

PENSION ADVISORY BOARD/HEALTH & WELFARE BOARD OF TRUSTEES
QUARTERLY MEETING
NOVEMBER 9, 2016

The Pension Advisory Board/Health & Welfare Board of Trustees, met for their Quarterly Meeting on Wednesday, November 9, 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: Eric Medrow, Chairperson; David G. Kraynik, Vice Chairperson; Police Chief Tom Nolan; Thomas Minger, Secretary. Others present were: Sgt. Andy Fidler, Police Representative; Sara Evans, HR Director; Nick Hiriak, Finance Director; Bill Daywalt, Non-Uniformed Representative. Supervisor Liaison/Trustee Greg Waks was absent.

MEETING MINUTES:

The June 8, 2016 Meeting Minutes were approved unanimously.

PRESENTATION BY D.F. DENT RE: UPPER MERION TOWNSHIP POLICE PENSION PLAN AND FUND

Mr. Daniel F. Dent, Chairman, D.F. Dent, discussed the policy guidelines. He said originally the equity percentage was capped at 55%. Two years ago a motion was approved to increase the equity percentage to 70%. As a result the returns on the equities are higher than the fixed income during that time frame. The equity percentage is currently at 67.3%.

Mr. Dent reviewed the portfolio which shows the development of the portfolio since 1990. The portfolio allocation as of October 31, 2016 is 67.3% in equities and 31.2% in fixed income and a minor portion in cash reserves.

Mr. Dent stated the Standard and Poor's has added a new Real Estate sector which includes a couple of REIT health care facilities and American Tower which is considered a real estate company now.

Mr. Medrow asked what is happening with Fastenal. Mr. Dent responded it was trimmed back. The volatility of today's markets is up considerably today because it is considered an infrastructure stock and it is doing well.

Mr. Dent reviewed the capital flow chart reflecting the history since 1994 when the portfolio's value was \$14.4 million. Since then total distributions have

added up to \$24.1 million and the value of the portfolio as of October 31, 2016 is \$44.1 million.

The performance as of October 31, 2016 (net of fees) in the overall portfolio is 3.7. October was a weak market overall. This year we are slightly below the benchmark for this year.

Contributions to Return as of October 31, 2016 – the best performers were led by QUALCOMM this year and the year to date basis is up about 50%. Also performing well are American Tower, WageWorks, and Waste Connections.

Mr. Medrow asked for more information about WageWorks. Mr. Dent responded it is a provider of health savings accounts and flexible spending accounts for corporations. WageWorks recently completed a deal with ADP, the largest payroll processor that had a very large business in consumer benefits such as HSA's and flexible spending accounts. WageWorks has also signed a contract with the Federal Government to provide the same service for federal employees. WageWorks has been a very strong performer because of this business. It was noted they are significantly larger than anyone else in the area and it is still a market that is not fully penetrated.

Michael N. Morrill, Vice President and COO, DF Dent, discussed the characteristics of the equity portion of the portfolio. The weighted average market cap and weighted median cap indicates the companies in the portfolio are much smaller than the benchmark. The equity portfolio is all cap growth (large, mid and small cap). Mr. Morrill said DF Dent is trying to put together a portfolio of equities that are going to grow faster than the benchmark and to do that they are willing to pay out a little for those equities.

Mr. Morrill reviewed the equity sector weights versus S&P. The big change for the year is the decline in financials. The bulk of that is from American Tower coming out of financials and going into the real estate. Mr. Morrill pointed out they are bottom up investors and do not try to match the benchmark rating. DF Dent wants to find great companies and they keep an overview of the weightings of the benchmark versus what they have and make sure there are no unintended consequences.

Mr. Dent mentioned one special item with regard to year to date purchases – Duluth Holdings. He said they are opening their 11th store in King of Prussia. It is a very small, edgy company and it has been a good stock.

Mr. Medrow asked for comment on Illumina. Mr. Dent responded Illumina Inc. is involved with DNA sequencing and advancing breakthroughs with the world's leading genomic analysis. Two applications can predict where chromosomes might be missing and where an individual might have a predisposition for a particular disease. The other one is for precise medicines

and pharmaceuticals which has extraordinary potential. Their machines are used to target specific deficiencies in a genome, irregularities in the chromosomes where a particular drug might have an application. Mr. Dent said there are two companies within health care which they think are not only revolutionary, but are transformative within medicine and Illumina is one of them. The other is Intuitive Surgical which is robotic surgery and both of these are in the portfolio.

Mr. Dent discussed another new purchase, WABTech Corp. which is the former Westinghouse Air Brake Company. This Pittsburgh-based company makes a lot of the carriage which is used on transit vehicles and trains, but more specifically they developed what is known as Positive Train Control (PTC), an advanced system designed to automatically stop a train before certain accidents occur. It has been approved and will be implemented in all passenger trains. This company is continuing to have a growing global presence. Mr. Dent stated this is a very attractive new company with a strong management team.

Mr. Morrill reviewed investing themes in the portfolio. He indicated the first is a global theme where credit cards are replacing cash and checks globally. A place like the United States is fairly saturated but in India they are still using cash and with the opportunity to use credit cards there is a potential for explosive growth. It was noted Mastercard and Visa are two of the best business models in the portfolio.

Mr. Morrill said there are software names helping businesses become more efficient. The first one is Blackbaud which does software for nonprofits and helps them raise money, target donors and run their office. CoStar Group is software for commercial real estate and Tyler Tech is software sold to municipalities and state governments. Mr. Dent commented this group of companies are using very advanced, sophisticated software in industries and areas that have not used it before.

Mr. Morrill discussed consumer businesses that are enhanced by technology. Included in this group are CarMax Inc., IMAX Corp., LKQ Corp. and Signet Jewelers.

Mr. Minger questioned with an all cap growth portfolio how will it perform relative to value if a shift from a bull market were to take place. Mr. Dent responded with an 80% assumed rate of return and since the equities have been pushed to as high a percentage as we are comfortable with within their guidelines (which is 67% almost 70%) they looked at Fixed Income and the likelihood that interest rates will be going up. He said we had a market that was interest rate driven by the Federal Reserve for the last 8-9 years. Mr. Dent believes that is coming to an end and we will not have the wind at our back with interest rates. When interest rates go up it will make it even more difficult for bonds which place a heavier burden on trying to get that 70% and we will have to make the equities work very hard.

Mr. Dent stated the economy is going to continue a period of very sluggish growth. He pointed out this has been the third longest recovery since the second World War and in a few months it will become the second longest recovery. It is also the weakest recovery and will continue to be a slow growth environment. The way to provide the higher rate of return is with stronger growth as opposed to value in this slow to no growth environment. The valued stocks would presumably stay as valued stocks. The overall valuation is high for both growth and value and Mr. Dent indicated he does not think there will be any expansion in the valuation from these levels. If interest rates go up that will not help valuation. The strategy is to use companies that are best in class with strong management, attractive business models and a high growth rate. To make the 8% assumed rate of return is a tall order right now because we are not even getting 3% out of the fixed income on an ongoing basis.

Mr. Morrill stated growth has had a good run since the end of the recession and some people are saying it is time for value. As growth managers DF Dent is not going to try to be value managers all of a sudden. He said we cannot be all things to all people.

Mr. Minger asked if there is anything we should be doing to gain exposure than just all cap growth.

With regard to international exposure, Mr. Dent commented interest rates are lower overseas than they are here. Some countries now have negative interest rates. He posed the question how do you value things when you have that kind of environment. Mr. Dent said with the strength in the dollar and expectation that rates are going to go up he would question whether international specifically would do well with the strength of the dollar because a lot of money has come into this country because the rates are higher in this country and that has given strength to the dollar.

Mr. Medrow mentioned the Quantitative Easing concept that has been utilized placing billions of dollars of fiat money into the economy and asked when that "comes back to bite us" and creates an inflationary situation. Mr. Dent said there are indications with the low unemployment rate and increased employment it is at a point where we will start seeing labor costs push inflation. He said one of the newer additions to the portfolio are Treasury Inflation-Protected Securities (TIPS) in the fixed income. The TIPS are one of the better performing segments because they perform well as inflationary expectations increase and the value of the TIP bond increases with inflationary expectations.

Mr. Medrow said the low unemployment figures are misleading because there is a big block of unutilized labor who are not applying for unemployment benefits who could begin to flood back into the market place changing the dynamic of that low unemployment rate and changing inflation dynamics.

Mr. Dent commented the job picture is not robust but we are seeing monthly increases in employment and that has caused the unemployment rate to slide down to 4.9% which is considered almost full employment.

Mr. Medrow mentioned the people who have been taken out of the employment market and have become discouraged and are not counted because they gave up looking for work. He said if those people start coming back into the market that unemployment rate could change.

Mr. Dent stated there has been a shift in the labor market away from unskilled labor toward skilled labor in areas such as software and technology. We are seeing the replacement of labor with capital.

Mr. Dent discussed the Fixed Income profile and pointed out the average maturity was extended to capture a slightly higher return with fixed income. It was noted from a maturity standpoint and duration it is a defensive portfolio.

Mr. Medrow asked if there are any investments in callable securities. Mr. Dent responded in the negative.

Mr. Dent discussed yield to maturity and indicated it was 2.2 a year ago and is now at 2.0 which is below the benchmark. The reason for that is the TIPS which has a much lower coupon – in lieu of more coupon there is inflation protection. Because of the TIPS the credit quality increased from BBB+ to A-. Corporates have decreased from 78% a year ago to 58%. Corporates are still getting more income but they have decreased because 10% of that has gone into the TIPS. Variable Rate Bonds have gone from 7% to 18%.

Mr. Dent explained the change in the regulations for money market funds.

Mr. Minger stated roughly 80% of all floating rate bonds issued over the past couple of years have been issued with a LIBOR floor. He asked Mr. Dent to find out what percentage [of bonds] have LIBOR floors and what rate of LIBOR is triggered.

Mr. Dent discussed the bond maturities schedule and noted there are several in the 1-3 year range.

Mr. Medrow asked that the maturities stay as short term as possible.

Mr. Dent noted the longer maturity (over 10 years) which is not normal for DF Dent for a Wells Fargo 7.980% coupon.

Mr. Dent pointed out the TIP note. The total cost is \$1,230,000 and in a recently rising interest rate environment it is worth a little over \$1,300,00 resulting in a \$77,000 increase in value.

ADDITIONAL BUSINESS

OLD BUSINESS: None

NEW BUSINESS: None

ADJOURNMENT

Without further business by the Pension Advisory Board, the meeting adjourned at 7:51 p.m.



David G. Kraynik
Township Manager and Vice Chairman

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Minutes Approved:
Minutes Entered: