# ***PENSION FUND COMMITTEE***

## *Minutes of Meeting*

## *August 2, 2012*

The Sussex County Pension Fund Committee met on August 2, 2012, at 10:00 a.m. in the County Council Chambers, Georgetown, Delaware. Those in attendance included members: Susan Webb, Todd Lawson, Jeffrey James, David Baker, and Hugh Leahy. Also attending were Michael Shone of Peirce Park Group, the County's Pension Investment Consultant; Gina Jennings, Sussex County Director of Accounting; as well as David Craik, the Pension Administrator for the State of Delaware. Committee members Lynda Messick and Karen Brewington were unable to attend.

On July 25, 2012, the Agenda for today's meeting was posted in the County's locked bulletin board located in the lobby of the County Administrative Office Building, as well as posted on the County's website.

The May 3, 2012 minutes were approved (by email) as follows:

5 Yea; 1 Not Voting; 1 Absent

Ms. Webb, Yea; Mr. Lawson, Yea; Mr. James, Yea; Ms. Messick, Yea; Mr. Leahy, Yea; Mr. Baker, Not Voting; Ms. Brewington, Absent.

1. **State of Delaware – State Pool Presentation**

Mr. Craik reviewed two handouts entitled, "Total Fund Composition – Asset Allocation" and "Fifteen Year Total Investment Rates of Return". Mr. Craik explained that the State is currently putting together their annual report for June 30, 2012 so the numbers presented reflect returns as of June 30, 2011. Below are the State's investment rates of return for the last 15 years:

| | Total Investment Portfolio Fair Value (in millions) | Fair Value Annual Rate of Return | Annual Consumer Price Index | Real Rate of Return |
|---|---|---|---|---|
| 2002 | $4,857.7 | (6.3%) | 1.0% | (7.3%) |
| 2003 | $4,880.7 | 3.4% | 2.2% | 1.2% |
| 2004 | $5,521.2 | 16.3% | 3.2% | 13.1% |
| 2005 | $5,928.0 | 10.0% | 2.5% | 7.5% |
| 2006 | $6,527.0 | 12.4% | 4.3% | 8.1% |

| | | | | |
|---|---|---|---|---|
| 2007 | $7,406.2 | 15.9% | 2.7% | 13.2% |
| 2008 | $7,089.2 | (1.3%) | 4.5% | (5.8%) |
| 2009 | $5,785.0 | (15.5%) | (1.4%) | (14.1%) |
| 2010 | $6,362.1 | 14.4% | 1.1% | 13.3% |
| 2011 | $7,638.1 | 24.3% | 3.6% | 20.7% |
| 5 Year | | 6.6% | 2.2% | 4.4% |
| 10 Year | | 6.7% | 2.4% | 4.3% |
| 15 Year | | 8.3% | 2.5% | 5.8% |

Mr. Craik further explained that the annual rate of return for the year ending June 30, 2012 was 2 percent, which would lower the return of 8.3 percent (for the 15 year period) to 7.6.

The "Total Fund Composition" represents the various asset classifications included in the State's fund as of March 31, 2012. Mr. Craik noted the State has made some conservative changes since March 30, 2012; namely, $250 million was moved out of international equity into domestic equity and fixed income. The State's Plan is presently at 22 percent in nontraditional assets (private program). As an example, Mr. Craik explained that the State was a big investor in Facebook at its inception and purchased stocks at 6 cents a share. When Facebook went public earlier this year, the State sold 30 percent of their holdings and made a profit of $50 million. This $50 million will not be reflected in the State's numbers until the September 30th quarter, and is also not reflected in the 2 percent return for the year ended June 30, 2012.

A question and answer period followed.

Mr. Craik was questioned about the State's Pension Board. He noted that the State has an Investment Committee, which is a subcommittee of their Pension Board. The Committee meets 17 to 18 times a year and is comprised of investment professionals who are appointed by the board. The State's Pension Board consists of 7 members, 5 of which are appointed by the Governor. Two members - Ann Visalli, Director of the State's Office of Management and Budget, and Thomas Cook, Delaware's Secretary of Finance - serve by nature of their position. The Investment Committee makes recommendations to the board and the board then approves those recommendations. The Board meets once a month, with the exception of August (if investment action is required, a poll vote is taken and then ratified at the next board meeting). The investment committee meetings are open to the public, with an executive session also being held during each meeting.

The State's Pension Fund includes approximately $7.5 billion in total assets and Ashford Capital Management, of Wilmington, Delaware, serves as investment advisor for the Investment Committee. As of June 2011, the actuarial assumed rate of return was reduced from 8 percent to 7.5. Mr. Craik noted that the State

may now comingle Pension and OPEB assets, with the State having approximately $150 million in their OPEB Trust. Although comingling with the Pension Fund is planned in the near future, the two funds are separate at the present time. Mr. Craik concurred that the County, if desired, could invest a portion of their OPEB money with the State.

When asked, Mr. Craik explained that additional Private Program Investments – in addition to Facebook – include IT related investments, China and India funds, Bio-tech, several hedge funds, with most being private partnerships. With these private partnerships, minimum investments are typically $100 million. The State's actuary is Cheiron, of Washington, D.C. Mr. Shone also confirmed that Peirce Park Group (PPG) has several clients who use Cheiron and noted their satisfaction.

Mr. Shone distributed copies of an article entitled, 'More state plans cutting assumed return rates', dated July 23, 2012. Examples given included: Baltimore County Employees' Retirement System reduced their assumed rate of return to 7.25 percent from 7.875, California Public Employees' Retirement System lowered its rate to 7.5 percent from 7.75, California State Teachers' Retirement System dropped their rate to 7.5 percent from 8 in 2011, and the Virginia Retirement System decreased their assumed rate of return twice since 2005 – now at 7 percent. The article goes on to state that 'assumed rates of returns among corporate pension funds have been declining since their peak of 9.17% on average in 2000 … At year end 2011, the average rate was 7.6 percent.'

Mr. Craik noted that his office administers 9 pension plans. Of the ones funded by the State, all but one, the State has always made 100 percent of their annual required contribution. The State has a closed State Police Plan (for officers hired before 1980), which is a pay-as-you-go plan. Mr. Craik noted that State employees have always contributed to their pension plan. As a result of pension reform that took place last year, State employees hired before January 2012, pay 3 percent of their salary above $6,000. Employees hired after January 1, 2012, pay 5 percent of their salary above $6,000.

Mr. Craik stated that for FY 2013, the State made a $26 million allocation to their OPEB Fund, $11 million of which was transferred from the health fund ($15 million reflects approximately .9 percent of payroll); with an 8.9 percentage rate of payroll for the regular pension for FY 2013.

In comparing Delaware to other state funds, Delaware was the number one fund for the 7-year return at the end of calendar year 2011. As of June 30, 2011, Mr. Craik stated that Delaware was in the top quartile; for longer periods of time – 10 to 15 years – the State had attained a higher quartile for their returns.

Ms. Webb thanked Mr. Craik for his very informative presentation. For future presentations, Mr. Craik noted that the Committee may want to keep in mind that the State's annual report is typically completed by the end of October of each year.

2. **Performance Reports – Peirce Park Group**

Mr. Shone, again, mentioned the article presented and noted past discussions regarding the implications of reducing the actuarial assumed rate of return and its impact on the annual required contribution. He noted that other PPG clients have reduced their rate of return to 7.5 percent, with some at 7. In addition to assets, Mr. Shone stated that the committee needs to consider its liabilities, including mortality assumptions that may need to be updated. It was suggested that the actuary should provide the necessary information to allow the Committee to see the impact to the County in differing markets (i.e., reducing the assumed rate of return, updating mortality assumptions, and the impact of assumed rates of return versus actual returns). It was noted that GASB requirements will impact the way in which liabilities will be recorded. These requirements will increase liabilities on financial statements, which will have the greatest impact on those plans not fully funded. The requirements could also impact credit ratings when borrowing money. Due to the County's pension funding levels, Mr. Shone noted that Sussex should be significantly less impacted as a result of these new requirements.

Mr. Shone distributed copies of a booklet entitled, "Sussex County Investment Performance Report – June 30, 2012". It should be noted that the report was not reviewed in its entirety.

**Market Environment – 2nd Quarter 2012** (Pension Plan):

- Stock market was down – gave back some of 2012's gains

  In comparison, the first quarter had very strong equity returns, with better than double digit returns.

- Euro-zone worries weigh heavily on the world economy
- Potential Euro break up increases debt risks
- Risk avoidance lowers yields and increases fixed income spreads abroad and in the U. S.
- Fed continues "Operation Twist" (attempt to keep long-term yields low)
- Banks lend only to best risks, weakening Fed's policy

- Energy prices fall on economic weakness, reducing the consumer price index, but core CPI inflation rate remains stable
- Unemployment rate constant as employment growth lags
- Current market prices reflect increased risk and some probability of another recession
- Bonds outperformed stocks
- Year to date – equities outperformed

  U. S. Fixed Income was up 1.1 percent, International Bonds up 2.1, and Emerging Market Bonds up 2.5. Stock markets were down, with U. S. Equities down 3.1 percent, Emerging Markets down 8.9, and International Markets down 7.1. These numbers reflect the entire U. S. Market – the Russell 3000 – which includes large, medium, and small cap stocks. When equity markets are down, the emerging markets tend to be hit the hardest. Over longer periods of time, it is expected that the emerging market equities would be one of the best performers, if not the best.

- U. S. equities outperforming International markets (the U. S. market was up 9.3 percent)
- Emerging market bonds did well
- Value stocks outperformed growth during the quarter

  Value stocks tend to be higher dividend paying than growth stocks; they tend to include the areas of energy, finance, and utilities; growth stocks include technology and healthcare. Mr. Shone noted that people are typically willing to pay more for growth stocks due to the expectation that there should be greater earnings in the future. Growth stocks tend to be more volatile – higher highs and lower lows. Across the board, it has been value stocks that have outperformed the growth stocks. For the year, the opposite is true – growth outperformed value.

- 2nd quarter – large cap value protected the best
- YTD – large cap outperformed small and mid cap
- Large cap growth best returns year-to-date
- Treasury yields declined during the second quarter

- Longer duration (bonds) outperformed shorter duration for quarter and year-to- date

  Mr. Shone noted that the County's portfolio had very little in long-term bonds; for the quarter, long-term treasuries (with longer than a 20-year maturity) had a return of 11.8 percent.

- Corporate bond spreads widened during the quarter
- TIPS (Treasury Inflation-Protected Securities) outperformed, due in part to their longer duration
- YTD – high yield bonds outperformed investment grade bonds

**Observations for Sussex County Pension**

- Fund continues to do 'very' well, especially in down markets
- Fund ranks in top 8 percentile this quarter
- Strong performance by State Pool
- Terminated Vanguard Global - helped lower overall allocation to international stocks

**Looking Ahead for Sussex County Pension**

- No need for investment changes
- Need to consider reducing actuarial return assumptions

In looking at the County's overall portfolio, Mr. Shone explained that the State's plan is more aggressive than the County's conservative approach, but that the two complement each other – the County has a conservative equity manager and a very conservative fixed income manager.

Mr. Shone reported that the overall year-to-date return for the entire Pension Fund was 5.3 percent. He explained that the 'Upside capture ratio vs. downside capture ratio (page 9) reflected the County's performance during a quarter versus the policy index; the County's investment strategy had protected itself significantly in the down markets. According to the chart, Mr. Shone explained that the County had outperformed its policy index 75 percent of the time when the market was down, and outperformed its index 30 percent of the time when the market was up. Since the third quarter of 2009, there have been three periods where the policy index has been negative. In all three of those quarters, the County outperformed its policy index; this past quarter – by about 1 percent, third quarter of last year – by 2 percent, and the second quarter of 2010 – by 1.75 percent.

The "Total Plan Performance" (page 10) shows that the County ranked in the top 8 percent for the past quarter, year to date – in the top 39 percent, and for the one year – in the top 24 percent (the lower the number the better). Over the last three years, the County was in the top 45 percent, which is consistently above average. Mr. Shone offered that due to the County's defensive nature and the State's strong performance for the quarter, the combination of the two is what ranked the County so high. There are other periods of time – the third quarter of 2011 – that the State did not have as strong a quarter. When the market is down, Mr. Shone explained that the County's plan does better than the State's. When the market is up, then the State performs better than the County, which is why the two plans blend so well.

Mr. Shone stated that the County pension plan had performed consistently above average, but when the market performs very strongly, the County will struggle to do as well as the average plan due to the County's very conservative investment strategy.

Mr. Shone reported that the one-year returns for DuPont Capital were in the top 10 percent**.**

**Performance Report – OPEB Fund**

Mr. Shone explained that PPG will be presenting the names of three possible OPEB investment managers for the Committee's consideration.

**Observations for Sussex OPEB**

- S & P down 2.8 percent this quarter; the County's plan was down 2.5 percent;
- Plan up 3.8 percent year-to-date
- Asset allocations close to targets
- Allianz RCM Disciplined Equity below benchmark (again)
- Harding Loevner continues to do very well

**Looking ahead for Sussex OPEB**

- Fund Changes (Recommendations):
  - Terminate Allianz RCM Disciplined Fund
  - Terminate Vanguard Value Index (recommends using a different Vanguard Index)

- Add Core Index Fund
- Add Active Core Manager
- Reduce allocation to Ridgeworth

Mr. Shone explained that he would like the County to have additional exposure to mid-cap companies, which PPG refers to as the 'goldilocks' - not too big and not too small.

Mr. Shone noted that PPG's three recommendations/candidates all specialize in the down markets.

The County's current overall investment management fee is .47 percent (page 31); Peirce Park's average client expense ratio is approximately 40 basis points. Mr. Shone explained that given the size of Sussex's OPEB Fund, the County's fee should be approximately 48 basis points.

3. **OPEB Investments**

Mr. Shone referenced the booklet entitled, "Sussex County OPEB – U. S. U.S. Equity Large Cap Core Manager Search, August 2012".

Peirce Park Group is making the following recommendations:

In order to initiate the purchase in three mutual funds not currently held by the OPEB portfolio, the following sales need to occur:

- Liquidate all assets of Vanguard Value Index
- Liquidate all assets of Allianz RCM Disciplined Equity
- Redeem $1,600,000 from Ridgeworth Small Cap Value

and

With the proceeds from the above sales, purchase (with same trade date):

- $5,000,000 of Vanguard Russell 1000 Index
- $1,000,000 of Vanguard Dividend Growth
- $1,000,000 of BlackRock Equity Dividend

Currently, the County's portfolio is overallocated in small cap. In PPG's recommendation, two funds would be added – Vanguard Russell 1000 Index and the selection of a new large cap core manager. Mr. Shone estimated that these changes could save the County approximately $25,000 annually in fees.

**Overview**:

**Purpose**:

- Decrease volatility in the overall portfolio
- Reduce overweight to value equities

**Current position**:

- Domestic large cap value – Vanguard Value Index Fund
- Large cap core (Allianz RCM Disciplined Equity) – active management

**PPG suggests**:

- Replace RCM with another large core manager
- Replace large value index with large core index

PPG believes a high quality equity strategy can offer better downside protection.

**Process – Selection Criteria**

- Offer better downside protection
- Lower portfolio volatility
- Lower portfolio beta
- Increase risk-adjusted returns
- Complement existing managers

As a result of this criteria, PPG is recommending the following possible investment strategies:

- BlackRock – Equity Dividend
- Legg Mason Clearbridge – Appreciation
- Vanguard – Dividend Growth

**Goal** – put together managers that complement one another:

- Enhance Diversification
- Lower portfolio volatility

All three candidates provide core or core/value approaches.

Mr. Shone and the Committee continued discussion regarding the various options and strategies for the County to consider in the selection of OPEB managers. If all managers look fairly consistent, Mr. Shone noted that price then might be a strong consideration. Mr. Shone did note that the Vanguard had performed the best in the down markets, while BlackRock had performed the best in up markets.

A Motion was made by Mr. James, seconded by Mr. Leahy, that the Pension Committee make recommendation to the Sussex County Council to close both the Vanguard Value Index Fund ($2,000,000) and the Allianz RCM Disciplined Fund ($3.4 million), and to lessen its current position in Ridgeworth Small Cap Value Fund by $1.6 million, and to then reallocate those funds into three new funds: Vanguard Russell 1000 Index Fund ($5 million) and to split the investment of $2,000,000 into two new funds: BlackRock Equity Dividend Fund and Vanguard Dividend Growth Fund.

Motion Adopted: 5 Yea.

Vote by Roll Call: Mr. Leahy, Yea; Mr. Lawson, Yea;
Mr. Baker, Yea; Mr. James, Yea;
Ms. Webb, Yea

(These recommendations will be brought before Council on Tuesday, August 21, 2012).

4. **Additional Business**

Ms. Webb reported that there would be a change in the way future meeting minutes are approved. The minutes will still be sent out in draft format for initial comment by members, but formal approval will not take place until the next meeting.

Ms. Webb noted that members will be sent copies of PPG's draft review of the Pension Plan Investment Policy Statement for possible discussion at November's meeting.

Ms. Webb thanked everyone for their attendance. The next meeting of the Pension Committee is scheduled for Wednesday, November 7, at 10:00 a.m.

The meeting was adjourned at 11:55 a.m.

Respectfully submitted,

Nancy J. Cordrey
Administrative Secretary