

PENSION ADVISORY BOARD/HEALTH & WELFARE BOARD OF TRUSTEES
APRIL 13, 2017
QUARTERLY MEETING

The Pension Advisory Board/Health & Welfare Board of Trustees, met for their Quarterly Meeting on Thursday, April 13, 2017, 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, Trustee and Board Liaison; David Kraynik, Vice Chairman; Police Chief Tom Nolan; Eric Medrow, Chairman; Sgt. Andy Fidler, Police Representative; Bill Daywalt, Non-Uniformed Representative; Director; Daniel F. Dent, Chairman, DF Dent and Company; Mike Morrill, Vice President, DF Dent and Company.

MEETING MINUTES:

It was moved by Mr. Kraynik, seconded by Chief Nolan, all voting "Aye" to approve the January 4, 2017 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 31, 2017. Highlights as follows:

- (Page 3) Current portfolio slightly over the minimum amount in fixed income at 30.5% and just below the ceiling in equities at 70%. *It was noted since there is a high equity allocation whenever a new investment is made in equities, DF Dent will always make sure to sell an equal amount of another issue so as not to go over the 70%.*
- (Page 5) Largest holdings do not change much from time to time because of the low turnover. Large holdings become large holdings not by putting a lot of capital into them, but by superior long term performance.
- (Page 6) Five years ago the market value of the portfolio was \$38,768,000 and as of March 31, 2017 the value is \$46 million which is an all-time high value.

Mr. Medrow noted 50% of the withdrawal amount is interest and dividends which is a good sign.

- (Page 7) The market value of the portfolio in 1994 was \$14,457,000 and the cumulative withdrawals over the entire 23-year period are \$25 million. The current market value is \$46 million.
- (Page 8) As of March 31, 2017, Account is up 4.71 year to date and Equities are up 6.47 which is 40 basis points better than the benchmark (S&P). Fixed Income (1.02) is a little less than the benchmark (Barclays Govt/Credit at 0.96).
- (Page 9) GASB 67 Total Gross Blended Return is 7.5% less 0.5% for plan expenses for a 7% projected return (net of fees and net of inflation).

A discussion followed about the challenge of meeting the 8% target for returns going forward.

Mr. Medrow asked about the 2% target allocation for the GASB 67. Mr. Dent responded the largest one is American Tower. There are two other companies – Healthcare Properties and Veritas which are health care Real Estate Investment Trusts (REIT's). The Real Estate sector is a new sector within the S&P as of last September.

With regard to American Tower, Mr. Dent stated every time they put a new tenant on the tower it means new revenues for the existed fixed cost. Going from original cellular communications to 2G, 3G, 4G, and 5G requires more data and antennas. American Towers is the largest publicly held company in this industry.

Mr. Morrill discussed the performance versus the Commonfund Benchmark on page 10. He explained the Commonfund Benchmark is used by all of the large foundations and endowments to measure how they are doing and based on the National Association of College and University Business Officers (NACUBO). Mr. Morrill noted from large endowments such as Yale and Harvard to smaller colleges and smaller foundations all report to Commonfund that in turn collects all the data. The Upper Merion portfolio has been through the test of time as an equity and fixed income based portfolio and has done well. Mr. Dent pointed out the blue numbers on the chart and indicated Upper Merion is in the top 25% performance-wise for each one of the periods listed versus the NACUBO.

Mr. Medrow asked for more details about the Commonfund Benchmark. Mr. Morrill responded the Commonfund is a financial services firm based in Wilton, Connecticut focusing on servicing foundations and endowments. They spend a lot of time developing investment programs for colleges, universities, foundations and endowments and collecting data from their clients.

Sgt. Fidler asked for additional clarification about the Commonfund. Mr. Dent responded the reason DF Dent likes to include it other than the fact Upper

Merion's performance has been significantly better as opposed to the S&P or the Russell 3000 is that these endowments are managed portfolios on a net basis and tax free. It is largely stocks and bonds, but they can also invest in private equity and real estate directly (direct ownership). They have the ability to go anywhere and do anything whether it is in a college endowment or a municipal, state or corporate pension.

Mr. Medrow asked how long they have been around. Mr. Morrill responded over 20 years or longer. He said this is all from the college and university client base which is pretty large.

Mr. Medrow asked if it is done before taxes. Mr. Dent responded these are all tax free. Mr. Morrill said instead of having to pay pensioners, their foundations and endowments are paying the operating budget of the college or university in most cases.

Mr. Morrill reviewed the Contribution to Return – 3/31/16 to 03/31/17 on page 11. He pointed out Visa is the top performer on a contribution basis and was up 17% in the portfolio at 5.5% which added 91 basis points of performance. IDXX Laboratories was up 97%, but it was only in a 1% position, but still produced a nice contribution into the returns. It was noted American Tower is up in the top five as well.

Reviewing the five lowest performers, Mr. Morrill pointed out that Stericycle, Inc., Signet Jewelers and PRA Group are the lowest ones and all came out of the portfolio at some point during that period.

Mr. Medrow asked for clarification about WageWorks. Mr. Morrill responded WageWorks has been in the portfolio for approximately four years. He said it is a company with software and services that help simplify consumer-directed benefits and makes the benefit programs easier to understand and use so that everyone can take advantage of pre-tax savings.

Mr. Dent explained the drivers for WageWorks in the last year. One was the acquisition of automatic data processing of employee benefits for Health Savings Accounts (HAS) and the other is they will be rolling out over the next three years their contract with the General Services Administration. Mr. Dent said WageWorks "has a lot of runway ahead" and the stock did very well in the first year because investors began to take notice.

Mr. Medrow asked if T. Rowe Price Group was still in the portfolio. Mr. Dent responded in the affirmative and said they have seen some loss of assets in the last year which was due to some extent to the trend within mutual funds toward indexing and that has hurt them somewhat. T. Rowe Price has a large mutual fund business.

Mr. Morrill reviewed the portfolio's equity sector weights versus the S&P 500 Index. The sectors that have been overweighted remain overweighted, especially industrials and technology because DF Dent has been able to find high quality companies with great management teams and good growth prospects. There is an overweight in the financials which are not banks, but rather financial services and insurance companies. DF Dent has stayed away from banks which hurt after the election since banks were one of the areas that did very well. It was noted there is an overweight in real estate because of American Tower.

Mr. Medrow asked why DF Dent has been staying away from banks. Mr. Morrill responded they do not think it is a high growth model and DF Dent is a high growth investor.

A question was asked if bank equities went up in value because of the potential repeal of Dodd-Frank. Mr. Morrill responded the banks probably got ahead of themselves and the valuations became somewhat extreme. He did not anticipate any action in 2017.

Mr. Morrill reviewed the purchases and sales. Three new purchases include Amazon.com Inc., Steris Pic, and Watsco Inc. Mr. Morrill explained the reason for entering Amazon at this point was because they became more transparent about their business model and web services. DF Dent could see the margin profile and cost structure providing more confidence in investing at the higher valuations because they could see where the growth was coming from.

Mr. Medrow asked if DF Dent anticipates continued growth with Amazon. Mr. Morrill responded in the affirmative.

Sgt. Fidler asked about the big news with O'Reilly Automotive since they were getting into the auto parts business. Mr. Dent responded about 7% of the auto parts retail is online and Amazon now has about 3 or 4% of that market and going faster than anyone else. There is also RockAuto which is strictly online. Mr. Dent said that is a concern for O'Reilly. He said the stock in the last 12 months or so has not done anything even though earnings last year were up 17%. It is the fear of Amazon and whether Amazon charging 30% lower prices will put pricing pressure on all the others. Mr. Dent pointed out mechanics working in shops get their product from O'Reilly. O'Reilly and AutoZone are the two biggest providers. It was noted O'Reilly has 4,800 actual stores and 40 or so distribution centers making it possible to get a needed part to a customer within a half hour or so which is worth paying the extra price. That is the argument for auto parts retailers. Mr. Dent does not feel Amazon can make inroads into that market and deliver that fast. They don't have 4,800 locations. It was noted both O'Reilly and Amazon are in the Upper Merion portfolio. Mr. Dent indicated

O'Reilly has been in the portfolio for quite a while. The cost basis is 325,000 and it is worth \$1.79 million.

Mr. Dent mentioned the other worry is some people fear that electric cars will not need as many parts as the conventional engine. He feels that is not an imminent issue and the immediate concern for O'Reilly, AutoZone, etc. is the possible pricing pressure from Amazon.

Mr. Morrill stated Steris is another new name. This company has infection prevention systems which can sterilize reusable parts within a hospital. Also newly added to the portfolio is Watsco Inc. the largest HVAC distributor in the country which is based in Florida.

On page 14, Mr. Morrill reviewed the investing themes in the portfolio. He said one of the things DF Dent looks at in reviewing consumer oriented names is will this be an area where Amazon could or would take over. In the past six months an online furniture retailer was rejected because Amazon is starting to get into that space. DF Dent does not want anything to do with anyone who is competing with Amazon. Mr. Morrill noted Carmax sells used cars, IMAX is the premium movie theater, and LKQ sells remanufactured, recycled auto parts.

On page 15, Mr. Morrill pointed out the portfolio broken down by market cap with the Mega Cap at 24% versus the benchmark. He said S&P is usually 50-60% and much lower in weighting in the mega-cap stocks. Large cap is 35%, Mid Cap is 28% and Small Cap is 13%.

Mr. Medrow asked for more information on Illumina. Mr. Dent responded Illumina has recently introduced a new sequencing machine which has greater capacity for mapping the genome. It is all about drug discovery and determining through people's genome their predisposition for certain diseases. DF Dent has talked to many of the experts within health care who feel that this genome is the wave of the future in health care.

Mr. Medrow asked if Illumina has any competition. Mr. Dent responded in the affirmative. He said there is one other company in California but it is not an important factor.

Mr. Dent reviewed the Fixed Income profile and highlighted some of the changes. It was noted the maturities and duration have been extended. To some extent this is largely due to the variable rate bonds going from 7% to 18% and that has extended the maturities. The variable rate bonds are keyed off of various interest rates primarily LIBOR and as interest rates go up coupons will go up. DF was willing to extend the maturities as long as they know rates will go up. The overall average credit quality is up from BBB+ to A-. That has always been below the benchmark because the benchmark is 55% in Treasuries and that is going to have a high credit rating. The Sector Allocation has gone from 0% a

year ago to 10% currently as a result of purchasing treasury and inflation protected securities (TIPS).

It was noted the Federal Reserve is talking about the possibility of four increases this year total versus one increase last year. DF Dent will participate in that with the variable rate and also with the TIPS.

Mr. Medrow asked about the spread between the corporates and treasuries currently. Mr. Dent responded it is very narrow because there is a scarcity of high grade income. The spread is now at 10 years and less than 50 basis points. The 10-year high grade corporates are probably a little under 3% and the 10-year treasury is about 2.4%.

Mr. Medrow asked if there are still 30-year treasury bonds. Mr. Dent responded in the affirmative.

Mr. Dent reviewed the bond maturity schedule with a large amount maturing in the next year.

On Page 10, Mr. Dent pointed out the history of the ten year treasury note yields. It was noted the yield came back up post-election, but has now stalled at about the 2.3/2.4 level.

Referring to the chart on page 19, Mr. Dent pointed out what happens to equities during periods of rising interest rates. The assumption is interest rates will be increasing. It was noted there have been 14 periods in the last sixty years when interest rates have been increasing. Of these 14 periods equities went up by various amounts in 12 of those 14 periods, and went down in 2 of the 14 periods. Many investors are concerned that if rates go up it means equity prices will be going down. Mr. Dent said that is not necessarily the case. He made the observation that when interest rates go up because the economy is strengthening that is also good for equities if the economy is getting better. This quarter it is anticipated that the earnings from the various companies will provide the best earnings report in the last two years.

Mr. Dent said the chart on page 20 looks at weekly stock returns and interest rate movements. He interpreted the correlations between weekly stock returns and interest rate movements and the patterns that emerge.

Mr. Medrow asked what effect it would have on the markets if the government decides to put a trillion dollars into infrastructure. Mr. Dent responded it would be very beneficial.

A discussion followed about how inflation would factor into accelerating growth with a fairly tight labor market and the inefficiency in the economy currently.

With regard to the 8% assumed rate of return, Mr. Dent stated from the standpoint of the township's funding it is almost a "pay me now or pay me later" issue. In lowering the assumption it would require some up front greater contributions in the plan. He said DF Dent will do everything they can to get the Township to 8% or higher. Mr. Dent stated Jim Kennedy with Thomas J. Anderson and Associates will have some thoughts on this matter at the Pension Board's May 10th meeting. He said Mr. Kennedy feels the assumptions are within the overall range based on the historic performance of this pension plan and they are high compared within the range of municipalities he sees.

ADJOURNMENT

There being no further business before the Pension Advisory Board, it was moved and seconded to adjourn the meeting at 6:39 p.m. None opposed. Motion was unanimously approved.

David G. Kraynik
Township Manager and Secretary

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Minutes Approved:
Minutes Entered: