

Minutes of the Special Meeting of the Region 9 Special Pension Committee Meeting

May 5, 2011

Filed subject to approval

Attendees: Leon Karvelis (chair), Thomas Logie, David Boczar, Jeanne Wendschuh, James Murray, Peggy Sullivan, Michael Welz (of The USI Consulting Group) and later, Wayne Connors (of 3D Asset Management)

1. Call to order at 6:00 pm in the Career Center at Joel Barlow High School.
2. James Murray asked that the minutes of the January 31, 2011 meeting reflect his attendance. Motion to approve the minutes of the January 31, 2011 meeting as amended made by Mr. Logie, seconded by Mr. Murray, and approved unanimously (Mrs. Wendschuh abstained).
3. Mr. Welz reviewed the domestic economic outlook as summarized in the March 31, 2011 report presented to the committee.
 - The current estimate of 1st Q 2011 GDP growth in the U.S. is 1.8%.
 - The Federal Reserve's increased its forecast for 2011 growth to a range of 3.4 – 3.9%.
 - The \$125 BN increase in public debt (which is 3 times the growth in the private sector) was unusually large and is unsustainable.
 - Despite higher gas prices, consumer spending increase and that increase was broadly based over all major components.
 - Unemployment at 8.8% at the end of March 2011 is down from 9.6% 2 quarters ago, but remains elevated above the 50-year average of 6.0% and is likely to take 3-4 years to fall back to that more normal level.
 - Total unemployment, including significant numbers of underemployed Americans who wish to work full-time but are working part-time or have temporarily dropped out of the job market, remains at 17-18% and continues its drag on consumer spending and federal, state, and local tax revenues).
 - Economists believe that significantly more jobs need to be created to replace the jobs lost in 2008-2009 and to absorb new entrants to the workforce (due to population growth, the coming of age of a new young generation, and immigrants).
 - As of May 5, house prices are lower than the most recent low, officially marking the beginning of a second decline into a double dip. The outlook for the housing market continues to be grim with 34% of properties currently on the market currently owned by banks (from mortgage defaults). Some economists predict a 7 – 11% decline in housing prices.
 - Corporations continue to post strong profits, but most (25% more than usual) of the profits are foreign source, not US, and will probably only be repatriated through mergers and acquisitions or long-term shifts in relative tax brackets.
 - As of May 5, inflation (headline CPI) is actually at 2.7%, with food and energy comprising 18% and 28%, respectively, of the increase. But commodity prices were down sharply today, perhaps reflecting reduced speculation as regulators appear to be moving toward reducing its impact on prices. Though inflation is trending up, the rate remains low compared with the last 50 years average of 4.1%.

- As the domestic economy slowly recovers the Federal Reserve will shift in stages from a loose monetary policy to tightening. The first step will be to end bond purchases in June 2011 (the effort to add liquidity often referred to as quantitative easing), followed later by a slow drain of liquidity (raising the target overnight interest rate by requiring core banks in the Fed network to buy bonds back from the Fed)
- Mr. Welz repeated his earlier concern that at some point (perhaps 2012 and beyond) interest rates will rise, creating headwinds for the fixed income market. The committee is aware of this looming threat and will closely monitor the situation each quarter to determine when (and to what degree) shifts in asset allocation will be prudent.
- Mr. Welz commented on the many challenges in international markets: political tensions in the Middle East and North Africa and the effect of speculation on oil prices, the earthquake and tsunami in Japan, and downgrading of Greece's and Spain's sovereign debt ratings and Portugal's bailout.
- Mr. Welz highlighted (page 6) the \$554 billion of GDP output lost in the 6 quarters ended June 2009 and the \$571 billion of output recovered in the subsequent 6 quarters ended December 2010.
- Mr. Welz noted that the US lost 8.8 million jobs in the recent recession but it has gained only 1.8 billion jobs since the recovery began.
- Mr. Welz highlighted (page 14) the change in mutual fund capital flows in 1Q 2011, in particular the withdrawals from tax-exempt bonds funds and into domestic equity funds. (Note that from 2007 through 2010 an estimated \$335 billion was withdrawn from domestic equity funds. From 2009 through 2010, over \$1 trillion was withdrawn from money market funds, with over half of this money rotating into taxable bond funds.)
- Mr. Welz highlighted the strong equity returns in 1Q 2011 (page 16) and that they continued through April 2011, but noted concerns about potential instability in the market.
- On the fixed income side, Mr. Welz highlighted: (page 24) the returns on high yield bonds and that money continues to flow into them as investors accept greater risk in their search for higher returns and (page 26) the increase in the yield on 10-year U.S. Treasuries to 3.47%.

4. Mr. Welz reviewed the Plan's assets (pages 30 – 31) noting that there were no significant changes in the portfolio from December 31, 2010. As of March 31, 2011, the Plan had total assets of \$2.963 million, up from \$2.897 million at December 31, 2010, reflecting \$138,000 investment gains and \$72,000 benefit payments during the quarter (page 33). In reviewing the allocation of the Plan's assets (page 32), he noted that its domestic equity and international equity allocations at March 31, 2011 exceeded their upper limits and recommended a review and update of the Investment Policy Statement to reflect best practices, in particular in the areas of funding policy, volatility, risk objectives and strategic allocation. Such a review and updating is appropriate now when interest rates are expected to begin to rise after a strong run in equity returns, and recognizing the long term problems in the real estate market and the outlook for fixed income. **Mr. Welz will provide the committee with suggested revisions to the Investment Policy Statement for consideration at its regular meeting in July 2011.**
5. Mr. Welz reviewed the funds currently on watch: Davis NY Venture fund, DFA All Equity Portfolio (see annual DFA review below), American Funds Growth Fund of America, Columbia Mid Cap Value fund, Invesco Van Kampen Small Cap Value fund (for manager changes only),

and Oppenheimer Senior Floating Rate fund. He noted that Columbia Mid Cap Value fund's 3 and 5 year returns were below benchmarks but performance is much improved for the last 12 months. He noted that Davis NY Venture fund underperformed its benchmarks in 2008; its strategy is to hold 50% of its investments in financials, keep turnover extremely low (13%) and have half the exposure to tech stocks of its peers. He pointed out that American Funds Growth Fund of America is broadly diversified, has many analysts, holds 4 times the average number of investments, has 30% higher average capitalization than its peers and double their exposure to internationals, and holds more in financials and less in technologies; the primary concern is the size of the fund; at 70 times the average asset size of other funds, it might not be able to move in and out of assets easily; USI will continue to monitor. After considering the performance of **Oppenheimer Senior Floating Rate fund against its benchmarks, the committee agreed unanimously to upgrade this to Hold.** Regarding the Plan's \$60,000 investment in Eaton Vance Build America Bonds, Mr. Welz noted that there were wide differences of opinion about this program, which sunset on December 31, 2010, but that USI will continue to monitor this investment.

6. Mr. Wayne Connors, a founding principal of 3D Asset Management, Inc. (3D), the fee-for-service manager of the Plan's DFA All Equity Portfolio, joined the meeting to review the DFA portfolio. He pointed out that 3D specializes in passive investment strategies built around a globally diversified core equity portfolio using Dimensional Funds, which are available only to institutional investors, providing stock diversification at a modest cost. Mr. Connors provided the Plan's DFA portfolio 2011 First Quarter Performance Report to the committee and highlighted the following (returns are net of fees):

- 3D started managing the Plan's DFA portfolio November 29, 2006, not the best time to begin investing, as can be seen by the 0.92% return since inception. The Plan's DFA portfolio returns for the first quarter 2011 were 5.86%, trailing 12 months were 19.39% and trailing 3 years were 3.12% (page 4). Mr. Connors also provided the committee an update of the portfolio performance through April 2011 reporting returns (gross of fees) of 3.25% in April 2011, 9.55% year to date, 20.35% trailing 12 months, 3.67% trailing 3 years and 2.51% since inception.
- Dimensional Funds tends to be a value manager. Dimensional Funds' investments are designed to track the performance of their asset classes and benchmarks. Specific market exposures are managed at the DFA fund level.
- The portfolio includes diversified commodities using iPath Dow Jones AIG Commodities Index ETF fund.
- Overall this portfolio is invested 70% in domestic, 20% in foreign developed markets and 10% in foreign emerging markets equity funds. None of this portfolio is in fixed income funds.
- 3D manages the asset allocation of this portfolio seeking to deliver more consistent returns with less volatility than the overall market. Rebalancing is driven by deviations greater than 20% from the asset allocation targets or when contributions come in. On average the portfolio is rebalanced annually.

7. Before leaving the meeting, **Mr. Connors agreed to forward the following information to Mrs. Sullivan:**

- **3D's Form ADV**

- **3D's fee structure/basis for the Plan**
- **3D's client presentation and firm overview.**

8. Mr. Welz pointed out that the Plan's portfolio is very broadly diversified and that benefit is reflected in its performance. Mr. Boczar added, by way of historical context, that the overall portfolio was designed to be a moderately aggressive core portfolio actively managed by USI complemented by the broadly diversified DFA portfolio passively managed by 3D. He pointed out that the benefits of the DFA portfolio: a high level of diversification, international exposure, a very low expense ratio and a rebalancing mechanism that have actually performed very well for the Plan.

9. The committee discussed several factors related to the timing and direction of possible changes to the portfolio:

- The \$300,000 - \$350,000 for the 2011-2012 contribution to the Plan to be made in mid-July.
- Interest rates have begun to rise in other parts of the world and are expected to rise in the US sometime in the next 12 to 18 months. (Mr. Welz again referred to a Merrill Lynch report entitled "The Longest Picture" which shows four cycles of falling interest rates in the U.S. over the past hundred years, with each 25-30 year cycle of falling rates followed by a 15-20 year cycle of rising interest rates.) What is the outlook for interest rates a year hence? The risk that the cycle may turn into the headwinds of rising interest rates has been an ongoing topic of concern for the committee for the past year and the committee will remain on watch for any evidence that such a cyclical shift may threaten the portfolio.
- Disinvestment in commodities has begun.
- The recovery in employment is likely to take 2 to 3 years. How much of unemployment is structural? How many "retired early?" How many are really expecting re-employment?
- Overall, the Plan's portfolio is currently more exposed on the fixed income side and we may consider moving toward TIPS (Treasury Inflation-Protected Securities) and dividend-paying stocks.
- How possible future changes in federal tax structures may affect investments, noting that what form they might take and when they might be enacted are unknown.
- The overall US economy, including profits, housing, interest rates and growth, are likely to be much better in 2 to 5 years.

10. The committee discussed changing the target allocation of fund assets from the past target of 55% equities and 45% fixed income. The fund is currently close to 62% equity v. 38% fixed income. The committee discussed alternative target allocations of 60%, 65% or 70% equities and corresponding 40%, 35% or 30% fixed income. Mr. Logie favors higher equity levels and moving toward large cap dividend paying equities, tech stocks and energy stocks (buying when oil prices are at lows in the range of \$80/gallon.) Mr. Boczar favors allocations more in line with mid-range target levels with a full rebalancing, increasing DFA to 15%, adding more international bonds and large cap dividend paying equities, rebalancing small and mid-caps and adding some larger cap growth and income funds going forward. Mr. Welz suggested that it would be more appropriate to disaggregate the DFA portfolio in assessing the Plan's asset allocation. **The committee asked Mr. Welz to incorporate these changes in a revised Investment Policy Statement for consideration at its July meeting.**

11. Mr. Boczar recommended a tactical partial rebalancing to take some profits on oil, small caps and large caps that have performed well and to protect the portfolio by emphasizing floating rate and international bonds on the fixed income side in the event there is a pullback before our July meeting. On a motion made by Mr. Boczar and seconded by Mr. Murray, the committee unanimously approved the following investment changes:

**Sell \$40,000 from Prudential Jennison Natural Resources R,
Sell \$50,000 from Sentinel Small Company A and
Sell \$50,000 from Columbia Mid Cap Value A
Totaling \$140,000;
Buy \$56,000 (40%) of Oppenheimer International Bond N,
Buy \$56,000 (40%) Oppenheimer Senior Floating Rate A and
Buy \$28,000 (20%) PIMCO Total Return A
Totaling \$140,000.**

12. The committee is aware that the current portfolio allocation is outside the limits of the Investment Policy. However, due to ongoing discussions next quarter, additional contributions to the portfolio in July, and potential revisions to the Investment Policy Statement, the committee will further rebalance the portfolio at its July meeting and asked **Mr. Welz to recommend additional investment choices for consideration prior to that meeting.** *(Subsequent review of the January 2011 minutes indicates that the committee changed the target allocation to 60/40 at that time and therefore the March 2011 portfolio was generally aligned with it.)*

13. The discussion related to accounting for unfunded pension liabilities was deferred until the next meeting on July 25, 2011 when Roberta Cable can attend the meeting.

14. Motion to adjourn was made by Mr. Logie, seconded by Mr. Murray, approved unanimously at 8:04 pm.

Respectfully submitted,

Jeanne Wendschuh, Secretary