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Lower Saucon Township  
Pension Advisory Committee Meeting

Meeting Minutes

March 12, 2014

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**Roll Call: Present** – Jack Cahalan, Township Manager; Cathy Gorman, Director of Finance; Priscilla deLeon, Council Liaison; Molly Bender; Chris Leidy; Lou Mahlman; Joe Scott, PSAB; and Thomas Schatzman, Morgan Stanley. Absent: Mary Curtin.

**1. MRT Report-Introduce New plan advisor**

Mr. Scott said there is a 16% investment return for you last year. MRT has seen an incredible amount of growth in new plan members in the last 14-15 months. We had eight new plans join for \$16 million in new assets. At the end of the year, I looked at your pension accounts costs and compare them to the percentage of assets. Non-Uniform was 1.45% and Uniform was 1.34%, which are both within the normal parameters. The fees you are charged are based on a fluctuating schedule. Last year your total included .58 % in soft dollars, which is your investment management fee. They are edited out of the returns before the returns are posted, which is a common practice.

Mr. Schatzman said the transition was seamless. They took the existing money managers and positions and transferred them to Morgan Stanley; nothing changed and it occurred January 4-5. They are going to be meeting with MRT on March 20 to look at the current managers and make suggestions. He would not expect anything big; a reallocation to the portfolio and some upgraded managers.

Mr. Schatzman said the first concern was to bring the portfolio over intact and keep things the same. Then they reviewed the asset allocation from the top down, deciding where we want to be, what type of risk we want to take, and what managers we want to implement that. They explored passive vs. index investing. For some parts of the portfolio, indexing will reduce your fees and give you an efficient return in large cap space.

Mr. Schatzman said the group is located in Wyomissing PA since 1978. He started in 1991. They currently manage more than \$10 billion in institutional assets between four consultants, each having no more than 15 relationships; he has 11. They have approximately \$1.6 billion in assets with PA municipal funds, which is one of the reasons they made it through the selection process with PSAB. Some of the PA clients include the PA Workman's Compensation fund and the Montgomery County police pension.

Mr. Schatzman said his card says Morgan Stanley Graystone. Graystone is the national brand for institutional consultants. When Smith Barney merged with Morgan Stanley, Morgan Stanley looked at the institutional consulting business and decided it had to be removed from the broker/dealer business; it needed to be its own registered investment advisory firm. There are rules that you have to comply with to be an independent consultant. The big rule is that you cannot be affiliated with a broker/dealer. Morgan Stanley took 44 institutional teams and put them into Graystone. There are strict prohibitions to fees and commissions. Mr. Scott refers to soft dollar fees, in our world it is an asset based fee. They cannot use Morgan Stanley products or any products affiliated with Morgan Stanley. They are all external managers. They visit the manager every quarter. As a group, Graystone has over \$200 billion in assets; public fund clients account for 10%. They report directly to the president of Graystone.

Mr. Schatzman said they produce your performance reports in-house. They focus on risk and transparency. They want to see the positions. They are selling the endowment fund. That is a hedge fund that has had mixed success, but it does not have the transparency that we demand. They want to know what you own. If they share information every three months, that is not good enough.

They have turned away a lot of hedge funds for that reason. They are not fans of hedge funds because they are expensive, do not perform, and there are too many of them.

Mr. Schatzman said we prefer private equity. They are priced appropriately and you see what you own. They are less expensive and fully transparent. They took in 16 thousand data points from Merrill Lynch and created a performance report, going back 16 years, which indicates risk. MRT is 67% of the risk of the market with a little bit of excess return. You have taken 1/3 of the risk off the table with that structure and that is the return of your benchmark. The problem is risk always changes. Their concern right now is that emerging markets are slowing down. You have no direct exposure to them. They are concerned about what not to own and that is one of them; don't own municipal bonds from Puerto Rico, emerging markets, emerging market debt, currencies in emerging markets, and be wary that the Fed is tapering. Tab 2 discusses our positioning.

Mr. Cahalan asked how many other funds were interviewed? Mr. Scott said seven firms and we narrowed it down to four. One of the concerns we had in selecting a firm was that we wanted someone rooted in PA, which is especially necessary when dealing with PA law. There were many firms experienced in municipal investments, but not PA municipal investments.

Mr. Cahalan on a scale of customer work, what is the PSAB percent? Mr. Schatzman said the transition phase can be 24/7. You have a very high level of administrative work. You also have a high level of asset allocation work. At this point in the process, at least a day a week is spent on this account. He will be interviewing six money managers today. It is a large commitment until we have the account where we want it. You are never in standby mode, but once we have the correct positioning, it should be a quarterly meeting with PSAB.

Mr. Schatzman said our performance reporting system lets us see your position and every trade daily. They have red flags that will come up, not every day, but at least once a week. For example, they had a money manager buy Facebook. They did not have a positive opinion of Facebook. They bought it at \$28, we asked why, and they had an incredibly high conviction, and it's more than tripled since then. They are not going to tell them what to do, but are going watch what they do. You have an investment policy statement that goes into our system. If someone breaches policy we know that minute. If you have a stock that becomes more than 10% of your portfolio, they will know. If your performance deviates from the market more than 20 basis points in any given day, they will know and ask why.

Ms. Gorman said they will be in compliance with the existing policy. Mr. Scott said absolutely. He said MRT migrated "in kind" to Morgan Stanley. In other words, if your current consultant terminated and you had to hire a new one, you would have had to go through everything on your own; liquidate all of your assets and buy new. Mr. Scott said none of that happened here. The money is with the same mangers, only the oversight and reporting is done with Morgan Stanley.

Mr. Schatzman said they will be discussing positioning with PSAB next week. You are largely in line with the markets. They like the United States, it is equally priced. They like Europe and Japan. They are cheaper than our market because they are coming out of a recession and cleaning up their banks. They hope this will give the economy and the market the capacity to take off.

Mr. Schatzman said they are incredibly wary of emerging markets because the ones we like are so tiny, like South Korea and Vietnam. They are not important. They are very wary of China and India because the currencies are a problem.

Mr. Schatzman said in terms of bonds, they do not want to have a lot of interest rate risk. They do believe interest rates will creep up in a year. Your position is 80% short term and 20% core. You

will benefit from higher rates. You will suffer a little at first, but as bonds come due, they will be invested at higher rates.

Mr. Schatzman said the S&P has moved straight up, 173% since 2009. They are due for a correction. It would be healthy to see a 10% correction. The second year of the election cycle is very difficult for markets; they have a tough time in the middle of the year and then roar back.

Mr. Schatzman said page 8 reviews what the Federal Reserve is doing. What is taper? It means they are going to print less money. They are still going to print \$409 billion, instead of \$750 billion. This is not a catastrophe and is liquidity being added to the market. Taper does not mean a rise in interest rates. They are still going to issue a lot of paper (debt).

Mr. Schatzman said your managers have a quality bias that we like. It means the companies they buy have earnings. That has not been a very good way to go. Since the market began its climb four years ago, companies without earnings, no growth, on average are up 160%. Companies with persistent growth, like Proctor & Gamble and Coca Cola, are up 80%.

Mr. Schatzman said the difference last year was 38% between risky and safe stock. The stocks that had the best performance last year, were Netflix, which was a disaster, Best Buy, which was almost bankrupt, and Delta Airlines, when is an airline a good investment. Best Buy is down 40% this year. If you didn't own that you didn't do well last year and we don't. One of the most negative stocks was IBM.

Mr. Schatzman said Europe and is a disaster, but the best performing market this year is Italy. The European market has not broken even yet and is cheaper than our market. They will slowly nudge the international market up because allocation and dividends matter. If Europe takes three years to get back to normal that is an 11.1% annualized rate of return.

Mr. Schatzman said they are staying with traditional fixed income, emphasizing high quality corporate bonds, and the short term. No long term bonds or treasury. They do not see you in extended credit, emerging market, high yield, or alternative, hedge fund type credit. They are staying with the traditional and being patient. Returns on fixed income are going to hurt you. They are going to be 1-3%. They don't want to reach for yield. When rates are low people buy worse credit, like junk bonds, which are not cheap.

Mr. Schatzman said real estate investment trusts are also overpriced right now. They are going to be moving on from greens, even though they have been the best performing asset class for 20 years. This scares us because it tells us that regression is going to set in. They are seeing a lot of investors buying greens because they are looking at the yields. They are removing some of the sensitive interest rate areas. Schaffer Cullen is another high dividend, high yield strategy that will not do well when interest rates rise. They are looking 5-7 years forward, not back. Stocks and bonds that are sensitive to interest rates will not be attractive places to be and places like Europe may be. You will own a little bit of everything.

Mr. Schatzman said they will not follow mutual fund investors for fixed income because they tend to be less informed. Not one penny has gone into this market since 2006, yet \$1.3 trillion has gone into bonds; they have never seen anything like that. It tells them that when mutual fund investors start to lose money, they will quickly pull it, which could accelerate a selloff in bonds. They would welcome that because we are short term and would benefit from it.

Mr. Schatzman said the average investor has had a return of 2.3% over the last 20 years because they buy high and sell low; the exact point of being emotionally detached from the portfolio. They

have to learn to ignore the news. They stress tested your portfolio against 9/11, the Mexican Peso crisis, and long term capital; after one year the worst was -5. They will be ever diligent to put you in the right places.

2. **Financial Reports**

Ms. Gorman said they were delayed in receiving some of the reports due to the switch of investors. She is working with Linda Costa to make sure we get them more timely and will continue to confer with her monthly. They have done exactly what we asked them to do to simplify the reporting process and the reports are great.

Ms. Gorman said the Township pays the administrative fees back to the plans. It is our requirement so the plan does not lose any money on the fees.

3. **COLA—G. Williams , V. Koszi**

Ms. Gorman said Officer Koszi's increase is 1.4%, bringing him up to 11.5% of the 30% maximum. Officer Williams is 1%, based on the CPI Index, bringing him up to a 16.5% of the 30% maximum. They will send them a notice of the increase to inform them what they are permitted to receive.

4. **Settlement filings**

a.) GE Capital Bank and Bank of America 1/1/92 – 8/18/11

Ms. Gorman said she received a call from the Township Solicitor advising that he received a notice that there was a class action for GE Capital Bank and Bank of American from January, 1992 – August, 2011. She checked with Chris Cap and there were no investments during that time that he was aware of. He said PSAB would take care of those filings.

Ms. Gorman said she tried to call Blue Ball, they initially had those investments, but they were sold to Susquehanna Trust, who will follow-up. They probably won't receive any money in the end. It is comforting to know that if one of the investment banks is sold, the new bank holds the responsibility for filing on our behalf.

Ms. Bender asked did you get in touch with Jim Walker. Ms. Gorman said Jim Walker no longer works there. They hired an outside service to provide it because this happens all the time. Ms. Gorman said she wanted to make the note because the Township Solicitor also received it.

Mrs. deLeon said does he normally receive information like that. Ms. Gorman said no, it normally comes here. He contacted me to ask if he should do anything. Priscilla said he got it and we didn't. Ms. Gorman said right. Mrs. deLeon said are they aware it should come here. Ms. Gorman said no. Ms. Gorman said she is sure they went down the list of municipalities and who the solicitor is, instead of sending it directly to the Administrator. Ms. Gorman said he contacted the office because it was out of the normal.

Ms. Gorman said everything was fine and clear with Mr. Baran's retirement. He should be receiving payments out of the non-uniform plan as of the February statement. Mr. Scott said does Linda have all that information? Ms. Gorman said yes. Mr. Scott said is he on direct deposit? Ms. Gorman said yes.

5. **Approval of December 11, 2013 meeting minutes:** All in favor

6. **Adjournment:** Meeting adjourned at 11:45 am

7. **Next Meeting:** June 11, 2014 @ 11:00 am