

PENSION ADVISORY BOARD/HEALTH & WELFARE BOARD OF TRUSTEES
MARCH 23, 2016
QUARTERLY MEETING

The Pension Advisory Board/Health & Welfare Board of Trustees, met for their Quarterly Meeting on Wednesday, March 23, 2016, 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; David Kraynik, Vice Chairman; Police Chief Tom Nolan; Eric Medrow, Chairman; Sgt. Andy Fidler, Police Representative; Thomas Minger, Jr.; Sara Evans, Human Resources Director; Daniel F. Dent, Chairman, DF Dent and Company; Mike Morrill, Vice President, DF Dent and Company. Mr. Nick Hiriak, Finance Director was absent.

MEETING MINUTES:

A motion was made and seconded, all voting "Aye" to approve the January 13, 2016 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, Chairman, D. F. Dent, discussed the performance of the Upper Merion Township Police Pension Plan as of March 23, 2016. Highlights as follows:

- Equities are down slightly and S&P is up slightly
- Portfolio had a total return of 1.10 for Fixed Income for calendar year 2015 which is almost 100 basis points better than the benchmark.
- On a year to date for this year the Fixed Income return is 1.19 and the benchmark is at 2.5.
- At the end of last year the 10-year bond closed at a yield of 2.4% and in the last few days it has been around 1.6%. Rates have gone down very significantly in February and there is a better performance in the benchmark.
- The defensive posture has been maintained which has not helped on a year to date basis but higher rates are anticipated going further out.

Mr. Medrow asked about the prospects for a further increase in interest rates. Mr. Dent responded his expectation is one further increase this year. Because of the weakness of the economic recovery, the Federal Reserve does not want to raise rates too fast.

Mr. Dent reviewed the equities 5-year rolling net returns versus S&P 500 and provided an idea of what is happening through cycles. Going back to the year 2000 there was a total of 16 instances where the portfolio equities underperformed the S&P 500. There was only one rolling 5-year period with negative returns for equities and 5 negative periods for the S&P.

It was noted in the last year there has been a little less than \$2 million worth of withdrawals in the police pension plan. Plan withdrawals have remained consistent with previous years. Going back to February 2015 there have been unrealized losses in the portfolio and the current value is \$41,261,844.06.

In reviewing the history of the plan, Mr. Dent pointed out the capital flows over the last 22 years have gone from \$14,457,114 to \$42,599,149 and the cumulative withdrawals over these same years amount to \$23,813,454.

Mr. Minger asked if DF Dent has an internal benchmark that is used for measuring performance. Mr. Morrill responded he deals with a lot of consultants and many of them use the Russell 3000 Growth Index. He said there is not a good benchmark for all cap growth equities and he has found the S&P 500 which this account has used since its inception is a natural and it is not desirable to change benchmarks too much. Mr. Morrill pointed out the Russell 3000 and S&P are probably two of the best benchmarks and it does not matter to DF Dent which one is used.

Mr. Medrow asked if Fastenal is still performing well and if it is being trimmed back. Mr. Dent responded Fastenal is being trimmed back slightly at this point. He said Fastenal has been in the portfolio for a long time and has been one of the very best performers. However, in the past two years the stock was very flat and did nothing. This year on a year to date basis it is doing very well. It was noted on the year to date both Fastenal and QUALCOMM have made comebacks as two of the best performers this year and conversely many good performers last year are not doing well this year.

Mr. Medrow asked about the percentage of the holding of Fastenal against the total value of the portfolio. Mr. Dent responded it is 3.45%.

Mr. Medrow mentioned it is still under the 5%. Mr. Morrill commented the average weight referred to on page 5 of the report is the weight of the equities. It does not take into account the fixed income portion of the portfolio.

Mr. Dent stated with the gain in Fastenal this year we are in a trim mode on Fastenal. He said it is a great company with great management. The negative with Fastenal is that having grown in size for so many years it cannot avoid the cyclical nature of the industrial economy which has not benefitted much from the recovery and is struggling to get back. It was noted Fastenal was growing at 30% 20 years ago and is approaching becoming a \$4 billion revenue company. Since Fastenal has to operate in a cyclical environment they cannot escape the industrial economy at that size.

Mr. Dent reviewed the Equity Sector weights versus S&P 500 Index. It was noted the first three sectors – technology, financials and industrials were overweighted and the remaining sectors are underweighted. Mr. Dent stated it is expected that the S&P which has ten different sectors will add real estate as the 11th sector and will include a lot of the REITs. The portfolio has a nice position in American Tower which already is within the real estate sector. Mr. Dent indicated there has been a tremendous increase in capital flowing into index funds (\$1 trillion) in the last three years in huge amounts out of mutual funds into index and ETFs which will have some significance and impact on American Tower. Those index funds are going to be forced to match the index and will be forced to go into these REITs. There is a huge amount of capital that will have to buy into the real estate sector dominated by the REITs. American Tower is the second largest REIT and it is expected that is going to be very beneficial for American Tower when that happens.

Mr. Medrow asked for clarification about American Tower and if it has been a recent decision that they be placed in an REIT. Mr. Dent responded American Tower going back a number of years was not an REIT. Mr. Morrill said the decision to make REITs its own sector was made about six to eight months ago. Mr. Dent mentioned American Tower received approval from the SEC and converted to a REIT from a straight regular C Corporation. As an REIT they have to pay all their earnings in dividends and continue to do that in order to maintain REIT status.

Mr. Dent commented once American Tower elected to become a REIT they no longer pay corporate taxes but make distributions to all their shareholders. Now that it is a REIT, shareholders are subjected to federal taxes unless the shareholders are a pension or non-profit. From a cash flow standpoint it has worked to the township's benefit because as a pension there are no taxes on the distribution.

Mr. Minger asked for additional clarification regarding tower companies and what this means as to their being dependent on the credit market moving forward. Mr. Dent responded tower companies are capital intensive and have always been dependent upon the capital markets to borrow as they are all very heavily leveraged. He said they can still continue to borrow to invest overseas. It was pointed out of the tower companies, American Tower has the most

exposure to international markets despite its name. The strategy behind all these tower companies has been to build more towers as the use of cell phones becomes more widespread and progress into more data and video intensive cellular communications which is much more intensive than voice.

Mr. Morrill stated in response to Mr. Minger's question, he believes on the margin their debt leverage increased slightly but for the portfolio it is probably one of the heaviest debt companies in the portfolio. He said DF Dent likes companies that are debt free and can use their own free cash flow to grow their businesses. American Tower has always been heavy on the debt side, but in terms of the broader scheme of the market he does not think they are that onerous because they have a range they maintain and there is nothing that should be of concern.

Mr. Morrill noted at the present time the portfolio does not contain any stock in the consumer staples, energy, telecom services or utilities sectors. He said as growth managers, consumer staples, telecom and utilities are sectors where they would rarely own stock.

Mr. Dent commented the complete absence of energy stocks has helped because it is a poor performing sector. The decision was made about a year ago to get out of energy and that has helped the performance in the last year.

Mr. Dent reviewed the breakdown by market capitalization. It was noted almost 70% is in large cap (companies with market capitalization in excess of \$10 billion), 22% in mid-cap and 4.8% in small cap.

In response to a question by Minger, Mr. Dent responded when they meet with company management they ask them at every meeting about their capital allocation. It was pointed out more and more the capital allocation decision is either reinvest in the company's existing operations, acquire other divisions, pay dividends or repurchase their stock which is in effect a way of returning capital to shareholders. DF Dent asks them about that consistently and wants to make sure they are making the capital allocation decision that makes sense. So many of the companies now are repurchasing stock rather than obtaining dividends.

Mr. Minger asked if DF Dent is happy with them buying back stock at elevated prices. Mr. Dent responded he would prefer to see them buying stock at a lower price for a given dollar amount, buy more stock, and shrink the capitalization more which means increasing the percentage. He pointed out each situation is different. For example, one of the small cap companies is Exponent that sells with a high valuation but that company generates more cash than they know what to do with. The question becomes do they want to pay it out as a dividend taxable to taxable shareholders or do they want to buy in their stock. They buy in their stock at a high valuation otherwise the cash accumulates and they have to pay it out to shareholders many of which are

taxable. They have the nice problem of generating too much cash flow and the problem of what to try to do with it.

Mr. Medrow asked if the repurchase of stock is very heavy at the present time. Mr. Dent responded in the affirmative.

Mr. Medrow asked what that says about where people think the market is going. Mr. Dent responded it reveals the management of these companies do not see the internal investment opportunities they once had, and with all the capital they have they are buying stock.

Mr. Medrow commented it sounds like a positive feeling about the market itself too. Mr. Dent responded he would say it is not a positive feeling about the uses of their capital either for internal reinvestments or for acquiring companies. As prices of all the companies have gone up many of these managements may come in and say there are targets they have that they would like to acquire but the prices are all too high. They find when they go through the calculations on the return on capital, they get a higher return on shrinking their capitalization so that each shareholder owns more of the company than buying an outside company. It does reflect less enthusiasm for buying other companies for acquisitions.

Mr. Medrow asked if a movement is still seen from the lower capitalization areas up to the larger capitalization. Mr. Dent responded in the affirmative.

Mr. Dent commented the increase in the market has lifted the valuation across the board which goes back to the Federal Reserve policy of quantitative easing which has pumped a lot of cash into the economy via the banking system. Banks have not used the cash for additional loans as the Federal Reserve would have liked but have held the cash which is swirling around in the economy and has found its way into financial assets, stocks and bonds and lifted the valuations. So quantitative easing has raised the value of financial assets but it has not increased lending to grow the economy.

Mr. Medrow commented one of his fears is that as unemployment comes down with all the fast money we are going to we are going to have to deal with inflation in a very serious way. Mr. Dent agreed. He pointed out DF Dent has not made too many changes until recently in the bond market. They have put 9% of the bond portfolio into TIPS (Treasury, Inflation-Protected Securities). At some point in the next three years or sooner we will see some inflation from rising wages that could feed into inflation.

Mr. Dent reviewed the fixed income portfolio composition. He pointed out the current average maturity has been extended out to 3.8 years, but it is still well below the benchmark. The maturity was extended late last year when rates were somewhat higher in order to capture some additional return. When looking at the

total portfolio against an 8% assumed rate of return it looks very difficult to get close to that 8% return now. As discussed in the past the maturities were extended slightly to pick up some additional income.

Mr. Dent noted the certificates of deposit are at 14%. He said these are much more attractive returns than comparable US treasuries and carry the same U.S. government backing as long as they are kept under \$250,000.

Mr. Medrow asked for more details on the reason for buying certificates of deposit since it would not normally be seen in a fully managed portfolio. Mr. Dent responded normally one would expect to see some kind of a spread on treasuries. He said the certificates of deposit have the same quality characteristics because they are guaranteed by the full faith and credit of the U.S. government. With certificates of deposit they are getting anywhere from 90-100 basis points better return than treasuries. With the same level of risk DF Dent wanted to get 120 basis points or so of additional return because the fixed income portfolio is getting a very modest level of return with a fairly short maturity and a higher quality. It is a rather unusual position to have but it is providing a better return than would otherwise be obtained.

With regard to the 8% assumed investment earnings rate, Mr. Dent commented almost all pension funds are using a rate of return that is higher than they are going to be able to achieve over time.

Mr. Medrow asked what would happen with a quarter of one percent change in the 8% bogey. Mr. Dent responded lowering the bogey from 8% to 7 ³/₄% would mean that the hurdle rate to get there is not as high. It would be possible to get a lower return in stocks but not much. Mr. Dent said one quarter of a percent is not going to solve the problem.

A discussion followed regarding the 8% bogey which covered much of the same ground discussed at the Pension Advisory Board's November 11, 2015 meeting.

Mr. Medrow commented some thought should be given to possible sources of revenue coming in from land development that might be allocated toward reducing the 8% bogey to a certain extent.

Referring back to the performance for the last five years, Mr. Dent stated the total account return net of fees is a little over 8%. He pointed out the portfolio went over 11% on the equities and the fixed income over that time period has been a little under 3%. These are pretty close to the numbers that are needed to get to 8%. Mr. Dent said it is unrealistic to expect returns in the next 5-10 years are going to be what they were in the last 5 years.

Mr. Minger asked if the assumed rate of return is annualized or averaged annual assumed rate of 8%. Mr. Dent responded it is an 8% compounded rate and it is necessary to get 8% a year.

Referring to the Fixed Income Portfolio Composition section of the report, Mr. Dent pointed out at the end of last year interest rates rose and at the same time the maturity was extended and that has been a benefit this year. He reiterated the position taken in the TIPS last year as well as adding some agency step ups. Corporates were reduced by 16% and 9% of that went into TIPS taking it from zero to 9%. The credit rating overall is higher and the yield is higher.

Mr. Medrow asked if there was anything new in the way of company additions or deletions. Mr. Dent responded no one expected the event at Chipotle and it was eliminated from the portfolio. A new addition is Illumina, Inc. which DF Dent believes is going to be one of the best investments in health care going forward. This company is involved with DNA sequencing and analysis.

Mr. Minger asked about DF Dent's succession plan. Mr. Dent provided an update on the firm's management. He stated over the last 17 years they have built the firm in a manner so that it would continue to keep pace with changing times and have made decisions about the future of DF Dent. He indicated that Mike Morrill is part of this process and asked him to comment further.

Mike Morrill stated On January 1, 2014, Matthew F. Dent was named President of the firm. He has been with the firm since 2001. He said Matt Dent was instrumental in moving the firm forward into the 21st century and was responsible introducing and automating state of the art software and systems for client accounting. Mr. Morrill provided a brief outline of DF Dent's management team.

Mr. Morrill stated DF Dent is a management owned firm. Dan Dent has the most equity in the firm and a plan was put into place two years ago to reduce his equity ownership in half and the other management are participating in increasing their equity ownership as Dan's comes down.

Mr. Minger asked if DF Dent is looking at diversifying into international equities. Mr. Morrill responded DF Dent does not invest internationally and their core competency as a growth manager is investment in U.S. companies, but they do have a significant portion of their revenues overseas. About 30-33% of the portfolio's revenues come from overseas.

NEW BUSINESS

APPOINTMENT OF NON-UNIFORMED REPRESENTATIVE FOR PENSION ADVISORY BOARD

Mrs. Sara Evans, HR Director, provided an update on the recruitment of staff members to serve as the non-uniformed representative. After sending out a solicitation to all employees, there were two respondents who expressed interest in serving in the voluntary capacity. After consulting with the Township Manager it was determined that Bill Daywalt, Deputy Fire Marshal, Safety and Codes Department would be joining the Pension Advisory Board effective at the next meeting.

No further action was needed by the Pension Advisory Board.

ADJOURNMENT

Due to a lack of a quorum at this point in the meeting, the meeting adjourned at 6:39 p.m.

David G. Kraynik
Township Manager and Secretary

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Minutes Approved:
Minutes Entered: