change the township's funding responsibilities. Mr. Medrow responded in the affirmative and said if we do not go to 8% then the township must come up with the shortfall.

Sgt. Fidler pointed out a big jump in retirees recently occurred, but a period is approaching where no one is going to retire for several years.

Mr. Minger asked about the assumed life expectancy on these figures. Mr. Dent responded Anderson would have that information.

Mr. Dent commented many years ago during the strong returns in the 1990's spousal benefits were voluntarily increased substantially from 50% to 100%.

Mr. Medrow asked if there is any type of credit quality risk on the CD's. Mr. Dent responded in the negative and cited the safeguards of the FDIC and FSLIC.

Referring to page 6, Mr. Dent pointed out one year ago the plan was valued at \$44.0 million. The current value of the Upper Merion Township Police Pension Plan is \$44.3 million after paying out almost \$1.9 million in distributions. The markets have been good to the underlying assets in the plan; however, he does not anticipate this going forward.

Mr. Dent discussed the long term progress of the plan starting 20 years ago. In 1994 the market value of the plan was \$14.4 million and is now at \$44.3 million. Over the 20 year period \$21 million has been paid out in total. Payouts have increased in recent years and they are currently at a \$2 million level.

Mr. Dent noted during the down year of 2008 the portfolio did not experience a permanent loss of capital but continued to grow. Many of the large banks and institutions saw a permanent loss of their capital as various loans and mortgages became worthless. Companies in the portfolio went down, but their operations were solid and they came out of it as strong as they were before.

Michael N. Morrill, Portfolio Manager, D. F. Dent & Company, discussed the highest five performers and the lowest five performers. 3D Systems Corporation, one of the lowest, is a 3D printing manufacturing company and in 2012 and 2013 they had phenomenal years in terms of performance. In 2013 this company was up 161% and was trimmed in the fall of 2013. In January 2014, the valuation on 3D Systems became excessive, but was not eliminated since it is a good name for the portfolio and because 3D manufacturing is in its early stages. In 2014 the mistake was not exiting positions when the valuations became excessive. Mr. Dent noted in our history this is rarely ever done. If a really good company is found that has the potential to grow over the long term and has a great management team it will be trimmed when valuation gets excessive. But if we had gotten rid of that name it probably would not have been bought back. D. F. Dent tends to hold onto really good names for a long period of time. Another point made about 3D Systems in 2014 which is analogous to other names in the portfolio that held us back is they announced they are going to elevate their R&D spending and launch 24 new products. When they delayed their profitability it hurt the stock and caused them to miss two quarters.

The second instance for the underperformance that hurt the equity portfolio almost as much was the fact that the stock market was rewarding large cap blue chip dividend payers that were almost being bought as bond substitutes because of the high dividend they paid. Mr. Morrill pointed out this is not what D. F. Dent invests in as they are growth managers. Their large cap portion of the portfolio is much lower than the S&P 500. The mega cap portion of the S&P 500 top quintile is \$43 billion and above the market cap which represents 64% of the S&P 500. The portfolio is about 10-13% above \$43 billion and very different versus the benchmark.

Mr. Medrow noted there is not much investment in small caps and asked for clarification about the investment in mid-caps. Mr. Morrill responded D. F. Dent is an "all cap company" they want to be able to own a great company through the different market cap sites. It was noted small caps can be more volatile and it is not always possible to get experienced management teams to run those companies and caution is advised. This has been a smaller portion of the investment. With mid-caps it is possible to get professional management teams and great growth and these are allowed to grow into large caps. It was noted when these are grown to large caps at some point due to the law of large numbers the growth will start slowing down. The issue is whether to continue owning as growth is slowing and where do we want to exit.

Mr. Dent mentioned the portfolio contains large caps, i.e., Visa, but relative to the benchmark which is heavily weighted for mega caps, the portfolio is underweighted in mega caps. He pointed out mega caps tend to be in the mature phases of their life cycles because they have gotten \$200-\$400 billion market cap and the question is how much growth you can get from there. The great exception is what occurred with Apple.

Mr. Dent pointed out the investment in the portfolio for many years in Qualcomm which has not performed recently nearly as well as Apple. The strategy going in was that Qualcomm sells to all of the mobile phone manufacturers including Apple and has its own operating system – the Android system. The thinking is there was much greater diversification among the customer base than going with Apple 5-10 years ago. While that strategy did not work out, Mr. Dent believes it was the sounder strategy to have the broad-based mobile phone manufacture customer base. Qualcomm over that full period has done extremely well. It just did not do well last year because of some specific issues with the company.

Mr. Morrill discussed the additions to the portfolio for the one year ending February 28, 2015 and the names that were deleted. He highlighted the increase in exposure to the consumer and mentioned IMAX Corporation (IMAX theaters) and Signet Jewelers (Kay Jewelers and Jared). Mr. Morrill pointed out we are still underweight in the benchmark, but are much closer than before.

Mr. Morrill discussed some of the deletions which included Range Resources, Clean Harbors and Jacobs Engineering. He said we were underweight in energy beforehand and are now even more underweight on the energy side. Another deletion was for Concur Technologies which was acquired by SAP late in the year.

Mr. Morrill discussed the sector breakdown of the portfolio and noted D. F. Dent likes to keep an eye on this to make sure there are no underweight or overweight sectors versus the benchmark.

(After a brief audio malfunction, the audio resumed at this point in the meeting)

Mr. Minger asked for the perspective on the underweight in health care. Mr. Morrill responded health care is underweight for two specific reasons; some names get classified by S&P as industrials that are truly health care. An example is Stericycle Inc. which does the hazardous waste removal from hospitals and doctor's offices. Other examples include Health Care Services Group which does linen laundry care at nursing homes and hospitals and Roper which is an industrial, but has a portion of their business that directly caters to health care. Mr. Dent pointed out we are 50% in health care. Mr. Morrill stated the other reason health care is underweight is there are two health care names over the past two years that did very well in the portfolio over the long term that were exited and have not been replaced. One was Idexx Laboratories in excess of a 4% position (sells diagnostic equipment to vets) and the other was ResMed (makes the sleep apnea mask) and generators which is probably a 2.5 to 3% position. There is about 6-7% in the health care weighting that was exited and has not been built back in again.

Referring to page 14 under Additions and Deletions from the portfolio, Mr. Dent pointed out purchases have been made within health care such as Bio-Techne Corporation and Biogen Idec which is a biotechnology company that has been a very good performer since it was added to the portfolio three or four months ago.

Mr. Medrow asked about energy. Mr. Morrill responded in energy it is about 4.3% versus 9.7% for the benchmark.

Mr. Medrow asked about the thinking on the energy industry at the present time in view of all the turmoil. Mr. Dent responded it is probably going to stay depressed indefinitely into the future. He does not envision a quick rebound. There has been a significant increase in oil and gas production in this country as well as natural gas. Mr. Medrow commented many rigs are being shut down at the present time. Mr. Dent noted if prices come back up rigs will start operating again. There will be a continuous supply in this country which will keep prices down and it is not viewed as a growth industry.

Mr. Medrow said it will keep the prices down on the product itself and asked if there is an opportunity with all the ancillary infrastructure needed such as pipelines and railroads moving oil from one place to another. Mr. Dent responded he does not see it as an opportunity as long as there is ample supply in this country.

Referring to page 16, Mr. Morrill reviewed the large, mid and small market caps.

Mr. Dent discussed the Fixed Income on page 17 which gives some general parameters for the portfolio versus one year ago. He noted last fall we held close to 3 years of average maturity versus 8.2 for the benchmark. Currently the yield to maturity is 2.3 which is 50 basis points more than it was and is more than the benchmark even though there are shorter maturities. Mr. Dent pointed out we wanted to have the principle protection of short maturities but still try to get as much income as possible. The portfolio currently reflects more yield than the benchmark with less principle risk in terms of maturity.

(After a brief audio malfunction, the audio resumed at this point in the meeting)

NEW BUSINESS

OLD BUSINESS

Mr. Medrow stated the Executive Committee of the Pension Advisory Board consists of the Township Manager, Chairman of the Pension Advisory Board and the Chief of Police. The Executive Committee has been reviewing questions and commenting on them over the past few months. There are a set of questions presented to the Executive Committee by Mr. Phil Fogli which have not been addressed as yet. Once the next Executive Committee meeting is held previous questions will be combined with additional questions presented by Mr. Fogli and a full report will be forthcoming.

ADJOURNMENT

With no further business to come before the Board, it was moved by Mr. Minger, seconded by Sgt. Fidler, all voting "Aye" to adjourn the meeting 6:33 p.m.

David G. Kraynik
Township Manager and Secretary

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Minutes Approved:
Minutes Entered: